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Learning from Mattel

> *"There is nothing I can say to gloss over how devastating the Learning Company's results have been to Mattel's overall performance. Because there must be accountability, I and the board agree that I must resign today as chairman and chief executive and from the board." – Jill E. Barad, Former Mattel CEO, Conference call with analysts on February 3, 2000*[1]

After just three years as chairman and chief executive, Ms. Barad's 18-year storybook career with Mattel ended dramatically on February 3, 2000 with another disappointing earnings announcement. As one of only three women running a Fortune 500 company, she became a role model for millions of women aspiring to positions in the top ranks of corporate management.[2]

Company History

Barbie fueled the growth that made Mattel a global toy powerhouse. While Mattel traces its origins to 1945 starting in a southern California garage workshop, it reached global share leadership through the growth of Barbie in the late 1980's and early 1990's. During this period of double-digit sales growth, former Mattel CEO, Jill E. Barad leveraged her marketing talent to build Barbie from $250 million in annual sales in the mid-1980's to $1.9 billion in 1998. Through successful segmentation and diversification of the Barbie line into hundreds of styles, the average American girl had eight Barbie dolls by the mid-1990's.[3]

Jill Barad ascends to CEO becoming one of three women heading Fortune 500 companies. After five years as Mattel's chief operating office, Ms. Barad was named CEO in January 1997, seemingly at the height of the company's success. A little over a year after

[1] Hays, Constance L; "Chief of Mattel Steps Down After Reporting Loss in 1999"; The New York Times; Feb 4, 2000.

[2] White, Michael; "Miscalculations undermine Mattel chief's bold strategy"; The Associated Press; Oct 8, 1999.

[3] Bannon, Lisa; "Goodbye Dolly: Mattel Tries to Adjust As 'Holiday Barbie' Leaves Under a Cloud"; The Wall Street Journal; June 7, 1999.

This case is based on research by John W. Torget T'00 under the supervision of Professor Sydney Finkelstein.

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Ms. Barad took the helm, Mattel's stock reached a ten-year and record high of $45.625 on March 13, 1998 from $27.75 at the beginning of her tenure as CEO.

While Mattel continued telling analysts and the outside world of strong future growth and excellence in operations, troubles began as early as 1994.[4] Toys made by other companies started taking market share away from Barbie. First Beanie Babies became a hit among young girls and collectors. Then later Furby, Tickle Me Elmo (bought by Mattel through the acquisition of Tyco), and a host of interactive media toys and games. Barbie could no longer grow at 15 percent a year or more.

Turning to mergers and acquisitions for growth. With declining growth in Barbie sales and a limited new product pipeline, Ms. Barad turned to acquisitions to continue expanding the top line. Her first was Tyco Toys Inc., which makes Matchbox cars and holds the license for Sesame Street branded products. Tyco's sales were declining as the deal closed in March 1997. Even so, Mattel paid $881 million, slightly more than Tyco's 1996 sales.[5]

Then in 1998, Mattel acquired Pleasant Company, a direct marketer of American Girl dolls with annual sales of $300 million. This time the price was more than twice annual sales at $700 million. Mattel also acquired Bluebird Toys PLC maker of Polly Pocket in 1998. Finally, in May of 1999 Mattel added the Learning Company paying $3.5 billion or 4.5 times annual sales. This final pricey deal ultimately led to the ouster of one of the 1990's highest profile corporate chiefs.

Problems

(1) Expecting too much and paying too much for the Learning Company

> *"It's a function of overpaying for an acquisition and bad due diligence. They should have had a better sense of what the accounting was like at the Learning Co." – Hayley Kissel, Analyst, Merrill Lynch*[6]

> *"I don't think Mattel's management really had any idea of what the problems were or how deep they were." – Sean McGowan, Analyst, Gerard Klauer Mattison*[7]

After badly surprising Wall Street analysts in December 1998 by announcing a $500 million revenue shortfall, Ms. Barad and Mattel acted on the changing desires and play patterns of children in the late 1990's by acquiring the Learning Company. After two strong years of growth in the educational-toy market and adventure game hits such as Myst and Riven, the Learning Company seamed a perfect way for Mattel to shift into the more desirable high-

[4] Morgenson, Gretchen; "Barbie's Guru Stumbles; Critics Say Chief's Flaws Weigh Heavily on Mattel"; The New Your Times; Nov 7, 1999.

[5] Morgenson, Gretchen; "Barbie's Guru Stumbles; Critics Say Chief's Flaws Weigh Heavily on Mattel"; The New Your Times; Nov 7, 1999.

