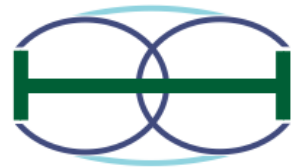


Strategic Report for Mattel, Inc.



Harkness Consulting
Innovation through Collaboration

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Mattel, Inc.

Mattel, Inc. (NYSE: MAT), the largest toy corporation in the world, employing over 32,000 people, designs, manufactures, markets, and retails a variety of toys, games, and entertainment products. Through direct and indirect sales channels, consumers around the world enjoy Mattel's various brand name toys as well as goods produced through their numerous licensing contracts. With global headquarters in El Segundo, California, Mattel differentiates its international products from those marketed domestically by adapting to the tastes and preferences of the demographic due to geographic variation. Thus, the company remains competitive through the strength of its existing core product lines and ability to innovate and change in a dynamic market. The many brands contained under the Mattel umbrella create an impressive portfolio. The company is split into three separately managed segments, Mattel Girls & Boys Brands, Fisher-Price Brands, and American Girl Brands, each with their own collection of subsidiary brands, joint ventures, and licensing agreements:

Segment	Core brands, joint ventures, or licensing agreements	
<u>Mattel Girls & Boys Brands:</u>	<ul style="list-style-type: none"> • Barbie • Polly Pocket! • Hot Wheels • Matchbox • Tyco R/C Vehicles • Nickelodeon 	<ul style="list-style-type: none"> • Disney Classics • Harry Potter • Batman • MegaMan • Yu Gi Oh! • MegaMan
<u>Fisher-Price Brands:</u>	<ul style="list-style-type: none"> • Little People • Power Wheels • BabyGear • See 'N Say • View-Master 	<ul style="list-style-type: none"> • InteracTV • Barney • Winnie the Pooh • Dora the Explorer • Sesame Street
<u>American Girl Brands:</u>	<ul style="list-style-type: none"> • American Girl • Bitty Baby • Angelina Ballerina 	<ul style="list-style-type: none"> • Hopscotch Hill School • Just Like You

Harkness Consulting was retained for advisory services after a particularly difficult 2007, in which Mattel was forced to recall almost 20 million toys manufactured in China when lead-

paint toxins and magnets were found to be a potential health hazard for children. Fears of a shift in consumer sentiment for the company and the costs associated with the recall caused a significant drop in Mattel's stock price.

While it was this sudden stock price movement that caused a concerned Mattel board to seek out Harkness Consulting, the recalls of late 2007 do not seem to be the major problems facing the company at this point in time. Since the recalls, Mattel's stock price has recovered from the initial concern with a relatively strong close to 2007. The recall scare has apparently done very little damage to the company's reputation. In fact, some would argue that the management's swift response and subsequent publicizing of safety efforts has earned the company some goodwill. As such, we do not consider the recall to be damaging from a reputation perspective. We believe that the major damage to Mattel's bottom line will be felt through the increased costs of using safer production techniques and legal fees.

The major problems facing Mattel are the result of a much larger trend. We see three major factors that pose a threat: (1) Shifting demand within and reduction of market size for Mattel's target age group; (2) Distribution channel concentration and margin-reducing demands on the part of retail customers; (3) Increasing manufacturing costs especially from safety initiatives and oil price increases.

The first two of these problems are not unique to Mattel. All toy manufacturers will face the fundamentally changing market as well as a rapidly changing distribution system as retail undergoes a large-scale consolidation and an increasing shift to online sales. The third problem, increasing cost of production, is not one that Mattel's closet competitors have felt. While Mattel has successfully increased sales revenues over the past three years, the company's costs have been growing at a faster rate, slimming margins. As such, the company has posted much lower EPS growth than its competitors and has suffered some of the smallest margins in the industry.

Our three major recommendations represent measures to control the threats listed above as well as attempts to maximize shareholder value through the investment in high-reward projects. They include: (1) Development, and acquisition of products that are higher margin and marketed to an older age group; (2) Investment in new distribution channels including e-retailing and the development of a retail store; (3) Relocation of manufacturing to Mexico.

Company History^{1,11}

Mattel's origins can be traced back to a small garage workshop in Southern California. In 1945, the wood products company founded by Harold "Matt" Matson and Elliot "El" Handler (hence "matt"- "el") sold picture frames to local customers. After branching into the design, production, and retail of dollhouse furniture, Harold and Ruth Handler bought out Matson to further expand their business to include musical toys. With success driving growth, the company incorporated in California in 1948. By that time Mattel had evolved into a general toy store including a wide array of toys, games, and family entertainment products.

Mattel modernized toy marketing by taking advantage of television advertisements in the 1950s, particularly during the "Mickey Mouse Club" show. However, it was not until 1959, when Ruth Handler was inspired by her daughter Barbara's interest in cutout paper dolls, that Mattel turned into a household name with the introduction of Barbie. Mattel became a publicly owned corporation in 1960 and three years later listed its common stock on the New York and Pacific Coast Stock Exchanges. During the hype surrounding the introduction of Ken, Barbie's boyfriend, See 'N Say talking toys, and Hot Wheels, Mattel grew to be a Fortune 500 company.

After Mattel reincorporated in Delaware in 1968, the company embarked on its "World of the Young" acquisition plan purchasing Monogram Models, Metaframe, Turco, Ringling Brothers, Barnum & Bailey Circus, Western Publishing Company, and Radnitz/Mattel Productions. After founders Elliot and Ruth Handler left the company in 1975, Mattel diversified itself further by expanding into the electronic games sector. However, the strategic move proved to be short-lived as record losses in 1983 hit \$394 million and Mattel was forced to sell all non-toy related

subsidiaries. The company found salvation as the He-Man and the Masters of the Universe, launched in 1982, grabbed attention from boys around the nation and brought sales to \$400 million in 1985.

