Mergers and Acquisitions – SGMT 6050

MATTEL INC.'S ACQUISITION OF MEGA BRANDS INC.

An Analysis

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On February 28th, 2014, Mattel announced a friendly acquisition of MEGA Brands, a deal which was completed on April 30th, 2014. MEGA Brands shareholders received $17.75 CDN per share in cash, equivalent to a 32% premium to the weighted average stock price in the month leading to the merger. The transaction represented a total value of $460 million US, including the debt of MEGA Brands to be assumed or repaid by Mattel. (Canadian Plastics Journal, 2014).

MEGA Brands acquisition was the best alternative for Mattel to advance its global growth strategy of building upon its world class portfolio of brands. The acquisition will create significant growth opportunities for Mattel as it will allow the company to expand into two of the fastest-growing toy categories: construction building sets and arts & crafts. Mega Brands gives Mattel the manufacturing and design know-how in the construction-toy category to build a solid platform to compete against LEGO and protect its No.1 position in the market.

Furthermore, the acquisition will unlock a number of synergies between the two companies. Mattel will be able to capitalize on existing MEGA Brands licenses and broaden its relationship with entertainment partners. Through the acquisition, Mattel will also have a tremendous opportunity to return some key manufacturing back to North America and mitigate some of the risk associated with production in China. The merged company could also see an increase in efficiencies in their distribution and purchasing capabilities.

Not surprisingly, a total of 99.96 per cent of Mega Brands shareholders approved the deal, and both companies' share price increased after the official announcement, reflecting market confidence on the significant value this acquisition will bring for Mattel in the upcoming future.

MATTEL

Mattel designs, manufacturers and markets a broad variety of toy products worldwide which are sold to retailers, distributors and directly to consumers (Mattel, 2013). In 2012, Mattel was the largest toy manufacturer in the world focusing on the traditional toys and games categories (Euromonitor, 2013).

Mattel sells their products in 150 countries and controls 17% of the US market. Its biggest competitors are Hasbro and Lego. Hasbro's expertise is in the action figures, puzzles and other educational games. They are mostly known for games such as Monopoly and Transformers. Part of Hasbro's strategy is to expand into the digital space world and compete against other computer or video game producers. Lego on the other hand, is the leader in the construction sets category mostly known for Lego Bricks that appeal to all age groups and its strategy is to expand into emerging markets. Lego currently controls 75% of the US market.

Mattel's product portfolio includes well-known brands such as, Barbie, Hot Wheels, Fisher Price, Disney Cars, and Matty Collector.

Mattel has sales and marketing offices and facilities in 36 countries, its manufacturing operations are located mainly in China but the company also operates plants in India, Indonesia, Italy, Malaysia, Mexico and Thailand. The variety of locations helps the company to prevent risk from any country's potential internal problems (Euromonitor, 2013).

Additionally, in order to further reduce costs and risk, Mattel uses company-owned facilities for the production of most of its core products and third-party manufacturers for the production of other non-core brands. Approximately half of Mattel's products are manufactured in one of nine owned factories: four in China, two in Mexico and one each in Malaysia, Indonesia and Thailand. The other 50% of their products are produced by vendors predominantly located in Southern China (Euromonitor, 2013). Please refer to Appendix 1 for a detailed analysis of the activities across the value chain.

Mattel outlined the following high-level objectives in their most recent annual report for 2013: Mattel's vision is "creating the future of play". Mattel's objectives are:

- To grow its share in the marketplace,
- Continue to improve its operating margins, and

- Create long-term stockholder value" (Mattel, 2013)

BUSINESS STRATEGY

Mattel also outlined the following strategies that will help them achieve their long-term objectives:

- Global Growth Strategy: "to deliver consistent growth by continuing the momentum in its core brands, optimizing entertainment partnerships, building new franchises, and working to expand and leverage its international footprint." (Mattel, 2013)
- "Optimize operating margins through sustaining gross margins within the low-to-mid 50% range in the near-term, above 50% in the long-term, and delivering on cost savings initiatives." (Mattel, 2013)
- Cash Flow and Value Enhancing: "Continue its disciplined, opportunistic, and value enhancing deployment." (Mattel, 2013)

MATTEL: STRENGTHS – WEAKNESSES – OPPORTUNITIES – THREATS

Strengths

Mattel gains a competitive advantage through its global brand awareness and the many iconic brands within its product portfolio. Moreover, Mattel also benefits from its licensing agreements with Disney that allows them to use Disney characters for their recognition value. Additionally, their main manufacturing facilities are located in major areas of growth, which works to allows Mattel the ability to enter these new markets relatively easily. Mattel is also one of the top retailers in the industry which allows them to utilize their economies of scale and enables them to utilize their collaborative powers with their competitors to maintain prices, and negotiate lower costs from suppliers.

Weaknesses

In comparison to its competitors, Mattel does not have a focus on educational, eco-friendly, and technology-based entertainment products. Based on their existing strategy, it appears that there is a major gap between what Mattel is capable of producing and what their long-term vision is targeted at. This is in part due to underutilization of its intellectual property resources. Furthermore, over the past several years Mattel has implemented a Global Cost Leadership program, which focuses on cost savings through optimizations in their value chain. This initiative has placed them at a higher risk of sacrificing product quality and damaging their brand as it has focused on controlling costs as opposed to driving product safety or renewing consumer preferences.

Opportunities

Due to its brand power and name recognition, Mattel is able to form strong partnerships for entering lifestyle, entertainment, clothing, gaming markets, and catering to a wider demographic in terms of age. Mattel can also leverage its global presence to maximize earnings, and hedge foreign exchange, political, or socio-economic risks.

Threats

Consumers' disposable income has fallen significantly in recent years leading analysts to predict growth in low-end or alternative products. Mattel's costs are also likely to increase due to compliance and cross-cultural marketing strategies as it continues to expand globally.

Strengths and Opportunities Strategies

- Mattel has a strong financial position which allows them to enter the electronic game market either through an acquisition or organically,
- Mattel can leverage existing brands and extend into other sub-brands in areas such as entertainment, clothing,
- Utilize its global supply and manufacturing base to mitigate risk of currency exchange, political and socio-economic risks,
- Mattel can extend into other product lines by an acquisition and/or licensing.

Strengths and Threats Strategies

- Utilize assets to expand into anther product lines to better position against competitors (i.e. electronic gaming),
- Impose stringent quality control standards on manufacturing suppliers,
- Leverage foreign earnings to hedge against currency fluctuations.

Weakness and Opportunities Strategies

- Continue to develop products to limit exposure to third-party content,

- Leverage to enter into new market segments, such as lifestyle, entertainment, construction set toys,
- Develop products targeted at older age groups to expand market presence.

Weakness and Threats Strategies

- Mattel may license its intellectual property to others for faster market penetration,
- Enter gaming segment targeted at 18 – 35 year olds,
- Acquire online gaming/electronic entertainment company to reduce dependency on manufacturing.

Please refer to Appendix 2 for further information.

MEGA BRANDS

MEGA Brands is a Montréal Based organization that specializes in toy design and manufacturing. The company is well-known for construction set toys and is recognized for top-of-the-line manufacturing practices. Its two main lines of products include children's toys and stationary products. The company has manufacturing facilities in over 17 countries with a product presence in over 100 international markets. Its toys segment includes MEGA BLOKS and MEGA PUZZLES while its stationary & activities segment is comprised of brands such as ROSE ART, BOARD DUDES, and WRITE DUDES.

The company's focus is on quality, price, play experience, marketing and distribution, and the acquisition of retail shelf space. It creates operational efficiency by managing its supply chain to create an optimal balance between in-house and third-party manufacturing. It aims to invest 3-4% of net sales in research and development as innovation is a key growth driver in the toy industry. Currently, North America accounts for 70% of the company's sales although the company continues to expand its international presence (MEGA Brands Inc., 2014). Its mission is to "nurture creativity in every child and every family" (MEGA Brands Inc., 2012)

BUSINESS STRATEGY

The strategies of MEGA Brands are (MEGA Brands Inc., 2014):

- Develop innovative products based on proprietary content and licensing agreements with popular brands.
- Manufacture and source high quality products on a competitive basis.
- Market products to leading retailers and consumers worldwide.

MEGA BRANDS: STRENGTHS – WEAKNESSES – OPPORTUNITIES – THREATS

Strengths

MEGA Brands has a relatively strong brand presence in western markets. Its strong relationships with companies such as Cartoon Network, Nickelodeon, and Viacom Consumer Products allows it to secure access to product series such as Generator Rex, Dora the explorer and Go, Diego, Go! It also has a licensing pact with Marvel for Spiderman, the Hulk, Blade and X-Men (Hoovers, 2013).

