

LEGO's *Star Wars* figures stand ready to defend market share against *Halo* toys from LEGO's Canadian rival, Mega Brands





THE EMPIRE STRIKES BACK

CANADIAN TOYMAKER MEGA BRANDS CARVED OUT ITS MARKET RIGHT UNDER THE NOSE OF SLEEPING GIANT LEGO. IT WAS PERMANENT PLAYTIME—UNTIL THE GIANT AWOKE AND MEGA MADE THE ACQUISITION FROM HELL

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MASTER CHIEF SCRATCHES

at his armour. The rubber-and-plastic uniform, complete with bulky headgear, chafes under the bright lights of a crowded convention centre. So the hero of *Halo*, Microsoft's blockbuster video game franchise and a licensing coup for Montreal-based toymaker Mega Brands Inc., is taking a break from striking poses for TV cameras and retailers at the New York Toy Fair to slouch around Mega's booth.

You have to feel for Master Chief, given the load weighing on his cybernetically enhanced shoulders: not only the salvation of a human race besieged by the alien armies of the Covenant but now the revival of a deeply indebted and tarnished manufacturer of construction toys. Mega, a family-run upstart whose chunky Mega Bloks snatched swaths of market share away from the Lego Group early in the decade, has had a nightmarish couple of years born of a badly bungled expansion. As Lutz Muller, a long-time industry analyst, observes, "It was the worst acquisition I've ever seen in my life."

Enter Master Chief. The recent deal with Microsoft Game Studios to turn the latest instalment of *Halo Wars* into studded-brick play sets is part of Mega's effort to "cool up the brand" and broaden its inroads into the tween market. This is, in part, a defensive manoeuvre against Mega's resurgent archrival, Lego, which itself had a near-death experience in 2003 stemming from an ill-advised expansion, has shed divisions, fixed its balance sheet and refocused on what it does best: selling plastic bricks to prepubescent boys. Now, the Danish giant is launching an attack on Mega's stronghold: toddlers and preschoolers, whose parents still favour Mega's big, colourful blocks, and the lower price tags attached to them.

The New York Toy Fair in mid-February is toymakers' last major opportunity to build buzz and secure shelf space for the end-of-year holiday season. At Mega's booth, head of PR Harold Chizick is in carnival-barker mode. At the *Halo* display, he points out the marbled effect on the "micro" bricks (smaller pieces aimed at older kids). The game is rated 13+, although most of Mega's consumers are still learning to hold a spoon. But Chizick says kids as young as 7 play *Halo* with their older siblings: "It's all part of age compression, of children getting older faster." But it's Battle Strikers, a magnetized twist on traditional battling tops, that elicits Chizick's most glowing predictions. Mega hopes to turn the line into the next Bakugans, the playground hit from Toronto's Spin Master Ltd.

Chizick's effervescence noticeably diminishes when CEO Marc Bertrand appears. Bertrand wears the ordeal of the past two years in his forced smile, carefully worded answers and air of fatigue. After taking over the company from his father in 2002



TOKYO HOLDS THE RECORD FOR THE WORLD'S TALLEST TOWER (29.7 METRES) BUILT OUT OF LEGO BRICKS.

and—along with his younger brother, Vic—overseeing the period of its most rapid growth, Bertrand had to engineer one of the largest toy recalls in recent history after dozens of children were hurt. Still, he tries to get into the cheerleading spirit. "We're No. 1 in preschool, and every year we're stronger there than Lego," he says. That's true; the problem is, the rest of the business is falling apart. A month and a half after the fair, Mega released disastrous 2008 results: a \$459-million loss—more than its total sales—with 70% of that coming in the year's final quarter (all currency in U.S. dollars unless otherwise noted). The company's shares, which once approached \$30 (Canadian), are now a penny stock. "It's a really sad story," says Anthony Zicha, an analyst with Scotia Capital Inc. But an all-too-common one, too: The father builds a company; the kids run it into the ground. By mid-April, one analyst was questioning whether Mega could even continue as a going concern.

Mega's slump and Lego's revival is just the latest chapter in a rivalry between the two family firms going back two decades. Now, as Mega fights for survival, it faces a competitor that's three times its size, highly profitable and toughened by hard-learned lessons. "[Mega] had the success they had not because they were that good, but because we were exceptionally bad," says Søren Torp Laursen, president of Lego Americas. Patting his hips to indicate a spreading rump, he adds, "Like us once, they expanded, they got complacent." But Lego is no longer that pudgy pushover. "We're not like that now. At all."



