

Completed acquisition by VTech Holdings Ltd of LeapFrog Enterprises Inc

Decision on relevant merger situation and substantial lessening of competition

ME/6614/16

The CMA's decision on reference under section 22(1) of the Enterprise Act 2002 given on 18 August 2016. Full text of the decision published on 16 September 2016.

Please note that [X] indicates figures or text which have been deleted or replaced in ranges at the request of the parties for reasons of commercial confidentiality.

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SUMMARY

1. On 4 April 2016, VTech Holdings Ltd (**VTech**) acquired LeapFrog Enterprises Inc (**LeapFrog**) (the **Merger**). VTech and LeapFrog are together referred to as the **Parties**.

2. The Competition and Markets Authority (**CMA**) believes that it is or may be the case that the Parties' enterprises have ceased to be distinct and that the share of supply test is met. The four-month period for a decision, as extended, has not yet expired. The CMA therefore believes that it is or may be the case that a relevant merger situation has been created.
3. The Parties overlap in the supply of electronic toys. The CMA assessed the Merger against product frames of reference for the supply of toddler electronic learning (**TEL**) toys; child laptops/tablets; child smartwatches; and child electronic reading systems. In relation to the geographic frame of reference, the CMA assessed the impact of the Merger in the UK (taking into account constraints posed by competitors from outside the UK).
4. The CMA examined whether the Merger gives rise to the prospect of unilateral horizontal effects (ie an increase in prices and/or a reduction in offering/quality) through the loss of actual competition in the supply of:
 - (a) TEL toys in the UK;
 - (b) child laptops/tablets in the UK; and
 - (c) child smartwatches in the UK.
5. The CMA also considered whether the Merger gives rise to the prospect of unilateral horizontal effects through the loss of potential competition in the supply of child electronic reading systems.
6. With regard to TEL toys, the Merger combines two of the three largest suppliers of TEL toys in the UK (based on shares of supply over the last four years). The CMA believes that LeapFrog and VTech are close competitors. While other types of toddler toys may provide some constraint on TEL toys, the CMA does not believe that sufficient competition would remain to constrain the Parties post-Merger.
7. With regard to child laptops/tablets, the Merger combines two of the main suppliers of child laptops/tablets in the UK. The CMA believes that the Parties are each other's closest competitor. The CMA found that a number of competitors have recently stopped supplying child laptops/tablets. The CMA does not believe that sufficient competition would remain to constrain the Parties post-Merger.
8. With regard to child smartwatches, the CMA did not find significant competition concerns as LeapFrog's smartwatch [X] for reasons not connected with the Merger and there are a number of alternative products available in the market.

9. With regard to child electronic reading systems, the CMA believes that the Parties would have been close competitors in the supply of child electronic reading systems. The CMA does not believe that sufficient competition would remain to constrain the Parties post-Merger.
10. On the basis of the evidence available, the CMA found that the Merger would give rise to a realistic prospect of a substantial lessening of competition (**SLC**) as a result of horizontal unilateral effects in the supply of TEL toys, child laptops/tablets and child electronic reading systems in the UK.
11. The CMA considered whether entry, or the expansion of existing firms, could mitigate the effect of the Merger on competition in relation to each of the three product categories listed at paragraph 10. Third parties submitted that entry would be difficult and/or costly for a number of reasons, including the need for a strong brand, specialist skills and technology, and knowledge and/or relevant contacts in the relevant segments. The CMA therefore believes that entry into these markets, or expansion by existing firms, will not prevent the SLC identified.
12. The CMA also considered whether buyer power could mitigate concerns arising from the Merger. VTech submitted that customers, in particular large retailers, have substantial buyer power. However, while the CMA recognises that some retailers may have a degree of buyer power, it did not receive sufficient evidence to conclude that buyer power would be sufficient to prevent the SLC identified.
13. In light of the above, the CMA believes that it is or may be the case that the Merger gives rise to a realistic prospect of an SLC in the supply of TEL toys, child laptops/tablets and child electronic reading systems in the UK.
14. The Parties invited the CMA to apply the *de minimis* exception¹ with regard to the markets for which the CMA concludes that there is a realistic prospect of an SLC. However, the aggregated annual value in the UK of the market(s) concerned is in excess of £10 million. Consistent with the CMA's policy not to apply the *de minimis* exception in circumstances where the size of the markets concerned exceeds £10 million, the CMA did not find it appropriate to apply this exception in this case.
15. VTech has until 25 August to offer an undertaking to the CMA that might be accepted by the CMA under section 73 of the Enterprise Act 2002 (**the Act**). If

¹ *Mergers: Exceptions to the duty to refer and undertakings in lieu of reference guidance* (OFT1122), December 2010, chapter 2. The *Mergers: Exceptions to the duty to refer and undertakings in lieu of reference guidance* were adopted by the CMA (see *Mergers: Guidance on the CMA's jurisdiction and procedure*, Annex D).

no such undertaking is offered, the CMA will refer the Merger pursuant to sections 22(1) and 34ZA(2) of the Act.

ASSESSMENT

Parties

16. VTech is a global leader in the supply of electronic learning products for infant and pre-school children and the world's largest manufacturer of cordless phones. It is incorporated in Bermuda, has its corporate/head office in Hong Kong and has subsidiaries in the UK (VTech Electronics Europe Plc and VTech Communications Limited). In the UK, VTech supplies a range of toys, ranging from baby walkers, rattles and soft toys to electronic learning toys, tablets, and gaming consoles. The turnover of VTech for the year ending 31 March 2016 was around £[redacted] million in the UK.
17. LeapFrog is a leading developer of educational entertainment for children. It is incorporated in the USA, has its global headquarters in California and has a subsidiary in the UK (LeapFrog Toys (UK) Limited). In the UK, LeapFrog supplies a range of toys, including multi-media learning platforms, electronic learning toys, tablets, developmental games, and 'learn to read and write systems'. LeapFrog's business in the UK and Ireland (**LeapFrog UK**) sells toys directly to retailers in the UK and Ireland, as well as to retailers in other countries.² LeapFrog UK also sells directly to customers through an online 'App centre'.³ The turnover of LeapFrog for the year ending 31 March 2016 was around £[redacted] million in the UK.

Transaction

18. The Merger involved the acquisition by VTech of 100% of the outstanding common stock of LeapFrog.⁴
19. VTech informed the CMA that the Merger was not notified to any competition authority but that the US Federal Trade Commission launched a voluntary investigation into the Transaction, which it closed on 28 March 2016.⁵

² Approximately [redacted]% of the workload for LeapFrog UK concerns the UK and Irish markets, with the remaining [redacted]% concerning sales in other countries.

³ The online App centre is a web-based store through which customers can purchase and download digital content developed by LeapFrog and other companies for compatible LeapFrog devices.

⁴ VTech press release (5 April 2016): '[VTech Completes Acquisition of LeapFrog](#)'.

⁵ Consolidated response to CMA requests for information of 27 April 2016 – 20 June 2016, paragraph 10.

Jurisdiction

20. As a result of the Merger, the enterprises of VTech and LeapFrog have ceased to be distinct.
21. The Parties overlap in the supply of TEL toys, with a combined share of supply by value of [50-60]% (increment of [10-20]%) (see Table 5 below). The CMA therefore believes that the share of supply test in section 23 of the Act is met.
22. The Merger completed on 4 April 2016. The CMA opened an own-initiative investigation into the Merger by sending an Enquiry Letter to VTech on 27 April 2016.⁶
23. The four month deadline for a decision under section 24 of the Act is 18 August 2016, following extensions under section 25(2) of the Act.
24. The CMA therefore believes that it is or may be the case that a relevant merger situation has been created.
25. The initial period for consideration of the Merger under section 34ZA(3) of the Act started on 27 June 2016 and the statutory 40 working day deadline for a decision is therefore 19 August 2016. The Merger was considered at a Case Review Meeting.⁷

Counterfactual

26. The CMA assesses a merger's impact relative to the situation that would prevail absent the merger (ie the counterfactual). For completed mergers the CMA generally adopts the pre-merger conditions of competition as the counterfactual against which to assess the impact of the merger. However, the CMA will assess the merger against an alternative counterfactual where, based on the evidence available to it, it believes that, in the absence of the merger, the prospect of these conditions continuing is not realistic, or there is a realistic prospect of a counterfactual that is more competitive than these conditions.⁸

⁶ See [Mergers: Guidance on the CMA's jurisdiction and procedure](#) (CMA2), January 2014, paragraphs 6.9-6.19 and 6.59-60.

⁷ See [Mergers: Guidance on the CMA's jurisdiction and procedure](#) (CMA2), January 2014, from paragraph 7.34.

⁸ [Merger Assessment Guidelines](#) (OFT1254/CC2), September 2010, from paragraph 4.3.5. The [Merger Assessment Guidelines](#) have been adopted by the CMA (see [Mergers: Guidance on the CMA's jurisdiction and procedure](#) (CMA2), January 2014, Annex D).

27. VTech submitted that the correct counterfactual for the assessment of the Merger is that, absent the transaction: (i) LeapFrog would have exited the market; (ii) there was no realistic alternative purchaser to VTech available; and (iii) if LeapFrog had exited the market, its sales would have moved not only to manufacturers of toys in the segments where LeapFrog was present, but also, significantly, to other segments of the toys market and/or to new products.⁹
28. As set out in the CMA's Merger Assessment Guidelines, for the CMA to accept an exiting firm scenario it would need to believe that:
- (a) it is inevitable that LeapFrog would exit the market (limb 1);
 - (b) there is no substantially less anti-competitive purchaser for the business or its assets (limb 2); and
 - (c) the Merger does not represent a substantially less competitive outcome compared with what would have happened to the sales of the business in the event of its exit (limb 3).¹⁰
29. The CMA considered each of these limbs, as set out below.

Limb 1 – would the target business have exited?

30. In considering whether LeapFrog, would, in the absence of the Merger, inevitably exit the market, the CMA examined evidence concerning LeapFrog's financial performance and a range of other factors, including its Board decisions and announcements, its interactions with third parties, its management actions and its discussions with potential purchasers.

Parties' views

31. VTech submitted that LeapFrog was a failing firm which was in serious financial distress and that there was a substantial risk that it would not have been able to continue normal business operations beyond mid-2016.¹¹ VTech told the CMA that, in LeapFrog's most recent financial report prior to the Merger (dated 9 February 2016), LeapFrog reported losses of \$105.6 million

⁹ Consolidated response to CMA requests for information of 27 April 2016 – 20 June 2016, paragraphs 242, 244 and 415.

¹⁰ [Merger Assessment Guidelines](#), see paragraph 4.3.10.

¹¹ LeapFrog submitted in its Quarterly Report (10-Q) that it will likely face substantial difficulties in generating sufficient liquidity to continue normal operations over the first two quarters of Fiscal 2017.

for the nine month period ending 31 December 2015. This followed losses of \$142.6 million for the same period in 2014.¹²

Financial performance

32. In assessing whether a firm's exit is inevitable, the CMA considers first whether the firm is unable to meet its financial obligations in the near future and whether it is unable to restructure itself successfully.¹³ In undertaking this assessment, the CMA examines both the firm's profitability over time and its balance sheet to determine the profile of its assets and liabilities. The CMA also considers the action management has taken to address the firm's position by reviewing contemporaneous documents such as board minutes, management accounts and strategic plans, and considers what further action might be taken.

Review of LeapFrog's profitability

33. Tables 1 and 2 below summarise LeapFrog's financial performance. Table 1, which is set out by financial year (**FY**), covers the period between FY 2011 and FY 2015. Table 2, which is set out by calendar quarter, shows the same information between the first quarter (Q1) of 2014 and the fourth quarter (Q4) of 2015. Table 3 summarises LeapFrog's net asset position using reported balance sheet figures, including submissions to the US Securities and Exchange Commission (**SEC**).
34. The CMA notes that, after limited profitability between 2009 and 2011, LeapFrog enjoyed two successful years in 2012 and 2013, with Profit after Tax of \$86 million and \$84 million respectively, and around 15% return on sales. The financial year end changed in 2014¹⁴ from December to March.

Table 1: Income Statement¹⁵ (Fiscal year) FY 11 to FY 15 in \$ million

	FY 11 Dec 11	FY 12 Dec 12	FY 13 Dec 13	FY 14 Mar 14	FY 15 Mar 15
Net Sales	455.15	581.29	553.62	527.56	339.15
Gross Profit	186.15	244.94	216.05	203.86	94.48
Net Profit (Loss)	19.90	86.45	84.01	75.57	(218.77)

¹² Annex 18F, 10Q for period ending 31 December 2015.

¹³ [Merger Assessment Guidelines](#), paragraph 4.3.14.

¹⁴ Year end changed from December 2013 to March 2014, so FY 2013 is year to 31 Dec 2013 and FY14 is 12 months to 31 March 2014 ie 9 months overlap.

¹⁵ Using summary of financial performance from [§], page 4 of Annex 21A and Annex 21B, Response to 1st S109 Notice and 10-Q and 10-K submissions.

35. VTech told the CMA that the toys business is seasonal, with greater sales in the second half of the calendar year. Problems emerged in 2014 as LeapFrog's profit in calendar Q1 2014 was \$8.4 million lower than a year earlier and the business was loss-making from this point on, peaking at a loss of \$124 million in Q4 2014, with sales of only \$145 million compared with expected sales of \$[redacted] million. This was principally due to disappointing sales from the LeapTV platform which was launched in autumn 2014.
36. The loss for FY 2015 (to March 15) was \$218.8 million and losses continued through 2015, with losses in calendar Q2, Q3 and Q4 of 2015 of \$27 million, \$34 million and \$44 million respectively, despite attempts to cut costs.