MEGA Brands has a significant market share in the Canadian market, accounting for 60.2% of Toy, Doll & Game Manufacturing segment of the Canadian market (Haider, Toy, Doll & Game Manufacturing in Canada, 2014). It has manufacturing operations across the world, but has also recently made an effort to on-shore molding operations (Stephen, 2013). The company also owns a portfolio of brands that can easily be expanded into other parts of the world, other classes of product and other non-toy areas. Its diversified product mix includes construction toys, puzzles, stationery and activity related products such as arts and crafts tools (Rose Art Group), presentation boards, and writing instruments (Stephen, 2013). The company also takes advantage of technologies such as 3D design to create unique products and help facilitate around-the-clock design (Sensable 3D Design, 2010). Having a flexible and fast design team would allow the company to capitalize on changes in consumer demand, a key success factor for the industry (Haider, 2014).

MEGA Brands also has had strong performance relative to industry peers, having outperformed Mattel and Hasbro for five straight quarters leading into the first quarter of 2013 (Stephen, 2013).

Weaknesses

MEGA Brands has experienced extremely volatile performance in the last 5 years of its operations. It also had to deal with losses due to product recalls relating to its Magnetix products, which impacted its brand reputation (Infomart, 2014). The company's geographic diversification is heavily concentrated in North America, mostly in Canada. Its operations in Europe and other areas of the world are just starting to take hold. (Hoovers)

Opportunities

MEGA Brands is key player in the construction set toy segment one of the few traditional toy segments that is growing year-over-year. This presents the company with the opportunity to capitalize on their presence in this market and continue to increase their market share. MEGA Brands possesses the rights to manufacture and sell numerous titles that go beyond the core children's market (Haider, Toy, Doll & Game Manufacturing in Canada, 2014). This provides a unique opportunity to MEGA Brands as the age range within which it competes is broader than most other toy manufacturers. Complying with government regulations is critical in this industry and becoming increasingly complex. It is expected that larger companies will be more adept at maneuvering through the complexities of the regulatory framework (Haider, Toy, Doll & Game Manufacturing in Canada, 2014). Being a well-established company with great government relations allows MEGA Brands more opportunities for growth and expansion than more traditional smaller organizations.

Threats

The company competes in a global and heavily concentrated industry with equally high levels of competition. This is also reflected in the fact that retailers have a tremendous amount of strength to dictate elements such as delivery times and have a significant control on shelf space. The industry participants are heavily reliant on export activity and are subject to economic conditions. Industry drivers include the Consumer Confidence Index, consumer spending, per capita disposable income, demand from hobby and toy stores, exchange rate fluctuations, and leisure time (Haider, Toy, Doll & Game Manufacturing in Canada, 2014). Industry revenue has dropped significantly since 2006 but has started to recover in recent years (Haider, Toy, Doll & Game Manufacturing in Canada, 2014). The industry is expected to continue to have difficulties with growth over the coming years. It is commonly expected that toys will continue to become more and more segmented with revenue growth becoming slower than the remainder of the economy (Haider, Toy, Doll & Game Manufacturing in Canada, 2014).

Strengths and Opportunities Strategies

- MEGA Brands can utilize its international presence and brand awareness to increase marketing and further expand its international footprint,
- The use of new technology such as 3D design can allow the company to create innovative products that can go beyond the core children's market,
- Strong licensing agreements and relationships with companies can be expanded to bring in additional titles.

Strengths and Threats Strategies

- The slow growth in the toy industry means innovation is vital. The company should increase its investment in research and development to continue developing proprietary content,
- Use global supply chain to minimize costs and create distribution efficiency

Weakness and Opportunities Strategies

- Investing in virtual toys helps further diversify products and cater to demand,
- Develop products targeted at older age groups to expand market presence.

Weakness and Threats Strategies

- Impose stringent quality control standards on manufacturing suppliers,
- Optimized supply chain and proprietary products delivered on time can help obtain preferred shelf space with retailers.

Please refer to Appendix 3 for further information

INDUSTRY ANALYSIS - TOY INDUSTRY

A PESTLE analysis was utilized to identify relevant trends in the Toy Industry over the next several years. Please refer to Appendix 2 for further information.

Economic Factors

Emerging markets' economic development and the emergent middle class may drive industry growth in the next few years: Eastern Europe and Latin America were the fastest growing regions globally in traditional toys and games in 2012, both recording double-digit value growth. Asia Pacific is expected to become the biggest traditional toy market over the next several years (Euromonitor, 2013).

The Construction category outperformed overall traditional toys and games by a large margin globally with and annual growth rate of 15% in 2012 up from 14% the year before. All markets saw an increase in sales, attributable to LEGO who has a dominant position in this category, accounting for more than 62% of global value sales in 2012 (Euromonitor, 2013).

Considering that three quarters of the world´s toys are made in China, the country's shrinking labor market and rising raw material costs may negatively impact many major players' operations in the toy industry.

Social and Cultural Factors

Construction toys have become popular among parents seeking to limit the amount of time their children spend using iPads and other electronics with screens. Parents are increasingly looking for products that can stimulate a child's imagination and creativity. The number of households where fathers stay at home and make most of the family purchases is increasing which has also driven an increase in preference for educative and construction toys (Euromonitor, 2013).

Children's television viewing habits and the popularity of films will continue to strongly determine children´s preferences and consequently industry dynamics. Other relevant trends that will impact the industry include: “Age compression phenomenon” (increasing children´s preferences for smartphones and video games after the age of 10), and the growing older kid´s preference for toys and games involving socializing activities.

Technological Factors

Key technological trends include the development of new inexpensive technologies and emerging tablet toys and games on Apple and Android devices, increasing penetration of electronics and digital elements into traditional toys, development of apps to be used as toys or accessories/complements for traditional toys and toys / games cross-overs (cross-industry collaboration between traditional toys, video games and electronics).

Legal Factors

Key trends to watch include: Import regulations, especially from China which may negatively impact expansion plans in emerging markets. Globalization of licenses is expected to increase licensors’ power over licensees and increased product safety regulations are expected to emerge as a consequence of the high level of outsourcing and offshoring

Environmental Factors

Eco-friendly toys are emerging as a relevant trend in the industry. In addition, demand for greater environmental sustainability of products is increasing not only from legislators and NGOs, but also from retailers who are reacting to customer demand.

Please refer to Appendix 4 and Appendix 5 for further information.

ALTERNATIVES TO THE MERGER

Alternative Acquisition to Strengthen Mattel’s Global Position

The acquisition of MEGA Brands is an attempt to better position Mattel to compete against LEGO; however, MEGA Brands may not be the best alternative to strengthen its position in markets where LEGO currently leads.

Seventy percent of total MEGA Brands' global net sales come from North America (MEGA Brands, 2013), which means the acquisition would have a significant impact on this region as the combined company will benefit from the full force of Mattel's marketing logistics and operational infrastructure in this market. Mattel however, already controls more than a fifth of the toy market in Latin and North America, and MEGA Brands' limited international presence in key strategic markets such as Asia Pacific and Eastern Europe undermines the growth potential behind this acquisition.

Alternatively, with most of the global forecast revenue expected to come from Asia Pacific, Mattel could consider acquisitions in this market which would guarantee a strong foothold in the fastest growing markets and would give Mattel a competitive advantage against LEGO whose dominance is still weak in this region. In China, Takara Tomy and Bandai Namco accounted for 8% and 7% of traditional toys and games sales in 2012 respectively; both companies deserve some attention as they may offer potential growth opportunities for Mattel in the future (Euromonitor, 2014).

Acquisition to Strengthen Mattel's Position in Alternative Growing Segment

The acquisition of MEGA Brands would provide Mattel with a growth platform by bringing new products to Mattel's current offerings and coming toy lineup. However, LEGO's expertise and solid dominant position in this category could jeopardize the intended growth that is expected to be achieved through this acquisition.

Further, the market for construction toys is showing signs of slowing as new entrants such as Hasbro have also entered the market. LEGO has also stated it expects global demand for building blocks to be moderate this year (Ziobro, 2014).

Mattel could consider acquisitions of companies with a strong dominance in alternative or complementary growing categories such as digital gaming. In 2013, digital gaming remains one of the best performing categories, posting 12% value growth due to the rising penetration of smartphones and tablets, as well as new game launches (Euromonitor, 2013). An acquisition in this category could help Mattel to build new characters and brand recognition and therefore it could offer greater growth potential in the long term.