[6] Goldman, Abigail; "Mattel 3rd-Quarter Estimate Bad News for Investors"; Los Angeles Times; Oct 5, 1999.

[7] Greenfeld, Karl Taro; "Mattel: Some (re)assembly required"; Time; Oct 25, 1999; pg. 58.

tech and interactive media segment. However, even casual observers knew the Learning Co. suffered from aging brands and questionable profitability. Its software characters, Reader Rabbit and Carmen Sandiego had lost money in all but one year since 1992.[8]

Prior to the 1999 acquisition, The Learning Co. suffered merger problems of its own. The company grew rapidly in the 1990's through acquisitions, but it was often a favorite of short-sellers believing that the company's stock price would fall (check that on Bloomberg).[9] Additionally, two of Learning Co.'s deals, while it was named Softkey International, rank among the 10 worst U.S. acquisitions during 1994-1996 as measured by shareholder value two years after the deal.[10]

Reports from the Center for Financial Research and Analysis highlight further the lack of proper due-diligence by Mattel during the Learning Co. acquisition. In the past several years, the Rockville, MD research firm released two critical reports about the Learning Co. In July 1999, the group stated it "displayed several negative indicators."[11] For example, the center reported that the Learning Company's sales only increased 4.2% in the first quarter of 1999 from the previous year compared to increases of at least 25% in each of the three previous quarters. Simultaneously, the firm noticed a sharp jump in accounts receivable.[12] The slowing of sales and growth in accounts receivable both negatively impacted Learning Company's free cash flow.

Mattel and Ms. Barad's aggressive estimates for revenue growth synergies from the Learning Co. only compounded the problem of poor due diligence, and both factors led to the exorbitant price of 4.5 times annual sales. With Barbie accounting for 40% of Mattel's profits and sales of this "cash cow" falling 14% in 1998, Ms. Barad assured investors that the Learning Co.'s educational software could be leveraged throughout the company.[13] However, an anticipated $50 million profit from the Learning Co. in the third quarter of 1999, turned into a loss of $105 million.

Officially, Mattel blamed the disappointing profits on a range of problems, including higher-than-expected returns of Learning Company merchandise, a lost licensing deal, and termination of agreements with some distributors.[14] However, the biggest mistake was Ms. Barad's continued optimism. After the negative earnings surprise in October 1999, Mattel said that earnings for the fourth quarter of 1999 would be 70 to 80 cents per share.[15] Instead,

[8] Morgenson, Gretchen; "Barbie's Guru Stumbles; Critics Say Chief's Flaws Weigh Heavily on Mattel"; The New Your Times; Nov 7, 1999.

[9] Bannon, Deogun, Hechinger; "Mattel Still Doesn't Grasp Snafu at Learning Co."; The Wall Street Journal, Oct 8, 1999.

[10] Source: Booz Allen Hamilton

[11] Bannon, Deogun, Hechinger; "Mattel Still Doesn't Grasp Snafu at Learning Co."; The Wall Street Journal, Oct 8, 1999.

[12] Bannon, Deogun, Hechinger; "Mattel Still Doesn't Grasp Snafu at Learning Co."; The Wall Street Journal, Oct 8, 1999.

[13] Greenfeld, Karl Taro; "Mattel: Some (re)assembly required"; Time; Oct 25, 1999; pg. 58.

[14] Bannon, Lisa; "Mattel's New Profit Shortfall Punishes Stock and Raises Questions About CEO"; The Wall Street Journal; Oct 5, 1999.

[15] Hays, Constance L; "Chief of Mattel Steps Down After Reporting Loss in 1999"; The New York Times; Feb 4, 2000.

Mattel reported a loss of $184 million, again primarily due to sales declines at the Learning Company.

(2) Continually over promising and under delivering

> *"She has made the big mistake of using her style of promotion and hoopla (which worked so well to build Barbie into a global brand) on Wall Street."*[16]

> *"We remain very frustrated with what's going on at Mattel. The present management team has vaporized two thirds of the value of the company" – Erik Gustafson, manager of the Stein Roe Growth Stock Fund, a major shareholder*[17]

During Ms. Barad's three year's as CEO, investors watched a well-run global company with double-digit revenue and earnings growth slip into disarray with two consecutive quarterly loses. The latest loss of $171 million in the first quarter of 2000, included significant charges for severance packages of Ms. Barad and other senior executives that departed within the past year.[18] Immediately following Ms. Barad's resignation, Mattel was operating without a top management team lacking a CEO, COO, CFO and division president for its international business.[19] Ms. Barad's leadership style significantly contributed to Mattel's decline.

