

COMPLETED ACQUISITION BY VTECH HOLDINGS LTD OF LEAPFROG ENTERPRISES INC

Issues statement

16 September 2016

The reference

1. On 30 August 2016, the Competition and Markets Authority (CMA), in exercise of its duty under section 22(1) of the Enterprise Act 2002 (the Act), referred the completed acquisition by VTech Holdings Ltd (VTech) of LeapFrog Enterprises Inc (Leapfrog) for further investigation and report by a group of CMA panel members (the inquiry group).
2. The CMA must decide:
 - (a) whether a relevant merger situation has been created; and
 - (b) if so, whether the creation of that situation has resulted, or may be expected to result, in a substantial lessening of competition (SLC) within any market or markets in the UK for goods or services.
3. In this statement, we set out the main issues we are likely to consider in reaching our decisions, having had regard to the evidence gathered to date including evidence set out in the phase 1 decision to refer the acquisition of Leapfrog by VTech for further investigation (the reference decision¹). This does not preclude the consideration of any other issues which may be identified during the course of our inquiry, which will include the gathering of further evidence.
4. Throughout this document, where appropriate, we refer to VTech and LeapFrog collectively as ‘the parties’.

¹ Reference decision.

Background

5. VTech purchased 100% of the outstanding common stock of LeapFrog at \$1 per share on 4 April 2016 through an all cash tender.
6. VTech is incorporated in Bermuda with its head office in Hong Kong. It produces electronic learning products for infant and pre-school children for sale globally, and is the world's largest manufacturer of cordless phones. In the UK, VTech supplies a range of toys, ranging from baby walkers, rattles and soft toys to electronic learning toys. It has no manufacturing facilities in the UK.
7. Leapfrog is a US corporation with its global headquarters in California. It is a leading developer of educational entertainment for children. In the UK, Leapfrog supplies a range of toys, including multi-media learning platforms, electronic learning toys, developmental games, and 'learn to read and write' systems. Leapfrog has no manufacturing facilities in the UK.
8. More information on the parties can be found in paragraphs 16 and 17 of the reference decision.
9. In this issues statement, we are using the following definitions:
 - **Toddler Electronic Learning (TEL) toys.** We consider TEL toys to be toys with an electronic element and a learning purpose, and targeted at children aged 0 to 3 years. This segment includes 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.
 - **Child laptops/tablets.** We consider child tablets/laptops to be toys which are targeted at children aged 3 years and older. They are similar visually to adult tablets/laptops, but differ significantly from adult tablets/laptops in functionality. For instance, the main purpose of child tablets/laptops is entertainment, such as playing games. Furthermore, child tablets/laptops contain special safety features such as parental controls and kid-safe web functions and their cases are more robust than adult tablets/laptops to protect them from breaking.
 - **Child reading systems.** We consider child reading systems to be 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 (eg electronic pen, figurine).

- **Child TV platforms.** We consider a child TV platform to be an educational, active video gaming system that can be connected to the TV, designed for children aged 3 to 8 years.
- **Child smartwatches.** We consider child smartwatches to be wrist-mounted devices that are targeted at children aged 3 and older and which, besides telling children the time, incorporate other functions such as playing games, taking photos, tracking activity.

Market definition

10. Market definition is a useful analytical tool, but not an end in itself, and identifying the relevant market involves an element of judgement. The boundaries of the market do not determine the outcome of the CMA's analysis of the competitive effects of the merger in any mechanistic way. In assessing whether a merger may give rise to an SLC, the CMA may take into account factors such as constraints outside the relevant market, segmentation within the relevant market, and other ways in which some constraints are more important than others.²
11. The parties overlap in the supply of electronic toys, and in particular:
 - TEL toys;
 - child tablets/laptops;
 - child TV platforms; and
 - child smartwatches.
12. Leapfrog also supplies child electronic reading systems, and, prior to the merger, VTech was in the process of developing a product for this market.
13. As set out in paragraphs 98 to 100 of the reference decision, the parties submitted that the appropriate product frame of reference in this case is the supply of all types of toys. They also submitted that the appropriate scope of the geographic frame of reference is wider than the UK (see paragraph 140 of the reference decision).

² [Merger Assessment Guidelines](#) (CC2/OFT 1254), September 2010, paragraph 5.2.2.