Construction Line Development (In-house or Through Joint Venture)

The acquisition of MEGA Brands was mainly driven by Mattel's interest in the growing construction category. Leveraging its internal capabilities and their well-recognized brands, Mattel could consider developing a construction line on its own or it could find a strategic partner able to provide the manufacturing and design know-how that Mattel lacks in this segment. Although this alternative may be feasible, it would take much more time to implement and it would involve much more complexity than an acquisition.

THE DEAL

In today's day and age many kids are surrounded by a variety of electronic games, such as video consoles, TV games, computer games, all market conditions that make it hard for traditional toy manufacturers such as Mattel to compete. Many companies such as Mattel and Hasbro not only depend on their toy sales but are also increasingly dependent on revenue from their licensing relationships with movie production companies such as Disney, Pixar etc… Additionally, toy companies continue to look to ventures into the virtual realm, which hold tremendous potential as they look for alternate sources of revenue. Couple these facts with increased pressures from other industry participants and more interest in sustainable solutions for manufacturing and shipping, and it becomes apparent that the toy industry is in a state of flux.

An acquisition between Mattel and MEGA Brands would unlock a number of synergies between the two companies in both traditional categories as well as some of the more recent segments in which toy manufacturers play. This acquisition plays into several areas of Mattel's strategic plan, and we will focus on how each is furthered by having MEGA Brands in their product portfolio.

CONSTRUCTION TOYS CATEGORY

In the traditional toy category, the MEGA Brands' portfolio consists of arts and crafts toys, puzzles and constructions sets. Its most popular product is MEGA Bloks which are construction sets with various target audiences. In this category, MEGA Brands competes directly against LEGO and despite being present in 17 countries, MEGA Brands only has approximately 10% of the market share (EBSCOHost). Even though this is proportionately small, it is still leaps-and-bounds above where Mattel currently sits. Despite being one of the largest toy companies in the world, Mattel has not been able to break into the construction sets category. This merger will allow them to obtain an immediate foothold into a market they haven't been successful in.

Further to this, in recent years Mattel has been under attack in the toy category it dominates, girl-oriented toys. The LEGO Group has been most aggressive with their LEGO Friends and Duplo lines. MEGA Brands has the potential to act as a defense measure against further LEGO intrusions. (Wilkinson, 2014)

Additionally, Mattel's products are mostly targeted towards younger children under the age of 10, whereas Hasbro and Lego products are for all age groups. This limits its reach from a wider audience. On the other hand, MEGA Brands products are targeted towards a wider audience and hence, Mattel would be able to benefit from it as it can reach this broader audience.

NON-TRADITIONAL TOYS

For Mattel, the MEGA Brands acquisition will extend its reach into new and growing categories that include online gaming related categories. MEGA Brands has numerous license arrangements for toys targeted at boys including - Halo, Call of Duty, and Assassin's Creed. (Wilkinson, 2014) This will bring new opportunities to Mattel, a company that has not had the success it was looking for staying with newer trends and recognizing the shifting demographics. MEGA Brands has numerous franchise agreements that should translate well into future growth opportunities and an increasing share of the older, “tween” and early teen market segments. This is a clear synergy opportunity for the two companies.

LICENSING RELATIONSHIPS

MEGA Brands also has licensing relationships with third party companies where it produces products such as HALO®, Skylanders®, Call of Duty®, Assassin's Creed®, Power Rangers®, Hello Kitty®, SpongeBob SquarePants® and others. Mattel also has licensing relationships with Disney and produces products such as Barbie and Hot Wheels. This acquisition will allow Mattel to expand its licensing and entertainment partners and compete better with Hasbro which has focused more heavily on licensing partners. (MSN Money, 2014)

Due to the unfavorable growth conditions in the industry, LEGO moved in an unprecedented direction by establishing their own franchise with the critically acclaimed LEGO movie. Lego’s move towards acquiring and licensing their own franchise while also capitalizing on other franchise agreements is truly a new action in the industry. It is both a threat and an opportunity that Mattel must capitalize on and owning MEGA Brands with experience in licenses which hold tremendous potential. (EBSCOHost)

MEGA BRANDS TO LEVERAGE MATTEL SCALE

Another aspect of synergies between the two companies is the similarity of their operations, and their ability to share distribution networks. Integration between the two companies will allow MEGA Brands to drastically capitalize on Mattel’s size, growth and scale. (Collins, 2014) MEGA Brands would also be able to take advantage of significant growth outside of North America as Mattel is present in 250 markets. (EBSCOHost) Emerging markets have proven to be lucrative, hence both MEGA Brands and Mattel have aspirations to expand into areas such as Brazil, China, Russia and India. This is becoming increasingly important as the toy market in the United States becomes saturated and the population continues to age. Products such as MEGA Bloks could also stand to gain market share by co-branding with Mattel in areas of the world where they are not positioned in the marketplace. This would allow them to capitalize on Mattel’s name recognition. (Horowitz, 2014)

In an effort to streamline operations, the company would also be able to utilize and cross-brand several of their own internal products allowing them to more efficiently and effectively market their products across their entire geographical distribution area. Finally, the two companies could see increase efficiencies in their purchasing capabilities and delivery methods as their product portfolio increases. (MSN Money, 2014)

PRODUCTION IN NORTH AMERICA

With the rising costs associated with production in China, the increased political instability in other parts of the world, MEGA Brands returned much of their production back to North America, more specifically, Montreal. That, coupled with the ever-increasing costs of oil and the rise in North American sentiment towards sustainability, it is no surprise that many toy manufacturers that rely on mass-production are starting to return to local production that is increasingly competitive by means of government incentive and high-end technologies that improve quality control. This is a tremendous opportunity for Mattel to establish a working model for returning some key manufacturing back to North America, capitalizing on the latest technology available to MEGA Brands and perhaps gaining a strong advantage by applying similar patterns to encourage partnerships with local governments.

POTENTIAL OBSTACLES TO THE ACQUISITION

Shareholders' Approval

The transaction announced on February 28th was approved by the Board of Directors and it had the support of shareholders with 39% of MEGA Brands stock, including the founders and the firm Fairfax Financial Holdings Ltd. (which had also invested in MEGA Brands); however, certain level of deal risk was involved as the arrangement resolution needed the approval of at least two-thirds of the votes cast by shareholders and a simple majority of the votes cast by shareholders other than the founders Marc Bertrand and Vic Bertrand (Marowits R, 2014). Of the MEGA Brands shareholders who voted at the meeting, 99.96% were in favour of the deal.

Provincial Government Approval Required

Additional deal risk was involved in the transaction as the final arrangement was also subject to the approval of the Superior Court of Québec (Commercial Division) at a final hearing. The agreement would only be completed if all regulatory closing conditions had been satisfied or waived by The Court.

Alternative Bidders

An alternative bidder could also have been an obstacle to the closing of the arrangement between Mattel and MEGA Brands. Although there was never an official offer at the time, Hasbro, had shown interest in MEGA Brands several years ago when the Company was in the midst of a turmoil that nearly sent it into bankruptcy. These problems from the early 2000's occurred when MEGA Brands was sued by LEGO for copyright infringement, had crippling debt and needed to recall an entire line of toys that had choking hazards. (EBSCOHost) Recognizing this potential obstacle, Mattel incorporated a defensive measure through a break fee of US$12 million in case the Board of Directors of MEGA Brands terminated the agreement in favor of an unsolicited superior proposal. In this way Mattel sought to increase the cost of the acquisition for other potential bidders (Mattel, 2014).

VALUATION

The comparable company analysis and the discounted cash flow method were used to determine a valuation for MEGA Brands. The valuation was performed as of December 31, 2013 since financial information regarding MEGA Brands and the comparable companies were readily available for this date. The three available comparable companies were Mattel, Hasbro, and LeapFrog Enterprises. Although there was a considerable difference in market capitalization between the companies, a lack of publicly traded companies in this sector (e.g. LEGO and Crayola LLC) meant using all three of these companies. MEGA Brands had a much larger market capitalization than LeapFrog although it was significantly smaller compared to Mattel and Hasbro. The comparable company analysis provided a wide price per share range for MEGA Brands between C$15.51 and C$24.84 with an average of C$20.07 (Appendix 6).

The discounted cash flow (DCF) method provided a price per share of C$16.36 on a stand-alone basis for MEGA Brands (Appendix 7). The company had a low cost of debt as well as a low cost of equity (as calculated using the Capital Asset Pricing Model), resulting in a weighted average cost of capital of 5.44% (Appendix 8). Consumer Goods is a defensive sector, which generally carries a lower risk relative to the market and therefore a low beta (0.701 for MEGA Brands). The company's revenue growth was assumed to be 10% per year in 2014 based annual sales data in the U.S. given that MEGA Brands is primarily in North America. The 10% was an estimate based on the 2012 and 2013 average sales growth in the Buildings Sets category and the Arts & Crafts category in which MEGA Brands operates (The NPD Group, 2014). The growth rate was assumed to decline by 2% per year over the next five resulting in a terminal growth rate of 2%. Costs as a percent of revenue were based on five year historical averages.