With Ms. Barad as chairman and CEO, Mattel surprised Wall Street analysis a total of four times. First, in September 1998, Mattel announces that earning growth for 1999 would be 9 to 12 percent instead of the anticipated 18 percent. Just three months later, in December 1998, Mattel warns that revenue will fall short by $500 million and earnings will be 30 percent below previous estimates.[20] Finally the steep losses in the third and fourth quarters of 1999 related to problems at the Learning Company force Ms. Barad to resign.

After each of these negative earnings announcements, Ms. Barad optimistically reassured Wall Street that the problems had ended. Her last opportunity for full disclosure came in October of 1999. In a conference call to analysts Ms. Barad stated,

> *"We continue to be confident in the future of this company. What we now need to do is prove the potential of international [sales] and the Learning Co."*[21]

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[16] Sellers, Patricia; "CEOs in Denial"; Fortune; Jun 21, 1999.

[17] Bannon, Lisa; "Learning Co. Is On Track, Says Mattel"; The Wall Street Journal; October 22, 1999.

[18] Bannon, Lisa; "Mattel Posts $171 Million Loss for Quarter"; The Wall Street Journal; April 20, 2000.

[19] Byrne and Grover; "Mattel's Lack-of-Action Figures"; Business Week; February 21, 2000.

[20] Morgenson, Gretchen; "Barbie's Guru Stumbles; Critics Say Chief's Flaws Weigh Heavily on Mattel"; The New Your Times; Nov 7, 1999.

[21] Goldman, Abigail; "Mattel CEO's Report Fails to Ease Investors' Doubts … But Barad says the worst is over"; Los Angeles Times; Oct 22, 1999.

Ms. Barad's comments come only weeks after the initial earnings warning at the beginning of October 1999. Her continued optimism indicates a reluctance to gain a full understanding of the Learning Company's problems and a refusal to accept responsibility.[22] Throughout 1999 and early 2000, a steady stream of executive departures marked Ms. Barad's tenure as CEO including:

- Bruce Stein, chief operating officer
- Gary Baughman, president of Mattel's Fisher Price unit
- David Haddad, head of Mattel Media
- Michael Perik and Kevin O'Leary, founders and heads of the Learning Co.
- Harry Pearce, chief financial officer, and
- Ned Mansour, president

"In the end, she alienated the very individuals charged with helping her grow the company and deliver shareholder value," says Roger Brunswick, a managing partner of consultants Hayes, Brunswick & Partners.[23]

(3) Licensing vs. new product development and innovation to fuel growth

> *"Mattel has lacked hit product power, and has been facing internal management turmoil for quite some time." – Jill Krutick, Analyst, Salomon Smith Barney*[24]

American demographic changes and rapid shifts in consumer preferences together with the significant management turnover leaves Mattel far behind in producing innovative toys that appeal to today's children. "Something's changed," says Eric Johnson, professor of management at Dartmouth's Tuck School of Business. "Kids are growing up faster. They want toys for a shorter length of time."[25] While toy sales have remained flat for the past two years at $21 billion annually, computer and video games have doubled in sales, to $6.2 billion.[26]

This consumer trend leaves Mattel playing catch up in the interactive game market. It's exclusive licensing arrangement with Disney to produce action figures for the latest full-length animation feature does not address these consumer trends. Adding to the disappointment of the Learning Company acquisition, Mattel had serious trouble with its Internet operations during the 1999 holiday season. They began selling selected merchandise direct through ShopMattel.com with limited customer service and logistics support. Mattel also neglected to fully deal with concerns of major toy retailers Toys "R" Us and Wal-Mart prior to launch.

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[22] Byrne and Grover; "Mattel's Lack-of-Action Figures"; Business Week; February 21, 2000.

[23] Byrne and Grover; "Mattel's Lack-of-Action Figures"; Business Week; February 21, 2000.

[24] White, Michael; "Profit warning prompts speculation Mattel's Barad could lose job"; The Associated Press; Oct 5, 1999.

[25] Greenfeld, Karl Taro; "Mattel: Some (re)assembly required"; Time; Oct 25, 1999; pg. 58.

[26] Greenfeld, Karl Taro; "Mattel: Some (re)assembly required"; Time; Oct 25, 1999; pg. 58.

