Hasbro Mattel Merger Could Produce Big Profits

Hasbro (HAS: $95/share) is not playing around. One of the largest companies in the toy industry is looking to acquire major competitor Mattel (MAT: $18/share) according to a report from *The Wall Street Journal*. Mattel reportedly rejected Hasbro's first offer, but we could still see more effort to make a deal happen.

This is not the first time Hasbro and Mattel have considered a combination. The two sides have failed to come to terms in the past, but conditions today make a deal more appealing than ever. The toy industry has been thrown into a state of uncertainty over the past few years for a number of reasons, including:

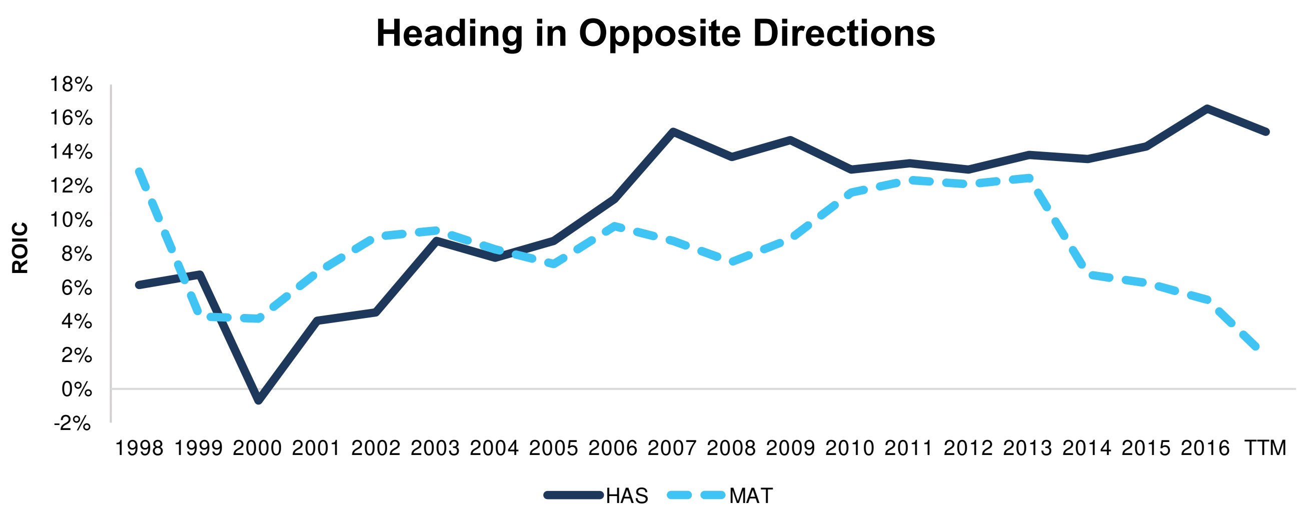
- The precipitous decline in revenue and profitability for Mattel
- Increased competition from a number of different sides
- Shifting trends among distribution partners

A Hasbro/Mattel merger could address some of these concerns and create significant profit growth opportunities through cross-licensing, increased bargaining power, and cost control. Hasbro already has a place on our Focus List of high-conviction long ideas, and a successful merger with Mattel could make it an even better buy – assuming the price does not go to high.

Good Time to Buy Low on Mattel

Historically, Hasbro and Mattel have gone toe-to-toe for the status as America's most profitable toymaker. As Figure 1 shows, this pattern shifted in 2014. Mattel's return on invested capital (ROIC) took a sharp fall and has continued its decline.

Figure 1: HAS vs. MAT ROIC Since 1998



Sources: New Constructs, LLC and company filings.

Over the past year, Hasbro also surpassed Mattel in terms of annual revenue. Key Mattel brands such as Barbie, Fisher-Price, and American Girl have experienced revenue declines ranging from 6% to 30%. At the same time, Hasbro continues to grow revenue in the mid-to-high single digits.

This divergence creates an opportunity for an acquisition at an attractive price point as Mattel's stock price (down 59% since 2014) has followed it's ROIC down. In the past, both Hasbro and Mattel have resisted acquisition offers at low ebbs in their profitability as they bet on cyclical trends lifting their performance. After three years of underperformance during an upswing for the industry, Mattel may no longer have the confidence in its ability to turn things around.

Potential Value Remains High

If Hasbro can acquire Mattel at a discount due to its current troubles and help regain its past profitability, this deal could create significant value. Any acquisition should be evaluated based on whether it can generate an ROIC above the acquirer's weighted average cost of capital (WACC), which stands at 5.5% for HAS. Figure 2 shows the price Hasbro could pay for Mattel and still create shareholder value for different profit (NOPAT) scenarios.

Figure 2: Implied Acquisition Prices for HAS to Achieve 5.5% ROIC

To Earn 5.5% ROIC On Acquisition		
NOPAT ($millions)	MAT's Implied Stock Price	Premium to Current Price
Current: $182	($1.03)	-106%
2014: $577	$19.88	9%
2013: $997	$42.10	131%

Sources: New Constructs, LLC and company filings.