Table 2: Income Statement by quarter March 2014 – December 2015 in \$million¹⁶

	Mar 14	Jun 14	Sep 14	Dec 14	Mar 15	Jun 15	Sep 15	Dec 15
Net Sales	56.89	46.98	113.64	144.60	33.93	38.68	67.25	83.09
Gross Profit	21.12	8.83	37.01	45.13	3.51	7.23	6.26	7.41
Net Profit (Loss)	(11.78)	(16.37)	(2.03)	(124.21)	(76.17)	(27.33)	(34.07)	(44.23)

37. As a result of these losses, net assets more than halved between March 2014 and March 2015 from \$418 million to \$206 million, and they declined further to \$150 million in September 2015 and to £106 million in December 15, as shown in Table 3.

Table 3: Net Assets December 2011 – September 2015 in \$ million¹⁷

	FY 11 Dec 11	FY 12 Dec 12	FY 13 Dec 13	FY 14 Mar 14	FY 15 Mar 15	Jun 15	Sep 15	Dec 15
Net Assets	232.74	329.94	427.32	418.12	206.53	182.65	149.59	106.45

Liquidity issues

38. VTech submitted that LeapFrog would have faced a liquidity shortfall during 2016. [redacted].¹⁸

Figure 1: Projected range of LeapFrog's cash balance Jan 2016 – Mar 2017
[redacted]¹⁹

¹⁶ Based on 10-Q and 10-K submissions, with Q1 2015 calculated from 10-k for fiscal year ended March 31 2015.

¹⁷ Based on 10-Q and 10-K submissions.

¹⁸ [redacted].

¹⁹ [redacted].

39. VTech submitted that LeapFrog's cash flow forecast did not include any additional funding [REDACTED].²⁰ VTech told the CMA that, in January and February 2016, LeapFrog [REDACTED].²¹
40. LeapFrog's primary credit facility was set to expire in March 2017 and, prior to the Merger, LeapFrog reported in SEC filings that it was likely that it would be unable to renew or replace the facility in light of its recent financial performance. [REDACTED].

Movement in LeapFrog share price

41. LeapFrog's share price declined significantly over the 12 months to February 2016 with a marked decline following the announcement of its FY 2015 results (year to March 2015), as illustrated in Figure 2.²²

Figure 2: LeapFrog's share price movement over year to 3 February 2016

[REDACTED]

42. The fall in the share price below \$1 led to the New York Stock Exchange (**NYSE**) writing to LeapFrog on 4 September 2015 to notify it that, for the previous consecutive 30-trading-day-period, the average closing price for LeapFrog's common stock had closed below the minimum \$1.00 per share listing standard required for continued listing on the NYSE and that LeapFrog had six months in which to regain compliance.
43. On 2 March 2016, LeapFrog advised the NYSE that if the Merger failed to close and LeapFrog continued as an independent company, then it intended to seek the approval of its stockholders for a reverse split of LeapFrog's common stock at its 2016 annual meeting, to be held in August 2016. The reverse split would have been in an amount sufficient to bring the per share price of LeapFrog's common stock into compliance with the listing standards.²³

Evidence from third parties

44. Three UK creditors which responded to the CMA's merger investigation suggested that business²⁴ from LeapFrog had reduced and there were occasional delays in payment, but at the time of the Merger they were not

²⁰ Response to Q3 in sixth RFI received on 12 July 2016.

²¹ Consolidated response to CMA requests for information of 27 April 2016 – 20 June 2016, paragraphs 229-231.

²² Slide 18 of [REDACTED] Annex 8G of Second Request for Information dated 20 May 2016

²³ Section 802.01C of the NYSE Listed Company Manual. March 2, 2016. [Letter](#) from LeapFrog to NYSE Regulation, Inc., dated March 2, 2016.

²⁴ These suppliers provided a range of services to LeapFrog relating to marketing, advertising, design and communications.

concerned that they would not be paid. However, the CMA notes that these creditors only related to LeapFrog UK's business and their level of debt was [REDACTED].

45. The CMA asked LeapFrog's bank (Bank of America (**BoA**)) for its view on the prospects of LeapFrog in the absence of the Merger and, in particular, its view on LeapFrog's ability to continue servicing its debt. BoA told the CMA that the credit facility which it offered to LeapFrog was an asset-based revolving credit line based on the seasonal nature of the market (ie the credit line was \$75 million between September and December, reducing to \$50 million between January and August of each calendar year) and was a multi-year deal which was due to mature on 30 April 2017. BoA had structured the credit line to include performance-based criteria [REDACTED].
46. BoA told the CMA that LeapFrog's 10Q statement²⁵, referring to its liquidity problems and implications for LeapFrog as a going concern, gave it some concern over LeapFrog's financial situation. Subsequently, BoA had several discussions with LeapFrog in relation to the financial situation and possible solutions. BoA told the CMA that the loan to LeapFrog was still a performing loan [REDACTED] and that, at the time of the Merger, LeapFrog still had cash and liquidity from this loan. [REDACTED].
47. The CMA notes that, although the credit facility/debt was not failing at the time of the Merger, the CMA needs to take a forward view in its assessment. It is unclear whether BoA would have sought to reduce LeapFrog's revolving credit line further, or refused to extend the loan beyond April 2017, once it received LeapFrog's financial projections which would inform its lending decision.

Restructuring

48. The CMA considered whether LeapFrog could have returned to profitability as a result of restructuring.
49. VTech told the CMA that Leapfrog had undertaken a number of actions to restructure the business, including:²⁶
 - (a) reducing headcount by approximately 45% between January 2015 and March 2016, from [REDACTED] to [REDACTED] personnel;

²⁵ The Form 10-Q is a quarterly report of a company's performance and financial position that must be submitted to the United States Securities and Exchange Commission by all publicly traded corporations.

²⁶ Consolidated response to CMA requests for information of 27 April 2016 – 20 June 2016, paragraphs 456 and 544.

- (b) reducing inventory purchases. At 31 March 2016, worldwide inventory was \$[redacted] million, compared with \$[redacted] million a year earlier;
 - (c) subleasing (i) approximately 50% of LeapFrog's global headquarters in Emeryville, California, and (ii) warehouse space, to generate additional income and offset rental expenses;
 - (d) [redacted] [see end note 1];
 - (e) re-evaluating LeapFrog's financing options;
 - (f) deferring the development of new products;
 - (g) reducing other budgeted spend, such as advertising costs;
 - (h) [redacted]; and
 - (i) other general activities to reduce overheads and expenses, such as [redacted].
50. VTech said that LeapFrog had considered putting itself into voluntary liquidation. However, this was rejected in part because it was perceived at the time as being unlikely to maximise shareholder value, and because the liquidation process would have involved considerable time and uncertainty while LeapFrog faced ongoing severe liquidity problems.
51. VTech said that LeapFrog's repeated attempts to restructure its business were unsuccessful and LeapFrog continued to make losses, despite taking action to reduce its costs.²⁷
52. However, the CMA notes that LeapFrog was continuing to invest in new products which it intended to launch (eg the LeapStart). In its 2017 operating plan, dated 5 April 2016, LeapFrog noted that [redacted].

CMA assessment

53. On the basis of the evidence set out above, the CMA believes that it is possible that LeapFrog would have failed in the foreseeable future. The CMA notes that LeapFrog had been loss-making since early 2015 and successive attempts by management to restructure the business had been unsuccessful. The size of losses incurred by LeapFrog and the consequent reduction in its net asset value was significant and, at the time of the Merger, this decline was

²⁷ VTech's response to Request for Information dated 12 May 2016, Q18.

continuing. The stock market's lack of confidence in LeapFrog was shown clearly by the collapse of its share price.

54. The CMA notes that LeapFrog's cash flow projections showed a significant cash shortfall around mid-2016. LeapFrog's 10Q report, dated 9 February 2016, raised doubt over the company's ability to continue as a going concern due to liquidity problems in the first two quarters of Fiscal 2017, ie April – September 2017 [see endnote 2]. On the basis of the evidence the CMA has seen, it appears that it would have been a challenge for LeapFrog to remain viable independently (ie without further borrowing) from this time onwards. The CMA notes that it is possible that lenders might have been willing to extend credit further but LeapFrog had already taken significant steps to try to restructure the business and it continued to make significant losses.

CMA conclusion on limb 1

55. The CMA believes that LeapFrog's poor financial circumstances and cash flow difficulties indicate that the business would have faced a challenge to remain financially viable, in particular from mid-2016 onwards. Despite the steps which LeapFrog had taken to restructure its business, LeapFrog would not have been able to continue as a going concern without further funds being obtained by mid-2016. The CMA believes that, at the time of the Merger, LeapFrog was in a parlous situation. However, given the CMA's conclusion with regard to limb 2 below, it has not been necessary for the CMA to conclude on whether limb 1 of the exiting firm scenario is satisfied.

Limb 2 - would there have been an alternative purchaser for the business or its assets?

56. Where the CMA believes that a firm would inevitably have exited, it then considers whether, in the absence of the merger, there would have been other buyers of the firm or its assets which would have produced a better outcome for competition than the merger. When considering the prospect of an alternative buyer for the firm or its assets, the CMA will look at available evidence supporting any claims that the merger under consideration was the only possible merger. The CMA will take into account the prospects of all alternative offers above the liquidation value of the firm.²⁸

²⁸ [Merger Assessment Guidelines](#), paragraphs 4.3.16 – 4.3.17.

Sales process

57. VTech provided the CMA with a detailed timeline and description of the sales process, and a summary of the interactions between LeapFrog or its advisers with key interested parties. The CMA corroborated this evidence with third parties.²⁹
58. Table 4 summarises the most relevant potential buyers of LeapFrog as identified by VTech.

Table 4: Identities of unnamed entities listed in the SEC filings that submitted Indications of Interest

Reference ³⁰	Company
Company A	[REDACTED]
Company B	[REDACTED]
Two private equity firms	[REDACTED]
Firm A	[REDACTED]
Firm B	[REDACTED]
Firm C	[REDACTED]

Source: Consolidated response to CMA requests for information of 27 April 2016 – 20 June 2016, paragraph 241

59. VTech submitted that Morgan Stanley was appointed in May 2015 as LeapFrog's financial advisor. During June 2015, Morgan Stanley met with senior management and members of the LeapFrog Board to review its business and to consider its historical and potential operating performance and its plans.
60. VTech told the CMA that, on 29 June 2015, Morgan Stanley presented the preliminary results of its review to the LeapFrog Board. It recommended to the Board that LeapFrog should:
- (a) focus its exploration of strategic alternatives on a sale process; and
 - (b) continue to explore other alternatives in the event that a sale is not successful, including opportunities to reduce costs further, divest or license certain assets, and/or restructure the business.
61. Following Morgan Stanley's presentation, the LeapFrog Board directed senior management to prepare additional, revised operating plans and forecasts for the company that would focus on controlling overheads, reduce operating costs by addressing staffing levels and other factors, preserve liquidity, and

²⁹ Consolidated response to CMA requests for information of 27 April 2016 – 20 June 2016, paragraphs 151-224.

³⁰ Company references in this section are used in line with VTech's submission to the CMA.

pursue product development efforts that could lead to increased revenues during the 2017 holiday season. At the same time, the Board requested Morgan Stanley to take steps to explore a potential sale of the company.

62. Commencing on 21 July 2015, Morgan Stanley initially contacted 25 strategic parties and 28 private equity firms. Morgan Stanley subsequently distributed a confidential Information Memorandum about LeapFrog to 9 strategic parties and 16 private equity firms.
63. Between July 2015 and November 2015, there were various expressions of interest from potential buyers who conducted various degrees of due diligence on LeapFrog.
64. On 10 September and 14 September 2015, Morgan Stanley received indications of interest from two strategic parties (Companies A and B) and two private equity firms.
65. In relation to Company A's interest in LeapFrog, the CMA understands that the key events were as follows:
 - (a) On 10 September 2015, Company A made an Indication of Interest at \$2.20 per share.
 - (b) On 30 October 2015, Company A then submitted a revised Indication of Interest of \$1.10 per share, together with a detailed markup of a draft purchase agreement.
 - (c) On 6 November 2015, Company A withdrew its Indication of Interest and terminated its discussions with LeapFrog. Company A indicated to Morgan Stanley that it believed that the funds required to stabilise the LeapFrog business could be very substantial, in addition to the purchase price, and that it was not willing to accept the business risks associated with an undertaking of this magnitude. However, Company A indicated that it might be interested in purchasing assets from LeapFrog in a bankruptcy proceeding if the opportunity were to arise in the future.
66. In relation to Company B's interest in LeapFrog, the CMA understands that the key events were as follows:
 - (a) On 12 September 2015, Company B made an Indication of Interest at \$1.22 to \$1.26 per share.
 - (b) On 31 October 2015, Company B advised Morgan Stanley that it was unwilling to consider an acquisition of the entire company but could be

interested in an acquisition of LeapFrog's brand, toy business and interactive reading business for a total consideration of \$25 to \$30 million.

67. The Indication of Interest from the first private equity firm was the 'lower of market price or \$0.92 per share'. VTech told the CMA that this firm was not invited to undertake further due diligence because its offer was substantially lower than the offers for LeapFrog from Company A, Company B and the second private equity firm.
68. The Indication of Interest from the second private equity firm was \$1.13 to \$1.27 per share. This firm ended discussions with LeapFrog on 9 October 2015, expressing concerns about LeapFrog's ability to deliver its product pipeline and the scale of LeapFrog's infrastructure relative to its existing and potential revenues.
69. VTech submitted that, on 1 November 2015, the LeapFrog Board and senior management attended a meeting with Morgan Stanley to discuss the status of the process. At this meeting, it was concluded that LeapFrog should (a) initiate contact with VTech; and (b) pursue other financing and strategic opportunities in China, in order to generate additional options for LeapFrog.
70. Between 6 and 8 November 2015, LeapFrog met with Morgan Stanley to discuss:
 - (a) the impact of the termination of Company A's offer and the prospects for an alternative transaction emerging, including with VTech; and
 - (b) LeapFrog's financial performance and prospects. The Board discussed the company's financial outlook, including its liquidity over the next twelve months and thereafter, and possible revisions to LeapFrog's near term operating plan, including a further reduction in workforce and other cost saving measures.
71. VTech submitted that, on 12 November 2015, representatives of Morgan Stanley prepared a preliminary analysis of potential outcomes if LeapFrog were liquidated, based on assumptions provided by LeapFrog. The analysis calculated that liquidation was not likely to return more than \$0.75 per share to shareholders on the basis of these assumptions. The Board concluded that a liquidation of LeapFrog would involve considerable time and uncertainty and that, given the importance of continuing to operate the business, it needed to focus on pursuing possible strategic alternatives. It decided that spending further time analysing the impact of a liquidation would be unproductive.
72. VTech submitted that, during the week of 16 November 2015, LeapFrog met with 12 strategic parties and private equity firms in Beijing and Hong Kong.