(4) Passive Board of Directors

> *"The board has a fiduciary duty to look at this. We're very upset, and we're very critical of management at this point." – Kevin Grant, Manager of Oakmank Fund, one of Mattel's largest shareholders*[27]

Mattel's Board of Directors gave Ms. Barad great leeway and likely one too many chances as chief in large part due to her successful pre-CEO track record with building the Barbie line. "We know her family," says William D. Rollnick, a director and interim board chairman. "We respect what she did for this company."[28] Another reason for poor oversight from the board comes from a lack of outside and senior level directors. Only after Ms. Barad's resignation did the 11-person board gain a turnaround specialist, Ralph Whitworth, head of investment fund Relational Investors LLC. Mr. Whitworth has been successful at forcing change through use of board seats at electronics company Tektronix Inc. and waste giant Waste Management Inc.[29]

Board members say they urged Ms. Barad in mid-October 1999 to hire a search firm to locate a new COO and bring in outside accountants to analyze the financial problems at the Learning Company.[30] However, the board did not act early enough. They did not interview exiting executives to seek out information on previous earnings shortfalls or try to work with Ms. Barad to correct her shortcomings as a CEO. Additionally, given the size of the Learning Company acquisition and that it was Mattel's first in the software business, some of this failure belongs with those 11 directors.[31]

Now that Mattel seeks a buyer for the money-losing Learning Co. unit at a price that could range from less than $500 million to about $1 billion one year after the $3.5 billion acquisition, the new board and CEO face a difficult turn around situation.[32] With two-thirds of the slated Board of Directors for 2000 still maintaining tenure through Ms. Barad's resignation, how fast can this governing body change gears?

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[27] Bannon, Lisa; "Mattel's New Profit Shortfall Punishes Stock and Raises Questions About CEO"; The Wall Street Journal; Oct 5, 1999.

[28] Byrne and Grover; "Mattel's Lack-of-Action Figures"; Business Week; February 21, 2000.

[29] Grover, Ronald; "Mattel: A Great Deal of Re-Assembly Required"; Business Week; April ??, 2000.

[30] Byrne and Grover; "Mattel's Lack-of-Action Figures"; Business Week; February 21, 2000.

[31] Byrne and Grover; "Mattel's Lack-of-Action Figures"; Business Week; February 21, 2000.

[32] Author?; "Mattel Hires Investment Banker To Pursue Sale Of Ailing Software Unit"; Dow Jones Business News; April 3, 2000.

Mattel Board of Directors elected at 1997 Annual Meeting[33]

Director Name	Principal Occupation or Position	Age	Director Since	Comments
John W. Amerman	Chairman of the Board and CEO	65	1985	Mattel CEO, 1987–1996
Jill E. Barad	COO	45	1991	
Dr. Harold Brown	Senior Managing Director of E.M. Warburg, Pincus & Co., LLC	69	1991	
Tully M. Friedman	Founding Partner of Hellman & Friedman, a private investment firm	55	1984	
Joseph C. Gandolfo	President, Mattel Worldwide Manufacturing Operations	55	1997	
Ronald M. Loeb	Partner in the law firm of Irell & Manella LLP	64	1970	Served as outside council to Mattel starting September 1997
Ned Mansour	President, Corporate Operations	48	1996	
Edward N. Ney	Chairman, Board of Advisors, Burson-Marsteller	71	1993	
William D. Rollnick	Retired Chairman and a Director of Genstar Rental Electronics, Inc.	65	1984	
Christopher A. Sinclair	President and CEO of Quality Food Centers	46	1996	
Bruce L. Stein	President, Mattel Worldwide	42	1996	
John L. Vogelstein	Vice Chairman of the Board, President of E.M. Warburg, Pincus & Co., LLC	62	1983	

Mattel Board of Directors proposed for 2000 Annual Meeting[34]

Director Name	Principal Occupation or Position	Age	Director Since	Comments
Eugene P. Beard	Employee/Consultant, The Interpublic Group of Companies	65	2000	
Dr. Harold Brown	Senior Managing Director of E.M. Warburg, Pincus & Co., LLC	72	1991	
Tully M. Friedman	Chairman and CEO of Friedman Fleischer & Lowe, a private investment firm	58	1984	
Ronald M. Loeb	Acting CEO of Mattel; SVP and General Council, Williams-Sonoma, Inc.	67	1970	Served as outside council to Mattel starting September 1997 until June 1999
Andrea L. Rich	President and CEO of the Los Angeles County Museum of Art	56	1998	
William D. Rollnick	Chairman of the Board of Mattel; Retired Chairman and a Director of Genstar Rental Electronics, Inc.	68	1984	
Christopher A. Sinclair	Chairman and CEO of Caribiner International	49	1996	
John L. Vogelstein	Vice Chairman of the Board, President of E.M. Warburg, Pincus & Co., LLC	65	1983	
Ralph V. Whitworth	Managing Member, Relational Investors, LLC	44	2000	

[33] Source: Mattel Inc. 1997 Proxy Statement

[34] Source: Mattel Inc. 2000 Proxy Statement