



Merrell Brothers, LLC Research Note on Mattel, Inc. (NYSE: MAT)

Sum Zero Buffett Challenge

[www.merrellinvestments.com](http://www.merrellinvestments.com)

Investment Managers Brennan Merrell & Ryan Merrell

April 7, 2015

## **Mattel, Inc. (NYSE: MAT): Berkshire and Mattel Could Make Perfect Playmates**

### **Investment Thesis:**

The Merrell Brothers investment management team believes Warren E. Buffett should consider adding toy maker Mattel, Inc. into the fold of Berkshire Hathaway Inc. We believe Mattel makes an excellent acquisition target for Berkshire Hathaway because of Mattel's iconic, decades old, wide moat brands, deep discounted price from peak earnings (FY 2013), worldwide distribution platform, strong market share in the toy market, and high economic margins. The Merrell Brothers believes the underlying value of Mattel is worth at least \$36 dollars a share. We generated an estimated price per share by taking a 14 multiple times Mattel's peak FY 2013 earnings of \$2.58. Earnings during FY 2014 have been slashed to \$1.45 due to a 7.1% decrease in revenue and gross margins, compressed operating margins, inventory issues, acquisition integration costs, and a senior management shakeup. The Merrell Brothers team believes Mattel will be able to reverse the one year speed bump and start growing its earnings during the near future. While children today have become more engaged with electronic devices, we believe the Mattel's iconic brands still resonate with kids today and in the future. During the past year, Mattel generated impressive revenues of \$6.023 billion. Mattel's competitors Hasbro and Lego are firing on all cylinders even with the threat of electronic devices and we believe Mattel can join the success of its competitors.

The newly appointed permanent CEO, Christopher Sinclair, is familiar with Mattel as he has been board member since 1996 and served as interim CEO from January of 2015. During the past, Sinclair has successfully turned around a handful of companies and lead PepsiCo's international division to significant growth. We believe the new management team can make the entire company more efficient by cutting costs, creating new products, and growing its brands. We believe all of Mattel's brands can be refreshed and reinvigorated back into growth mode with Mr. Sinclair at the helm. At current price levels, the Merrell Brothers believe Mattel could fit within the Berkshire Hathaway Inc family. As avid Berkshire Hathaway shareholders, we would enjoy seeing it added to the Buffett portfolio.



It is estimated that Mattel controls approximately 17% of domestic and 14% of the international toy market. Mattel generates 46% of revenues outside of the United States and Canada. Mattel's core portfolio brands include Barbie, Fisher Price, American Girl, Monster High, Hot Wheels, Thomas & Friends, and MEGA BLOKS. During FY 2014, Mattel earned gross margins of 49.8% and operating margins of 10.9%. However, these impressive margins have taken a breather from the prior year. During FY 2013, Mattel earned gross margins of 53.6% and operating margins of 18.0%. We believe Mattel's refreshed leadership team can significantly improve their margins. Some of the margin compression was the result of the integration of the MEGA Brands acquisition for \$460 million during 2014. Mattel generates significant free cash flow (FCF) of \$1.84 per share during FY 2014. Shares are currently trading at 13.0 times their FY 2014 FCF. During the past ten years, Mattel has generated aggregate FCF of \$15.31 a share (\$5.54 billion) and paid \$9.38 in dividends per share.

The Merrell Brothers believes that Mattel is significantly undervalued and shares could be acquired at the current levels of \$24.00 per share. We believe Mattel meets most of Buffett's key investing requirements and the current valuation represents a long term buy.

### **Mattel, Inc. An Acquisition for Berkshire Hathaway Inc.**

Page 23 of Berkshire Hathaway's 2014 Annual Report describes Warren Buffett's acquisition criteria, which are the following:

- (1) Large purchases (at least \$75 million of pre-tax earnings unless the business will fit into one of our existing units),
- (2) Demonstrated consistent earning power (future projections are of no interest to us, nor are "turnaround" situations),
- (3) Businesses earning good returns on equity while employing little or no debt,
- (4) Management in place (we can't supply it),
- (5) Simple businesses (if there's lots of technology, we won't understand it),
- (6) An offering price (we don't want to waste our time or that of the seller by talking, even preliminarily, about a transaction when price is unknown).

The larger the company, the greater will be our interest: We would like to make an acquisition in the \$5-20 billion range.