MORE THAN FOUR BILLION LEGO MINI-FIGURES HAVE BEEN PRODUCED IN THE PAST 30 YEARS.

a larger playing field. Lego's large-block Duplo line had little uptake in North America, so Bertrand created his own version of snap-together bricks for toddlers and preschoolers. The bright-colored, low-priced Mega Bloks took off immediately. By the late '80s, they were selling in 30 countries.

Mega's blocks were initially bigger than any Lego made, but in time grew to closely resemble Lego's products—so much so that kids could snap pieces from the two lines together. In 1996, Lego filed a trademark-infringement lawsuit, claiming that the shape of its bricks was legally protected intellectual property. The Canadian judge's demurral didn't deter Lego, already infamous among rivals for its litigiousness. It has been dragging Mega through courts around the world ever since. (The latest skirmish, an appeal in European Union courts last November, was the 15th time in a row Mega has prevailed.)

Seen by North American retailers as a homegrown underdog to a foreign monopolist, Mega won acres of shelf space for its cheaper alternatives. "The Bertrand brothers had very good relations with the retail community. A lot of vendors don't," says Jim Silver, editor-in-chief of ANB Media, a publisher of toy-industry publications. "They were seen as honest and fair." Through the mid-'90s, Mega's sales were surging by around 70% a year, growing even when the rest of the category was down. By 2006, Mega controlled roughly half of Canada's construction-toy market, supported by such valuable licences as *Dora the Explorer*, *Spider-Man* and Disney's various properties.

With Mega's share price zooming—it topped \$20 (Canadian) in 2004—the Bertrands decided it was time to diversify, and looked toward the arts-and-crafts sector, in part to make inroads with girls. As it happened, New Jersey-based Rose Art Industries, the second-biggest player in that segment, was run by another two-brother team that had taken over from their father. Aside from colour-in posters and activity kits, Lawrence and Jeffrey Rosen also boasted a hit line of magnetic construction toys, Magnetix. Here was Mega's chance to expand beyond the brick. In the summer of 2005, Mega bought Rose Art for \$350 million, amid much celebration of the companies' similar roots and family loyalties. Rose Art was bigger than Mega, and most of its products retailed through channels with which Mega had no experience, but investors applauded, giving Mega's shares their biggest single-day jump to that point.

Despite the soaring stock, the deal was financed largely with debt, which made it risky. "There wasn't much margin of safety if something went wrong," says an analyst who followed the company at the time. Mega previously had virtually no debt, and had never made an acquisition. "In terms of building and operating a toy company, it's hard to rate [the Bertrands] any lower than 8.5 out of 10," says Benoit Caron, an analyst with National Bank Financial who covered Mega until recently. "In terms of the Rose Art deal, it's 4 out of 10. Everything that could go wrong with that acquisition, went wrong."

I: A FALTERING GIANT

Founded by Danish carpenter Ole Kirk Christiansen, Lego introduced its iconic brick in 1958, patenting the interlocking system that enabled the studded pieces to fit together firmly while still allowing kids to separate them. The toys' versatility—the six basic bricks can combine into more than 900 million arrangements—in time turned Lego into Europe's largest toymaker, and Christiansen's grandson into Denmark's richest man. From the start, the company was renowned for its quality control: It kept manufacturing close to home and ensured that each new Lego piece could fit with any other one ever made.

Through much of the 1980s and '90s, Lego averaged 10% annual sales growth, far exceeding the industry rate. By 1992, the private company held 80% of the global construction-toy market. Eager to capitalize on consumer loyalty, Lego expanded into theme parks, clothing lines, movies and books. But the company neglected the changing needs of its core consumers—boys aged 5 to 9—who were increasingly opting for toys linked to hit movies, comic books and cartoons. The trend toward video games also hurt. The misreading of the market, combined with bad investments, conspired to produce a \$350-million loss in 2004, dangerously low cash reserves and the risk of bankruptcy.

During Lego's decades-long hegemony, many tried to muscle in on its terrain. Lego's lawyers fought back, but by the late '70s, the company's major patent had expired and it was increasingly losing in court. And in the mid-'80s, a Montreal toy distributor named Victor Bertrand saw an opening in Lego's flank.