Geographic expansion into Asia began in 1986 as Mattel acquired ARCO Industries in Hong Kong and entered a joint venture agreement with Bandai in Japan. Additionally, Mattel gained a foothold in the European market through the acquisition of Corolle S.A. in France, Corgi Toys Ltd. in Britain, and later Aviva Sports, Inc., International Games, Inc., Kransco (Power Wheels, Frisbee, and Morey Bodyboards), and J.W. Spears & Sons (Scrabble). In addition to their achievements through expansion, strategic focus on gaining good relations with Walt Disney paid off as Mattel captured licenses over Mickey Mouse, Toy Story, Winnie the Pooh, and the Disney Princesses in 1988. However Mattel truly hit it big in 1993 merging with Fisher-Price, a well-established infant toy company based in New York. The addition of Fisher-Price and its extensive product line gave Mattel a larger share of the market and customer loyalty due to its brand-name capital.

Corporate actions in the later half the 1990s demonstrate Mattel's determination to be the premier toy company. During this time, the board directed its efforts toward developing strategic relationships and successful, existing and new, product lines. In 1995, they gained rights to the Cabbage Patch Kids followed by contracts for Sesame Street plush toys the next year. Launching Tickle Me Elmo, Mattel sold \$300 million in a two-year time window with this one product item alone. Mattel also obtained licenses over Nickelodeon, which became another big hit during the decade. In 1997, the merger with Tyco Toys, the third-largest toy company, solidified Mattel's stance as the market leader by adding primary licenses to international top selling brands and augmenting existing core niches (Sesame Street, Matchbox, and Magna Doodle). Furthermore, Mattel purchased Bluebird Toys (Polly Pocket) and Pleasant Company (American Girl) in 1998, which gave them a strong hold on the consumer goods sector for girls; Barbie ranked first and American Girl ranked second.

After a much needed leadership change at the turn of the century, Mattel's corporate strategy focused on building brands, cutting costs, and developing people in order to help their declining stock price. As official first moves for the new board, Mattel sold the Learning Company and captured the licensing agreement to Harry Potter. Next, the company entered agreements with Vivendi Universal Publishing and THQ, interactive industry leaders, in 2001 and introduced a collection of their top brands – Barbie, Hot Wheels, American Girl, Matchbox, Fisher-Price, etc – to the entertainment gaming and educational software market. Modernizing in the digital age, Mattel continues to keep their brands in the hands of children worldwide.

In addition to corporate survival and strategy, Mattel has always kept its consumers as its primary concern. In 1978, board members established the Mattel Children's Foundation promoting philanthropic endeavors, which receive annual funding from a percentage of Mattel's pre-tax corporate profits. After a generous multiyear donation of \$25 million starting in 1998, UCLA renamed their project (then under construction) the Mattel Children's Hospital. To ensure safety and compliance to rules and regulations, Mattel established the Global Manufacturing Principles (GMP) in 1997. The Mattel Independent Monitoring Council (MIMCO) regulates as they oversee submission to the principles specified in the GMP as well as the United States' provisions and requirements (for those items destined to distribution and retail in the United States) of the Consumer Product Safety Act, Federal Hazardous Substances Act, Flammable Fabrics Act, and/or Food, Drug and Cosmetics Act.

Even with rigorous standards in place, massive product recalls in 2007—nearly 20 million toys produced in Chinese manufacturing plants ranging from Barbie, Polly Pocket, Cars, and Fisher-Price Brands—due to possible lead-paint toxins and magnet hazards deeply affected the company. Not only did revenues take a hit as these items were pulled from shelves and returned to retailers, but consumers questioned the safety of Mattel products. Additionally, Mattel was forced to restructure and augment testing and inspections to reduce the possibility of similar instances in the future, further increasing costs. As Mattel continues to rebound from its missteps and assure parents of their commitment to produce at high standards, studies show

that customers worldwide are satisfied with the urgency and concern Mattel expressed throughout this ordeal. Moreover, after a better-than-expected holiday season and increased profits in the fourth-quarter, prospects are hopeful that Mattel's brand name is only slightly bruised. Thus, the number-one toy company is back in the incessant fight to secure anticipated licensing contracts, augment existing product lines, and entertain children in every corner of the world.

Competitive Analysis

Mattel is one of the premier designers, producers, and marketers of a wide variety of toy products worldwide. According to Mattel's 10-K, its portfolio of brands and products are grouped into three categories:

- (1) Mattel Girls & Boys Brands—including Barbie® fashion dolls and accessories (“Barbie®”), Polly Pocket®, Little Mommy®, Disney Classics, Pixel Chix®, and High School Musical (collectively “Other Girls Brands”), Hot Wheels®, Matchbox®, and Tyco® R/C vehicles and playsets (collectively “Wheels”), and CARSTM, Radica® products, and games and puzzles (collectively “Entertainment”);
- (2) Fisher-Price Brands—including Fisher-Price®, Little People®, BabyGear™, and View-Master® (collectively “Core Fisher-Price®”), Sesame Street®, Dora the Explorer™, Winnie the Pooh, Go-Diego-Go!™, and See ‘N Say® (collectively “Fisher-Price® Friends”), and Power Wheels®; and
- (3) American Girl Brands—including Just Like You®, the historical collection and Bitty Baby®. American Girl Brands products are sold directly to consumers, and its children's publications are also sold to certain retailers.

Internal Rivalry

Competition is based on quality, play value, and price. Mattel's biggest competitors in the first two business segments are Hasbro, Bandai, Jakks Pacific, Leap Frog, Lego, MGA Entertainment, and VTech, as well as smaller toy companies, and several manufacturers of video games and consumer electronics. American Girls Brands competes with companies that produce girls' toys

and with children's book publishers and retailers. In addition to many of these companies, in foreign markets, Mattel also faces competition from more specialized competitors who do not compete with Mattel and other international toy companies worldwide.

Although Mattel faces stiff competition across all three categories of its business, it has generally maintained its market share. The various players in the industry compete heavily for specific licenses and products, but there are enough of them that losing a single one to a competitor does not have a major effect on market share distribution, provided the major players all carry roughly the same number of "hit" products.