Several of these firms subsequently executed non-disclosure agreements with LeapFrog and received information from Morgan Stanley concerning the business as well as a process timeline. This included Firms A, B and C (see Table 4 above).

73. In relation to Firm A's interest in LeapFrog, the CMA understands that the key events were as follows:

- (a) On 23 December 2015, Firm A presented an Indication of Interest to acquire LeapFrog for \$0.85 per share. Following submission of its proposal, Firm A was invited to engage in further due diligence and to schedule sessions with LeapFrog's senior management.
- (b) In January 2016, representatives of Firm A met with LeapFrog's senior management and performed due diligence in an electronic data room. Firm A retained professional service firms to assist it in this effort.
- (c) On 29 January 2016, Firm A withdrew its Indication of Interest to acquire LeapFrog for \$0.85 per share and submitted an alternative proposal to purchase a majority stake in and control of the business with an investment of \$65 million in a new series of preferred stock to be issued by LeapFrog for \$0.85 per share, with the preferred stock having a liquidation preference over the common stock.

74. Of the other parties which expressed an interest in LeapFrog in the week of 16 November 2015, the CMA understands that:

- (a) Firm B submitted a proposal on 13 January 2016 for LeapFrog to issue equity to Firm B at \$1.00 per share, under which Firm B would gain economic and voting control over LeapFrog. Firm B indicated that its proposal was subject to the approval of several governmental and regulatory agencies and parties and said that its timeline to receive these necessary approvals and to complete a transaction would be at least five to six months.
- (b) Firm C presented an Indication of Interest on 14 January 2016 to acquire LeapFrog for a purchase price of \$1.20 per share. Firm C indicated that it did not have the capability of financing its offer but was exploring options. The form of purchase agreement was provided to Firm C and Firm C engaged professional advisors; however, Firm C chose not to conduct on-site diligence meetings with LeapFrog's senior management. Firm C requested an extension to the end of February to submit a more definitive proposal.

75. In relation to VTech's interest in LeapFrog, the CMA understands that the key events were as follows:
- (a) On 15 December 2015, VTech submitted an Indication of Interest to acquire LeapFrog for \$1.00 per share.
 - (b) On 31 December 2015, a form of purchase agreement proposed by LeapFrog was submitted to VTech for comment.
 - (c) On 22 January 2016, VTech submitted a detailed markup of the purchase agreement and a form of tender and support agreement.
 - (d) On 27 January 2016, representatives of the LeapFrog Board and Morgan Stanley met with representatives of LeapFrog's shareholders and outlined the terms of a potential transaction with VTech.
 - (e) On 5 February 2016, VTech and LeapFrog issued a joint press release announcing the execution of the Merger Agreement. VTech agreed to acquire 100% of the outstanding common stock of LeapFrog for \$1.00 per share for LeapFrog's Class A and Class B shares and the total purchase consideration was around \$72 million.

Views of third parties

76. Morgan Stanley told the CMA that around 60 potential bidders were contacted during the initial sales process for LeapFrog. It said that, by October 2015, all but one potential bidder had withdrawn from the process and this potential bidder withdrew in early November 2015. Given these circumstances, LeapFrog identified additional financial and strategic investors and held meetings in China with various firms, including VTech, other strategic parties, and possible financial investors. Morgan Stanley told the CMA that it was transparent with parties about the urgency of LeapFrog's financial state. It said that VTech was the only firm that put forward an actionable proposal, while, for all the other bidders, there were concerns as to whether they could complete the deal in the necessary timeframe, including getting the necessary financing in place.³¹
77. Morgan Stanley told the CMA that, if VTech had dropped out, it would probably have continued to search for alternative buyers for LeapFrog, but it was unable to predict whether it would have found any alternative bidder or strategic investor. Morgan Stanley said that, if the business had been

³¹ [REDACTED].

liquidated, the brand may have had some value to a potential purchaser [see endnote 3].

78. [X] told the CMA that it saw LeapFrog as a globally recognised brand that would allow it to expand its business into the pre-school and infant market sectors and also to develop new products. [X] was interested in LeapFrog's physical assets, the brand and, in part, the electronic reading systems. It was less interested in Leap TV and the laptops/tablets. [X] said that it withdrew from acquiring LeapFrog because it considered that the tablets business (which accounted for a significant portion of LeapFrog's business) was unprofitable and the cost of restructuring LeapFrog was too high. [X] told the CMA that, if LeapFrog had been liquidated, it would have been interested in the brand (as long as exclusivity was ensured) and the physical assets.³²
79. [X] told the CMA that it was interested in LeapFrog's educational software. However, it withdrew from acquiring LeapFrog because it felt the valuation of the business was too high, taking into account its low profitability and the high costs of integration and restructuring. [X] expected that there would have been interest in LeapFrog from other toy companies because of its strong brand. [X] said that, in the event of liquidation or restructuring, while the brand value would be reduced, acquiring specific assets would probably have become more achievable. It expected that there would still have been interest in acquiring the LeapFrog brand.³³
80. Firm A told the CMA that it was a financial investor whose strategy focused on looking for firms with the opportunity to expand in the Chinese market. In relation to its possible acquisition of LeapFrog, Firm A told the CMA that it was surprised to learn on 5 February 2016 that LeapFrog had accepted VTech's offer as it had thought it was still in with a chance of having its bid accepted. Firm A indicated that it considered itself a serious bidder for LeapFrog, which was evidenced by: (a) submitting a detailed second round bid; (b) making two trips to meet with the management of LeapFrog in San Francisco; and (c) engaging the services of both a law firm and an accounting firm in New York for legal and financial due diligence work. Firm A also told the CMA that it has invested in 18 companies in the USA and, therefore, it believes that it has the necessary experience for such an acquisition.³⁴
81. Firm A stressed that at no point did it withdraw its bid, and that it was fully aware that LeapFrog was loss-making. It said that its revised offer (of \$65 million) was made in recognition of the fact that the LeapFrog business

³² [X].

³³ [X].

³⁴ [X].

needed additional funds in order to remain solvent. Firm A expected that its detailed financial, legal and intellectual property due diligence would have taken 4 to 6 weeks [see endnote 4].

82. Several competitors and retailers provided views on what they believed would have happened to LeapFrog in the absence of the Merger. One competitor suggested that another toy company was likely to have acquired LeapFrog, while another competitor suggested that bankruptcy was likely, though the brand was likely to have been sold. Three retailers highlighted the strength of LeapFrog's brand, though one suggested that the sale of the brand alone could have resulted in reduced innovation in the product range. One retailer suggested that LeapFrog would have continued to struggle on.

CMA assessment

83. The CMA notes that:
- (a) On 29 January 2016 (five days before VTech announced the Merger), Firm A had submitted a proposal to purchase a majority stake in LeapFrog with an investment of \$65 million (see paragraph 73).
 - (b) On 30 January 2016, when the LeapFrog Board met with Morgan Stanley to discuss the terms and conditions of VTech's proposal, the proposals of Firm A, Firm B and Firm C were also discussed. The Board noted that there was uncertainty as to the time required to negotiate and complete a transaction with any of these firms and to whether:
 - (i) LeapFrog's shareholders were likely to agree to support Firm A's offer;
 - (ii) delaying a transaction until later in February could be beneficial to LeapFrog's shareholders because of the higher price of Firm C's proposal; and
 - (iii) LeapFrog's share price might decline substantially further upon reporting the results of the third fiscal quarter, and whether a perception of weakness in LeapFrog's outlook could lead VTech to reduce its offer price below \$1.00 per share.
 - (c) VTech submitted that, on 22 March 2016, L&M Acquisitions, Inc. (**L&M**) submitted an unsolicited non-binding proposal to Leapfrog to purchase all of the outstanding Class A and Class B common stock of LeapFrog for a purchase price of \$1.10 per share. L&M also submitted forms of a proposed agreement, a plan of merger and a tender and support agreement. The CMA notes that the LeapFrog Board considered this offer

and determined that this proposal did not constitute a superior proposal to the VTech offer for various reasons, including that the transaction would be subject to the pre-merger notification requirements of the Hart-Scott-Rodino Act,³⁵ presenting a risk of additional regulatory review that could delay or even prevent completion of the transaction.

84. In relation to Firm A's bid, the CMA notes that:
- (a) Firm A would have been aware of LeapFrog's significant financial problems³⁶ and had revised its offer to a cash injection in light of this. The CMA believes Firm A's proposed cash injection should have been sufficient to meet Leapfrog's short-term liquidity shortfall;
 - (b) Leapfrog's shareholders were willing to approve a sale to VTech which suggests that, in the absence of the Merger, they would have been willing to accept an outcome that offered a higher value than liquidation. On this basis, the possibility that they would have accepted Firm A's lower bid appears plausible; and
 - (c) given the timing and status of Firm A's offer, and the further work it still needed to do, a deal with Firm A could have been completed before LeapFrog's expected liquidity problems emerged.
85. On the basis of this evidence, the CMA believes that, if the VTech bid had not been available, [REDACTED] an alternative purchaser and various bidders, including Firm A, are likely to have remained interested.
86. In relation to the prospects of LeapFrog receiving alternative offers above its liquidation value,³⁷ the CMA notes that:
- (a) third parties who responded to the CMA's merger investigation told the CMA that the LeapFrog brand is strong and would have been an attractive acquisition. This was confirmed by several bidders. Therefore, if the sale of the company was unsuccessful and not sold in its entirety, it appears likely that the brand of LeapFrog and some of its assets might have been sold separately;

³⁵ The HSR Act established the pre-merger notification program in USA which requires parties to certain proposed transactions to submit pre-merger notification to the Federal Trade Commission and Department of Justice.

³⁶ From publicly available information, Firm A would have been aware of the 2015 Q2 results which showed a loss of \$61m for the first 6 months with net assets of \$150m; in addition it would have seen the November revised forecast, projecting a full year loss of \$117m.

³⁷ [Merger Assessment Guidelines](#), paragraph 4.3.17.

- (b) there was an offer in relation to an asset acquisition of LeapFrog's brand, toy business and interactive reading business for a total consideration of \$25 to \$30 million (as noted in paragraph 66 above) [see endnote 5]; and
- (c) there was explicit interest from another potential buyer in purchasing assets from LeapFrog in a bankruptcy (as noted in paragraph 65 above).

87. Taking into account the broad range of bidders (including private equity firms) that expressed an interest in LeapFrog and/or its assets, the CMA considers that there would have been other buyers whose acquisition of LeapFrog as a going concern, or of its assets, would have produced a better outcome for competition than the Merger.

CMA conclusion on limb 2

88. In light of the evidence set out above, the CMA believes that the offer from VTech was not the only offer available for the LeapFrog business. The CMA believes that, in the absence of the Merger, there would have been alternative purchasers for the LeapFrog business or its assets that would not have raised competition concerns. For this reason, the CMA believes that limb 2 of the exiting firm scenario is not satisfied.

Limb 3 - what would have happened to the sales of LeapFrog?

Parties' views

89. VTech submitted that, if LeapFrog had exited the UK toys market, the absence of LeapFrog products would have resulted in increased sales in many alternative toys segments. It said that LeapFrog's sales would have shifted not only to manufacturers of toys in the segments where LeapFrog was present (eg TEL toys) but also to other segments of the toys market. This is because:

- (a) the toys market is dynamic with demand shifting among segments depending on what is 'trendy' at any given time;³⁸ and
- (b) the removal of LeapFrog products from UK retail stores (online, catalogues and bricks and mortar) would reduce the consumer exposure of the segments in which LeapFrog was present. Retailers would fill empty shelf space, not by doubling up on products similar to those of LeapFrog's, but with new products which are likely to generate consumer

³⁸ Consolidated response to CMA requests for information of 27 April 2016 – 20 June 2016, paragraphs 415-416.

demand. With reduced exposure to consumers, the overall demand would decrease in the segments where LeapFrog was present.

90. VTech said that demand had already shifted away from the deeper educational characteristic of LeapFrog's products, as shown in its decline, and the exit of LeapFrog would accelerate this shift, eg towards educational apps available for tablets at Google Play (Android) or the App Store (iOS).

CMA assessment

91. Given that the CMA believes that limb 2 is not met, the CMA has not considered where the sales of LeapFrog might go in the absence of the Merger.

CMA conclusion on limb 3

92. Given the CMA's conclusion with regard to limb 2 above, it has not been necessary for the CMA to conclude on whether limb 3 of the exiting firm scenario is satisfied.

Conclusion on counterfactual

93. For the reasons set out above, the CMA does not believe that all three limbs of the exiting firm counterfactual are satisfied in this case.
94. Therefore, the CMA believes the pre-Merger conditions of competition to be the relevant counterfactual.
95. The CMA notes that, taking into account the financial difficulties of LeapFrog, LeapFrog was a weaker competitor pre-Merger than it had been previously (eg up to FY 2015).³⁹ The CMA believes that, in any alternative scenario to the Merger (ie a full sale or liquidation), LeapFrog is likely to have remained a weakened competitor in the short to medium term, in particular given its staff cutbacks and its deferral of some development. For this reason, LeapFrog may have posed a weaker competitive constraint on VTech for at least some products than it had previously. However, the CMA also notes that LeapFrog still had a significant share of supply in all of its core segments, had retained most of its key staff and was continuing to develop new products.⁴⁰ Moreover, it is unclear how any alternative purchaser of LeapFrog would have sought to

³⁹ There is a reduction in shares of supply in relation to TEL toys from [10-20]% to [10-20]% between 2014 and 2015.