A toy salesman from the age of 17, Bertrand was manufacturing his own plastic toys by his early 20s and soon built one of Canada's biggest toy distribution businesses. But he wanted



II: MEGA-DISASTER

Perhaps the first hint of trouble in toyland was the two fraternal duos' different approaches to business. "It was a poor blend of personalities, like mixing oil and water," says ANB Media's Jim Silver. Another observer puts the polarity more vividly: "It was like putting a cat and a mouse into a cage."

Rose Art had three business units: activity kits, where it was the low-cost market leader; stationery and crayons, a very competitive segment dominated by Crayola; and Magnetix. The Bertrands had little experience with the first two categories, so they left them in the Rosens' care in New Jersey. Mega focused on mining Magnetix's potential by boosting its international distribution. But the supply chains soon got tangled, and inefficiencies multiplied. Suddenly transformed into a half-billion-dollar company, Mega lacked the infrastructure to handle its expanded product menu. Retailers were complaining about orders arriving late and riddled with errors.

When Mega decided to close Rose Art's New Jersey manufacturing plant, the Rosens, who were proud of their record as employers, weren't pleased. "This was not part of the game plan" when the company was sold, Larry Rosen grumbled. The Bertrands' problem was threefold, according to Lutz Muller, who runs toy-industry consultancy Klosters Trading Corp.: "They didn't have the supply-chain management they needed, they didn't have control over manufacturers in China, and they didn't have control over the Rosens."

Tensions between the two families soon broke out into open conflict. The precipitating incident came in November, 2005, just five months after the merger was announced. A Seattle-area toddler died after he swallowed loose magnets from his older brother's

Magnetix set. Whether the risk of such an accident was disclosed ahead of the sale is a point hotly argued by the Rosens and the Bertrands. In any case, the U.S. Consumer Product Safety Commission has revealed that complaints about magnets coming loose from the toys go back to 2000. (In mid-April, Mega agreed to pay \$1.1 million to CPSC for failing to "provide the government with timely information about dangers to children with Magnetix magnetic building sets.")

Initially, Mega merely added more glue to the magnets and relabelled some of the products aimed at younger children, meanwhile negotiating the terms of a recall with the CPSC. In March, 2006, the company recalled a limited number of toys, but the recall wording confused retailers. Some, including Toys R Us, yanked *all* Magnetix products off the shelves, while others held on to sets they shouldn't have. After reports of more hurt children surfaced, the company made a second, wider recall, in April, 2007.

The timing was terrible: Dangerous, Chinese-made toys were becoming a front-page scandal in the U.S., with Congress investigating after Fisher-Price, Mattel and others were found to be selling tainted products. In the spring of 2007, the *Chicago Tribune* ran a series on Mega's alleged "botched recall," using the company as a case study of how, it said, manufacturers haggled with regulators over recall criteria and wording to minimize fallout for themselves.

The Bertrands had never handled a recall before, and this one ultimately became a doozy, ending in the spring of 2007, when every last Magnetix box was taken off the shelves and scrapped. All told, more than seven million units were pulled worldwide. "That's a huge, gigantic recall," especially for a company Mega's size, says analyst Caron. The fact



BUILDING SETS ARE THE FASTEST-GROWING TOY CATEGORY (+26% IN 2008 OVER 2007). VEHICLES ARE THE FASTEST-SLUMPING CATEGORY (-16%).

that it took three recalls to solve the problem infuriated many retailers. “Buyers hate recalls,” says Lutz Muller, “but they understand that sometimes you could be unlucky. But...many got totally frustrated when they didn’t want Magnetix up on the shelves but Mega wouldn’t take it back.”

The Rosens and the Bertrands were by then in the courts. As worries stemming from customer complaints about Magnetix mounted, the Bertrands withheld about \$50 million in performance-related payments to the Rosens while the company investigated the problem. When the Rosen family sued for the money, the Bertrands fired the Rosen brothers and counterclaimed a failure to disclose material information prior to the sale. Last year, the Rosens additionally alleged that Mega’s principals engaged in insider trading before news of Magnetix-related injuries became public.

Caron estimates the total cost of the fiasco at \$150 million. Meanwhile, he figures, Magnetix went from a \$75-million business to zero. Asked about that time, Marc Bertrand says, “The easy way to put it is, there’s been no injury related to any products we’ve manufactured.” The cold language belies what has been a deeply traumatic experience for the brothers, according to two people close to the company. At the New York fair, Bertrand says quietly, “We had a successful business, and this has been a very difficult period.” As he talks, he absent-mindedly plays with a battleship built out of MagNext pieces—the line Mega introduced last year in place of the tainted Magnetix. When a part disconnects in his hands, he takes the opportunity to point out that the new line is sturdier and has bigger pieces. “And the product is now ingestible,” he says. For a moment, it appears he



LEGO IS THE WORLD'S LARGEST TIRE MANUFACTURER, WITH 300 MILLION PRODUCED EACH YEAR.

might pop a part in his mouth to prove the point.