14. The CMA will investigate the extent to which different types of toys can be aggregated on the basis of demand-side substitution, or supply-side substitution, or both. In particular we will consider:
 - (a) the extent to which the product frame of reference should be widened from TEL toys to include other types of toys;
 - (b) the extent to which the child tablets/laptops product frame of reference should be widened to other types of toys, or to include adult laptops/tablets and smartphones;
 - (c) the extent to which there should be a separate product frame of reference for software, which is used along with hardware; and
 - (d) the extent to which the child reading systems frame of reference should be widened to other types of toys (including child laptops or tablets) or non-electronic reading systems.

Assessment of the competitive effects of the merger

Counterfactual

15. We will assess the possible effects of the merger on competition compared with the competitive conditions in the counterfactual situation (ie the competitive situation in the absence of the merger). We will therefore consider what would have been likely to have happened if the merger had not taken place, and in particular whether LeapFrog would have exited the relevant market(s) in the absence of the acquisition and, if so, whether there would have been an alternative purchaser to VTech of the company or its assets. We will also consider what would have happened to LeapFrog's sales in the event of its exit if there was not an alternative purchaser for the company.
16. As set out in paragraph 31 of the reference decision, the parties submitted that LeapFrog's exit from the UK was inevitable and that the appropriate counterfactual would be the market without LeapFrog.
17. In making our assessment, we will consider possible alternative scenarios and decide upon the appropriate counterfactual situation based on the facts available to us and the extent of foreseeable future developments.

Theories of harm

18. Theories of harm describe the possible ways in which an SLC could arise as a result of the merger and provide the framework for our analysis of the

competitive effects of the merger. We have set out below the four theories of harm which we intend to investigate. The first three theories of harm capture the effect on static competition, whilst the fourth theory of harm captures the dynamic aspects of competition in relation to innovation. However, we may revise our theories of harm as our inquiry progresses. Also, the identification of a theory of harm does not preclude an SLC being identified on another basis following further work by us, or the receipt of additional evidence. We welcome views on all the theories of harm set out below.

Theory of harm 1: Horizontal unilateral effects through the loss of actual competition in TEL toys

19. The removal of one party as a competitor in the supply of TEL could provide the incentive for the parties to deteriorate elements of their competitive offering in the UK, these could include:
 - (a) increasing the price of TEL toys; and/or
 - (b) deteriorating another competitive parameter that matters to retailers or end consumers such as quality.
20. We will investigate the extent to which:
 - (a) TEL toys are constrained by non-electronic, non-educational toys, or toys that are addressed at a wider age group than 0 to 3 year olds;
 - (b) pre-merger LeapFrog and VTech are close competitors;
 - (c) TEL toys produced by existing manufacturers constrain the parties;
 - (d) existing UK TEL participants are able to expand their range in a timely, likely or sufficient manner to constrain the parties; and
 - (e) possible entry into UK TEL by a new manufacturer(s) would be timely, likely or sufficient to constrain the parties.

Theory of harm 2: Horizontal unilateral effects through the loss of actual competition in child tablets/laptops

21. The removal of one party as a competitor in the market for the supply of child tablets/laptops, could provide the incentive for the parties to deteriorate elements of their competitive offering in the UK. These could include:
 - (a) increase the price of child tablets/laptops; and/or

(b) deteriorate another competitive parameter that matters to retailers or end consumers, such as quality.

22. We will investigate the extent to which:

- (a) child tablets and laptops are substitutable for one another and as such whether they should be analysed separately or together;
- (b) child tablets/laptops are constrained by other toys;
- (c) child tablets/laptops are constrained by 'hand me down' adult tablets/laptops;
- (d) pre-merger LeapFrog and VTech are close competitors;
- (e) child tablets/laptops produced by existing manufacturers constrain the parties;
- (f) existing UK child tablets/laptops market participants are able to expand in a timely, likely or sufficient manner to constrain the parties; and
- (g) Possible entry into UK child tablets/laptops by a new manufacturer(s) would be timely, likely or sufficient to constrain the parties.