At its current level of profitability, Mattel is not worth buying at any price. If Hasbro can increase Mattel's profits back to 2014 levels, it can afford to pay a slight premium for Mattel. Were sales to increase to Mattel's peak NOPAT from 2013, all of a sudden Hasbro could pay more than double the current share price and still create value for its shareholders.

Figure 2 shows that an acquisition of Mattel has its risks, but under the right circumstances it could pay off in a big way for Hasbro. The fact that Hasbro links executive compensation to ROIC gives us more confidence that the company will only go through with this deal if management believe it can enhance shareholder value by earning an ROIC above its WACC on the acquisition.

Competitors on All Sides

On top of the fundamental evaluation, there are a number of strategic concerns to consider with this deal. Hasbro and Mattel have both faced significant competition over the past several years from high tech gadgets as well as traditional competitors such as Lego.

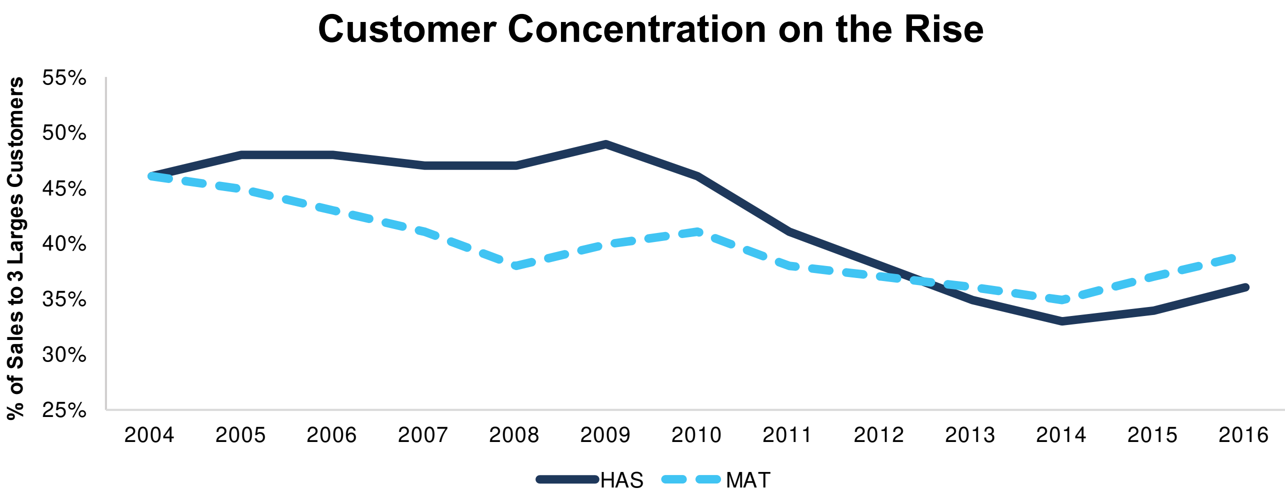
Both companies have invested in digital efforts to combat these challenges, with Mattel going so far as to hire Google (GOOGL) veteran Margo Georgiadis as CEO. Hasbro has focused more on the branding side, with Hasbro Studios creating TV shows and movies to drive product awareness.

An acquisition could allow both companies to combine their strengths and stave off high-tech competitors while taking market share from Lego, which looks vulnerable for the first time in years.

Combination Would Provide Leverage Over Distributors

Distribution channels have been another big problem for Hasbro and Mattel recently. After several years of reducing their dependence on the big 3 of Wal-Mart (WMT), Target (TGT), and Toys 'R' Us, both companies saw their customer concentration increase in the past few years.

Figure 3: HAS and MAT Percent of Sales to Top 3 Customers



Sources: New Constructs, LLC and company filings.

This increased concentration leads to a decline in bargaining power and more risk when a key distributor faces financial trouble, such as the recent bankruptcy of Toys 'R' US. A combined Hasbro and Mattel would have more leverage in negotiations for better prices, more shelf space, and more favorable repayment terms from Toys 'R' Us.

The combined company's scale and leverage could be valuable on the cost side as well. One of the triggers for Mattel's decline was its loss of the Disney Princess license in a bidding war with Hasbro in 2015. If the two companies aren't bidding against one another, they could presumably attain these licenses at a cheaper cost. We're bullish on Disney's (DIS) long-term prospects, so securing that partnership at a more reasonable cost creates value.

Growth Potential Is High

We mentioned the potential value for Hasbro if it can restore Mattel to previous profit levels. However, the potential synergies of this acquisition make the upside even higher. In many ways, the two companies have complementary strengths. Hasbro's valuable licenses could generate even more profits out of Mattel's iconic brands. Mattel's digital and internet-connected technologies could improve Hasbro's successful toys.

On the cost side, the two companies would have significant redundancies that could be eliminated to cut overhead. Mattel has already made cost-cutting a priority, and this deal could accelerate that process.

We don't normally love big acquisitions, but Mattel's cheap price, Hasbro's excellent corporate governance, strategic advantages, and significant potential synergies make this deal a potential winner.

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Disclosure: David Trainer and Sam McBride receive no compensation to write about any specific stock, style, or theme.

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