Source: Berkshire Hathaway 2014 annual report, page 23

**(1) Large Purchases:** With over \$60 billion in cash and cash equivalents (4Q, 2014) the Berkshire elephant gun is loaded and Warren Buffett would like a deal for Berkshire Hathaway in the range of \$5-20 billion that earns at least \$75 million in pre-tax earnings. Mattel is currently trading at \$8.1 billion and earned pre-tax \$587 million during 2014. At current levels and even with a premium of up to 30 to 50% a buyout of Mattel, Inc. would fit well within Mr. Buffett's criteria for a preference of large deals and buying the entire business. Alternatively, Buffett could invest up to \$1.2 billion into Mattel below \$30 a share by buying up to a third of the 6,000,000 average shares traded within a few months, which would translate into Berkshire



owning approximately 15% of Mattel shares through the open market. Mattel affords Berkshire an opportunity to put a significant amount of capital to work.

**(2) Demonstrated Consistent Earnings Power:** Mr. Buffett seeks companies that are stable and have the ability to grow earnings. While Mattel has experienced a road bump during the past year, the company has demonstrated the ability to expand earnings during the past ten years. During the ten year period, revenues increased from \$5.17 billion to \$6.024 billion and peaked out at \$6.5 billion during FY 2013. Net income has increased from \$417 million to \$499 million during the past decade and peaked at \$904 million during FY 2013. Mattel has nearly doubled its free cash flow over the past ten years, growing from \$330 million to \$628 million and it peaked out at \$1,057 million during FY 2012. During FY 2014, Mattel earned impressive gross margins of 49.8% and operating margins of 10.9%. During FY 2013, Mattel earned gross margins of 53.6% and operating margins of 18.0%. We believe Mattel would meet Mr. Buffett's requirement of demonstrated consistent earnings power.

**(3) The Company Must Earn Good Returns On Equity With Little Debt:** During the past decade, Mattel has generated average Returns On Equity ("ROE") of 23.8%. Currently, Mattel has \$1.1 billion in net debt (\$0.9 billion in cash vs. \$2.1 billion long term debt). Mattel is not significantly levered. Mattel's book value is \$2.94 billion and has total assets of \$6.72 billion. The debt was used to fund the acquisitions of MEGA Brands and HIT Entertainment, for \$460 million and \$680 million. During the past decade, Mattel has increased its book value per share by nearly 70% from \$5.20 to \$8.72. Even with the current speed bump, Mattel's current ROE is still a respectable 16%.

**(4) Capable Management Team:** Berkshire is primarily looking for an established management team to lead a subsidiary business. On April 2, 2015, Mattel named Christopher Sinclair the permanent CEO. Christopher is familiar with Mattel as he is the Chairman of the Board and been board member since 1996. He has served as interim CEO since January of 2015, when previous CEO, Bryan Stockton stepped down. Mr. Sinclair has vast senior management experience including successfully turning around a handful of companies and lead PepsiCo's international division to significant growth. Additionally, Richard Dickson, 47, was promoted to Chief Operating Officer from Chief Brands Officer. Previously, Mr. Dickson worked at Mattel for a decade where he was in charge of Barbie including product lines, marketing, and packaging. During his time with Mattel, Dickson is credited with turning around Barbie during the 2000's. Dickson left Mattel for a small stint with apparel manufacture the Jones Group and rejoined Mattel during 2014. Finally, Tim Kilpin was named head of Mattel's international division last year. Tim has worked for Mattel since 1984 and had brief career stop at Walt Disney before returning to Mattel. Mr. Kilpin is one of reasons Mattel has produced significant growth overseas. We believe that either Mr. Dickson or Mr. Kilpin could provide Mattel with a deep management bench in future years. "Lose money for the firm, and I will be understanding; lose a shred of reputation for the firm, and I will be ruthless" (Warren Buffett 1991 Salomon Testimony). Though Mattel is transitioning with new management, Mattel does have a company



culture that we believe Mr. Buffett would admire because Mattel has consistently been named to CR’s 100 Best Corporate Citizens and one of the World’s Most Ethical Companies by Ethisphere.com. While Mattel just replaced its CEO, the Merrell Brothers believes the newly named senior management team is capable of increasing revenues, margins, expanding brands, and creating new product lines and we don’t believe Berkshire will have to supply the management, but if need be, Warren Buffett does have his own toy business management bench since Berkshire Hathaway has acquired two toy companies: Garan, Incorporated and Oriental Trading Company (more on these below).

