



Merrell Brothers, LLC Research Note on Mattel Inc

www.merrellinvestments.com

Investment Managers Brennan Merrell & Ryan Merrell

September 26, 2014

Mattel (NYSE: MAT): Stop toying around and pick up shares of Mattel at a discount

Mattel shares have been discounted to a two year low because of slowing growth, margin pressure, and their Disney (NYSE:DIS) Princess line will depart during the spring of 2016. However, we believe Mattel will prevail with their iconic brands, new acquisitions, strong margins, clean balance sheet, and capable management team. The Merrell Brothers Investment Management team believes investors buying shares today will be rewarded in the future and are paid a nice yield to wait for the market to appreciate this gem. We rate Mattel as a buy and anticipate this as a long term holding for over five years. Any price around \$30.81 (9/26/2014 closing price) is an excellent entry point and the stock pays a 4.93% yield.

A Princess is in your life for 20 years and BAM she leaves

Mattel has been gaining traction with the Disney Princesses, especially from the strength of the hit 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 last earnings call on July 17th, Mattel CEO Bryan Stockton indicated their Frozen products were a bright star during the quarter. Then, on September 24, 2014, Hasbro (NYSE:HAS) announced that they received the rights to the Disney Princess line, including Disney's Frozen, starting in the spring of 2016. 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. In reality 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. Mattel is still a partner with Disney and we believe they have a good



working relationship. Currently, Mattel will continue to produce the Disney Princess toys until the spring of 2016 so Mattel will have two 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 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 just launched Star Wars characters. Finally, MEGA Brands also has license deals with Disney property.

Impact from the loss of Disney Princess

The Disney Princess line is still a loss 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 \$1.2 billion in revenue for Mattel during 2013. On a prior 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 \$632.5 million in revenue in 2013. Mattel includes the Disney Princess, Monster High, Ever After High, Little Mommy, and Polly Pockets in the "Other Girls" category in the 2013 Mattel 10K. The Other Girls category contributed \$1.322 billion in revenue during 2013. Mattel's number four doll category, American Girl, made \$632.5 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 \$632.5 million in revenue for the American Girl line, but less than \$661 million in 2013 revenue ($\$1.322 \text{ billion Other Girls Revenue} / 2$ 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. We recognize that we are omitting the first half of 2014 earnings expansion for the Disney Princess line. However, we believe the Disney Princess revenue numbers are in the general ballpark of around \$650 million. 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 has averaged 15.88% over the past five years which means Mattel could earn less than \$103 million 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 \$80 million. Mattel earned \$904 million during 2013, so the hit to the bottom line for losing the Disney Princess line to Hasbro is approximately 11.3% to 8.8% at worst. We believe Mattel will be able to fill this minor void with their other product offerings and the MEGA Brands and HIT Entertainment acquisitions they completed in 2012 and 2013. However, we are sad to see the Disney Princess Line move on since Mattel has had them for nearly 20 years.



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 \$423 million, net of cash, during July 2013. 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. 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 the Tank, 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 \$713.5 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 the Tank Engine has 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.

Mattel owns numerous iconic brands

Mattel is the largest toy manufacture in the world and controls an estimated 17% of the total US toy market share and their world market share is around 14%. Their core portfolio brands include Barbie, Fisher Price, American Girl, Monster High, Hot Wheels, Thomas & Friends, and MEGA Brands. 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 144 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.

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

Mattel offers a solid dividend, share buyback, acquisitions, and margins

Mattel pays a dividend of \$1.52 per year which equals a solid 4.93% yield. We believe the dividend is safe as the management team has stated the dividend is one of many ways they intend to effectively deploy capital. During the past year, Mattel paid out \$503 million in dividends and earned net income of \$809 million or a 62% payout. Over the past ten years, Mattel has paid \$8.28 in dividends per share (earned \$16.77 earnings per share (EPS)) and \$5.18 per share during the past five years (earned \$10.29 EPS). Mattel has been an active acquirer of their stock by dropping the share count by nearly 20% from 423 million to 344 million over the past ten years. During the last quarter, Mattel acquired \$100 million worth of stock and we believe the buyback trend will continue as long as the shares are undervalued. Mattel has done a great job integrating acquisitions and the management team asks three important questions before acquiring a company: is it the right thing, at the right time, and at the right price. Mattel acquired MEGA Brands for \$423 million during 2014 and HIT Entertainment (Thomas & Friends, Bob the Builder, Angelina Ballerina, Fireman Sam, Pingu, Mike the Knight, and Barney) during 2012 for \$713.5 million. Mattel has great margins on their products, the ten year average gross margin is