Theory of harm 3: Horizontal unilateral effects through the loss of potential competition in child reading systems

23. Leapfrog manufactures a child reading system while at present, VTech does not. Prior to the merger, VTech explored the possibility of launching its own child reading system which would have competed against Leapfrog's product. The merger may result in an SLC if VTech abandoned its efforts to start supplying child reading systems as a result of the merger.

24. We will investigate:

- (a) the likelihood of VTech launching a child reading system pre-merger;
- (b) the extent to which LeapFrog and VTech were likely to have been close competitors should VTech have launched a child reading system;
- (c) whether child reading systems produced by existing manufacturers (both active and not active in the UK) would have constrained the parties; and
- (d) whether there are constraints on the merging parties' products, either within the child reading systems segment or outside of it.

Theory of harm 4: General loss of future competition in innovation

25. The industry is characterised by a high degree of product churn. As a result, firms need to constantly update existing products to add new features or develop entirely new products, in response to such changes by their rivals. As a result of the merger, innovation may decrease as Leapfrog and VTech will no longer be competing against each other to develop new products, so may be able to extend the lifespan of existing products without losing sales to rivals. Therefore, the merger could lead to a reduction in innovation and product development across the portfolio of products.
26. We will investigate the extent to which:
- (a) the parties compete against each other in innovating and developing new toys across the toy sector; and
 - (b) other competitors are able to drive innovation such that the current rate of innovation would be maintained.
27. We propose to assess the following:
- (a) analysis of the products the parties produced in the past and what reaction that triggered from the other party; and
 - (b) the frequency and intensity with which VTech and LeapFrog launch new products, how intensely they innovated in the past and how this may have changed over time.

Countervailing factors

28. We will consider whether there are countervailing factors which are likely to prevent or mitigate any SLC that we may find.

Entry and expansion

29. We plan to investigate the likelihood of entry and expansion and, in particular, whether:
- firms which produce other toys other than the overlap products, would be likely to enter the production of overlap products; and
 - large customers like Toys R Us and Amazon could sponsor new entry or expansion by guaranteeing shelf-space/listing prominence to a new entrant.

30. In order for entry and/or expansion to offset an SLC, entry and/or expansion would need to be timely, likely and sufficient.
31. To investigate these issues we intend to collect information on:
 - the history of entry, expansion and exit;
 - the likelihood of future entry/expansion in this market, including the potential for sponsored entry/expansion by large customers;
 - the likelihood of exit from this market. The parties have submitted that the market for child tablets is declining and likely to cease to exist in the long run. Therefore, we intend to explore further whether the market for child tablets and TEL is declining, and whether any future exits can be expected;
 - the barriers to entry, including the technical know-how required to produce some toys (eg tablets), the investments involved, and the likely time required to launch new products;
 - retailers' preferences to switch manufacturer (eg cost of switching, length of existing contracts, and importance of an established relationship); and
 - consumers' preferences associated with brand loyalty.

Buyer power

32. In order for countervailing buyer power to offset an SLC, retailers would have to have sufficient buyer power that could offset any attempt of the parties to increase prices or reduce quality and/or innovation.
33. We intend to investigate further how negotiations are carried out between the parties and buyers and how frequently these happen.
34. This analysis will be closely tied to the analysis of the different theories of harm given the conditions that need to hold for countervailing buyer power to be sufficient to offset an SLC, namely that there are sufficient outside options for retailers to switch to post-merger. These outside options may be (i) existing or new products from other competitors that retailers can credibly switch to; or (ii) the option for retailers to quickly and easily sponsor expansion from an existing competitor or new entry.

Efficiencies

35. We will examine any submissions made in relation to efficiencies arising from the merger. In particular, we will examine whether any potential efficiencies are rivalry-enhancing and could be expected to offset any loss of competition.

Other

36. We are not currently aware of any other countervailing factors.

Possible remedies and relevant customer benefits

37. If we conclude that the merger has resulted, or may be expected to result, in an SLC in any market(s), we will consider whether, and if so what, remedies might be appropriate, and will issue a further statement.
38. In any consideration of possible remedies, we may have regard to their effect on any relevant customer benefits in relation to the merger and, if so, what these benefits are likely to be and which customers would benefit.

Responses to the issues statement

39. Any party wishing to respond to this issues statement should do so in writing, by no later than **5pm on 30 September 2016**. Please email VTech.Leapfrog@cma.gsi.gov.uk or write to:

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