**(5) Simple Businesses That Are Easy To Understand:** The Merrell Brothers Investment Management team believes Mattel is a business that is easy to grasp. Mattel is a leader in the creation, design, manufacturing, and marketing of toys and children’s entertainment. Mattel is the largest toy manufacture in the world and controls an estimated 17% of the total domestic toy market and their world market share is around 14%. Mattel generates half of revenues outside of the United States and Canada. Their core portfolio brands include Barbie, Fisher Price, American Girl, Monster High, Hot Wheels, Thomas & Friends, and MEGA BLOKS. We believe these brands have the ability to be relevant to kids for decades to come. American Girl has achieved fantastic growth and the other brands are a cash cow. Newly launched Boomco is gaining popularity with several positive articles and reviews including 4.7 out of 5.0 rating on Amazon with 255 reviews. Boomco is Mattel’s first attempt to unseat Hasbro’s Nerf, which controls around 75% of the \$500 million blaster market. We believe all of these brands have the ability to rule the toy market for decades to come and even offers mindshare for the parents buying the toys for their kids. Traditionally, Mattel has produced several “must buy” holiday toys every year.

## MATTEL DIFFERENTIATORS DIVERSIFIED BRAND PORTFOLIO



©2014 Mattel, Inc. All Rights Reserved. / All other product names and associated designs mentioned or shown in this presentation are trademarks and copyrighted properties of their respective owners.

17

Source: Mattel 2014 Toy Fair Analyst Meeting, chart excludes MEGA Brands



**(6) A Reasonable Priced Company:** Berkshire Hathaway prefers to buy investments at a reasonable valuation. We believe Mattel could be acquired up to \$36 dollars per share which would represent a near 14 multiple of peak FY 2013 earnings of \$2.58. Mattel is trading at a five year low because of a slowdown in sales, operating margin compression, loss of the Disney Princess contract in 2016, and a senior leadership shakeup. Additionally, Mattel has been battling electronic toys and tablets for kids playing time. The past year has been challenging for Mattel. However, competitors Hasbro and Lego are firing on all cylinders. Hasbro is currently trading at an all time high because of record earnings and revenues. Hasbro owns the property and toy rights to Transforms and GI Joe. Both brands have been successful made into a hit movie, which undoubtedly increased demand for their Transformers and GI Joe toys. We believe Mattel could transition their brands to the big screen like Hasbro. Based on peak net income during FY 2013, Mattel is trading at 9.3 times the net income of \$2.58. Based on the past twelve months of net income and free cash flow, Mattel is trading at a 16.57 and 13 multiple. We believe Mr. Market is offering Mattel at a significant discount to its intrinsic value.

#### **Other Reasons For Berkshire To Consider Mattel:**

##### **Berkshire Hathaway Toys**

The Merrell Brothers Investment Management team believes Berkshire Hathaway could merge Mattel with their wholly owned subsidiaries, Garan Incorporated and/or the Oriental Trading Company. Garan produces Garanimals for kids including toys, clothes, books, bedding, and footwear. Berkshire acquired Garn Inc. in 2002 for \$270.6 million. During 2012, Berkshire acquired the Oriental Trading Co., a U.S. direct retailer of party supplies, toy manufacturer, and craft supplies for about \$500 million. Although Mattel is much larger in size and scale, we believe Mattel could be a bolt on acquisition for Berkshire Hathaway because of Mattel's iconic brands, global distribution, and large market share. Although, we do not give much credence to synergies, we believe that Mattel's international distribution network could benefit both Garan and Oriental Trading.

##### **Mattel's Company Owned Properties Could Be Turned Into A Big Screen Success**

Successful motion picture franchises have been inspired from the pages of comic books and traditional toy lines. Successful Lego movies include Spiderman, Wolverine, X-Man, Avengers, Incredible Hulk, Transformers, Lego, and GI Joe. The strong movie demand has revitalized older brands and increased toy sales. Mattel could team up with a movie production company to create blockbuster movies. Potential movie material includes Mattel owned franchise He-Man, the Masters of the Universe, Hot Wheels, Monsters High, Barbie, Max Steel, MEGA Blok, and American Girl. Sony has expressed interested in creating a Masters of the Universe film in the near future.