Mega ended its *annus horribilis* with its share price in the \$6 (Canadian) range and a roughly \$100-million loss for 2007—the first in the company’s history. To reduce debt, it put the Rose Art division, still responsible for about 40% of its sales thanks to the non-Magnetix lines, on the block. Mega initially reported that there were more than 20 expressions of interest—including one from the ousted Rosen brothers. But a deal never materialized. Observers believe most of the interest came from private equity players, and dried up as the financing market froze.

Entering 2008 facing supply-chain problems, strained relations with retailers, ongoing lawsuits and \$252 million of debt from the Rose Art acquisition, Mega pledged to turn things around. Marc Bertrand promised to streamline operations, recover lost margins and return to pretax profitability by 2009. And while the company did claim a profitable third quarter (as long as you don’t count the \$150-million writedown of goodwill), it’s continued to struggle with its distribution network. After the tainted-toy scandals, the industry’s Chinese supply chain went through an upheaval last year, with many companies going under and the survivors demanding stricter payment terms. Last summer, there was rampant speculation that Mega wasn’t paying its suppliers, which would have led them to stop shipments. “That could have been the end right there,” says Caron—“a Christmas holiday season with no Mega Bloks on the shelves.”

In August, Mega struck a deal with Prem Watsa’s Fairfax Financial Holdings Ltd., which has become a specialist in investing in distressed companies. Fairfax invested \$64 million (Canadian), which it can convert into shares that would give it more than a third of the company—and almost three times the stake of the Bertrand family. Caron calls the transaction “a deal of last resort.” According to another analyst, the Bertrands are no longer fully calling the shots.

For all its travails, Mega has made progress. It has reduced expenses and inventories, hired an independent quality-control company to monitor production in China (where 75% of its toys continue to be manufactured) and shuttered some distribution facilities. “Operationally, Mega’s doing what they need to do, but the timing is tough,” says Caron. “[Last year] was a very bad year for everybody.”

III: LEGO SURGES BACK

Well, not for everybody. Lego had a record 2008. While the toy industry slumped by 3% amid a swooning economy, Lego’s North American division saw sales grow by 37%, extending a run of strong results thanks to such smash hits as the Bionicle action figures and *Star Wars* toy sets and video games. The company’s U.S. market share in the construction category jumped 7% last year alone, to 73%. “It’s a simple headline: We’ve focused back on the core,” says Søren Torp Laursen, the North American chief. “We needed to fix our core business with boys aged 5 to 9. Now that’s fixed.”

A globetrotting Lego lifer, Laursen has spent the past five years fixing operations on this continent, tapping the Hollywood connection whose importance Lego so disastrously underestimated in its dark days. The *Star Wars* franchise in particular has proven to be a gold mine: Sales of toys and games are



growing by double digits even though there hasn't been a new *Star Wars* movie since 2005. Last year alone, *Star Wars*-related Lego sales in the U.S. surged by 78%. While there has been a "rebalancing" toward non-licensed lines, Lego's not turning away from Hollywood. In fact, Lego wrested the coveted Disney licence away from Mega early this year, positioning itself to profit from looming *Toy Story* and *Cars* sequels.

Lego's return from the brink has followed a well-tested recipe: First, bring fresh blood into the corner office—in the person of Jørgen Vig Knudstorp, a former McKinsey consultant who took the reins from the Christiansen family. Second, shore up the balance sheet by selling off extraneous divisions, notably the amusement parks. Third, refocus on what you do best—delighting boys with ever-new marvels that can be made out of a few plastic bricks. Fourth, become as efficient as your rivals.

In 2006, Lego broke with company tradition by outsourcing manufacturing to lower-cost countries, but it has never ventured into China, believing production lead times would be too long—faster response to market trends being one of the keys to its turnaround. Laursen says Lego may soon be able to go from manufacturing order to product on the shelves in as little as six weeks. "That means that in October, we can read the success of our fall launches before we decide on the Christmas quantities, whereas our competitors that use China have to make those calls before the products are on the market."