⁴⁰ LeapFrog still had [10-20]% share of supply of TEL toys and had products in every list of the US overall top 20 TEL toys until 2015. Furthermore, while VTech increased sales values for [X] of its UK top 20 products, LeapFrog increased sales value for [X] of its top 20 UK items. Additionally, sales data shows that LeapFrog launched [X] new products in 2015 (3rd S109, Annex 1B).

stabilise and restore the business. For these reasons, in its competitive assessment the CMA has considered the competitive constraint from LeapFrog as demonstrated in its activities over recent years as the appropriate counterfactual against which to assess the Merger.

Frame of reference

96. Market definition provides a framework for assessing the competitive effects of a merger and involves an element of judgement. The boundaries of the market do not determine the outcome of the analysis of the competitive effects of the merger, as it is recognised that there can be constraints on merger parties from outside the relevant market, segmentation within the relevant market, or other ways in which some constraints are more important than others. The CMA will take these factors into account in its competitive assessment.⁴¹

Product scope

97. The CMA's approach to assessing the product frame of reference is to begin with the overlapping products of the Parties in the narrowest plausible candidate product frame of reference and then to investigate whether this can be widened on the basis, primarily, of demand-side considerations.⁴²

Parties' views

98. VTech submitted that the relevant frame of reference is the supply of all types of toys. VTech said that toys constitute a single product market, which should not be broken down into segments for the purposes of the competitive assessment.⁴³
99. In support of this, VTech stated that, from a demand-side perspective, the characteristics of toys overlap across segments (within the toys industry) and customers do not view specific segments (eg electronic learning or pre-school electronic learning) as separate markets. Customers would simply purchase other toys if prices of individual products increased or quality decreased. The Parties also noted that consumer demand in relation to toys was particularly 'capricious' as different toys fall in and out of fashion. The Parties said that, for

⁴¹ [Merger Assessment Guidelines](#), paragraph 5.2.2.

⁴² While the boundaries of the relevant product market are generally determined by reference to demand-side substitution alone, the CMA may widen the scope of the market where there is evidence of supply-side substitution, see [Merger Assessment Guidelines](#), paragraph 5.2.17.

⁴³ Consolidated response to CMA requests for information of 27 April 2016 – 20 June 2016, paragraphs 273 - 275 and 347.

this reason, toy manufacturers have to continue to develop and innovate their products to anticipate and influence demand.

100. VTech also submitted information to the CMA which showed that the toys market could be segmented by age (based on the segmentation used by NPD⁴⁴) into infant/toddler toys (for children of ages 0 to 3), pre-school toys (for children of ages 3 to 4) and youth toys (for children of ages 4 and older).⁴⁵

CMA assessment

101. The CMA has found that the evidence does not support a frame of reference for the supply of all toys. In particular:
- (a) NPD, which appears to be widely used as a source of market data in the toys industry, segments toys by type of toy and by age, and identifies various sub-categories, segments and sub-classes within the toy market.⁴⁶
 - (b) In *Hasbro, Argos and Littlewoods*, the CMA's predecessor body indicated that the relevant market is not as wide as all toys and games. It identified 10 categories within the toys market (including electronic learning aids and hand-held electronic games) and treated each of these as a separate relevant product market.⁴⁷
 - (c) In the present case, 18 third parties that responded to the CMA's merger investigation indicated that the toys market was segmented in some way:
 - (i) 12 third parties (retailers and competitors) said they segment the toys market by age.
 - (ii) Six third parties told the CMA that they have an 'electronic toys' segment, and one retailer told the CMA that, within the electronic toys segment, retailers segment the toy market by brand.

⁴⁴ NPD is a British company offering consumer market research and business solutions for the beauty, foodservice, sport and toy industry. VTech told the CMA that NPD gathers sales data directly from a large number of retailers in the UK (eg supermarkets and specialist retailers) and this data is then aggregated and included in market research reports and tables. NPD sales data covers 75% of toy sales in the UK. VTech considers that if the additional 25% of sales data were to be included (from retailers that have not agreed to supply sales data to NPD), the change to the Parties' shares would be minimal.

⁴⁵ Consolidated response to CMA requests for information of 27 April 2016 – 20 June 2016, paragraph 81.

⁴⁶ While the NPD segmentation is informative as to the absence of a frame of reference for the supply of toys, the CMA was unable to use the NPD data for the purposes of segmenting the market as similar toys were not always allocated to the same segments.

⁴⁷ This was for the purpose of the OFT's Guidance on Penalties. Decision of the Office of Fair Trading No. CA98/8/2003, *Agreements between Hasbro U.K. Ltd, Argos Ltd and Littlewoods Ltd fixing the price of Hasbro toys and games*, 21 November 2003 (Case CP/0480-01); paragraph 36.

- (iii) 10 third parties told the CMA that they have a segment for toys with a developmental, learning and/or educational purpose, and two third parties specifically said that they segmented toys into toys for educational and entertainment (play) purposes.
 - (d) Some alternative toy manufacturers which supply the UK market and which were identified by the Parties told the CMA that they do not consider themselves to compete with VTech or LeapFrog because their toys are targeted to meet different customer demand. Other competitors said that they only compete with VTech or LeapFrog in relation to some types of toy, but not others, indicating separate customer demand.
 - (e) Evidence of any demand-side substitution by retailers between segments was very weak. Responses from retailers indicated that, in response to a 5% to 10% price increase in the price of TEL toys,⁴⁸ consumers would not switch readily between different types of toys.
 - (f) Furthermore, evidence of supply-side substitution was weak. Toy suppliers did not consider it easy to switch to supplying other types of toy that they were not currently supplying.
102. An analysis by the CMA of the product information supplied by the Parties⁴⁹ indicated that they overlap primarily in relation to the supply of electronic toys.⁵⁰ On the basis of a segmentation by age (similar to the approach by NPD), the CMA notes that the Parties supply:
- (a) toddler electronic learning (**TEL**) toys (for children of ages 0 to 3). TEL toys supplied by the Parties include: number/alphabet learning toys, fine motor skills toys (eg shape sorters, stacking toys), role play toys, musical toys, soft (or plush) toys, tablets/laptops, electronic books, etc;
 - (b) pre-school electronic learning (**PSEL**) toys (ages 3 to 4). PSEL toys supplied by the Parties include laptops/tablets, TV platforms, portable game consoles, electronic reading systems and fun electronic toys (eg activity toys, role play toys, outdoor toys, vehicles, musical instruments etc); and

⁴⁸ Customers were asked to explain how they would react if VTech and/or LeapFrog increased the wholesale price of TEL toys by 5% to 10%.

⁴⁹ See: Response to 3rd S109, Annex 1A VTech products 2015 & Annex 1B LeapFrog products 2015.

⁵⁰ Consolidated response to CMA requests for information of 27 April 2016 – 20 June 2016, paragraphs 110.

(c) youth electronic entertainment (**YEE**) toys (ages 4 and older). YEE toys supplied by the Parties include: smartwatches, cameras, portable game consoles, etc.

103. However, the CMA found that these segments are not mutually exclusive by age (especially for PSEL and YEE), as (a) many toys are used by children throughout the ‘early years foundation stage’ (ie ages 3-5) of the national curriculum;⁵¹ and (b) some toys are age graded or rated⁵² for use by children at various age bands from ages 3 – 11. For these reasons, the CMA refers to ‘child’ toys in defining the frame of reference, where this includes toys targeted at children from ages 3 and older.

104. Further analysis by the CMA of the Parties’ product sales⁵³ showed that the Parties overlap primarily in the supply of TEL toys, PSEL toys (specifically, child laptops/tablets and child smartwatches) and YEE toys (specifically, child smartwatches).⁵⁴ The CMA also noted that VTech was in the process of developing a child electronic reading system.

105. As its starting point, the CMA therefore considered the following narrow frames of reference, for the supply of:

(a) TEL toys;

(b) child laptops/tablets (and related software);

(c) child smartwatches; and

(d) child electronic reading systems.

106. The CMA then considered whether these frames of reference should be widened (or narrowed further), as discussed in the sections below.

TEL toys

107. TEL toys supplied by the Parties include: number/alphabet learning toys, fine motor skills toys (eg shape sorters, stacking toys), role play toys (eg kitchen

⁵¹ [The national curriculum](#).

⁵² For example, LeapFrog’s LeapPad series (for ages 3 – 9); the LeapBand (for ages 4 – 7); VTech’s InnoTab series (for ages 3 – 9); Kidizoom Camera series (for ages 3 – 9).

⁵³ Response to 3rd S109 Notice, Annex 1A VTech products 2015 & Annex 1B LeapFrog products 2015.

⁵⁴ The Parties have minor overlaps in musical instruments, walkers, and other infant toys. VTech has not provided detailed information on these products but the CMA notes that these products appear to have low shares of supply and small increments and, as such, are not considered further.

set, kids doctor case), musical toys, soft (or plush) toys, tablets/laptops, electronic books, etc.

108. VTech submitted that there is a high degree of product substitutability across the entire toys market, not least from the purchasing patterns of consumers which can be influenced by a number of factors including, but not limited to, new films or television programmes and fashionable or popular toys.⁵⁵
109. The CMA considered whether the product frame of reference could be widened to cover all ‘toddler toys’ (ie taking into account toys targeted at toddlers that do not fall into the category of electronic learning toys (eg non-electronic toys)).
110. Retailers told the CMA that, if the price of the Parties’ TEL toys increased by 5% to 10%, they would switch to other competitors (eg Hasbro, Mattel and Chicco) who supply similar TEL toys as well as other types of toddler toys.⁵⁶ It was unclear whether this was therefore an indication of substitutability with other TEL toys or other types of toddler toys.
111. Internal documents provided by VTech and LeapFrog (as discussed in paragraphs 159 to 167) show that, in relation to the Parties’ TEL products, the Parties primarily consider competition from other TEL toys. In particular:
 - (a) market analysis⁵⁷ by VTech from March 2014 and 2015 shows that, in relation to its TEL products, [REDACTED]; and
 - (b) a product plan (March 2015) submitted by LeapFrog on [REDACTED].⁵⁸
112. However, two internal documents⁵⁹ on product development show that LeapFrog may also consider competitive constraints from outside TEL toys:
 - (a) In one internal document, LeapFrog [REDACTED].⁶⁰
 - (b) In another internal document, for an electronic toy [REDACTED].⁶¹
113. The CMA recognises that there may be some degree of demand-side substitutability between TEL and other types of toddler toys. However, on the

⁵⁵ Consolidated response to CMA requests for information of 27 April 2016 – 20 June 2016, paragraphs 110.

⁵⁶ The CMA asked retailers how they would react (eg switch suppliers, reduce volumes purchased, alter prominence/display of these product groups, accept price increase, de-list product groups, etc.) if VTech and/or LeapFrog increased the wholesale price of TEL toys by 5 to 10%.

⁵⁷ See Annex 2A, 3rd S109: [REDACTED].

⁵⁸ 3rd S109 response follow up, Annex 2B, 2016 [REDACTED], p. 16.

⁵⁹ The CMA notes that these two documents were from a non-representative selection of documents provided to the CMA by LeapFrog and also represent a small subset of all evidence reviewed.

⁶⁰ Response to the CMA’s 3rd Section 109 notice, 2016 LFPD_Pineapple, pages 15-16.

⁶¹ Response to the CMA’s 3rd Section 109 notice, [REDACTED], page 3.

basis of the evidence set out above, in particular from third parties, and on a cautious basis, the CMA has adopted a narrow frame of reference for TEL toys only.

114. The CMA considered whether the product frame of reference should be narrowed further, taking into account the range of toys considered under TEL toys (as set out in paragraph 102(a)). However, the CMA found that TEL toys have a range of different characteristics which makes them difficult to place in a given segment. For instance, a plush toy could also be considered to be a musical toy if it sings and/or a learning toy if it promotes learning the alphabet or letters. There are therefore less well defined sub-segments in the toddler age group to support distinct frames of reference within TEL toys and, for this reason, the CMA has not defined a narrower frame of reference.
115. The CMA also considered whether the product frame of reference should be segmented to reflect customer preferences for TEL toys with more or less of an entertainment/play focus. However, the CMA found that there was no clear distinction between these toys as some TEL toys that appear to be marketed on the basis of their play element have strong learning value, and vice versa.
116. In light of the evidence summarised above, and on a cautious basis, the CMA has assessed the impact of the Merger in relation to the supply of TEL toys. However, the CMA has considered competitive constraints from outside this frame of reference where relevant in its competitive assessment.

Child laptops/tablets

117. Child laptops/tablets⁶² have some similarities to adult laptops/tablets but they differ significantly from adult tablets in their functionality. For instance, child laptops/tablets contain special safety features such as parental controls and kid-safe web functions, and their cases are more robust than adult laptops/tablets to protect them from breaking.
118. VTech again told the CMA that there is a high degree of product substitutability across the entire toys market. VTech compared the Argos catalogue from 2013 to 2015 and observed that the page space given to VTech's tablets has been reduced and replaced with other types of toys, including toys from other suppliers. VTech said that this shows that tablets are interchangeable (or substitutable) with other toys. VTech showed that the

⁶² The CMA does not see a clear distinction between laptops and tablets for children on the basis of functionality, price, etc and has therefore considered them together under the same frame of reference.