Price competition is a major factor in the industry, and, according to Mattel's 10-K, it expects to experience continued cost pressures in 2008. These stem from having many sellers in the market, which makes collusion difficult, low switching costs for buyers (although products may be considered highly differentiated, buyer tastes can change on a whim), large sales orders, and strong exit barriers for the larger firms in the industry, such as Mattel, who have entered multi-year licensing agreements and own large production and distribution facilities. In addition, Mattel's management foresees higher prices for commodities, labor, and foreign currency in 2008.^{III}

Internal rivalry is also enhanced because of recent evolutions in the industry. Recent trends towards shorter product life cycles for individual toys, age compression, and an increasing use of technology in toys all increase competition for rights to the latest hit product. In addition, competition is rising because a small number of retailers account for an increasingly large portion of toy sales, control shelf space in retail outlets, and have direct contact with consumers through in-store sales, coupons, and advertisements. Moreover, such retailers promote their own private-label toys, facilitate the sale of competitors' products, and give shelf space to one type of toy over another.^{IV}

Entry

The two key factors in determining a firm's ability to enter the market are licensing agreements and reputation. Because toy products are primarily differentiated by logo and brand (e.g., Barbie versus Bratz), it is essential for a firm to have the license to design, market, and produce popular toys. Although there are exceptions, most hit toys are based on concepts from television or movies. Bidding for the licenses to these products is extremely competitive, making it unlikely a new entrant to the market could win. Moreover, large, existing firms such as Mattel have already established relationships and brand loyalty with the major production companies and studios. In addition, even in cases where hit products do not stem from television or the movies (e.g., American Girls or Bratz), the small independent companies that develop these products are often forced to sell out to a major player like Mattel in order to gain economies of scale and access to a global distribution and marketing network. Along similar lines, "as the world's largest toy company, Mattel believes it can realize cost savings when making purchasing decisions based on a One Mattel philosophy."^v Thus, while there may be frequent new entrants to the market, licensing issues and economies of scale prevent them from competing directly with the existing players in any real sense.

Reputation is also extremely important, as the main buyers in this market are parents shopping for their children. Mattel suffered in this area during 2007 following a recall of several toys with high-powered magnets and lead paint, and, according to its 10-K, will consequently suffer higher product testing costs and legal expenses in 2008. A brief excerpt from Mattel's 10-K further illustrate the importance of reputation in the industry: "Mattel believes that it has some of the most rigorous quality and safety testing procedures in the toy industry. Management also believes that Mattel's history of acting responsibly and quickly will maintain the trust of its customers and consumers. However, the 2007 Product Recalls may have a negative impact on both customer and consumer demand for Mattel's products in the future." Thus, entry would be quite difficult for a new firm, since it takes years to build a reputation for producing quality, safe toy products.

Entry is also made more difficult by the seasonality of the business. Consumers make a large percentage of all toy purchases during the holiday season. This means toy companies need to maintain substantial credit or liquidity to finance seasonal working capital requirements. Access to unsecured committed revolving credit with a commercial bank group is much harder for a new entrant to obtain than for an existing leading toy company like Mattel.

Despite these obstacles, entry does occur and may pose a serious threat to Mattel looking forward. One example is Marvel's decision to take design, production, and distribution of its action figurines in-house. Marvel entered the market through a partnership with Sony five years ago, and has greater than 50 percent profit on margin, which dwarfs Mattel's. This proves that it is possible for new entrants to succeed. Marvel is a somewhat unique case in that it already owned all of the licenses to its action figurines (and its partnership with Sony gave it many more), but there are many other companies that currently license design, production, and distribution of toys based on their brands to Mattel and others that could make a similar move in the future. If this happened, it would represent a tremendous threat to the existing players in the market like Mattel, which rely primarily on licensed content.

Substitutes and Complements

Depending on the breadth of the definition, the toy industry faces a wide range of substitutes and complements. Using a narrow definition, substitutes include other individual toys (e.g., Barbie versus Bratz); a wider definition would include books, video games, and media (especially interactive media). In fact, video games are increasingly one of the most important substitutes for traditional toys. This shift has been enhanced by age compression and the increased use of high technology in toys. Because children are outgrowing toys at younger ages, they are increasingly substituting other leisure products. Substitutes therefore pose an increasing obstacle to the industry.

Narrowly defined, complements similarly include other individual toys (e.g., Barbie and Ken). More broadly defined, complements also include related popular content for kids available in

“non-toy” form (e.g., Sponge Bob on television) and, most importantly, leisure time. The relationship between leisure and demand for toys is especially important because leisure time is currently declining even for children. Consequently, demand for toys is falling. Toy companies like Mattel are therefore well positioned to develop complements through cross-branding, but the decline in leisure poses a serious threat to future revenues.

Supplier Power

Supplier power is difficult to measure for companies like Mattel in the toy industry because the availability of close substitutes depends very much on the breadth of the definition of substitute. On one hand, consumers have essentially zero switching cost (i.e., buying a Barbie or a Bratz doll is the same in terms of time and money). On the other hand, individual toys succeed and fail based on the whim of consumer taste. For example, if a child wants a *Barbie* doll, a *Bratz* doll is not a substitute, but if the child simply wants a doll, then it would be. Thus, the extent to which customers are locked into relationships with specific toy companies is open to debate.

Moreover, price elasticity of industry demand fluctuates. For an event like a birthday or the holiday season, price elasticity is relatively low. Again using Barbie as an example, if a child asks for a Barbie for the holidays, it is likely the parent will purchase it regardless of whether the doll costs \$8 or \$10. During nonevents, however, price elasticity is much higher, as impulse buys are likely highly affected by price. Thus, for the majority of the year, there is moderately high price elasticity of industry demand, which reduces supplier power. This is particularly true for a company like Mattel, whose toys are already priced at a relatively high price point to much of the competitors’.

Buyer Power

One of the biggest sources of buyer power in the industry is the purchase volume of downstream firms. In the case of Mattel, Wal-Mart is its biggest distributor, and accounts for \$1.1 billion, or a little more than 20 percent, of its Mattel’s worldwide net sales, and Toys ‘R Us

and Target account for another \$0.7 and \$0.6 billion of net sales, respectively. Thus, three downstream firms account for almost 50 percent of Mattel's worldwide net sales. Moreover, because downstream distributors are able to price the toys as they please, suppliers have little ability to price discriminate. This further increases buyer power.