The synergies that would be created as a result of the merger can be broadly categorized into increased revenue and lower costs. Synergies were calculated based on the following assumptions (Appendix 9):

- Access to Mattel's broader international reach, its distribution networks, and additional licensing could increase revenue by 2% per year for the next 5 years, which would result in additional value of US$59.3MM.
- MEGA Brands could leverage the marketing efforts of Mattel resulting in reduction of marketing costs of 1% per year for the next 5 years. This will create US$21.9MM in savings.
- Access to Mattel's networks could also lower distribution and administrative expenses by 1% per year for the next 5 years. Given that these costs accounted for roughly 23% of revenues, the savings generated by this is significant at US$112.5MM.

The total value of synergies in addition to the company's existing value will result in a value per share of C$23.73, which indicates that Mattel could potentially realize approximately 34% in additional value from this merger using the estimates mentioned above.

Bloomberg's analyst estimates as of February 27, 2014, one day prior to the announcement, showed five estimates ranging from C$14 to C$19 with an average of C$16.80 (Bloomberg Finance L.P., 2014). The announcement of the deal was welcome by analysts who agreed that the acquisition was helpful and would create international expansion opportunities, attractive licensing opportunities, and cost savings (Johnson, 2014) (Linsdell, 2014). Based on the valuation analysis and considering the potential synergies that can be created, the premium paid by Mattel at C$17.75 per share is justified.

Mattel has a strong balance sheet with a cash balance of US$1.039 billion, which is well in excess of the MEGA Brands acquisition price. An all cash deal is supported by Mattel's current position. Although the company's debt to equity ratio is at 0.98, its cost of debt is low given its BBB+ credit rating. The yield on a 7 year bond for example, was around 3.5% (Bloomberg Finance L.P., 2014). While the use of cash has its risks, it also has the benefit of avoiding shareholder dilution and avoiding future dividend payments.

One issue specific to the valuation of MEGA Brands is the company's revenue growth. The company's growth does not show a clear trend thus it is difficult to predict. The industry growth rate is used as a proxy to help alleviate this issue. Next, MEGA Brands is a mid-cap company while the comparable companies available were small caps and large caps. There was a noticeable difference in the ratios of small caps and large caps, however, both were included given that the size of MEGA Brands was in between the two. Also, the company's reporting currency is the US dollar. Thus, the exchange rate needs to be taken into consideration when determining a valuation for MEGA Brands. The exchange rate used was the approximate 5 year annual average CADUSD rate of $0.967 (OANDA Corporation, 2014). The exchange rate plays a key role in determining the company's value.

SHARE PRICE

The share price of Mattel and MEGA Brands were examined from January 2012 until June 30, 2014 (Appendix 10). Mattel's share price trended higher in 2012 and early 2013 but stagnated in the latter part of 2013. MEGA Brands trended lower in the first three quarters of 2012 but increased significantly over the next year until October 2013 when it reported weaker third quarter 2013 earnings causing the share price to decrease.

In the first quarter of 2014, Mattel reported lower than expected earnings on weaker holiday demand and its share rating was lowered by various analysts causing the share price to decrease by 21% until the day prior to the acquisition announcement. The share price of MEGA Brands followed suite possibly on the expectation that it too would miss its earnings estimates. MEGA Brands' share price decreased by 14% since the start of 2014 to settle at C$13.07 on February 27, 2014, one day prior to the acquisition announcement. On the day of the announcement, the share price of MEGA Brands increased by 36% to close at C$17.72, a value just below the offer price of C$17.75. Mattel's share price increased slightly by 0.4% to close at US$36.94.

From the acquisition announcement date until June 30, 2014, the share price of Mattel has increased by 6%, which is exactly in line with the movement of the S&P 500 index. It is evident that Mattel's share price has stabilized since the announcement, which is a positive sign for the company. Given the mature nature of the industry and low beta for the stock, a movement in line with the market further reinforces the positive nature of the acquisition although a longer time horizon will need to be examined for the definitive impact of this acquisition.

CRITICAL MILESTONES

Shareholder vote - March 18, 2014

The merger needed to obtain 2/3 of votes cast by shareholders present or by proxy, and simple majority of votes in person or by proxy of all those that are not Interested Holders. (Plan of Arrangement, 2014)

December 2014

The true value of the acquisition will come to light as the merged entity comes out of the holiday season as Mattel suffered a 10% decline in North American sales last year. (Ziobro, 2014)

2015 Fiscal Year End

Mattel's earnings will take a hit in 2014 due to the acquisition, but it is expected that the company will obtain future profits starting in 2015. (Ziobro, 2014) Future press releases and fiscal year-ends should be monitored in order to gauge what effect the MEGA Brands acquisition had on Mattel's bottom line.

RISKS AND ROCKY PLACES

INTEGRATION APTITUDE

The most apparent risk to this acquisition's success is Mattel's lack of capability in businesses integration. In previous cases, there seemed to limited information sharing and synergy capture between businesses. Mattel does not traditionally meddle with the companies that they acquire. (EBSCOHost) This is a risk for the company, as it will not take best practices and apply them to the other businesses and brands that are in their portfolio in order to remain competitive. As outlined above, the company has the potential to gain from many different types of synergies and the appropriate levels of investment must be made.

INDUSTRY CONSOLIDATION

As mentioned earlier, the risks exposed by this transaction include the possibility of even further problems in the competitive environment. Industry professionals argue that Hasbro and several other large players would be looking to make defensive measures that may, in the long-term hamper growth in the industry.

SUSTAINABILITY IN TOY MANUFACTURING

Further to this, sustainability is becoming an increasing concern for the industry participants. Not only is the company production heavily focused in Asia, the materials used to construct the toys (for the most part) is made of plastic polymers and other materials that are not environmentally friendly. At this time LEGO is looking to make changes to their current plastic compositions. (Canadian Plastics Journal, 2014) Add to this the shipping associated with getting these products into North American Consumers' hands, and it is a recipe for a non-sustainable business – something consumers are becoming more cognizant of. A shift in consumer demand has tremendous consequences. With the move to purchase MEGA Brands, Mattel has shielded itself against this risk and gets a head-start with direct manufacturing in North America.

INTEGRATION ISSUES

Government Sponsorship

MEGA Brands has focused on bringing construction back to Canada as it invested millions in building capacity within Montreal. This may present potential issues as the companies merge operations. The company is heavily invested in state-of-the-art equipment that allows it to compete with factories in China by improving efficiencies. (EBSCOHost) MEGA Brands has been tremendously efficient in obtaining government support in Quebec. This acquisition may impact the amount of funding the company receives.

Cultural Integration

Brothers Marc and Vic Bertrand will stay on for one year to ensure a smooth transition. (Ziobro, 2014) Having owners/founders on-board for such an extended period of time may also impact the organization and how effectively the two company cultures come together. MEGA Brands was a company that was on the verge of extinction as recently as 2002. It can be reasonably assumed that the two corporate cultures are very different and that Mattel's approach of keeping the businesses separate may be appropriate. If the entities are kept separate, there may be limited information sharing and no manufacturing/shipping optimizations, which may affect long-term profitability for Mattel. The two companies must come together to improve their existing individual positions especially if they are to justify the premium that Mattel paid.

