MATTEL AND THE LEARNING COMPANY: A CASE OF AN ACQUISITION IN TROUBLE

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ABSTRACT

At yearend 1998, Mattel announced the acquisition of The Learning Company, the second largest consumer software publisher (Reader Rabbit, the Princeton Review test preparation series, etc.). The purchase price was $3.5 billion for The Learning Company, and Mattel anticipated transforming itself from a traditional toy company to a global provider of products for children. A mere sixteen months later, the acquisition was deemed a failure. In September 2000, Mattel announced the sale of the Learning Company unit, for almost no cash and the right to a share of the unit's future earnings. Along the way, the Learning Company unit lost up to $1 million per day under Mattel's leadership. This case, appropriate for Financial Statement Analysis or a capstone course, gives background on the industry, the acquisition and subsequent developments, and asks students to consider accounting and valuation issues relevant to the decisions to purchase and subsequently sell the Learning Company.

DESCRIPTION OF COMPANIES AND INDUSTRIES

The Learning Company was formed in 1994. Through more than a dozen acquisitions, by 1998 it was a giant in educational software, with over 500 titles including the Reader Rabbit and Princeton Review series. Revenue in 1998 totaled $839 million, making the Learning Company the second largest manufacturer of software (after Microsoft) and the leader in educational software with over a 40% market share. So, the Learning Company was well positioned as a leader in the fast growing (sales of $1.8 billion in 1998) educational and entertainment software industry.

Mattel was likewise a giant in the $22 billion toy industry, with key product lines including Barbie, Tyco and Fisher Price. Most of Mattel's sales were in the mature end of the toy industry (overall, toy sales declined 2% in 1998, the first decline in history), with relatively little presence in the electronic toys segment. An added issue for Mattel was the company's dependence on retailers such as Toys R Us, with almost no direct-to-customer sales.

THE ACQUISITION OF LEARNING COMPANY BY MATTEL

In December 1998, Mattel entered into an acquisition agreement with the Learning Company, paying $3.5 billion for the smaller company. The acquisition was finalized in April 1999. Table 1, below, shows balance sheet information for both Mattel and the Learning Company as of December 1998, prior to the acquisition.

TABLE 1
BALANCE SHEET INFORMATION FOR MATTEL AND THE LEARNING COMPANY AS OF DECEMBER 31, 1998

(dollars in millions)		MATTEL	LEARNING CO.
Cash	$	212.5	256,8
Accounts receivable		983.0	167.0
Inventories		584.4	59.9
Other current assets		277.9	56.5
Fixed assets		736.5	54.8
Other long-term assets		1467.9	0.0
Intangibles		0.0	225.8
Total assets		**4262.2**	**820.8**
Current liabilities		1317.2	242.0
Long term debt		983.6	191.2
Other long term liabilities		141.2	101.4
Shareholders' equity		1820.2	286.2
Total liab. & equity	$	**4262.2**	**820.8**

Table 2, shown below, summarizes income statement information for Mattel for the year 1998, and quarter-by-quarter information for the Learning Company.

TABLE 2
INCOME STATEMENT INFORMATION FOR MATTEL AND THE LEARNING COMPANY
YEAR ENDED DECEMBER 31, 1998 AND QUARTERS FOR 1998 AND 1997

	MATTEL 1998	LEARN 12/98	LEARN 9/98	LEARN 6/98	LEARN 3/98	LEARN 12/97	LEARN 9/97	LEARN 6/97	LEARN 3/97
Sales	1543.1	383.7	212.7	129.3	113.6	303.0	141.7	89.3	86.9
Cost of sales	761.0	133.3	63.0	38.5	34.0	99.1	40.3	25.8	24.0
Other exp	641.7	191.7	93.5	55.4	46.7	141.8	74.5	38.9	40.2
EBITDA	140.4	58.7	56.2	35.4	32.9	62.1	26.9	24.6	22.7
Net income	63.5	70.0	-21.2	-24.7	-129.4	-171.9	-113.2	-102.6	-107.3

It may be of interest to know that at December 1998, Microsoft traded at 35 times EBITDA, Oracle at 44 times EBITDA and Electronic Arts at 308 times EBITDA.

POST-MERGER ACTIVITY

Without a doubt, Mattel was in serious difficulties nearly immediately after the Learning Company acquisition. Where the firm's market price was $46 per share at March 1998, it fell to under $12 per share at February and September 2000, a total loss of $14.5 billion in less than two years. It was widely reported that Mattel's Learning Company unit was losing $1 million per day. The consolidated company lost 4 cents per share in the fourth quarter of 1999, against analyst estimates of a 25 cent profit. The firm continued to lose money in 2000, totaling 40 cents in the first quarter of 2000. More details about post-merger consolidated results are shown in Table 3 below.

TABLE 3
POST-MERGER CONSOLIDATED INCOME STATEMENT INFORMATION FOR MATTEL INC.
QUARTERLY INFORMATION FOR 2000 AND 1999

	9/00	6/00	3/00	12/99	9/99	6/99	3/99
Sales	1583.7	817.8	693.3	2199.1	1825.2	802.3	688.3
Cost of sales	917.1	453.9	378.9	1140.4	958.0	442.6	372.9
Advertising, selling, and administrative costs	449.9	317.3	345.5	920.5	628.3	295.4	292.7
Restructuring/unusual chg	17.9	0.0	0.0	52.9	0.0	293.1	0.0
Other exp	17.9	2.4	6.1	6.4	22.0	13.9	15.3
Interest	42.6	35.9	24.4	58.1	41.0	27.6	24.9
Taxes	31.6	2.3	+17.0	52.0	40.6	+59.4	+4.8
Disc. Operations,net	-440.6	0.0	-126.6		0.0	+6.6	+17.7
Net income	-336.9	6.0	-171.2	-18.4	135.3	-204.3	5.0
Note: total depr & amort	64.2	64.6	61.2	84.9	95.7	60.0	59.5

In February 2000 Mattel CEO Jill Barad resigned, along with several other key executives. Mattel laid off 16% of the Learning Company workforce in an attempt to reduce costs by $100 million per year. Mattel announced an intention to sell the Learning Company unit after the unit had lost $300 million in operations since acquisition.

In October 2000, Mattel announced a final deal whereby the Learning Company would be sold to Gores Technology Group, a closely held company that specializes in acquiring and turning around undervalued technology companies. The deal involved Mattel receiving virtually no cash up-front. Mattel would receive a share of future Learning Company earnings, a portion of the net proceeds of any sale of the company, or, if Gores kept the company, a portion of its value after five years. The proportion of future earnings and proceeds accruing to Mattel was not made public, but the press estimated the value of the total deal at $300 million. Moreover, Mattel retained $500 million in Learning Company debt. Mattel recorded an after-tax loss of $430 million as a result of the sale.

QUESTIONS FOR STUDENTS TO CONSIDER

a. Put yourself in the position of Mattel management at December 1998, prior to the merger. Evaluate the proposed merger. Does it make sense from a strategic perspective?

b. Evaluate the reasonableness of the $3.5 billion purchase price. What assumptions are inherent in the price paid?

c. What purchase price do you believe was justified? To answer these questions, there are two suggested procedures. First, project future earnings of the Learning Company and discount them to the date of purchase. Second, compare the price-earnings multiples of other software companies to Learning Company information.

d. Evaluate Mattel's decision to sell the Learning Company. What assumptions are inherent in the price of $300 million?

CONCLUSION

Above is a condensed version of the Mattel/Learning Company case. The longer version of the case, available from the author, includes more analysis of accounting issues, as well as extensive teaching notes to assist the professor in administering the case.

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