Another issue is the threat of forward integration by suppliers. Toy companies like Mattel are essentially suppliers of licensed content. As the recent entry of Marvel/Sony into the market shows, however, Mattel and other toy companies face the threat that content providers will stop selling their content. In addition, although Mattel's licensing contracts are almost always exclusive, short product life-cycles for individual toys mean Mattel nonetheless faces losing a significant source of revenue if consumers decide to reduce their purchase of a hit product.

Finally, Mattel and similar toy companies are subject to a highly competitive input market. The most important example of this is oil, which is used in the production of plastic toys. Because oil has so many uses, the market for it is enormous, leaving even the largest toy companies like Mattel with no negotiating leverage. According to Mattel's CFO,^{vi} Mattel will be relatively unaffected as long as oil remains between \$95 and \$100 per barrel. If the price goes up to \$110 to \$115 dollars per barrel, however, Mattel's margins will be significantly squeezed, which is particularly important given that Mattel already has the smallest margins of its competition—in 2007, Mattel was four percent below the competition on EBITDA.

Financial Analysis

Looking at the balance sheet, an increase in inventory turnover has been accompanied by a lengthening duration of accounts receivable. Overall, the effect has been a lengthening of the net cash conversion cycle since 2003. Mattel has reduced this effect, which was felt most strongly in 2005, though efforts to lengthen the time that accounts are payable and reduce further its ability to turnover inventory, an area in which it was already an industry leader. This is evident in the following table:

	2007	2006	2005	2004	2003
AR Turn	6	7	7	8	9
Days AR	59	55	54	47	40
AP Turn	8	9	9	8	9
Days AP	47	39	40	43	42
Inv. Turn	8	8	7	7	7
Days Inv.	46	46	52	55	56
NCCC	59	62	65	58	54

In contrast, competitor Hasbro has reduced its net cash conversion cycle by seven days (78 to 71) over the same period through significant reductions in days AR and days in inventory. However, Mattel remains an industry leader in this area despite recent improvement by its closest competitor. Its days AP is comparable with most competitors, but it has been able to turn inventory much more quickly than competitors and has kept its days AR below the industry norm. While not overly problematic in the most recent periods, a plan to reduce the net cash conversion cycle could bolster financial health in the coming periods, in which economic conditions may be less favorable for recreational product firms. Our suggestion would be to work to reduce days AR, which Hasbro was able to do during the time period studied (70 to 58), to try to return them to 2004 levels.

Sales revenues have grown for each of the past five years with outstanding growth in 2006 of 9.1% on the previous year and 5.6% in 2007. Over the same period, gross profit margins have fallen from 49.0% to 46.5%. Profit margins have also declined. Income before taxes as a percentage of sales (EBT) has dropped from 14.9% to 11.8%. Analysis of the cash flow statement indicates that this has largely been a product of increasing manufacturing costs. Both the three-year CAGRs of selling, general and administrative expenses and cost of goods sold have exceeded the three-year CAGR of sales between 2004 and 2007, reducing Mattel's profitability over the most recent three-year period. This has not been the case for Mattel's closest competitor. A table comparing the two companies shows this:

CAGR 2004-2006	MAT	HAS
Sales revenues	5.37%	11.48%
Cost of goods sold	5.85%	10.71%
Selling, general and admin. expenses	8.88%	10.31%
Gross Profit	4.83%	12.03%
Net income	1.56%	25.31%
Diluted EPS	4.49%	34.44%

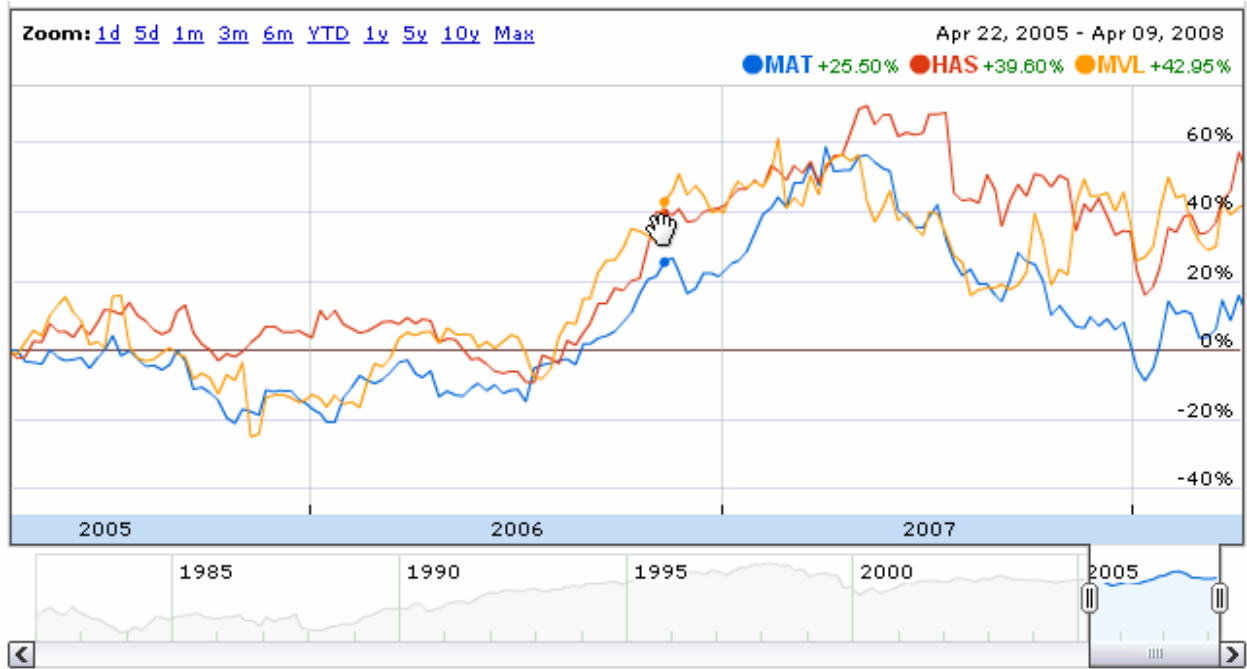
In short, Mattel's costs have increased faster than its sales revenues have. One key factor to this phenomenon has been Mattel's inability to beat Hasbro for the most desirable rights for movie action figures. In the most recent holiday season, action figure sales were driven by Transformers, Spider Man, and Star Wars, none of which are Mattel properties.^{vii} Another factor to consider is the increasing cost of Mattel's exposure to oil price fluctuations. Continued increases to oil prices will result on further pressure on Mattel's narrowing margins. The following table displays industry profitability ratios:

	Mattel (MAT)	Hasbro (HAS)	Marvel Entertain. (MVL)	JAKKS Pacific (JAKK)	LeapFrog (LF)	Industry
EBITD margin (2007)	15.11%	17.61%	57.17%	15.59%	-18.44%	19.35%

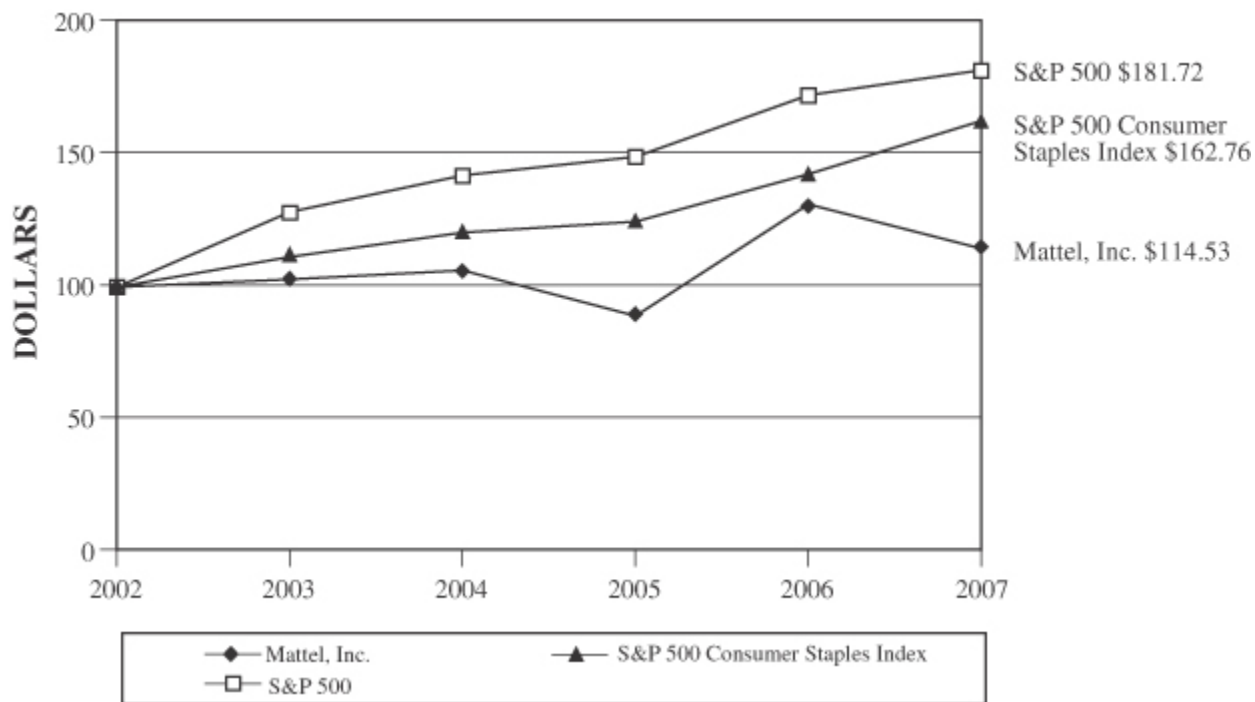
Of the profitable companies displayed above, Mattel had the lowest margins in 2007. Since margins will continue to be pressured by external forces in the coming periods, and shelf space will continue to shrink for many of Mattel's higher margin lower volume products, Mattel will need to focus on cost control for their high volume products going forward. One option is the relocation of production to Mexico. Going forward, this reduces Mattel's exposure to oil price fluctuations.

Mattel's stock price has significantly underperformed those of its competitors over the past few years. It has also underperformed the S&P 500 over the past twelve months by a large margin, but has recovered somewhat against the market since the first of the year, outperforming the S&P 500 by about 20% of return, similar to the overperformance of closest competitor Hasbro. Much of the loss of value that occurred in the months after the recalls on toys has been recovered due to strong 4Q profits in 2007.

Comparison of Three Year Cumulative Total Return Mattel, Inc., Hasbro, Inc., and Marvel Inc. 2005 to 2008



Comparison of Five Year Cumulative Total Return Mattel, Inc., S&P 500, and S&P 500 Consumer Staples Index 2002 to 2007



At present, the company seems fairly valued when compared to its competitors. The following table displays comps on certain financial multiples:

Multiple	Mattel (MAT)	Hasbro (HAS)	Marvel Entertain. (MVL)	JAKKS Pacific (JAKK)	LeapFrog (LF)	Industry
P/E	13.83x	14.12x	16.23x	10.16x	NM	13.87x
P/S	1.32x	1.06x	4.44x	0.95x	1.10x	1.54x
P/B	3.43x	2.98x	11.82x	1.16x	1.99x	4.07x
P/FCF	19.11x	9.76x	NM	11.66x	NM	34.92x

Mattel's multiples seem fair in the context of both its closest competitor and the industry as a whole. One multiple that jumps out is Marvel's P/S of 4.44x. This is sensible in the context of Marvel's exceptional profit margins, which are achievable because of their ownership of

character licenses. Their joint partnership with Sony Pictures gives them a library of over 5,000 characters.

This highlights one of Mattel’s secondary problems going forward: its expenditure on movie licensing rights. Looking ahead, Mattel’s rights to upcoming movies appear weak in comparison to those of Hasbro. Additionally, Marvel has several movies in the pipeline. One component of Mattel’s cost structure that needs reevaluating is its reliance on winning the rights to movie characters for its action figure business. Mattel’s inability to compete with Marvel and Hasbro means that it needs to consider strategic alliances with movie studios, like the relationship that they currently have with Disney. Another option is to choose not to compete in this expensive auction. As margins shrink, it will become more important to control expenditure on this front.