Argos 2016 catalogue displays VTech's products such as tablets, children cameras, TV platforms, smartwatches, and software on the same page.⁶³

119. The CMA considered whether the product frame of reference should be widened to cover other types of toys. The CMA noted that:
- (a) the positioning of products in a retail catalogue can be for a number of reasons, including branding, so little weight should be given to VTech's wider electronic products being positioned together; and
 - (b) retailers that responded to the CMA's merger investigation did not identify any other types of products to which retailers and consumers would switch in the event of a 5% to 10% price increase in child laptops/tablets.
120. On the basis of this evidence, the CMA believes that there is insufficient evidence to expand the product frame of reference beyond child laptops/tablets to include other types of toys.
121. VTech also submitted that consumers may switch from child laptops/tablets to similar adult-focused products. VTech provided an example from John Lewis' website, where customers who viewed a LeapFrog tablet also viewed the Amazon Fire Kids Edition, which is a tablet specifically targeted at children, as well as a number of adult tablets.⁶⁴ In VTech's view, this showed that customers who were considering purchasing the LeapFrog tablet also considered Amazon, Samsung and Apple tablets as possible alternatives.⁶⁵
122. Furthermore, VTech referred to an Ofcom report⁶⁶ which states that, in 2014, one in three children aged between 5 and 15 years owned their own 'tablet computer', rather than using devices belonging to their parents or school. The CMA notes while the Ofcom report provides some useful insight into the popularity of tablets amongst children, it is unable to draw any conclusions from this report as it neither defines the term 'tablet computer' nor differentiates explicitly between child and adult tablets. As such, the CMA is unable to infer the extent to which adult tablets are seen as alternatives to child tablets and/or the proportion of children that own adult tablets as opposed to child tablets.

⁶³ No other brand's product are displayed alongside VTech's products. See Consolidated response to CMA requests for information of 27 April 2016 – 20 June 2016, page 97.

⁶⁴ Consolidated response to CMA requests for information of 27 April 2016 – 20 June 2016, paragraphs 386 and 396.

⁶⁵ However, the CMA considers that there is insufficient information on consumer behaviour online to conclude that online searches reflect substitute products, as opposed to complementary or even unrelated products.

⁶⁶ OFCOM report, [Children and Parents: Media Use and Attitudes Report](#), October 2014 (page 4). See also Ofcom news (9 October 2014): '[One in three children now has their own tablet computer](#)'.

123. The CMA therefore considered whether the product frame of reference should be widened to take into account adult laptops/tablets and smartphones.
124. Seven third parties identified adult tablets and smartphones to be suitable substitute products for children. However, one retailer told the CMA that adult laptops/tablets may not be substitutable for the child versions for parents who are concerned about online security.
125. The CMA also notes that:
- (a) adult laptops/tablets and smartphones are targeted at a different customer segment (ie adults) and are not purchased by retailers' toy-buying teams or typically located in the shelf-space for toys at retailers;
 - (b) certain adult tablets (eg Apple iPads) are priced significantly higher than child laptops/tablets, and some of the accessories required to make adult tablets child-friendly (eg to protect from breakage) are expensive;
 - (c) the Amazon Fire Kids tablet is the children's version of Amazon's adult tablet (ie the Amazon Fire) that is specifically designed for and targeted at children, which indicates that Amazon believes there is demand for child laptops/tablets distinct from the demand for adult products; and
 - (d) there are important distinguishing features between adult and child laptop/tablets, including that a child laptop/tablet ensures that the child cannot access inappropriate content on the internet, it is more robust and less likely to break, it is branded differently, and typically it has a more child-friendly user interface.
126. The CMA acknowledges that demand for child laptops/tablets might be reduced by some parents choosing to allow children to use their devices, or by giving them spare devices which the adult no longer uses. However, while this may reduce sales of child laptops/tablets, the CMA has not seen evidence to indicate that adult tablets are close economic substitutes which would effectively constrain the price of child laptops/tablets.
127. For the reasons set out above, and on a cautious basis, the CMA believes that there is insufficient evidence to support widening the frame of reference to include adult laptops/tablets and/or smartphones.
128. The CMA also considered whether there should be a separate product frame of reference for software, which is used along with hardware.⁶⁷ However, the

⁶⁷ Both LeapFrog and VTech hardware mostly include some software. However, the majority of software has to be bought separately.

CMA found that both VTech's and LeapFrog's software is hardware specific (ie only VTech's and LeapFrog's software works respectively on VTech's and LeapFrog's devices). Third parties also told the CMA that consumers decide which hardware to purchase first and then choose the specific software. On the basis of this evidence, the CMA has not considered a separate product frame of reference for software, but has considered software as being in the same frame of reference as hardware.

129. In light of the evidence summarised above, and on a cautious basis, the CMA has assessed the impact of the Merger in relation to the supply of child laptops/tablets. However, the CMA has considered competitive constraints from outside this frame of reference where relevant in its competitive assessment.

Child smartwatches

130. Child smartwatches are wrist-mounted devices targeted at children aged 3 and older which, besides telling the time, incorporate other functions such as playing games, taking photos and tracking activity.
131. VTech did not make any submissions in relation to child smartwatches specifically (apart from the case set out in paragraph 108) and did not identify any other types of products to which retailers and consumers would switch in the event of a 5% to 10% price increase.
132. The CMA did not consider smartwatches in its initial market testing, although two retailers told the CMA that the Parties compete strongly in smartwatches. These retailers did not identify any other products to which retailers and consumers would switch in the event of a 5% to 10% price increase.
133. The CMA received no evidence indicating that a narrower frame of reference (eg by functionality) was appropriate.
134. On the basis of this evidence, the CMA has assessed the impact of the Merger in relation to the supply of child smartwatches.

Child electronic reading systems

135. Child electronic reading systems are electronic systems that involve the audio (electronic) narration of an accompanying physical book. These child electronic reading systems enhance the reading experience of children aged 3 and older. They typically use electronic devices that trigger the audio narrative.

136. VTech did not make any submission in relation to child electronic reading systems specifically (apart from the case set out in paragraph 108) and did not identify any other types of products to which retailers and consumers would switch in the event of a 5% to 10% price increase.
137. The CMA received no evidence indicating that a wider frame of reference was appropriate. Furthermore, the Parties did not provide any evidence to support a wider frame of reference.
138. On a cautious basis, the CMA has assessed the impact of the Merger in relation to the supply of child electronic reading systems.

Conclusion on product scope

139. For the reasons set out above, and on a cautious basis, the CMA has considered the impact of the Merger in the following product frames of reference:
 - (a) the supply of TEL toys;
 - (b) the supply of child laptops/tablets;
 - (c) the supply of child smartwatches; and
 - (d) the supply of child electronic reading systems.

Geographic scope

140. VTech submitted that children's toys are, to a large extent, developed and sold to retailers at a global level (eg Amazon are active at a global level). Therefore, the geographic market for children's toys is wider than the UK.
141. In *Hasbro, Argos and Littlewoods*, the CMA's predecessor body considered that it was unlikely that the market for toys and games could be defined more narrowly than national and, for the purposes of calculating penalties, it considered the relevant market was for toys and games in the UK.⁶⁸
142. In the present case, third parties which responded to the CMA's merger investigation indicated that:

⁶⁸ Decision of the Office of Fair Trading No. CA98/8/2003, Agreements between Hasbro U.K. Ltd, Argos Ltd and Littlewoods Ltd fixing the price of Hasbro toys and games, 21 November 2003 (Case CP/0480-01); paragraph 36.

- (a) whilst the supply, development and production for most toys occurs at an international level, many other functions, including advertising, marketing and price setting are typically determined on a UK or EEA level; and
 - (b) having a close relationship with UK retailers is ‘very important’ for a toy supplier seeking to supply into the UK, which generally necessitates a local UK presence.
143. In relation to product development and innovation, the evidence available to the CMA in relation to the Parties’ activities indicates that:
- (a) [REDACTED];⁶⁹
 - (b) [REDACTED];⁷⁰ and
 - (c) [REDACTED].⁷¹
144. Seven retailers told the CMA that they had not considered using toy suppliers that are not already supplying into the UK.
145. The CMA also notes that some of the Parties’ products are designed specifically for English-speaking children, and use UK English rather than North American English.
146. On the basis of this evidence, and on a cautious basis, the CMA has considered the impact of the Merger in the UK. Nevertheless, the CMA considered the constraint posed by competitors from outside the UK in its competitive assessment.

Conclusion on frame of reference

147. For the reasons set out above, the CMA has considered the impact of the Merger in the following product frames of reference on a UK-wide basis:
- (a) the supply of TEL toys;
 - (b) the supply of child laptops/tablets;
 - (c) the supply of child smartwatches; and
 - (d) the supply of child electronic reading systems.

⁶⁹ Consolidated response to CMA requests for information of 27 April 2016 – 20 June 2016, paragraph 10.

⁷⁰ Briefing Paper: LeapFrog’s business in the UK, 3 May 2016, paragraph 19.

⁷¹ [REDACTED].

Competitive assessment

Horizontal unilateral effects

148. Horizontal unilateral effects may arise when one firm merges with a competitor that previously provided a competitive constraint, allowing the merged firm profitably to raise prices or degrade quality on its own and without needing to coordinate with its rivals.⁷² Horizontal unilateral effects are more likely when the merger parties are close competitors.
149. The CMA has considered whether the Merger gives rise to the prospect of unilateral horizontal effects through the loss of actual competition in the supply of:
- (a) TEL toys;
 - (b) child laptops/tablets; and
 - (c) child smartwatches.
150. The CMA has also considered whether the Merger gives rise to the prospect of unilateral horizontal effects through the loss of potential competition in the supply of child electronic reading systems.
151. The CMA believes that the Merger does not give rise to competition concerns in relation to the supply of other toys⁷³ where the Parties overlap, given the Parties' low combined share of supply in these products, the low increment as a result of the Merger, and/or the presence of a number of alternative competitors. Therefore, the CMA does not discuss further the impact of the Merger on the supply of these toys.
152. In order to assess the likelihood of the Merger resulting in unilateral effects, the CMA has considered:
- (a) shares of supply;
 - (b) the closeness of competition between the Parties; and
 - (c) competitive constraints from alternative suppliers.
153. In the competitive assessment, the CMA has considered the impact of the Merger on the functions which typically occur at the UK level (ie advertising,

⁷² [Merger Assessment Guidelines](#), from paragraph 5.4.1.

⁷³ For example, children's musical instruments, walkers and other infant toys. The CMA considered child TV platforms where the Parties overlapped but noted that the Parties' TV platforms [§<] for reasons not connected with the Merger. See *Parties' response to the Issue letter of 28 July 2016, paragraph 94 and Annexes 10A-C*.

marketing and price setting), while recognising that the Merger may impact on product development and innovation as it impacts on the UK for the reasons set out in paragraph 143.

Horizontal unilateral effects arising from the loss of actual competition in the supply of TEL toys

Shares of supply

154. VTech submitted NPD data which shows shares of supply for TEL toys by value. Notwithstanding the limitations of this data,⁷⁴ Table 5 shows that VTech is the biggest supplier of TEL toys followed by Mattel and LeapFrog. There are four other named suppliers but these all have shares of supply of less than [0-5]%.

Table 5: Toddler electronic learning toys market, UK

	2012		2013		2014		2015	
	Value (£000s)	Share	Value (£000s)	Share	Value (£000s)	Share	Value (£000s)	Share
VTech	[X]	[40-50]%	[X]	[40-50]%	[X]	[30-40]%	[X]	[40-50]%
Leapfrog	[X]	[20-30]%	[X]	[20-30]%	[X]	[10-20]%	[X]	[10-20]%
Combined	[X]	[60-70]%	[X]	[60-70]%	[X]	[50-60]%	[X]	[50-60]%
Mattel	[X]	[20-30]%	[X]	[20-30]%	[X]	[20-30]%	[X]	[20-30]%
MGA	[X]	[0-5]%	[X]	[0-5]%	[X]	[0-5]%	[X]	[0-5]%
KD Group	[X]	[0-5]%	[X]	[0-5]%	[X]	[0-5]%	[X]	[0-5]%
Clementoni	[X]	[0-5]%	[X]	[0-5]%	[X]	[0-5]%	[X]	[0-5]%
Kids II	[X]	[0-5]%	[X]	[0-5]%	[X]	[0-5]%	[X]	[0-5]%
Others	[X]	[5-10]%	[X]	[5-10]%	[X]	[5-10]%	[X]	[5-10]%
TOTAL	[X]	100%	[X]	100%	[X]	100%	[X]	100%

Source: Consolidated response to CMA requests for information of 27 April 2016 – 20 June 2016

155. The Parties have a combined share of supply of TEL toys in the UK of around [50-60]%. The CMA believes that this combined share of supply raises *prima facie* competition concerns, in particular given that:

- (a) apart from Mattel, all other suppliers of TEL toys have substantially smaller shares in the UK; and

⁷⁴ The CMA notes that segments under NPD do not appear to be comprehensive ie there was no clear and systematic pattern as to why certain products have been allocated to certain segments and why similar products have been excluded.

(b) shares of supply, and the value of sales, for the three main suppliers of TEL toys (VTech, Mattel and LeapFrog) have all been quite stable since 2012.⁷⁵

156. The CMA notes that this level of stability does not appear consistent with the Parties' submission that the capricious nature of consumer demand creates great volatility in the Parties' sales. Rather, the stability of the shares appears to indicate (i) the importance of the brands of the largest manufacturers, (ii) the distinctive abilities of their development teams to drive new products, and/or (iii) the existence of established toys which these major suppliers can rely on or develop incrementally.

157. However, the CMA recognises that market shares may not necessarily provide an accurate reflection of the extent of competition between firms when products are differentiated and has therefore considered other measures to assess the closeness of competition.

Closeness of competition

158. The CMA has examined the closeness of competition between the Parties and considered within its assessment:

(a) evidence from internal documents; and

(b) third party views.