APPENDICES

APPENDIX 1: PORTER'S VALUE CHAIN

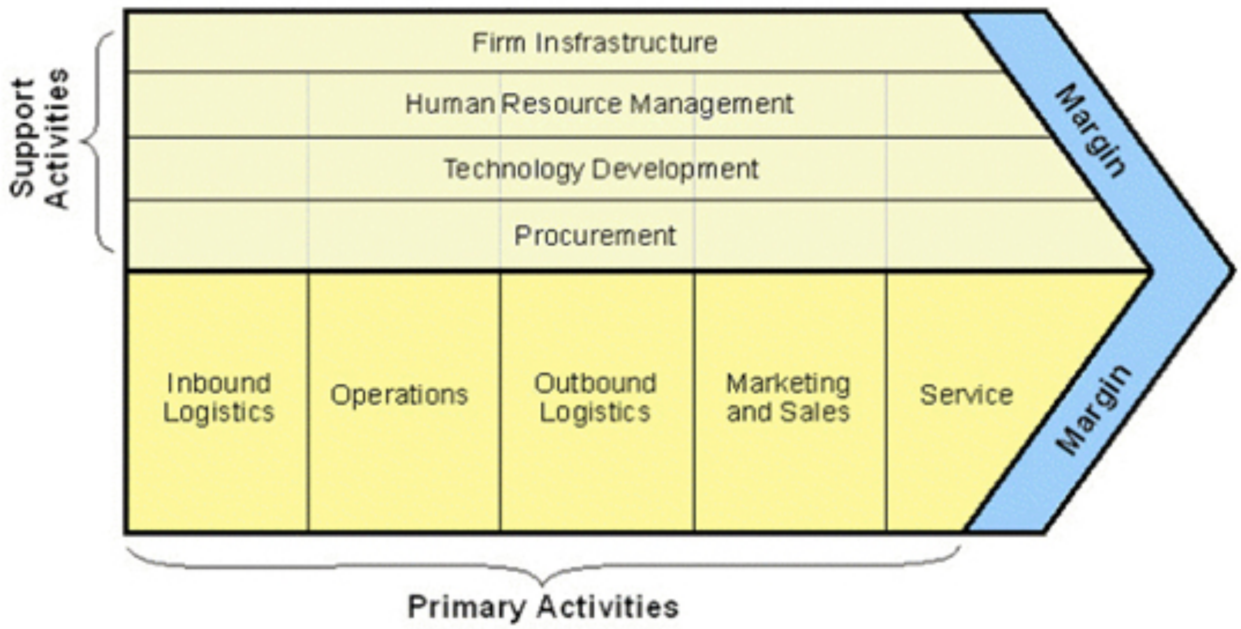


Figure 1 Value Chain

PRIMARY ACTIVITIES

Inbound Logistics

- SKU efficiencies minimize logistics costs
- Mattel owns and operates 13 Distribution Centres, Manufacturing & Tooling Plants
- Mattel concentrates its efforts on the selection of well-qualified licensees and setting clear expectations in the contract process in order to influence both product quality and working conditions.

Operations

- Mattel's Global Manufacturing Principles (GMP) sets the production standards for Mattel owned factories and those that produce products for them
- Approximately half of Mattel's products are manufactured in one of nine owned factories: four in China, two in Mexico and one each in Malaysia, Indonesia and Thailand

- The other 50% of their products are produced by vendors predominantly located in Southern China; their vendor manufacturing base is composed of approximately 40 major vendors and 30 specialty vendors that are called upon for specific processes or technologies needed to produce small-volume, non-core products
- Mattel reversed its earlier strategy of outsourcing to factories in Asia by owning and operating some plants in Asia for producing its most popular products in order to better control product quality and safety
- Mattel operates more accredited testing labs than any other toy maker in the world

Outbound Logistics

- The company has its presence in 40 countries and territories around the world
- Mattel employs packaging optimization to minimize transport costs

Marketing and Sales

- Strong brand portfolio; 2013 growth led by core brands. Barbie is the world's No. 1 doll property
- Mattel's product are sold in 150 countries by retailers, as well as directly to consumers

Service

- In 2011, 80% of Mattel's contacts were web-based, up 10% from 2009, and attributed in part to improvements to Mattel's consumer websites
- Mattel is improving its ability to listen and engage with consumers through social media
- Mattel receives close to 1,000 responses per week from customers who take their email survey. They constantly seek feedback from our consumers about the quality of the service Mattel provides and have made changes based on their responses.

SUPPORT ACTIVITIES

Firm Infrastructure

- Mattel has organized its business structure into the Global Brands Team, North America Division model, and American Girl
- Mattel integrates quality, Global Manufacturing Principles (GMP) and sustainability performance considerations into business processes such as new project launches

Technology Development

- Expanded digital capabilities to help brands engage with customers
- Historically, consumer inquiries were handled primarily by telephone, but Mattel has expanded their services since 2009 to include email, live chat and social media

Procurement

- Mattel has numerous suppliers for its raw materials. Materials are evaluated considering safety, quality, durability and compliance with regulations worldwide
- In 2011, Mattel adopted principles to guide the company's procurement of paper and wood fiber used in packaging and products
- The company has in place a global initiative called The Global Cost Leadership program which includes procurement initiatives designed to fully leverage Mattel's global scale in areas such as creative agency partnerships, legal services and distribution.

APPENDIX 2: SWOT STRATEGIES MATTEL

Strengths

- Strong profitability
- High brand awareness
  - Known-brands: Barbie, Hot Wheels, Fischer Price
- Licences content from Disney
- Global manufacturing and sourcing

Weaknesses

- Heavy reliances from licensing content from Disney
  - Walmart, Target and Toys "R" Us account for 71% of sales in the U.S
- Reliance on movie performances. If a movie is not successful -> low sales of toys
- Lack of present in the online or digital entertainment business
- Products are targeted at a specific age range (under 10 year olds)

Opportunities

- License Mattel products out to third parties for entry into other vertical markets
- Develop Mattel-owned lifestyle brand (i.e Barbie yoga mats)
- Acquire a company in the same industry and expand Mattel portfolio

Threats

- Electronic games more attractive to younger audiences than traditional toys
- Recall of toys in 2007 negatively still affects Mattel's brand with consumers and licensees
- Foreign exchange fluctuation risk
- Political unrest, labour strike

APPENDIX 3: SWOT STRATEGIES MEGA BRANDS

Strengths

- Profitability and financial performance
- Strong brand awareness
  - Known-brands: MEGA BLOKS, MEGA PUZZLES, ROSE ART
- Strong relationships with companies to secure access to product series and liscencing pacts (Nickelodeon, Disney)
- Global manufacturing and sourcing

Weaknesses

- Losses due to product recalls (Magnetix)
- Volatile performance
- Mostly concentrated in Canada and North America.
- Low market share in international markets
- Company has faced lawsuits from players such as LEGO in the past.

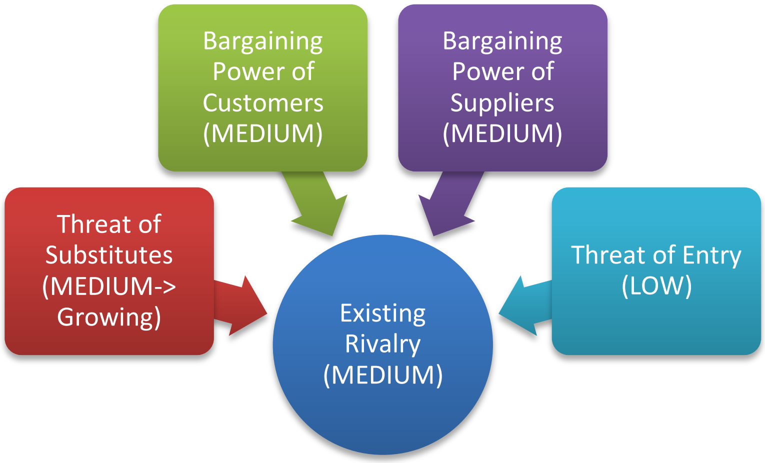
Opportunities

- Movement from physical toys to virtual toys
- Innovative and efficient design processes would allow companies to capitalize on changing consumer preferences
- Rights to manufacture and sell brand titles beyond the children's core market
- International operations allow for further global expansion

Threats

- Strong competition with dominance by large players
- Strict rules and regulations
- Retailers have significant influence in terms of delivery times and shelf space
- Industry is seasonal and also dependent on economic activity
- Stagnant industry growth
- Industry participants heavily reliant on export activity.
- Global operations creates additional risks due to currency fluctuations, political unrest, labour disputes
- Knockoff brands and counterfeit goods can reduce profitability

APPENDIX 4: FIVE FORCES ANALYSIS



BARGAINING POWER OF SUPPLIERS (MEDIUM)

Industry

- Mattel's raw materials consist of plastic, resins, metals, alloys and fabric. (Hoover's Online) In general, due to its strong global brand presence the biggest toy manufacturers such as Mattel, Hasbro and Lego have a huge bargaining power over their suppliers
- Most toy companies have their own manufacturing facilities where labour is outsourced from low cost labour countries such as China
- Toy companies establish licensing relationships with media companies that allow them to produce toys for their brands. Given that licensing creates a significant share of their revenue, licensors have a strong power over its suppliers as suppliers of licensing rights for their valuable brands.