Mattel is less leveraged than its closest competitors, Hasbro and Marvel. It is also below the industry average. The following table shows Mattel’s long-term debt to equity as compared to their competitors:

	Mattel (MAT)	Hasbro (HAS)	Marvel Entertain. (MVL)	JAKKS Pacific (JAKK)	LeapFrog (LF)	Industry
LTD/E	0.24	0.51	1.36	0.14	0.00	0.46

Mattel does have the cash flow to take on additional debt. Despite this, taking on additional debt does not appear to be strategically advantageous at this point in time. Mattel has sufficient cash on hand for smaller acquisitions and the state of the debt market makes issuing debt unattractive.

A potential financial strength that Mattel derives from their balance sheet is that they hold a large amount of cash. They hold a comparatively larger amount of cash than their competitors

when considered as a percentage of total assets. This will allow them the flexibility to invest in systems that will reduce their exposure to the pressure that oil places on their operating margins, the ability to buy back undervalued stock, the opportunity to purchase cheaply valued competitors and products, and many other investment options. JAKKS Pacific presents an acquisition opportunity. It offers a complimentary set of product lines and currently has a market cap of approximately \$800M.

This is tempered by Mattel's recently decreasing cash on hand. From an all-time high of over \$1.2 billion in 2006, Mattel finished 2007 with \$901 million in cash and equivalents. This was due to a poor holiday season, the cost of recalls, and the corresponding increasing the company's standards of production.^{viii} Also tempering Mattel's ability to use their cash is the cyclical nature of Mattel's business, which requires that the company hold cash and short-term securities during the year so that they can effectively deploy it in during the holiday rush in which they will have to ramp up production.^{ix}

SWOT

Strengths

- Established brands with strong reputations and desirable names for many consumers
- Good publicity after lead paint scare
- Economies of scale and scope
- Low-cost manufacturing techniques
- Diverse product lines appealing to a range of ages and both genders
- Cash on hand
- Marketing abilities and relationships
- Access to distribution channels

Weaknesses

- BBB rated debt makes raising capital more difficult and expensive

- Concentrated distribution channels result in volume purchases that lower margins, leave company vulnerable to the demands of certain retailers
- Some products are contingent on the availability of licensing agreements
- Poor licensing agreements for upcoming movies
- Poor catalogue of “tween” and teen oriented products
- Products face competition from higher and lower quality substitutes
- High variation in seasonal demand for products forces company to have excess cash on hand, suffer fluctuating revenues, have difficulty predicting the optimal number of a product to produce
- Lower EBITDA margins than competitor firms
- No binding long-term contracts with retailers

Opportunities

- Acquisition of companies or products that compliment the existing lines or target a new age group
- Development of new products
- Relocation of production facilities
- Room for growth of international sales
- New advertising opportunities on the internet
- Investment in web retailing opportunities
- Development of specialized stores

Threats

- Age compression
- Toys ‘R Us solvency issues, bankruptcy of other retail customers
- Shifting consumer tastes and product preferences, i.e. further erosion of the flagship Barbie line
- Easy entry by competing firms
- Decline in children’s leisure time

- Falling consumer spending and deterioration of the economic health of consumer countries
- Production of private-label toys by Mattel's retail customers
- Further recalls including the cost thereof, the threat of litigation, and possible damage to company's reputation
- Changing trade relations between the United States and its international trading partners
- Currency fluctuation, specifically of the Chinese yuan and Venezuela bolivar

Strategic Recommendations

Our major strategic recommendations for Mattel are threefold. They are responses to what we see as key threats to Mattel going forward, so in that sense they are defensive. However, Harkness Consulting believes that the recommendations will serve shareholder value by using Mattel's core competencies to expand market share through the investment in growth opportunities.

We have identified three key threats: (1) Shifting demand within and reduction of market size for Mattel's target age group; (2) Distribution channel concentration and margin-reducing demands on the part of retail customers; (3) Increasing manufacturing costs especially from safety initiatives and oil price increases.

New Product Development

As mentioned in the *Competitive Analysis* section of this report, age compression and diminishing children's leisure time present a challenge to Mattel going forward. Product lines under the Fisher-Price label face less of a threat since they cater to a younger age group which will be unaffected by these trends, but products in the Mattel Girls & Boys group and—less so—the American Girl line cater to what has been a shrinking market. One example of this is the Barbie line, which has experienced increased competition from entry into the space (Bratz) as well as slowing demand for the product.^x Additionally, the reduction in leisure time for early

elementary-school children will result in a shrinking market for some of Mattel's key products including action figures, dolls, and 1:64 scale cars. The most recent holiday season saw a decrease in doll sales of 8% and a decrease in toy sales overall of 2%.^{XI} Our recommendation to Mattel is to focus on the development and acquisition of products aimed at the "tween" age group (10-12). Many opportunities exist including toys that integrate the use of computer software (Lego, Webkins), an increased focus on video game development, especially in the space of console-less gaming systems like Hasbro's Dreamlife, and the acquisition of board games that present a branding opportunity such as Hasbro's \$77.5 million acquisition of Cranium and subsequent development of over 20 offshoot products.^{XII}

Mattel should try a mix of strategies in furthering this goal. Some technological know-how is already in house; the Tyco R/C products are technology intensive and present an excellent base of design knowledge that can be integrated into other product lines. Further partnership (such as the one with THQ), acquisition, and internal development could all be viable means to expand into console-less video gaming or to integrate computer software into the Hotwheels, Matchbox, Barbie, Tyco R/C, and other lines.

We believe this shift to high-tech and tween-oriented toys is both a safe and profitable investment. Mattel's core competencies, as discussed in our *Strengths* section, include marketing and manufacturing. We believe that Mattel can bring these skills to bear on new product lines that will expand the market for their products. Additionally, these products will provide higher margins than most of Mattel's other lines in two important ways: First, Mattel will be competing in a less concentrated space. Second, these products are less reliant on licensing agreements, reducing a key cost. Further, this step will be necessary to the implementation of our second recommendation.