Internal documents

159. The CMA asked the Parties to submit all documents prepared since 1 January 2014 in relation to price setting, including documents showing how VTech and LeapFrog take into account the prices of similar products sold by competitors.

160. The internal documents submitted by VTech indicate that it views LeapFrog as a close competitor. For example, one of VTech's internal documents (a board minute) states that LeapFrog [redacted].⁷⁶

⁷⁵ The CMA notes that there is a reduction in LeapFrog's shares of supply in relation to TEL toys from [10-20]% to [10-20]% between 2014 and 2015.

⁷⁶ Response to the CMA's 1st Section 109 Notice, Annex Q21-Board Minutes.

161. In 2014, VTech carried out market analysis comparing the top 20 TEL toys in the USA in 2013.⁷⁷ [REDACTED]:⁷⁸

(a) [REDACTED]

(b) [REDACTED]

(c) [REDACTED]

Table 6: VTech's reaction to its competitors' most successful products in the US, 2013

[REDACTED]

Source: Annex 2A, 3rd Section 109 Notice⁷⁹

162. This market analysis was repeated one year later, in March 2015, analysing the top 20 TEL toys in the USA in 2014.⁸⁰ [REDACTED]:

(a) [REDACTED]

(b) [REDACTED]

(c) [REDACTED]

163. This market analysis was repeated in 2016, analysing the top 20 TEL toys in the USA in 2015.⁸¹ [REDACTED].

164. The CMA notes that, by 2015:

(a) [REDACTED]

(b) [REDACTED]

165. In a separate presentation prepared by NPD for LeapFrog, LeapFrog's [REDACTED].⁸² [REDACTED].

166. LeapFrog submitted eight Product Concept Reviews that analyse potentially competing products. [REDACTED].

⁷⁷ [REDACTED] (prepared 14 March 2014), Response to 3rd Section 109 Notice: 2015_Core Learning _0314_NO appendix final.ppt, slides 45-48.

⁷⁸ There is no evidence to indicate that this analysis is not applicable to the UK market given that all the listed products were also available in the UK at some point, and the findings are consistent with the CMA's analysis of the top 10 products from VTech and LeapFrog.

⁷⁹ [REDACTED].

⁸⁰ Appendix 2A, 3rd S109, Core learning-no appendix 20150326(Macau final presented).ppt, slides 43ff.

⁸¹ [REDACTED].

⁸² Response to the CMA's 2nd Section 109 notice, Annex 1E - 2015 review of UK toy market, p.79

167. The CMA believes that these internal documents indicate that:
- (a) both LeapFrog and VTech develop new and upgrade existing TEL toys every year;
 - (b) in the past, LeapFrog appears to have been the leader in relation to innovative TEL products and VTech has responded to its innovation with similar products, though occasionally this has been the other way round; and
 - (c) VTech's direct response to all of LeapFrog's successful TEL toys (as well as Mattel's successful products) shows VTech competes closely with LeapFrog and Mattel in the supply of TEL toys.
168. The CMA notes that, while the above evidence relates to the USA, it is probative of the UK market given that the products marketed in the USA are similar to the products marketed in the UK and all the products listed were also available in the UK at some point in time. Furthermore, the CMA considers that the development and production for most toys occurs at an international level (as set out in paragraph 142) and, as such, VTech's responses would have impacted on the toys supplied to the UK. The CMA did not receive evidence relating specifically to the UK.

Third party views

169. The majority of retailers (and some competitors) stated that VTech's and LeapFrog's TEL toys are very similar and are close substitutes, particularly in terms of quality, value, educational purpose and/or brand recognition.
170. Two retailers said that LeapFrog is slightly more focused on educational toys, while VTech is more focused on toys for entertainment (play).
171. One retailer told the CMA that LeapFrog was historically the more innovative company but that, after the launch of a LeapFrog product, VTech would develop very similar products in subsequent seasons. Two retailers told the CMA that the Merger will reduce competition in relation to TEL toys. They said that, in particular, the Merger would reduce the need for innovation and price competitiveness.
172. Some retailers who responded to the CMA's merger investigation commented on the likely impact of the Merger on their buyer power:
- (a) one retailer stated that both VTech and LeapFrog were competing for a share of the same market, which meant there was healthy competition between them. It said that this competition could be leveraged as a buyer.

It said that, in particular, its negotiating power in relation to child laptops/tablets would be impacted as a result of the Merger;

- (b) another retailer stated that it has a stronger negotiating position with LeapFrog than with VTech. It said that it expects the Merger to result in it losing its negotiating power with LeapFrog. This retailer told the CMA that it relies on comparisons between the Parties' offers to negotiate better trading terms with the Parties, and that it expects the most significant impact from the Merger to be in relation to TEL toys;
- (c) another retailer told the CMA that, because the Parties were supplying similar products for sale within similar categories, VTech and LeapFrog were always aware that they had competition from each other and therefore always provided competitive quotes. It said that, if there were similar item launches in the same year (eg LeapFrog's LeapBand and VTech's Smartwatch), the Parties knew they were competing for the same shelf space and would offer competitive prices from the outset; and
- (d) other retailers indicated that, in the event of a 5% to 10% price increase, they would reduce sales volumes, reduce the prominence of products across all of the Parties' overlap products and/or try to negotiate on the price and seek supplier support towards advertising.

173. Overall, the CMA believes that the evidence from third parties is consistent with the evidence from the Parties' internal documents, indicating that: (a) the Parties' products are close substitutes; and (b) the Parties are close competitors in the supply of TEL toys. The CMA believes that the evidence shows LeapFrog provides an important competitive constraint on VTech and vice versa.

Alternative suppliers

174. Unilateral effects are more likely where retailers have little choice of alternative supplier. The CMA has therefore considered whether there are alternative suppliers of TEL toys which would provide a competitive constraint on the combined entity.
175. VTech named the following significant competitors to the Parties for TEL toys: LEGO, Hasbro, Mattel, Spin Master, KD Group and Ravensburger.
176. The CMA has assessed the constraint from these alternative suppliers by taking into consideration:
- (a) evidence from internal documents; and

(b) third party views.

Internal documents

177. The evidence from internal documents (eg in relation to Mattel) is discussed in paragraphs 161 to 167 above.

Third party views

178. Three competitors that responded to the CMA's merger investigation stated that their products are similar to those of VTech and LeapFrog. One competitor told the CMA that its TEL toys were similar to the Parties' products in terms of educational value, content and quality, while the other competitor indicated that its TEL toys were similar to the Parties' products in terms of their 'ability to support early development'. The third competitor told the CMA that it competes closely with VTech on price but less closely with LeapFrog as LeapFrog's products tend to be more educational in nature.

179. Of the other competitors that responded to the CMA's merger investigation:

(a) one competitor told the CMA that its products are much simpler in design and function than those of LeapFrog and VTech and it offers a smaller range of products; and

(b) one competitor did not consider itself to be a competitor in the toddlers segment.

180. One competitor mentioned own-brand products as possible alternatives to the Parties' products. However, all competitors who expressed a view on brand importance stated that an established brand is important in relation to TEL toys. Additionally, own-brand products are only available at a specific retailer, limiting the extent to which they constrain the Parties. For this reason, the CMA believes that own-brand products provide a limited competitive constraint on branded products.⁸³

CMA assessment

181. The CMA notes that:

(a) the Merger combines two of the three largest suppliers of TEL toys in the UK (based on shares of supply over the last four years);

⁸³ Five competitors responded to the question on brand importance.

- (b) internal documents show that VTech sees LeapFrog as a close competitor for TEL toys and reacts to its products with new product launches and product upgrades;
- (c) third parties identified the Parties as close competitors for TEL toys , with limited other competitors for these products; and
- (d) while there is some evidence to indicate that other types of toddler toys may provide some constraint on TEL toys, and there are other smaller suppliers of TEL toys which also provide some constraint on the Parties, third parties indicated that the Merger will reduce competition (in particular, by reducing innovation and price competitiveness).

182. For the reasons set out above, the CMA believes that there is not sufficient competition remaining post-Merger to constrain the Parties and that the Merger gives rise to a realistic prospect of an SLC as a result of horizontal unilateral effects in relation to the supply of TEL toys in the UK.

Horizontal unilateral effects through the loss of actual competition in the supply of child laptops/tablets

Shares of supply

183. VTech submitted NPD data which shows VTech’s and LeapFrog’s laptops/tablets for children in three different categories: (a) pre-school electronic learning; (b) hardware and software; and (c) children’s tablets. However, the CMA did not believe it appropriate to use this segmentation for the purpose of estimating shares of supply as:
- (a) there was no clear and systematic pattern as to why certain products were allocated to each of the three specific segments; and
 - (b) shares in some segments include products which are not laptops/tablets and exclude products that are laptops/tablets (eg none of VTech’s laptops/tablets are included in the children’s tablets segment, whilst some of LeapFrog’s laptops/tablets are included).
184. LeapFrog submitted an internal presentation⁸⁴ that lists the top 15 tablets (for 3 years and older) by value of sales for the UK, as shown in Table 7 below.

⁸⁴ 2015 review of the UK toy market by NPD.

Table 7: Sales Data by value (£) YTD December 2015 vs. 2014 based on TOP 15 tablets (3 years +)

	YTD 2014		YTD 2015	
	£	%	£	%
LeapFrog	[REDACTED]	[40-50]%	[REDACTED]	[40-50]%
VTech	[REDACTED]	[40-50]%	[REDACTED]	[30-40]%
Combined	[REDACTED]	[80-90]%	[REDACTED]	[80-90]%
KD Group	[REDACTED]	[5-10]%	[REDACTED]	[10-20]%
Samsung	[REDACTED]	[10-20]%	[REDACTED]	[0-5]%
Spin Master	[REDACTED]	[0-5]%	[REDACTED]	[0-5]%
TOTAL	[REDACTED]	100%	[REDACTED]	100%

Source: Annex 1E, 2nd Section 109 Notice, p.79.

185. The CMA notes that, based on total sales of the top 15 products:
- (a) the Parties had a combined share of supply of [80-90]% in 2014, which increased to [80-90]% in 2015;
 - (b) [REDACTED] of the top 15 child tablets are supplied by LeapFrog and [REDACTED] are supplied by VTech;
 - (c) KD Group, with three tablets in the top 15, is the third biggest competitor, with a significantly smaller market share of 6% in 2014 and 11% in 2015; and
 - (d) the total value of sales of the top 15 products declined significantly in the period, from £[REDACTED] million in 2014 to £[REDACTED] million in 2015.
186. The CMA notes that these shares of supply are only indicative as:
- (a) all child tablets outside of the top 15 products (if any) have been excluded;
 - (b) an analysis of VTech's and LeapFrog's sales data shows that the list of the top 15 child laptop/tablets does not include:
 - (i) VTech's newest tablet, the InnoTab Max 7, which has been sold since 2014 and is its most successful product to date;
 - (ii) LeapFrog's newest tablet, the LeapPad Tablet Epic, which was newly introduced in 2015 and performed better than the least successful tablet in the list of 15;
 - (iii) Amazon's Kindle Fire Kids and EE's Robin; and

- (c) VTech submitted that the list of products includes products like VTech's [redacted] which are located in the NPD category of Toddler Electronic Learning and may not fall under the frame of reference for child laptops/tablets.⁸⁵

187. However, the CMA notes that:

- (a) a LeapFrog presentation⁸⁶ states that the LeapPad had a market share of [30-40]% in 2013 and [40-50]% in 2014 based on NPD sales; and
- (b) a 2014 UK presentation by LeapFrog states that 'the tablet market is worth £[redacted]m' and 'two major players [redacted] with 90% share' [redacted].^{87,88}

188. On the basis of this evidence, the CMA believes that the Parties' combined share of supply in child laptops/tablets is high enough to raise *prima facie* competition concerns.

Closeness of competition

189. The CMA has examined the closeness of competition between the Parties and considered within its assessment:

- (a) the Parties' views;
- (b) evidence from internal documents; and
- (c) third party views.

Parties' views

190. VTech told the CMA that its tablets compete with tablets and smartphones manufactured by large tablet manufacturers, such as Apple, Amazon, Samsung, Microsoft, other Android tablet suppliers and retailer own-label tablet brands such as Argos' Eluma. VTech submitted that, due to the increased competition from these tablet manufacturers, the market for child-specific tablets is in decline.⁸⁹

⁸⁵ VTech's response to Issues Letter of 22 July 2016, dated 28 July, paragraph 82.

⁸⁶ 2nd Section 109 response, Annex 9J, p.77

⁸⁷ 2nd Section 109 response, Annex 9H, p. 40ff.

⁸⁸ LeapFrog told the CMA that these figures are taken from a quote by a toy industry analyst in an NPD press release. LeapFrog said that it does not have access to any data supporting this figure, or any insight into the products or products categories used to generate this estimate. Consolidated response to CMA requests for information of 27 April 2016 – 20 June 2016, paragraph 250.

⁸⁹ Consolidated response to CMA requests for information of 27 April 2016 – 20 June 2016, paragraph 289.

Internal documents

191. The CMA considered the extent to which the Parties' view each other as close competitors based on their internal documents.
192. VTech provided the CMA with the LeapPad Epic product development plan (Plan of Record) which summarises [REDACTED].⁹⁰ In terms of target audience, [REDACTED]. In terms of prices in the US, the LeapPad was [REDACTED]; however, the Parties told the CMA that [REDACTED].⁹¹
193. The Parties' internal documents indicate that [REDACTED]. For example, LeapFrog's 2014 UK road-show presentation indicates that the [REDACTED].⁹²
194. The Parties also submitted a number of presentations which suggest that VTech and LeapFrog are each other's closest competitor in the supply of child laptops/tablets:
- (a) [REDACTED].
- (b) An internal report by LeapFrog contains [REDACTED].⁹³

Third party views

195. Six third parties told the CMA that VTech and LeapFrog are very similar in the child laptops/tablets they supply on the basis of their content, quality and educational value. One competitor identified price and storage volume as key differences between VTech's and LeapFrog's child laptops/tablets.
196. Third parties said that consumers focus largely on price, educational content, quality/value and brand, and that the Parties compete closely on all these points. One competitor stated that brand had historically been an important factor in relation to child laptops/tablets because of the limited alternatives suitable for children and high levels of TV advertising. Another competitor told the CMA that it had been unsuccessful in trying to gain any significant market share because VTech's and LeapFrog's tablets are displayed most prominently by retailers.
197. Retailers told the CMA that LeapFrog had a consistently innovative approach to child laptop/tablets, with VTech often producing a similar product to LeapFrog in response in the following season.