Mattel's Position

- There exists a real threat of shortages in inputs such as that experienced by Mattel in the past (Mattel, Inc., 2013) Further, Hasbro has cited ongoing risks in their annual report due to the volatility in prices of raw materials reinforcing the risk manufacturers in this industry faced with fluctuating raw material and component prices.
- Mattel owns facilities for manufacturing in Asia-Pacific and Mexico where both wages and production costs are low. (Hoover's Online)

- Mattel's largest licensing relationship is with Disney. The lion's share of $262 Million USD that Mattel spent in 2011 on license acquisitions is attributed to Disney. (Euromonitor International, 2013) While Mattel's status as the largest traditional toy manufacturer in the world provides them with a good bargaining position against Disney, this dependence is a risk for Mattel as any future difficulties in renewing such license could have a material effect on Mattel's revenues. (Euromonitor International, 2013)
- Significant increases in the price of commodities, transportation, or labor, if not offset by declines in other input costs, or a reduction of costs of the delivery of raw materials, components and finished products from Mattel's vendors could negatively impact Mattel's financial results. (Mattel, Inc., 2013)
- Any material failure, inadequacy, or interruption resulting from third party vendors or outsourcings could harm Mattel's ability to effectively operate its business. (Mattel, Inc., 2013)
- While prices have increased for raw materials and labour in Asia in the period post 2009, Mattel has countered successfully by raising their own prices and improving gross margin in the process. (Townsend, 2012) This indicates that while there is the risk of volatility of inputs with regards to cost, price elasticity of demand is relatively low for Mattel's consumers.

BARGAINING POWER OF CUSTOMERS (MEDIUM)

Industry

Customers are comprised of:

- Traditional large, medium and small retailers - Walmart, Target, Toys-r-us, etc.
- Online retailers - Amazon
- Individual customers

- Individually, consumers have low power relative to the manufacturers in the industry however in aggregate, economic factors, trends, demographics can have a strong effect on the industry and thus drive up their bargaining power.
  - Global child population had been declining due to falling family sizes however this is expected to be a short-lived phenomenon as developing countries populations grow.

(Euromonitor International, 2011) This aspect of demographics is extremely important for Toy manufacturers given that "growth in the population of children aged 12 and younger drives demands for toys." (Hoover's Online)

- Consumer spending power largely influences industry's revenues and thus profits. In this respect, the general state of the economy, available disposable income and unemployment are all leading indicators of what direction the industry will head. (IBISWorld, 2013)
- Industry is highly seasonal with the peak occurring during the traditional holiday season (leading towards the end of the fourth quarter). This has an aggregating effect with regards to consumers influencing toy manufacturer's schedules, particularly around production and product releases.
- The larger retailers such as Walmart have been developing their own private-label toys that would take shelf space away from branded traditional toys as well as compete directly. (Mattel, Inc., 2013)

Mattel's Position

- There is a relatively low price elasticity of demand with respect to customers of Mattel
- Mattel has demonstrated they are to a certain extent, a price setter in this industry.
- The threat of Mattel's major retailer customers such as Walmart developing their own competitive private-label toys that would compete with Mattel's offerings has been cited as a risk by Mattel themselves in their annual report. (Mattel, Inc., 2013)
- Mattel enjoys high consumer loyalty through their strong brand equity position that would serve to mitigate this threat to a certain level.
- Mattel's business is highly seasonal and its operating results depend, in large part, on sales during the relatively brief traditional holiday season. (Mattel, Inc., 2013)

THREAT OF NEW ENTRANTS (LOW)

Industry

- Global manufacturers such as Mattel and Hasbro have economies of scale and economies of scope.
- Long-term licensing agreements for most lucrative film, sporting properties in place present barriers given that licensed toys account for a large percentage of the toy

industry's revenues. "In the US, for instance, licensed toys accounted for 26% of traditional toys and game sales in 2011." (Euromonitor International, 2013)

- Capitalization costs are high for competitors looking to compete globally.
- Establishing relationships with toy retailers and global distributors.
  - Global distribution networks
  - Relationships with toy retailers and shelf space.
- Barriers to entry for substitute industries are relatively low (Mobile device software, gaming content, etc.)

Mattel's Position

- Significant changes in currency exchange rates or the ability to transfer capital across borders could have a significant adverse effect on Mattel's business and results of operations. (Mattel, Inc., 2013)
  - Mattel operates facilities and sells products in numerous countries outside the United States. During 2012, Mattel's net sales to international customers comprised 46% of Mattel's total consolidated net sales. Management expects that sales to international customers will continue to account for a significant portion of Mattel's sales.

THREAT OF SUBSTITUTES (MEDIUM -> GROWING)

Industry

Examples of Substitutes:

- Apple iPad, Android Tablets, mobile smartphones
- PCs, Laptops with educational or targeted content/software for children
- Video game consoles and handheld gaming devices
- The threat of substitutes is growing thereby will have an impact on the traditional toy industry's profits in the longer term.
  - Quality of substitutes is increasing as platforms mature, developers become more adept at leveraging the capabilities of such platforms in developing higher quality and more compelling content. Device technology is improving at a rapid pace enabling new forms of interactivity and enhanced content.

  - Relatively low switching costs involving primarily the base platform or device and incremental costs for content for those platforms. Once a consumer has bought into a device platform, there are potentially powerful network effects that tie that consumer into the platform (such as with gaming consoles, a mobile device platform such as Android or iOS, etc.)

Mattel's Position

- Mattel's business is highly seasonal and its operating results depend, in large part, on sales during the relatively brief traditional holiday season.
- Inaccurately anticipating changes and trends in popular culture, media and movies, fashion, or technology can negatively affect Mattel's sales. (Mattel, Inc., 2013)
- Due to a high percentage of Mattel-branded products coming from licenses with Disney, other third-parties, threat of entry of new players poses a significant risk to Mattel losing these licensing agreements. (Mattel, Inc., 2013)
- Franchises and licensed product lines of the major manufacturers such as Mattel and Hasbro serve as strong counters to substitute threats as no direct substitutes (although they can be complements) can compete directly for such products that are in demand by consumers.
- The production and sale of private-label toys by Mattel's retail customers such as Walmart and Toys-R-US may result in lower purchases of Mattel-branded products by those retail customers. (Mattel, Inc., 2013)
  - In recent years, consumer goods companies, including those in the toy business, generally have experienced the phenomenon of retail customers developing their own private-label products that directly compete with the products of traditional manufacturers. Some retail chains that are customers of Mattel sell private-label toys designed, manufactured and branded by the retailers themselves. These toys may be sold at prices lower than comparable toys sold by Mattel and may result in lower purchases of Mattel-branded products by these retailers. In some cases, retailers who sell these private-label toys are larger than Mattel and may have substantially more resources than Mattel.

EXISTING COMPETITIVE RIVALRY (MEDIUM)

Industry

Major players:

- Mattel and Hasbro are the largest firms in the global toy manufacturing industry.
- Lego (privately held, limited financial information)
  - By some reports, Lego has recently become the number two manufacturer based on 2012 revenues. (Gottlieb, 2013)
- Namco Bandai, Tomy Co
- Collectively account for >85% of revenues in the industry

- The industry is highly competitive where firms jostle for securing licenses to produce toys for major film, television, comic and other marketable franchises.
- Firms are also under pressure to develop new in-house franchises in addition to securing long-term license agreements.
- The three largest firms, Mattel, Hasbro and Lego are essentially an oligopoly with enough power and brand recognition to keep prices high enough to generate attractive margins.

Mattel's Position

- Mattel accounts for ~30% of revenues, the largest single player
  - Established economies of scale with ownership of factories in China and Mexico.
- Mattel's largest brands are well-known globally:
  - Barbie, Hot Wheels, Disney-licensed brands, including Toy Story, Cars, Fisher-Price to target young children
- High levels of competition make it difficult to achieve, maintain, or build upon the success of Mattel's brands, products, and product lines. (Mattel, Inc., 2013)
  - "Mattel faces competitors who are also constantly monitoring and attempting to anticipate consumer tastes, seeking ideas which will appeal to consumers and introducing new products that compete with Mattel's products. In addition, competition for access to entertainment properties could lessen Mattel's ability to secure, maintain, and renew popular licenses to entertainment products developed by other parties and

licensed to Mattel or require Mattel to pay licensors higher royalties and higher minimum guaranteed payments in order to obtain or retain these licenses.