### **MEGA Brands has a bright future with Mattel's distribution reach**

Mattel acquired MEGA BLOKS, MEGA Puzzles, Board Dudes, and Rose Art parent MEGA Brands for \$460 million during 2014. MEGA Brands gives Mattel a weapon to combat Lego in the construction toy category which is estimated to be a \$4 to \$5 billion dollar market. In addition, MEGA generates a portion from the arts and crafts category which generates \$2 billion a year industry wide. When the MEGA Brands deal was announced, MEGA generated \$405 million in revenue of which \$300 million came from the construction division, MEGA BLOKS. MEGA is a distant second with an estimated 10% market share behind its primary competitor, Lego which has an 85% market share. Prior to the deal, Mattel had less than 1% of the construction category. MEGA's other products are a synergetic fit for Mattel. MEGA Puzzles offers children a constructive learning experience. Rose art offers sidewalk art materials, markers, crayons, and Magic Fun Dough, which competes with Hasbro's Play Doh. At the time of the acquisition, Seventy percent (70%) of MEGA's revenue comes from US and Canada, whereas half of Mattel's revenue is generated in international markets. We believe Mattel will be able to successfully distribute MEGA's products to Mattel's international markets. Additionally, MEGA has license agreements with Caterpillar, John Deere, HALO, Skylanders, Call of Duty, Assassin's Creed, Power Rangers, Hello Kitty, SpongeBob Square Pants and others. Mattel might be able to leverage these license relationships with their other products.

### **Thomas & Friends, Bob the Builder, and Barney joined Mattel in 2012**

Mattel acquired HIT Entertainment, whose brands include Thomas & Friends, Bob the Builder, Angelina Ballerina, Fireman Sam, Pingu, Mike the Knight, and Barney during 2012 for \$680 million. Mattel bought HIT Entertainment from Apax Partners, which had acquired the company for \$890 million during 2005. Thomas & Friends contribute 80% of HIT's profits and they have a strong foothold in Latin America and Asia. Thomas & Friends have become the top selling preschool toy for boys in China. Thomas & Friends generates more than half of their revenue from licensing non toy products. Apax Partners retained the HIT Entertainment stake in the Sprout Network as Mattel didn't have a strategic fit for the network.

### **International growth a catalyst**

Mattel generates half of their sales from the overseas market. Europe, Latin America, and Asia regions represent long term growth drivers as we see an increase to the middle class, an estimated 400 million global births during the next five years, and increase spending per capital in emerging economies. We believe that Mattel will be able to increase sales from the positive demographics shifts during the next five years.



## **Challenges For Mattel:**

### **Disney Pulls Disney Princess Line From Mattel**

Disney announced during September 2014 that the 20 year Mattel and Disney Princess relationship will end during the spring of 2016. Mattel has been gaining traction with the Disney Princesses, especially from the strength of the hit Disney movie Frozen. Disney's Frozen debuted during November of 2013 and quickly became a top five grossing movies of all time. Frozen has become a bonanza for licensed products and children are snapping up anything "Frozen" at a high rate. During Mattel's past earnings calls, they singled out the success of their Frozen products. During 2013, Disney signed a lucrative licensing agreement with Hasbro for the Disney Marvel rights which includes \$170 million in guaranteed royalties of which \$50 million is due during 2014 and the agreement ends in 2020. We believe Hasbro has to make a similar payment to Disney when Hasbro takes over the Disney Princess line in 2016; including paying a significant chunk of guaranteed money and a high royalty to Disney, which likely will squeeze Hasbro's margins. We believe that Mattel could win back the Disney Princess line or other Disney owned property in the future. Disney will likely partner with either Mattel or Hasbro, the two main toy competitors because of their size, distribution, product knowledge, financial firepower, and marketing to make Disney products a success. Smaller toy companies do make dolls for Disney, but most are smaller edition and higher priced compared to the mass market Mattel Disney Princess line. Currently, Mattel will continue to produce the Disney Princess toys until the spring of 2016 so Mattel will have benefit from one more holiday shopping seasons with the Disney Princess line. The lure of Frozen brand could diminish by the time Hasbro starts selling the Disney Princess line in 2016. Mattel is still a partner with Disney and we believe they have a good working relationship. Mattel still has a license with Disney to produce products under the Disney Mickey Mouse Club House, Disney Jake & Never Land Pirates, Disney Pixar Cars, Disney Pixar Planes, and Disney Pixar Toy Story products. Mattel's Hot Wheels has a licensing deal with Disney's Marvel and they recently launched Star Wars characters. Finally, MEGA Brands also has license deal with Disney property. Since Mattel competes with Disney Princess with its other doll lines, the loss of selling a commoditized Disney product may free up talent to focus of Mattel's wholly owned doll brands, Barbie, Monster High, and American Girl. During the past three years, Mattel paid royalty payments of over \$240 million each year. The Merrell Brothers believes a significant chunk of the royalty is from the Disney Princess line.