Diversification of Distribution Channels

As discussed in the *Threats* and *Weaknesses* sections of this report, Mattel suffers from few distribution channels. Its retail customers present four major problems. First, the large retailers

exert major buyer power in terms of negotiating purchase prices which reduces margins. Second, some retailers develop private label toys that compete with Mattel's products at a slightly lower price point.^{xiii} Third, the increasing prominence of Wal-Mart and Target as one-stop retailers has reduced the shelf-space available to Mattel, reducing the diversity of products that the company can bring to market. Fourth, bankruptcy or financial problems on the part of any major retail customer will provide significant distribution problems and financial difficulty for Mattel. Two at risk retailers are KB Toys and Toys"R"Us.

Seeing these current and potential threats, Harkness Consulting encourages Mattel to seek alternate distribution channels. Two options are the development of a small scale retail store and a website redesign. The first of these would be possible on a longer time-scale and would necessitate the development of a high-margin strong-branded line. The store we envision is in an indoor mall and based on the Lego Stores. The second suggestion, redesigning the website, will help Mattel to control its distribution channels by reducing its dependency on the current retail model. The model online store should be Hasbro's www.hasbrotoyshop.com. We think that online toy sales will increase in the coming years. 2007 saw 57% growth of online sales of toys and hobbies.^{xiv} It will be important for Mattel to position itself to compete in what is becoming a more e-commerce-based business.

Relocation of Manufacturing Facilities

Our final recommendation is the relocation of manufacturing facilities to Mexico. Harkness Consulting believes there to be four key advantages to this relocation. First, the proximity of Mexico to the United States will reduce shipping time, allowing for just-in-time production. This will reduce inventory costs, especially in the holiday season. Mattel's difficulty projecting demand for products during the high-demand period of their business cycle forces them to keep extra cash on hand, and often results in excess or deficient production of a product. Second, Mexico's relatively stronger protection of intellectual property will help prevent counterfeiting, a key problem with Chinese manufacturing. Third, trade relations are

normalized and well regulated with respect to the country. Fourth, the proximity provides a hedge against oil cost spikes.

^I http://www.mattel.com/about_us/history/default.asp?f=false

^{II} <http://finance.yahoo.com/q?s=MAT>

^{III} Mattel 10-K (2008)

^{IV} Mattel 10-K (2008)

^V Mattel 10-K (2008)

^{VI} <http://www.reuters.com/article/rbssConsumerGoodsAndRetailNews/idUSN1221377120080312>

^{VII} <http://www.playthings.com/article/CA6531660.html>

^{VIII} Mattel 10-K (2008)

^{IX} Mattel 10-K (2008)

^X Mattel 10-K (2008)

^{XI} <http://www.playthings.com/article/CA6531660.html>

^{XII} http://biz.yahoo.com/ap/080104/hasbro_cranium.html?.v=2

^{XIII} Mattel 10-K (2008)

^{XIV} <http://www.ecommercetimes.com/story/60070.html>

Appendix A

Mattel Balance Sheets (in thousands)

	2007	2006	2005	2004	2003
Cash	\$ 901,148	\$ 1,205,552	\$ 997,734	\$ 1,156,835	\$ 1,152,681
Short-term Investments	-	-	-	-	-
Accounts receivable	991,196	943,813	760,643	759,033	543,888
Inventory	428,710	383,149	376,897	418,633	388,658
Prepaid expenses and other current assets	<u>271,882</u>	<u>317,624</u>	<u>277,226</u>	<u>302,649</u>	<u>309,629</u>
Total current assets	2,592,936	2,850,138	2,412,500	2,637,150	2,394,856
Property, plant and equipment	518,616	536,749	547,104	586,526	625,893
Goodwill	845,694	845,324	718,069	735,680	722,249
Other assets	<u>848,254</u>	<u>723,673</u>	<u>694,640</u>	<u>797,136</u>	<u>767,952</u>
Total assets	\$ 4,805,500	\$ 4,955,884	\$ 4,372,313	\$ 4,756,492	\$ 4,510,950
Short-term borrowings	\$ 349,003	\$ -	\$ 117,994	\$ 28,995	\$ 19,590
Current portion of long-term debt	50,000	64,286	100,000	189,130	52,274
Accounts Payable	441,145	375,882	265,936	349,159	289,680
Accrued Liabilities	713,209	980,435	796,473	880,038	852,978
Income taxes payable	<u>17,072</u>	<u>161,917</u>	<u>182,782</u>	<u>279,849</u>	<u>253,224</u>
Total current liabilities	1,570,429	1,582,520	1,463,185	1,727,171	1,467,746
Long-term debt	550,000	635,714	525,000	400,000	589,130
Warranty payable	-	-	-	-	-
Other liabilities	<u>378,284</u>	<u>304,676</u>	<u>282,395</u>	<u>243,509</u>	<u>237,853</u>
Total liabilities	2,498,713	2,522,910	2,270,580	2,370,680	2,294,729
Preferred stock	-	-	-	-	-
Common stock	441,369	441,369	441,369	441,369	441,212
Additional paid-in capital	1,635,238	1,613,307	1,589,281	1,594,332	1,599,278
Treasury stock	(1,571,511)	(996,981)	(935,711)	(473,349)	(244,691)
Retained earnings	1,977,456	1,652,140	1,309,822	1,093,288	707,429
Other comprehensive income	(175,810)	(276,861)	(303,028)	(269,828)	(287,007)
Other equity adjustments	-	-	-	-	-
Total shareholders' equity	<u>2,306,742</u>	<u>2,432,974</u>	<u>2,101,733</u>	<u>2,385,812</u>	<u>2,216,221</u>
Total liabilities and shareholders equity	\$ 4,805,455	\$ 4,955,884	\$ 4,372,313	\$ 4,756,492	\$ 4,510,950