  - In 2012, Mattel's three largest customers, Walmart, Toys "R" Us, and Target, accounted for approximately 37% of net sales, and its ten largest customers, in the aggregate, accounted for approximately 47% of net sales. (Mattel, Inc., 2013)
    - Liquidity problems or bankruptcy of Mattel's key customers could have a significant adverse effect on Mattel's business, financial condition and results of operations.
- Mattel's ability to meet customer demand depends, in part, on its ability to obtain timely and adequate delivery of materials, parts and components from its suppliers and internal manufacturing capacity.
  - 85% of industry revenues attributed to five firms.
    - Oligopoly structure - higher industry profitability amongst larger firms.
  - Industry structure changing due to primarily to high threat from substitutes
    - Lower profitability in the longer term implies the industry may decline over the long-term.
      - Even though there is strong revenue growth opportunities in emerging markets, these have lower profitability due to the lower price points expected in such markets.

Firms in the industry will need strategies that will position them accordingly, in order to protect against this growing threat.

APPENDIX 5: PESTLE ANALYSIS OF THE TOY INDUSTRY

Economic	• Emerging markets economic development and the emergent middle class could drive industry growth in the next few years: Eastern Europe and Latin America were the fastest growing regions globally in traditional toys and games in 2011, both recording a double-digit value growth. Asia Pacific is expected to become the biggest traditional toy market over the next years (Euromonitor, 2013) • The Construction category outperformed overall traditional toys and games by a large margin globally with and annual growth rate of 15% in 2012 up from 14% the year before. All markets saw an increase in sales, attributable to LEGO who has a dominant position in this category, accounting for more than 62% of global value sales in 2012 (Euromonitor, 2013) • Even though China continues to be the most important source of toys, the country is losing the competitive advantage as operating conditions for factories remain challenging, with quadrupling blue-collar wages, a shrinking labor market, and rising raw material costs. This trend may force toys makers to look for different sourcing alternatives over the next few years (Toy Industry Association, 2013)
Socio/Cultural	• While electronic toys continue to growth in popularity, the amount of time children spend playing on these devices has become a primary concern for parents around the world. In addition, parents with less recreational time increasingly prefer toys that their children can safely play by themselves. (IBIS World, 2013). As a result, Construction toys have become popular among parents seeking to limit the amount of time their children spend using iPads and other electronics with screens. Parents are increasingly looking for products that can stimulate a child's imagination and creativity (Euromonitor, 2013) • Children's television viewing habits and the popularity of forthcoming children's films will continue to strongly influence children´s preferences and therefore industry dynamics. Viewership of global television channels, such as Nickelodeon and Cartoon Network, is spreading in emerging markets, supporting the brands tied up with children's programmes. (Euromonitor, 2011) • Age Compression Phenomenon: Increasing children´s preferences for smartphones and video games after the age of 10 can threaten traditional toys makers that may find it difficult to retain this audience. (Euromonitor, 2011) • Socializing and wanting to interact with others is a dominant factor in the way older kids (>10) are playing. This trend is an opportunity for toy makers to retain the tween/teen market through new product development involving socializing elements. (Toy Fair Times, 2013) • Fathers are doing more of the family shopping as the number of two-income

	households and those in which the woman works and the man stays at home continues to grow (In the U.S. one-fifth of fathers with preschool-age children and working wives said they were the primary caretaker in 2010). This trend is expected to drive sales in categories like construction toys that appeal more to dads. (Clifford, 2012)
Technology Trends	• New inexpensive technologies and emerging tablet toys and games on Apple and Android devices continue to be released, and their offerings are varied. It is expected that these technologies will continue to cut into traditional toys sales. NPD's list of the top toys of 2012 shows that Leap Enterprises' children's tablets are among four of the year's 10 biggest sellers, including positions 1, 2 and 4 (Goldberg, 2013). According to IBIS World electronic toys will make up the largest product segment for toy, game and doll manufacturers, accounting for an estimated 32.9% of industry revenue in 2013. (IBIS World, 2013) • Increasing penetration of electronics, incorporation of digital elements into traditional toys (i.e. plush toys) and growing demand for intelligent and interactive toys is expected to increase over the next few years. This trend can push non-toys companies (like Microsoft and Intel) to add their offerings to the market. (Reportlinker, 2013) • Toys and Games Cross-overs: Emerging trends towards cross-industry collaboration between traditional toys, video games and electronics are expected to increase. Hasbro and LEGO have moved from traditional toys and games into video games via collaborations with Electronic Arts and Traveller's Tales, respectively. (Euromonitor, 2011)
Legal	• Import Regulations: taking into consideration that approximately three quarters of the world´s toys are made in China, any import restrictions from China on the grounds of toy quality or safety may negatively impact expansion plans in emerging markets of toys companies that produce their products in this country. (Euromonitor, 2011) • Licenses Risk: There is a trend towards globalisation of licences; for instance, the top 10 licensors in 2011 are set to account for 80% of licensed toys in Western Europe. This trend is increasing licensors' power, giving them the ability to dominate licensing agreement conditions. In addition, some powerful licensors (i.e. Walt Disney) are moving into operating its own stores putting toy makers at risk of losing key licenses. (Euromonitor, 2011) • Increased product safety regulations are expected to emerge as a consequence of the high level of outsourcing and offshoring (relocation of a company's business process from one country to another). This trend could put increased pressure on toys manufacturers as regulations differ enough

	to result in complex and costly compliance and testing to better control quality and safety standards (IBIS World, 2013)
Environmental	• Environmentally friendly and hazard-free features are expected to become some of the main selling points of traditional toys and games over the next years. As a consequence, green, eco-friendly toys are increasingly emerging. For example, at the New York Toy Fair in 2013 and in South America´s biggest toys event, environmentally friendly dolls as well as games promoting green practices like recycling were strongly promoted. (Fontenelle, 2013) • Demands for greater environmental sustainability of products are increasing, not only from legislators and NGOs, but also from retailers. Increasing green initiatives like the “ Extended Producer Responsibility in the U.S. (requirements for manufacturers of specified consumer products to either accept back products at the end of their useful life or to subscribe to a collective arrangement to do so) continue to emerge around the world. (Toy Industry Association, Inc., 2012)

APPENDIX 6: COMPARABLE COMPANY ANALYSIS

Company	EV/EBITDA	Market Cap / Earnings	Market Cap / Book value	Market Cap to Sales
Mattell	12.25	19.33	4.96	2.10
Hasbro	12.17	22.40	4.24	1.75
Leap Frog	6.88	6.67	1.29	0.99
Average	10.43	16.13	3.50	1.61

*Jakks Pacific was considered as a comparable, however, the company has negative earnings and is significantly smaller than Mega Brands and therefore excluded. Leap Frog was still included although it is a small cap compared to the other competitors. This is because Mega Brands is a mid cap while Mattell and Hasbro are considered large caps. Many toy companies such as LEGO and Crayola are private thus no information is available.

MEGA Brands		
Adjusted EBITDA	$	47.00
EV/EBITDA Average		10.43
Total Enterprise Value	$	490.37
(-) Fair Value of Debt	$	64.19
(-) Minority Interest	$	-
(+) Cash & Cash Equivalents	$	16.42
Estimated Market Cap	$	442.60
Shares Outstanding		27,186,768
Price per Share	**$**	**16.28**
Diluted Earnings per Share	$	0.93
Average Market Cap to Earnings		16.13
Price per Share	**$**	**15.00**
Book Value	$	173,611,000
Book Value per Share	$	6.39
Average Market Cap to Book Value		3.50
Price per Share	**$**	**22.33**
Sales	$	404.74
Sales per Share	$	14.89
Average Market Cap to Sales		1.61
Price per Share	**$**	**24.02**

**Comparable ratios were obtained from Bloomberg while the MEGA Brands company specific information was obtained from the company's 2013 Annual Report.*

The comparable company analysis provided a wide range of prices for MEGA Brands between US$15.00 and US$24.02 with an average of US$19.41. This translates to a Canadian dollar equivalent range of C$15.51 to $24.84 with an average of C$20.07.