Still, the tainted-toy scandals have proven that outsourcing is fundamentally risky with toys, both because of the importance of quality control and the need to protect new ideas in an industry that constantly innovates. So Lego is now "insourcing" by building its own plant in Mexico and taking over the management of an outsourced plant in the Czech Republic. This earnest dedication to quality control has served Lego well: While most of its major rivals have dealt with product investigations and recalls, Lego's record is virtually spotless, and consumers haven't forgotten that, says Muller.

With its business fixed, Lego is diversifying again—cautiously, into games. In North America, however, it's the preschool market that's now the "strategic priority," says Laursen. For years, Lego has allowed Mega to dominate among the tots, doing little to push its large-brick Duplo brand into North America. Consequently, Duplo accounts for 14% of Lego's business in Europe but less than 4% in North America. Laursen concedes that, with Mega in financial trouble, it's a good time to attack the segment, but the market has always held appeal. After all, the lifetime value of a preschooler is much greater than a 10-year-old who'll soon graduate to video games. As well, preschool is a relatively stable segment, less given to fads, because mom and dad control the pocketbook.

Laursen claims his focus now isn't on battling for a few extra points of market share but rather on expanding the construction category overall. Outside North America, building toys make up 15% of the toy market; in Canada and the U.S., it's only about 4%. The category has been growing: While most toy segments dropped last year, sales of building sets surged by more than a quarter. Bertrand agrees that the main opportunity lies in pulling more kids and their parents into construction early, and he's betting Mega's price advantage will tap into consumers' current thrift. These days, 20 is the magic price band—whether dollars, pounds or euros. Any toys over \$50 are tough sells.

Bertrand sees the economy as Mega's biggest challenge. Sales were down 14% last year from the previous year, with the biggest slide in the last quarter. "We have to be very smart in how we approach



FOUR OUT OF FIVE KIDS BETWEEN AGES 2 AND 5 USE INTERACTIVE DEVICES SUCH AS VIDEO GAME CONSOLES AND LAPTOPS.

our product line and how we work with retailers," he says. "Retailers are going to be very cautious, from an inventory standpoint." Mega lost significant retail shelf space after the recall debacle, and may lose more as retailers worry whether it can pull through its difficulties. Muller says Wal-Mart and Toys R Us in the U.S. have been reducing shelf space devoted to Mega goods in recent months. He reports that Lego has "end-cap" (end of aisle) displays in Target and Wal-Mart—prized by suppliers because they draw seven times the sales of regular shelves. He found no Mega endcaps.

Regaining retailer and consumer trust won't be easy. The *Halo* deal, announced in February, briefly revived Mega's share price, as investors were heartened that a player the size of Microsoft was willing to do business with the wounded toymaker. But there's a disconnect here: *Halo*, after all, is a violent game marketed to adults, not little boys; things have been toned down for the Mega-licensed *Halo Wars*, but only to the teenager level. Caron believes the line could reach around \$40 million in sales in a few years, but it's not going to be a \$200-million business like Lego's *Star Wars* line.

The *Halo* deal also won't make up for the loss of Disney, which accounted for half of Mega's licensed sales. Mega's big tie-in bets for this year are Nickelodeon preschool shows such as *Wonder Pets!* and *Yo Gabba Gabba!*—hardly household names. Observers believe Disney was unimpressed with how Mega was capitalizing on its brand. Two years ago, Mega put out a product based on *Cars* and had a hit with *Pirates of the Caribbean* toys. But licences for *Iron Man* (Marvel) and *Transformers* (Hasbro) went largely unexploited, which can't have escaped Disney's notice. Muller speculates that recall-singed retailers were reluctant to commit to new Mega lines, and without those commitments, Mega couldn't make the investment.

The 2008 results have started speculation about how long Mega can hold out. "There's always a chance it will survive, but the likelihood is not great," says Scotia Capital's Zicha. The answer may come as early as this summer, when retailers make their big holiday orders. As well, if Mega fails to maintain earnings and cash minimums through the second quarter ended June 30, its lenders can pull the plug.

There's some market talk of privately held Spin Master making a run at Mega, but the latter's \$388-million debt load is a big deterrent. Still, Mega's original block business remains strong, with 30% Canadian market share. It's what Bertrand Sr. used to build an international toy giant, before his sons' poor performance on due diligence and crisis management pushed it to the edge of the abyss. In the toy business, says Zicha, "you have to have consumer confidence. If you break the relationship between the consumer and the retailer, you're pretty much done." Mega broke that rule, and it may pay with its life.



THERE ARE 62 LEGO BRICKS FOR EVERY PERSON IN THE WORLD.