⁹⁰ 2nd Section 109 response, Annex 9F, p.3.

⁹¹ [REDACTED].

⁹² 2nd Section 109 response, Annex 9h, p. 43.

⁹³ Response to 3rd RFI, Annex 17B.

198. Whilst a number of third parties identified adult tablets/smartphone brands as possible alternatives for end-customers in the event of a 5% to 10% price increase by the merged entity or a reduction in quality, these third parties did not specify whether the switch to more adult tablets would occur through hand-me-down tablets or through the purchase of new adult tablets instead of a child tablet.
199. Taking account the VTech's submission that the demand for child laptops/tablets is in decline, the CMA asked third parties about their expectations of child tablets over the next five years in respect of consumer demand.⁹⁴ The CMA understands that in 2013 there was very high demand from customers for child laptops/tablets. This was followed by over-saturation of the market and there was a lot of excess stock of child tablets as well as price swings which resulted in an overall decline in the demand for child tablets. Based on the information received from third parties, the CMA does not consider that there is sufficient evidence to support a view that demand for child tablets will disappear or that the market is not sustainable with multiple suppliers.
200. Overall, the CMA believes that the evidence from third parties is consistent with the evidence from the Parties' internal documents, indicating that: (a) the Parties' products are close substitutes; and (b) the Parties are two of the principal innovators in the supply of child laptops/tablets. The CMA believes that the evidence shows LeapFrog provides an important competitive constraint on VTech and vice versa.

Alternative suppliers

201. The CMA considered whether there are alternative suppliers of child laptops/tablets which would provide a competitive constraint on the combined entity.
202. VTech identified several alternative suppliers, including: Apple, Amazon, Samsung and Microsoft.
203. The CMA has assessed the constraint from these alternatives by taking into consideration:
- (a) evidence from internal documents; and

⁹⁴ Three competitors expect demand to increase; one competitor and two retailers expect demand to stabilise (with a possible decline in the long run); and two competitors and five retailers expect demand to continue to decline.

(b) third party views.

Internal documents

204. The evidence from internal documents is discussed in paragraphs 191 to 194 above.

Third party views

205. Two retailers told the CMA that child laptops/tablets would be the category that would provide the biggest opportunity for price increases. One retailer indicated that this would be the case particularly for parents who are concerned about child safety and may feel pressurised to accept price increases, rather than switch to adult tablets.

206. One competitor told the CMA that there are no other manufacturers of child tablets that serve the same age group (ages 2-6 years) as the Parties.

207. Third parties named a number of competitors in the supply of child laptops/tablets, but also noted some significant exit from the market in recent months. The CMA notes that:

(a) Tesco has exited the tablet market altogether, with the Hudl no longer being actively promoted;

(b) Fuhu has exited the UK;

(c) Sakar does not sell its tablet in the UK; and

(d) Lexibook told the CMA that it will only sell a few hundred tablets this year in the UK and will continue its focus on France.

CMA assessment

208. The CMA notes that:

(a) demand for child laptops/tablets is declining, as many parents hand down their own tablets and smartphones to children, but the size of this frame of reference is still substantial at around £[redacted]million (as shown in Table 7);

(b) while adult laptops/tablets may constrain child laptops/tablets to some extent, there is insufficient evidence to indicate customer demand substitution. Moreover, this constraint may be limited given the substantially higher cost of certain adult laptops/tablets (eg Apple iPads),

the greater functionality of adult laptops/tablets and parents' concerns about children's safety whilst online (see paragraph 117);

- (c) the Parties are the two main suppliers of child laptops/tablets in the UK, with a very high combined share of supply. Many of the child laptops/tablets that were identified as placing competitive constraints on the Parties have exited the market, whilst the Parties continue to supply their leading products. Furthermore, the other laptops/tablets that are still available from competitors are all targeted at older children than the Parties' products. In particular:
 - (i) [redacted] performance (as shown in Table 7 above) indicates that non-traditional toy manufacturers are not gaining share in the supply of child laptops/tablets;
 - (ii) KD Group's Kurio may pose some competitive constraint on the Parties but is targeted at older children; and
 - (iii) Amazon's Kindle Fire Kids may pose some competitive constraint on the Parties but appears to be targeted at older children;
- (d) internal documents from the Parties suggest that the Parties are each other's closest competitor for child laptops/tablets; and
- (e) third party evidence indicates that the Parties are each other's closest competitor for child laptops/tablets.

209. For the reasons set out above, the CMA believes that there is not sufficient competition remaining post-Merger to constrain the Parties, and that the Merger gives rise to a realistic prospect of an SLC as a result of horizontal unilateral effects in relation to the supply of child laptops/tablets in the UK.

Horizontal unilateral effects through the loss of actual competition in the supply of child smartwatches

Shares of supply

210. The Parties did not provide any information on shares of supply in relation to the supply of child smartwatches. VTech submitted that NPD does not report sales in relation to child smartwatches.

Closeness of competition

211. The CMA has examined the closeness of competition between the Parties and considered within its assessment:

- (a) similarities in the Parties' products;
- (b) evidence from internal documents; and
- (c) third party views.

Parties' products

212. The Parties submitted that neither VTech nor LeapFrog sells a product that is a smartwatch. They noted that VTech's Kidizoom Smartwatch is a wrist mounted camera while LeapFrog's LeapBand is an activity tracker. The Parties also told the CMA that children's watches and smartwatches are generally not purchased by toy-buying teams at retailers and some types of smartwatches (eg the Apple watch) are not audited by the toy industry.⁹⁵
213. VTech told the CMA that, [REDACTED].
214. The CMA notes that both products are listed in the top 20 items in NPD's youth electronics segment and no other smartwatch product is on the NPD list.
215. The CMA also notes that both products feature regularly in reviews of child smartwatches and have been compared directly against each other.⁹⁶

Internal documents

216. The CMA considered the extent to which the Parties' view each other as close competitors in relation to child smartwatches based on their internal documents.
217. An internal document⁹⁷ submitted by VTech suggests that it does not view LeapFrog's smartwatch as a close competitor to its smartwatch. In [REDACTED], VTech's smartwatch was considered to be differentiated to LeapFrog's LeapBand on the basis of:
- (a) Functionality: VTech's Kidizoom had more functions built in (eg alarm, stop watch, timer, voice recorder, etc) while the LeapBand was considered to be used for tracking activity and gaming;
 - (b) Price: Kidizoom was in the mid-range price band for smartwatches, while the LeapBand was in the lowest price band; and

⁹⁵ Consolidated response to CMA requests for information of 27 April 2016 – 20 June 2016, paragraph 85.

⁹⁶ See [Which is the best smartwatch for kids?](#)

⁹⁷ Annex 2A, 2015 [REDACTED], Follow Up on 3rd S109, p. 2

The analysis indicated that the closest competitor to VTech's Kidizoom in terms of functionality and price is the Sakar smartwatch.

Third party views

218. Two retailers identified smartwatches as an overlap product in which VTech and LeapFrog compete strongly. One retailer told the CMA that both products are located on the same shelf space in retailers' shops (amongst the Electronic Learning Aids (**ELA**) toys), and the main difference between LeapFrog's and VTech's smartwatches was VTech's link to the learning lodge⁹⁸ (which has now been stopped due to a hacking incident experienced by VTech in November 2015). This retailer told the CMA that it expects VTech to develop the Kidizoom smartwatch further each season whilst LeapFrog's smartwatch is unlikely to be further developed.

Alternative suppliers

219. The CMA considered whether there are alternative suppliers of child smartwatches which would provide a competitive constraint on the combined entity.
220. The CMA identified a number of alternative suppliers of child smartwatches, such as KD Group (Kurio smartwatch), Alcatel (kids tracker) and Lexibook.
221. The CMA assessed the constraint from these alternatives by taking into consideration:
- (a) similarities in the products; and
 - (b) third party views.

Similarity of products

222. In terms of functionality, the CMA notes that all of the smartwatches identified in paragraph 220, including the Parties products, are wrist-mounted products, have a time-telling function and some additional electronic functionality.

⁹⁸ Learning Lodge allows VTech customers to download learning games, e-books and other educational content to their VTech products from an online platform.

Third party views

223. One retailer told the CMA that, while the Alcatel smartwatch is located in the consumer electronics departments, the Kurio smartwatch is located in the same shelf space as LeapFrog's and VTech's smartwatches.
224. Sakar's smartwatch is not yet launched in the UK but is planned to enter in the last quarter of 2016. Sakar told the CMA that it sees itself as a close competitor to both LeapFrog and VTech in the supply of smartwatches. Additionally, Sakar identified Samsung, Lexibook⁹⁹ (with a license from Disney) and KD Group as competing producers of child smartwatches.

CMA assessment

225. The CMA notes that:
- (a) LeapFrog's smartwatch is [redacted] for reasons unconnected with the Merger; and
 - (b) there are a number of competing alternative products currently available in the UK (eg by Alcatel, KD Group, Lexibook) or soon to be launched (eg by Sakar).
226. Overall, the CMA did not find significant competition concerns in relation to child smartwatches.

Horizontal unilateral effects through the loss of potential competition in the supply of child electronic reading systems

227. LeapFrog supplies the LeapFrog LeapReader, LeapReader Junior and LeapStart electronic reading systems. VTech explained that:¹⁰⁰
- (a) LeapFrog's LeapReader reading and writing system is an electronic pen with a library of reading, activity and audio-books, used to teach children how to recognise and say letters or words, and how to write them. It is targeted at children aged 4-8. The LeapReader Junior is similar to the LeapReader, except that the electronic pen is shaped like a puppy. It is targeted at children aged 1-3.
 - (b) LeapFrog's LeapStart uses a stylus pen that recognises elements in dedicated physical books and speaks aloud to aid reading or for other

⁹⁹ Lexibook's Disney Frozen Multimedia Camera Watch sells at £40 and contains a camera, games and voice recorder, which is very similar to VTech's Kidizoom smartwatch.

¹⁰⁰ VTech's response to Issues Letter of 22 July 2016, dated 28 July, paragraphs 106-108.

educational purposes and is targeted at children aged 2-4 (LeapStart
Preschool) and 5-7 (LeapStart Primary School).

228. VTech's internal documents show the development of a [REDACTED] electronic child
electronic reading system [REDACTED]. [REDACTED] [see endnote 6].
229. The [REDACTED] is similar to LeapFrog's LeapReader and LeapStart electronic
reading systems in that it provides a toddler or young child with an audio
(electronic) narration of an accompanying physical book.
230. VTech's product is [REDACTED] in this frame of reference. However, the CMA
considered whether the Merger will result in lost potential competition.

Closeness of competition

231. In order to assess whether the loss of potential entry from VTech would lead
to an SLC, the CMA considered whether the entry of [REDACTED] would have been
likely and sufficient to constrain LeapFrog's product.

Likely

232. VTech's 2016 product development presentation [REDACTED].¹⁰¹
233. [REDACTED].
234. The CMA notes that:
- (a) the decision to [REDACTED] was taken after the Merger was announced and there
is no evidence to indicate that the [REDACTED] would have been discontinued
absent the Merger;
 - (b) no evidence has been provided in the form of contemporaneous
documents [REDACTED] to indicate that the [REDACTED];
 - (c) VTech [REDACTED];
 - (d) the notes of a meeting in [REDACTED] to discuss the [REDACTED] suggest that other
options for further development of the [REDACTED] were still being explored [REDACTED];
and
 - (e) it is plausible that, in the absence of the Merger, VTech would have kept
[REDACTED] (see paragraph (d)).

¹⁰¹ 3rd Section 109 response to follow up, [REDACTED], slides 3, 30-33.

235. On the basis of this evidence, the CMA believes that, absent the Merger, VTech intended to supply its [redacted] child electronic reading system from [redacted].

Sufficient

236. The CMA notes that there are similarities between the Parties' products. For example, [redacted] [see endnote 7]. The CMA notes that the planned price for [redacted] would have been [redacted] than LeapFrog's product. Taking into account the brand and advertising reach of VTech, the CMA believes that the entry of this product would have provided a constraint on LeapFrog in this frame of reference.

Alternative suppliers

237. The CMA has considered whether there are alternative suppliers of child electronic reading systems which would provide a competitive constraint on the combined entity.

238. VTech identified only one other supplier of child electronic reading systems in the UK: Learning Resources. Learning Resources supplies:

(a) 'Hot Dots' Pen and 'Hot Dots Jolly Phonics Inky Mouse Pen' which are electronic pens similar to LeapFrog's LeapReader. They function by interacting with dedicated Hot Dots content (books, flashcards, etc) and are targeted at the same age range as the LeapReader; and

(b) 'Hot Dots Jr. 'Ace' the Talking, Teaching Dog', 'Kat the Talking, Teaching Kitty Pen' and 'Ollie the Talking Teaching Owl', which, like LeapFrog's LeapReader Junior, are electronic pens shaped like a animal, which also function by interacting with dedicated Hot Dots content.

239. The CMA notes that the Hot Dots toys are electronic pens and therefore compete more closely with LeapFrog's LeapReader, rather than LeapFrog Junior. VTech's [redacted] would have imposed a competitive constraint on both LeapFrog Junior [redacted] and on LeapFrog's LeapReader and the Hot Dots products [redacted].