APPENDIX 7: DISCOUNTED CASH FLOW METHOD

Mega Brands ($MM)	31/12/2009	31/12/2010	31/12/2011	31/12/2012	31/12/2013	31/12/2014	31/12/2015	31/12/2016	31/12/2017	31/12/2018
Net Sales	$ 338.90	$ 368.00	$ 376.80	$ 420.27	$ 404.74	$ 445.21	$ 480.83	$ 509.68	$ 530.07	$ 540.67
Cost of Sales	219.10	222.70	235.60	262.45	255.70	278.99	301.31	319.38	332.16	338.80
Gross Profit	$ 119.80	$ 145.30	$ 141.20	$ 157.82	$ 149.04	$ 166.23	$ 179.52	$ 190.29	$ 197.91	$ 201.86
Marketing & Advertising	14.20	19.40	17.00	16.94	18.23	20.04	21.64	22.94	23.86	24.34
Research & Development	11.40	12.30	14.50	16.22	15.39	16.22	17.52	18.57	19.31	19.70
Selling, Distribution, & Admin. Expense	88.00	95.40	82.50	87.83	84.06	102.80	111.03	117.69	122.39	124.84
Other	- 55.80	0.30	2.40	0.96	- 1.46	-	-	-	-	-
Operating Income	$ 62.00	$ 17.90	$ 24.80	$ 35.88	$ 32.82	$ 27.16	$ 29.34	$ 31.10	$ 32.34	$ 32.99
Interest Expense	43.90	25.80	18.70	17.65	10.77	5.02	5.02	5.02	5.02	5.02
Other Expense (Income)	7.70	- 144.30	3.00	-	2.87	-	-	-	-	-
Income Before Taxes	$ 10.40	$ 136.40	$ 3.10	$ 18.23	$ 19.18	$ 22.15	$ 24.32	$ 26.08	$ 27.32	$ 27.97
Income Tax Expense (Recovery)	- 0.30	5.50	- 5.20	1.64	- 1.59	5.92	6.50	6.97	7.31	7.48
Net Income	$ 10.70	$ 130.90	$ 8.30	$ 16.59	$ 20.77	$ 16.22	$ 17.82	$ 19.11	$ 20.02	$ 20.49
Depreciation	17.61	11.41	13.50	12.90	13.81	13.40	13.40	13.40	13.40	13.40
Changes in Working Capital	- 0.73	14.70	24.01	- 14.41	7.71	-	-	-	-	-
Capital Expenditures	7.10	9.98	23.25	19.23	20.23	20.90	20.90	20.90	20.90	20.90
Operating Income	62.00	17.90	24.80	35.88	32.82	27.16	29.34	31.10	32.34	32.99
(-) Taxes	0.30	- 5.50	5.20	- 1.64	1.59	- 5.92	- 6.50	- 6.97	- 7.31	- 7.48
(+) Depreciation	17.61	11.41	13.50	12.90	13.81	13.40	13.40	13.40	13.40	13.40
(-) Increase in Working Capital	0.73	- 14.70	- 24.01	14.41	- 7.71	-	-	-	-	-
(-) Capital Expenditures	- 7.10	- 9.98	- 23.25	- 19.23	- 20.23	- 20.90	- 20.90	- 20.90	- 20.90	- 20.90
Free Cash Flow	**$ 73.55**	**-$ 0.87**	**-$ 3.76**	**$ 42.30**	**$ 20.28**	**$ 13.74**	**$ 15.33**	**$ 16.62**	**$ 17.53**	**$ 18.01**
WACC	5.44%									
Tax Rate	26.74%									
Present Value						**13.03**	**13.79**	**14.17**	**14.18**	**13.81**
Terminal Value										
Growth Rate	2%									
Terminal Value as of 31/12/2018	$ 533.16									
PV as of 31/12/2013	$ 408.95									
Total Enterprise Value	**$ 477.93**									
(-) Fair Value of Debt	$ 64.19									
(-) Minority Interest	0									
(+) Cash & Cash Equivalents	16.417									
Estimated Market Cap ($MM)	**$ 430.17**									
Shares Outstanding	**27,186,768**									
Price per Share	**$ 15.82**									

Revenue Growth Rate		8.6%	2.4%	11.5%	-3.7%	10%	8%	6%	4%	2%
Margin (as % of Revenue)										
Cost of Sales	64.7%	60.5%	62.5%	62.4%	63.2%	62.7%	62.7%	62.7%	62.7%	62.7%
Marketing & Advertising	4.2%	5.3%	4.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%
Research & Development	3.4%	3.3%	3.8%	3.9%	3.8%	3.6%	3.6%	3.6%	3.6%	3.6%
Selling, Distribution, & Admin. Expense	26.0%	25.9%	21.9%	20.9%	20.8%	23.1%	23.1%	23.1%	23.1%	23.1%

The price per share based on the discounted cash flow method is US$15.82 or C$16.36

Assumptions:

- Interest expense was assumed to be constant based on current rates and current debt outstanding. Thus, the company is expected to take on debt as debt is retired at current rates.
- Taxes are based on the company's current tax rate. No Tax recovery is assumed.
- Depreciation and Capital Expenditures were based on 3 year averages since these values were very consistent.
- Given the swings in net working capital changes, this value was assumed to be zero.
- Costs as a % of revenue were based on 5 year averages.
- Revenue growth rate of 10% is assumed, which will decline 2% per year to reach a terminal growth rate of 2%.
- Once the value is determined in US$, it is converted to C$ using a 5 year average exchange rate of 0.967CADUSD.

APPENDIX 8: MEGA BRANDS WACC

Cost of Equity - Capital Asset Pricing Model		
Risk Free Rate	2.865%	10 year Government of Canada Bonds
Beta	0.701	Obtained from Bloomberg. Beta less than 1 indicates company is less volatile
Market Return	6.87%	10 year average return of the S&P/TSX Index
Cost of Equity	**5.67%**	

Settlement Date	31/12/2013
Maturity	30/03/2015
Price	$ 105.39
Coupon	10%
Frequency	2
Yield / Cost of Debt	**5.45%**
Tax Rate	26.74%
After Tax Cost of Debt	**3.99%**

Company conducted a private placement of secured debentures in 2010. Based on the company's recent partial redemption of the bond, a price of $105.39 is estimated and used to calculated the current yield. Given that these bonds are private, no market value of debt is currently available and no fair value is disclosed.

Fair Value of Debt	$ 64.19	Company redeemed $53.8 million in principal amount of debentures and recorded a $2.9 million charge. This amounts to a 5% premium added to the face value of $61.13 million.
Fair Value of Equity	$ 413.51	Based on 2013 year ending share price of $15.21 and fully diluted shares of 27,186,768
Total	**$ 477.70**	
Percent of Debt	13%	
Percent of Equity	87%	
Total	**100%**	

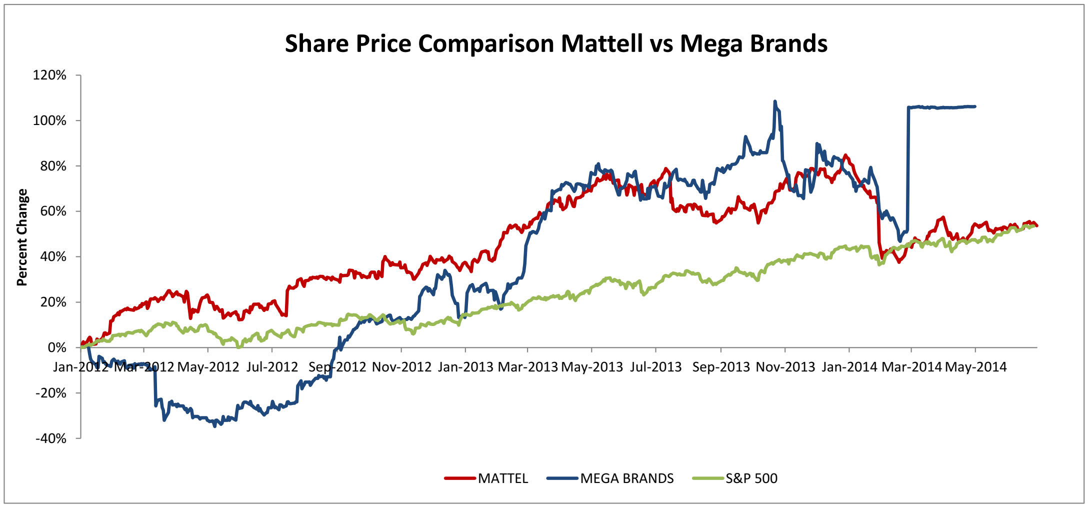
Weighted Average Cost of Capital = 5.44%

APPENDIX 9: POTENTIAL VALUE OF SYNERGIES

Stand-Alone Market Cap	**$ 430.17**
Increased revenue as a result of access to new markets and distribution channels	$ 59.26
Lower Marketing & Advertising by 1% each year for the next 5 years.	$ 21.92
Lower Selling, Distribution, & Admin. Expenses by 1% each year for the next 5 years.	$ 112.46
Synergies	**$ 193.64**
Total Value	**$ 623.81**
Value per Share	**$ 22.95**

Values in US$ millions. The value per share in Canadian dollars is C$23.73

APPENDIX 10: STOCK PERFORMANCE



(Yahoo Finance, 2014)

Toy companies have come under pressure over the last year and Mattel has lagged. The acquisition of MEGA Brands brings a new market and opportunities of scale to the company.

(MSN Money, 2014)

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