48.9% and over the past five years the margin has averaged 51.5%. Operating Margins have been robust as well, averaging 14.1% over the past ten years and 15.9% over the past five years. Mattel's return on equity has averaged 24.61% over the past ten years and 26.92% during the past five years. Last quarter's margin was depressed due to the acquisition costs associated with the MEGA Brands acquisition, reduced leverage of fixed manufacturing costs, inventory cleanup, and a change in the sales mix. Mattel's goal is to achieve gross margins in the low to mid 50% range. The company did issue \$500 million in debt for MEGA deal and to buyback shares. During the past ten years, Mattel increased their EPS by 58%, revenues by 27%, and increased their dividend by 328%. We believe this trend will continue and the Merrell Brothers Investment Management team views Mattel has a solid core holding that pays a nice yield.

What about the tablet & smart phone revolution? Is that killing off traditional toys?

We do believe the technology revolution has been in full swing for over thirty years and competes against the toy market. Over the years, Kids have had the option to play a variety of video game consoles including Atari, Nintendo, Sega, Sony PlayStation , and Microsoft X-Box to name a few, however, the traditional toy market has grown significantly during that time. Children today do have the option of advanced video games, tablets, phablets, and smart phones, which can have an impact on the traditional toy market; however, we believe that these technologies should complement the traditional toy market. Mattel has made a push to sell their products online through their partners and company owned websites. In addition, Mattel has created content for the tablet & smart phone with many mobile applications, some of which can be view at Mattel's website (<http://www.mattel.com/mobile-apps>). Mattel offers content through TV shows, movies, games, and other avenues.

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.

Holiday season around the corner

We are entering the prime holiday shopping season and Mattel's products have appeared on several hot holiday toy lists and must have items for the 2014 holiday season. Mattel made two appearances on the Toys 'R' Us top 15 toys for 2014 and they include Fisher Price Imaginext 2 in 1 Supernova Battle Rover for \$119.99 and the Hot Wheels Street Hawk R/C Flying Car for \$56.99. Target's Hot Toys for the Holiday Season include five items from Mattel: Fisher Price Little People City Skyway Play Set for \$39.99, Monster High Sweet Screams Ghoulia Yelp and



Abbey Bominable dolls for \$19.99 each, Boomco Rapid Madness Blaster for \$39.99, Hot Wheels Super Loop Chase Race Track for \$44.99, and Barbie Fashion Design Maker Doll for \$49.99. Mattel made two of the hot 20 toys according to the Toy Insider. These two include Laugh and Learn Short Stages Chair and Ever After High Homecoming Dolls. Wal-Mart Kid-Approved 2014 Holiday Toy List reveals four Mattel's products on the top 20 list. We believe Mattel will do well during the 2014 holiday season.

Attractive valuation:

Currently trading at a 13.0 P/E (TTM) and a market capitalization of \$10.41 billion (9/26/2014 closing price), Mattel is inexpensive. Based on September 26th share price, shares have performed poorly over the past year with the one year share decline of 27.5% and the six month drop of 22.1%. As mentioned above, Mattel has earned impressive ROE, margins, revenue and EPS growth over the past ten years; we are comfortable with the breather Mattel has taken. Mattel's best year was the year that ended on December 2013, as they generated revenue of \$6.5 billion and earnings per share (EPS) of \$2.58. During the trailing past 12 months, Mattel earned revenue of \$6.33 billion and diluted EPS of \$2.33.

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.

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 doesn't 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/>