Appendix B

Mattel Balance Sheets

Vertical Common Size	2007	2006	2005	2004	2003
Cash	18.8%	24.3%	22.8%	24.3%	25.6%
Short-term Investments	0.0%	0.0%	0.0%	0.0%	0.0%
Accounts receivable	20.6%	19.0%	17.4%	16.0%	12.1%
Inventory	8.9%	7.7%	8.6%	8.8%	8.6%
Other current assets	5.7%	6.4%	6.3%	6.4%	6.9%
Total current assets	54.0%	57.5%	55.2%	55.4%	53.1%
Property, plant and equipment	10.8%	10.8%	12.5%	12.3%	13.9%
Goodwill	17.6%	17.1%	16.4%	15.5%	16.0%
Other assets	17.7%	14.6%	15.9%	16.8%	17.0%
Total assets	100.0%	100.0%	100.0%	100.0%	100.0%
Short-term borrowings	7.3%	0.0%	2.7%	0.6%	0.4%
Current portion of long-term debt	1.0%	1.3%	2.3%	4.0%	1.2%
Accounts Payable	9.2%	7.6%	6.1%	7.3%	6.4%
Accrued Liabilities	14.8%	19.8%	18.2%	18.5%	18.9%
Income taxes payable	0.4%	3.3%	4.2%	5.9%	5.6%
Total current liabilities	32.7%	31.9%	33.5%	36.3%	32.5%
Long-term debt	11.4%	12.8%	12.0%	8.4%	13.1%
Warranty payable	0.0%	0.0%	0.0%	0.0%	0.0%
Other liabilities	7.9%	6.1%	6.5%	5.1%	5.3%
Total liabilities	52.0%	50.9%	51.9%	49.8%	50.9%
Preferred stock	0.0%	0.0%	0.0%	0.0%	0.0%
Common stock	9.2%	8.9%	10.1%	9.3%	9.8%
Additional paid-in capital	34.0%	32.6%	36.3%	33.5%	35.5%
Treasury stock	-32.7%	-20.1%	-21.4%	-10.0%	-5.4%
Retained earnings	41.2%	33.3%	30.0%	23.0%	15.7%
Other comprehensive income	-3.7%	-5.6%	-6.9%	-5.7%	-6.4%
Other equity adjustments	0.0%	0.0%	0.0%	0.0%	0.0%
Total shareholders' equity	48.0%	49.1%	48.1%	50.2%	49.1%
Total liabilities and shareholders equity	100.0%	100.0%	100.0%	100.0%	100.0%

Appendix C

Mattie Income Statement

(in thousands)	2007	2006	2005	2004	2003
Sales revenues	\$ 5,970,090	\$ 5,650,156	\$ 5,179,016	\$ 5,102,786	\$4,960,100
Cost of goods sold	<u>3,192,790</u>	<u>3,038,363</u>	<u>2,806,148</u>	<u>2,692,061</u>	<u>2,530,617</u>
Gross profit	2,777,300	2,611,793	2,372,868	2,410,725	2,429,483
Selling, general and administrative expenses	1,338,454	1,232,000	1,079,224	1,036,941	1,002,899
Research and development	-	-	-	-	-
Advertising and promotion expenses	708,768	650,975	629,115	642,967	636,105
Depreciation	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>4,769</u>
Total operating expenses	<u>2,047,222</u>	<u>1,882,975</u>	<u>1,708,339</u>	<u>1,679,908</u>	<u>1,643,773</u>
Operating income	730,078	728,818	664,529	730,817	785,710
Interest expense	70,974	79,853	76,490	77,764	80,577
Interest (income)	(33,305)	(30,468)	(34,211)	(19,683)	(18,966)
Other non-operating (income), net	<u>(10,989)</u>	<u>(4,323)</u>	<u>(29,799)</u>	<u>(23,518)</u>	<u>(16,755)</u>
Income before income taxes	703,398	683,756	652,049	696,254	740,854
Tax expense	103,405	90,829	235,030	123,531	203,222
Cumulative effect of change in accounting principle	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Net income	\$ 599,993	\$ 592,927	\$ 417,019	\$ 572,723	\$ 537,632
Basic EPS	\$ 1.56	\$ 1.55	\$ 1.02	\$ 1.37	\$1.23
Diluted EPS	\$ 1.54	\$ 1.53	\$ 1.01	\$ 1.35	\$1.22
Dividends per common share	\$ 0.75	\$ 0.65	\$ 0.50	\$ 0.45	\$0.40

Appendix D

Mattel Income Statements

Vertical Common Size	2007	2006	2005	2004	2003
Cost of goods sold	53.5%	53.8%	54.2%	52.8%	51.0%
Gross profit	46.5%	46.2%	45.8%	47.2%	49.0%
Selling, general and administrative expenses	22.4%	21.8%	20.8%	20.3%	20.2%
Advertising and promotion expenses	11.9%	11.5%	12.1%	12.6%	12.8%
Total operating expenses	34.3%	33.3%	33.0%	32.9%	33.1%
Operating income	12.2%	12.9%	12.8%	14.3%	15.8%
Interest expense	1.2%	1.4%	1.5%	1.5%	1.6%
Interest (income)	-0.6%	-0.5%	-0.7%	-0.4%	-0.4%
Other non-operating (income), net	-0.2%	-0.1%	-0.6%	-0.5%	-0.3%
Income before income taxes	11.8%	12.1%	12.6%	13.6%	14.9%
Tax expense	1.7%	1.6%	4.5%	2.4%	4.1%
Net income	10.0%	10.5%	8.1%	11.2%	10.8%

Mattel Income Statements

Compound Annual Growth Rate	2007	2006	2005	2004
Sales revenues	5.37%	5.23%	2.18%	2.20%
Cost of goods sold	5.85%	6.24%	5.30%	3.27%
Gross profit	4.83%	4.09%	-1.17%	1.05%
Selling, general and administrative expenses	8.88%	9.00%	3.74%	-0.64%
Advertising and promotion expenses	3.30%	0.62%	-0.55%	7.88%
Total operating expenses	6.81%	5.87%	1.95%	1.60%
Operating income	-0.03%	-0.14%	-8.03%	-0.19%
Interest expense	-3.00%	1.33%	-2.57%	-17.37%
Interest (income)	19.16%	24.42%	34.31%	5.38%
Other non-operating (income), net	-22.40%	-57.13%	33.36%	-
Income before income taxes	0.34%	-0.90%	-6.18%	5.84%
Tax expense	-5.76%	-14.25%	7.54%	-13.85%
Net income	1.56%	1.75%	-11.93%	57.77%
Basic EPS	4.42%	6.37%	-8.94%	62.31%
Diluted EPS	4.49%	6.46%	-9.01%	61.13%
Dividends per common share	18.56%	20.19%	11.80%	200.00%