### **Impact From The Loss Of Disney Princess**

The Disney Princess line will be a challenge for Mattel and will impact their numbers when they are forced to drop the line during the spring of 2016. Currently, Mattel does not quantify how much revenue the Disney Princess line generates. We believe the Disney Princess line contributes at most \$650 million of revenue per year. Mattel separated out Barbie, their number



one doll, as contributing \$1.0 billion in revenue for Mattel during 2014. On a prior conference call, Mattel stated their number two doll is the Monster High line, their number three doll is the Disney Princess offerings, and the fourth doll is American Girl which made \$620.7 million in revenue in 2014. Mattel includes the Disney Princess, Monster High, Ever After High, Little Mommy, and Polly Pockets in the “Other Girls” category in the 2014 Mattel 10K. The Other Girls category contributed \$1.3 billion in revenue during 2014. Mattel’s number four doll category, American Girl, made \$620.7 million in revenue and we know that the Monster High line holds the number two position behind the Disney Princess line, as the number three. We can deduce that the Disney Princess line made more than the \$620.7 million in revenue for the American Girl line, but less than \$650 million in 2014 revenue (\$1.3 billion Other Girls Revenue/2 to account for the number two line, Monster High). Since Monster High, as number two, is the biggest part of the Other Girls category we believe the category is monopolized by the Monster High and Disney Princess Line. Mattel’s margins are approximately 50%, which means Mattel may bring in \$325 million before accounting for their overhead and royalties for the Disney Princess line. Mattel’s operating margin last year was 10.9% which means Mattel could earn less than \$70.85 million in operating income from the Disney Princess line. We believe that Mattel has to pay a higher royalty to Disney for the right to sell the Disney Princess line and we wouldn’t be surprised to see Mattel’s Disney Princess ultimate earnings dropping below \$50 million. Mattel earned total operating income of \$654 million during 2014, so the hit to the bottom line for losing the Disney Princess line to Hasbro is approximately 10.8% to 7.6% at worst. We believe Mattel will be able to fill this minor void by focusing on their own wholly owned doll brands, with their other product offerings, and the MEGA Brands and HIT Entertainment acquisitions they completed in 2014 and 2012.

## **Conclusion**

The Merrell Brothers believes Mattel meets the criteria to become a Berkshire Hathaway company owned subsidiary. These include a significant purchase price, demonstrated consistent earnings power, good returns on equity with little debt, capable management team, simple businesses that are easy to understand, and all at a discount to intrinsic value. As Berkshire Hathaway shareholders, we would enjoy seeing Mattel added to the Buffett portfolio. Mattel is the largest toy manufacture with approximately 17% domestic and 14% international market share. They generate over \$6 billion in yearly revenues from their established brands including Barbie, Fisher Price, American Girl, Monster High, Hot Wheels, Thomas & Friends, and MEGA BLOKS. During FY 2014, Mattel earned impressive gross margins of 49.8% and operating margins of 10.9%. Mattel generates significant free cash flow (FCF) of \$1.84 per share during FY 2014. Shares are currently trading at 13 times their FY 2014 FCF. Management has historically been shareholder friendly. During the past ten years, Mattel has generated aggregate FCF of \$15.31 a share (\$5.54 billion) and paid \$9.38 in dividends per share. Furthermore, Mattel management has acquired 70 million shares or 17% of the shares outstanding over the past ten years.



## **About the Merrell Brothers, LLC**

The Merrell Brothers, LLC is a Jacksonville, FL based Independent Registered Investment Advisor that offers long-term investment management in securities. Our investment objective is to create a portfolio of undervalued securities that contain high quality companies for our clients that achieves meaningful long-term growth. The Merrell Brothers follows several of Warren Buffett, Charlie Munger (Buffett's right hand man), and Benjamin Graham's (the father of value investing) core investment principals. These potentially include finding investments that maintain a corporate moat or a durable competitive advantage, high return on equity ("ROE"), minimal or no debt, high cash and cash equivalent balances, low capital expenditures, and high free cash flows. We also like to invest in stocks that pay dividends that we will reinvest in new companies. Review our website at [www.merrellinvestments.com](http://www.merrellinvestments.com) or call the office at 904-222-8881 to gain more information about our firm.

## **Disclosures:**

This report was distributed to the Merrell Brothers, LLC investment management clients. This research note is not a solicitation for an investment or a recommendation for the securities listed above. You should understand the risks and objectives before investing and returns are not guaranteed. Past performance does not guarantee future returns.

## **Great articles on Mattel's products:**

<http://www.fastcodesign.com/3028240/mattels-3-year-quest-to-make-a-better-toy-guns>

<http://blog.caranddriver.com/hot-wheels-launching-line-of-star-wars-characters-as-cars-predictably-theyre-awesome/>