240. VTech also identified Ravensburger as a supplier of an electronic pen-based child reading system called the 'TipToi'. However, the CMA notes that this product is not yet available in the English language and it has seen no evidence that it will be launched in the UK.

CMA assessment

241. On the basis of this evidence, the CMA believes that the Parties would have been close competitors in the supply of child electronic reading systems. Third parties have indicated that VTech has repeatedly tracked the products of LeapFrog and developed competing products (see paragraphs 161 to 167). The CMA believes that, over the last three years, VTech has been seeking to develop a product in direct competition with LeapFrog's LeapReader and LeapStart child electronic reading systems, and [X] would have imposed a significant competitive constraint on LeapFrog. Although there is one competing provider of child electronic reading systems in the UK, the CMA believes that there is not sufficient competition remaining post-Merger to constrain the Parties.
242. For these reasons, the CMA believes that the Merger gives rise to a realistic prospect of an SLC as a result of horizontal unilateral effects in relation to the supply of child electronic reading systems in the UK.

Conclusion on horizontal unilateral effects

243. For the reasons set out in paragraphs 181, 209 and 241, the CMA found that the Merger would give rise to a realistic prospect of a SLC as a result of horizontal unilateral effects in relation to the supply of TEL toys, child laptops/tablets and child electronic reading systems in the UK.

Barriers to entry and expansion

244. Entry, or the expansion of existing firms, can mitigate the initial effect of a merger on competition, and in some cases may mean that there is no SLC. In assessing whether entry or expansion might prevent an SLC, the CMA considers whether such entry or expansion would be timely, likely and sufficient.¹⁰²
245. VTech submitted that there are many toy manufactures and developers and that the barriers to entry are generally considered to be low in light of the low capital requirements for research and development (**R&D**), product manufacturing, advertising and supply/distribution. VTech told the CMA that:¹⁰³
- (a) a toy can be launched following approximately one year of R&D;

¹⁰² [Merger Assessment Guidelines](#), from paragraph 5.8.1.

¹⁰³ Consolidated response to CMA requests for information of 27 April 2016 – 20 June 2016, paragraphs 88-90 and 340-344.

- (b) the development and manufacturing of toys is not a technology intensive activity, and it is possible to enter the toys market without incurring substantial capital expenditure. Given the ease with which 'white-label' products can be sourced from third-party manufacturers, no plant or machinery, and no factory, is required;
 - (c) it is not necessary to rely on any proprietary technology, patents or intellectual property owned by VTech or LeapFrog. If required, product design and development can be outsourced to a third party design agency;
 - (d) sales resource can be deployed from another division (in the case of a company entering the toys market from a different business area) or can otherwise be easily recruited; and
 - (e) given the volatility and dynamism of the trend-driven toys market in the UK, it is possible to gain a substantial share of supply within 12 months, particularly where a manufacturer (including a new entrant manufacturer) develops a very popular toy.
246. The CMA asked third parties, both competitors and retailers, about their entry and expansion plans, as well as about sponsored entry. The majority of respondents did not answer these questions as they said that they do not intend to expand beyond those toy segments in which they currently operate. Four of the five retailers which expressed a view said that they had not sponsored entry and had no plans to do so. Only one retailer indicated that it had sponsored entrants into the UK. However, the CMA notes that the entrants sponsored by this retailer do not supply toys in the Parties' overlap areas and the toys that were supplied are very simple and seasonal toys with little need for post-purchase customer service (eg no electronic or software element).
247. In relation to TEL toys, two competitors told the CMA that developing a new TEL toy is difficult or very difficult due to the expertise required. Retailers told the CMA that there are strong market players competing for shelf space and three retailers stated that having a strong brand is a key requirement to competing effectively. They said that these requirements make it difficult for a new entrant.
248. In relation to child laptops/tablets, two competitors said that they intend to launch new/updated child laptops/tablets; however one competitor stressed that its child laptops/tablets are different from and do not have the functionality of VTech and LeapFrog's child laptops/tablets. One retailer told the CMA that the strength of the Parties' brand and associated quality meant that VTech

and LeapFrog remained strong market participants even though a number of new child laptops/tablets have entered the market. Five competitors that are not active in the supply of child laptops/tablets told the CMA that it would be difficult and costly to produce these products for various reasons, including declining consumer demand, high production costs, lack of expertise and/or lack of relevant contacts in the segment. One of these competitors emphasised that it would not consider developing products in this category due to the specialist skills, technology and knowledge required and the significant time and investment that would be necessary. These competitors estimated that a product launch would take between one and three years.

249. The CMA has not received any evidence from third parties in relation to any of the frames of reference to indicate that entry or expansion is likely, or that it will be timely and sufficient to mitigate the identified SLC.
250. For the reasons set out above, in particular the responses from third parties to the CMA's merger investigation, the CMA believes that entry or expansion would not be timely, likely and sufficient to prevent a realistic prospect of an SLC as a result of the Merger.

Countervailing buyer power

251. In some circumstances, a customer may be able to use its negotiating strength to limit the ability of a merged firm to raise prices. The CMA refers to this as countervailing buyer power.¹⁰⁴
252. VTech submitted that the Parties sell the vast majority of their products to the largest retailers of toys in the UK, which are companies with substantial buying power. VTech provided two examples of interactions with [X] and [X] which in its view demonstrate countervailing buyer power.¹⁰⁵
253. VTech told the CMA that [X]
- (a) [X].
- (b) [X].
254. The CMA asked competitors to provide examples for any of their products which overlapped with the Parties' products where retailers had: (a) successfully threatened to allocate shelf space to another supplier in order to secure a lower wholesale price; or (b) allocated shelf space to another

¹⁰⁴ [Merger Assessment Guidelines](#), from paragraph 5.9.1.

¹⁰⁵ Consolidated response to CMA requests for information of 27 April 2016 – 20 June 2016, paragraphs 346-354.

supplier because it could not secure the wholesale price it wanted. None of the competitors provided us with any examples.

255. The CMA also considered the views of retailers who responded to the CMA's merger investigation and commented on the likely impact of the Merger on their buyer power (as set out in paragraph 172). The CMA asked competitors to indicate their rate of innovation of toys. Competitor's rates of innovation varied between six months and three years but, generally, product updates were considered after around two years. All competitors who responded told the CMA that innovation is costly, time consuming and difficult. All of the competitors who responded said that they are not currently developing any TEL toy to enter the UK market.
256. The CMA notes that, in relation to the points made by VTech:
- (a) VTech's [redacted] was addressed to [redacted]retailers, yet VTech was able to report only two examples of [redacted];
 - (b) LeapFrog did not provide any examples of countervailing buyer power;
 - (c) [redacted] ultimately agreed to [redacted]proposed by VTech [redacted], suggesting limited if any buyer power; and
 - (d) the relevant products in the [redacted] example are not an area of overlap of the Parties (ie LeapFrog does not supply child cameras).
257. While the CMA recognises that some retailers may have some buyer power, the CMA also notes that many retailers raised concerns about the Merger, particularly in relation to TEL toys and child laptops/tablets, saying that the Merger would have the effect of limiting their negotiating options.
258. On the basis of this evidence, the CMA believes that, if the Parties' customers have any buyer power, it is too limited to prevent an SLC in the supply of TEL toys, child laptops/tablets and child electronic reading systems in the UK.

Third party views

259. The CMA contacted retailers and competitors of the Parties and received responses from 14 retailers and 19 competitors. Although the majority of retailers were not, in general, concerned by the Merger, some retailers (in particular, toy retailers) expressed concerns that the number of suppliers available to them would be reduced and that the merged entity would be in a dominant position. Four competitors were also concerned about the Merger.

260. Third party comments have been taken into account where appropriate in the competitive assessment above.

Conclusion on SLC

261. Based on the evidence set out above, the CMA believes that it is or may be the case that the Merger has resulted, or may be expected to result, in an SLC as a result of horizontal unilateral effects in relation to the supply of TEL toys, child laptops/tablets and child electronic reading systems in the UK.

Exceptions to the duty to refer

262. Where the CMA's duty to refer is engaged, the CMA may, pursuant to section 22(2)(a) of the Act, decide not to refer the merger under investigation for a Phase 2 investigation on the basis that the market(s) concerned is/are not of sufficient importance to justify the making of a reference (the ***de minimis*** exception). The CMA has considered below whether it is appropriate to apply the *de minimis* exception to the present case.

Markets of insufficient importance

263. In considering whether to apply the *de minimis* exception, the CMA will consider, in broad terms, whether the costs involved in a reference would be disproportionate to the size of the market(s) concerned, taking into account also the likelihood that harm will arise, the magnitude of competition potentially lost and the duration of such effects.¹⁰⁶ The CMA will not generally apply the *de minimis* exception where the size of the markets concerned exceeds £10 million.¹⁰⁷
264. The Parties submitted that the CMA should consider applying the *de minimis* exception in this case.
265. The CMA notes that the aggregated annual value in the UK of the market(s) concerned (ie the markets for which the CMA concludes that there is a realistic prospect of an SLC) is in excess of £10 million. Specifically:

¹⁰⁶ [Mergers: Exceptions to the duty to refer and undertakings in lieu of reference guidance](#) (OFT1122), December 2010, chapter 2. The [Mergers: Exceptions to the duty to refer and undertakings in lieu of reference guidance](#) were adopted by the CMA (see [Mergers: Guidance on the CMA's jurisdiction and procedure](#), Annex D).

¹⁰⁷ [Mergers: Exceptions to the duty to refer and undertakings in lieu of reference guidance](#), paragraph 2.2.

- (a) the annual UK market size for TEL toys in 2015 was approximately £[redacted] million;¹⁰⁸
- (b) the annual UK market size for child laptops/tablets in 2015 was at least £[redacted] million (see Table 7);¹⁰⁹ and
- (c) the annual UK market size for child electronic reading systems in 2015 was at least £[redacted] million.¹¹⁰

266. Consistent with the CMA's policy not to apply the *de minimis* exception in circumstances where the size of the markets concerned exceeds £10 million, the CMA believes that it would not be appropriate to apply this exception in this case. Rather, the CMA believes that the markets concerned in this case are of sufficient importance to justify the making of a reference.

Decision

267. Consequently, the CMA believes that it is or may be the case that the Merger has resulted, or may be expected to result, in an SLC within a market or markets in the UK.

268. The CMA therefore believes that it is under a duty to refer under section 22(1) of the Act. However, the duty to refer is not exercised¹¹¹ whilst the CMA is considering whether to accept undertakings¹¹² instead of making such a reference. VTech has until 25 August¹¹³ to offer an undertaking to the CMA.¹¹⁴ The CMA will refer the Merger for a phase 2 investigation¹¹⁵ if VTech does not offer an undertaking by this date; if VTech indicates before this date that it does not wish to offer an undertaking; or if the CMA decides¹¹⁶ by 2 September that there are no reasonable grounds for believing that it might accept the undertaking offered by VTech, or a modified version of it.

269. The statutory four-month period mentioned in section 24 of the Act in which the CMA must reach a decision on reference in this case expires on 18 August. For the avoidance of doubt, the CMA hereby gives VTech notice pursuant to section 25(4) of the Act that it is extending the four-month period

¹⁰⁸ This is based on NPD sales data for the NPD sub-segment of TEL (Response to 3rd S109 Notice, Annex 2).

¹⁰⁹ This is based on NPD sales data for year to date (YTD) December 2015 of the Top 15 tablets by sales value. (Response to 2nd S109 Notice, Annex 1E, p.79)

¹¹⁰ This is based on sales data provided by LeapFrog for LeapFrog's LeapReader and Tag Junior reading systems and corresponding books. (Response to 3rd S109 Notice, Annex 1B).

¹¹¹ Section 22(3)(b) of the Act.

¹¹² Section 73 of the Act.

¹¹³ Section 73A(1) of the Act.

¹¹⁴ Section 73(2) of the Act.

¹¹⁵ Sections 22(1) and 34ZA(2) of the Act.

¹¹⁶ Section 73A(2) of the Act.

mentioned in section 24 of the Act. This extension comes into force on the date of receipt of this notice by VTech and will end with the earliest of the following events: the giving of the undertakings concerned; the expiry of the period of 10 working days beginning with the first day after the receipt by the CMA of a notice from VTech stating that it does not intend to give the undertakings; or the cancellation by the CMA of the extension.

Kate Collyer
Deputy Chief Economic Advisor
Competition and Markets Authority
18 August 2016

Endnotes

1. [✂].
2. In relation to paragraph 54, the reference to the first two quarters of Fiscal 2017, ie 'April – September 2017' should refer to 'April – September 2016'.
3. Paragraph 77 should read: Morgan Stanley told the CMA that, if VTech had dropped out, Morgan Stanley (at the direction of the LF Board) would probably have continued to search for alternative buyers for LeapFrog, but it was unable to predict whether it would have found any alternative bidder or strategic investor. Morgan Stanley said that, based on an indication of interest from a potential bidder, if the business had been liquidated, the brand may have had some value to a potential purchaser. Morgan Stanley informed the CMA that they were not experts in liquidations.
4. Paragraph 81 should read: Firm A confirmed that while it did change its second round offer to be different from its first round offer, it did not withdraw its bid during the process and it was fully aware that LeapFrog was loss-making. It said that its revised offer (of \$65 million) was made in recognition of the fact that the LeapFrog business needed additional funds in order to remain solvent. Firm A gave a rough estimate that its detailed financial, legal and intellectual property due diligence would have taken 4 to 6 weeks.
5. In relation to paragraph 86(b), the CMA notes that Company B, as per paragraph 66, had submitted an indication of interest, but later advised Morgan Stanley that it would be interested in an asset acquisition of LeapFrog's brand, toy business and interactive reading business for a total consideration of \$25 to \$30 million.
6. [✂]
7. [✂]