Completed Acquisition by VTech Holdings Limited of LeapFrog Enterprises Inc.

Initial Submission to the Competition and Markets Authority

11 October 2016

Linklaters

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COMPLETED ACQUISITION BY VTECH HOLDINGS LTD
OF LEAPFROG ENTERPRISES INC.

INITIAL SUBMISSION TO THE COMPETITION AND MARKETS AUTHORITY

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The problems with allocating time and resources to the tablet and content segment are simple: there are virtually no barriers to entry, penetration rates are now very high, and new competitors enter the field every year. Earning any profit, let alone an acceptable return on capital, is incredibly difficult, and at this point in time, seemingly unattainable.

Open letter of Blue Pacific Partners LLC to the LeapFrog Board of Directors, 15 July 2015[1]

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Post-merger:	number of new LeapFrog learning toys to be launched in the first season:	[Confidential]
Pre-merger:	average total of LeapFrog learning toys launched per season in 2015/2016:	[Confidential]
Counterfactual:	LeapFrog learning toys launched in the most likely counterfactual:	0

I. EXECUTIVE SUMMARY[2]

1. On 4 April 2016, VTech completed the acquisition of LeapFrog, in lieu of LeapFrog's liquidation. The latter was the inevitable alternative given the absence of other credible and timely bidders that could forestall the likely exercise of LeapFrog's directors' duties to place the firm in voluntary liquidation as early as [Confidential].

2. In order to restore stability to the LeapFrog global business which it desperately required, and [Confidential], VTech proceeded to commence integration of LeapFrog into VTech [Confidential]

3. By acquiring the business pre-liquidation, before it was too late, VTech was able [Confidential] of [Confidential].[3] In VTech's view, this pro-competitive outcome is demonstrably superior to UK consumers (and retailers) than any remotely plausible, let alone likely, counterfactual scenario.

4. On 27 April 2016 the CMA opened an investigation into the Transaction and LeapFrog UK has been carved out of the global integration programme of VTech since 12 May 2016, the date of the CMA's initial enforcement order.[4] On 30 August 2016, the CMA opened a Phase II inquiry, finding at Phase I that while LeapFrog's exit was inevitable, it could not rule out a realistic prospect of other potential purchasers, and (against an implicit a counterfactual of a wholly healthy LeapFrog) finding concerns in so-called Toddler Electronic Learning (TEL), child tablets/laptops, and child electronic reading systems.

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1 Open letter of Blue Pacific Partners (a LeapFrog stockholder) to the Board of LeapFrog, available at: http://www.prnewswire.com/news-releases/blue-pacific-partners-delivers-letter-to-leapfrog-board-300113435.html.

2 Capitalised terms are defined later on in this Submission.

3 This does not include ancillary products and LeapFrog products outside of learning toys. For learning toys, the average for 2015 ([Confidential]) and 2016 ([Confidential]) is [Confidential] new products. For comparison, the figure was [Confidential] in 2014.

4 As replaced by the subsequent interim order of 8 September 2016.

5. Even with an untenable disregard of the "elephant in the room" – LeapFrog's counterfactual position – in VTech's respectful view, such concerns are premised on a static snapshot of NPD data that presuppose that an array of other factors can be held constant. Such factors cannot reasonably be assumed to hold constant, given (i) dynamic consumer (and in turn retailer) tastes and substitution to new "hot products" across toy categories and away from child-specific tablets (especially in the costly "Apple-style" integrated hardware/software model which, for VTech and Leapfrog tablets, limits the utility of the product once the child has outgrown it, against a background of relatively saturated UK household Apple or/and Android tablet ownership) and across and outside TEL; and (ii) retailer's ability to vary shelf space allocation and negotiate across toy supplier product ranges – to reflect not only consumer tastes but the SKUs most profitable to them.

6. VTech is pleased to be engaging with the CMA Phase II team to demonstrate that an expeditious clearance of the Transaction would likely be not only not adverse to – but in the best interests of – UK consumers and retailers. As such, VTech believes that it is fully open to the CMA to find there is "no SLC" on the basis of (i) the "exiting firm" counterfactual analysis alone; or (ii) the competitive effects analysis alone even absent an appropriate counterfactual (i.e. assuming an implausibly healthy LeapFrog absent the Transaction) or both – which would constitute the most comprehensive approach, but may not be required.

7. In any event, under no circumstance can VTech see that the weight of evidence would permit any reasonable finding of an expectation that the Transaction has resulted, or may result, in a SLC in the UK.

8. Due to the upcoming 2017 autumn/winter cycle [Confidential] should the CMA agree that the Transaction does not give rise to a provisional expectation of a SLC in the UK.

I.1 No realistic counterfactual scenario, let alone the most likely one, is substantially more competitive than the post-Transaction outcome

9. The CMA's approach in a Phase II context focuses on the "*most likely*" counterfactual absent the merger in question.

I.1.1 Inevitable exit via voluntary liquidation but for the Transaction

10. The evidence is compelling in this case that – but for its rescue by VTech – LeapFrog was a "failing firm" in every sense. It would inevitably have exited the global marketplace, including the UK, most likely between [Confidential], through a voluntary liquidation process that had already been in contemplation in [Confidential].

11. In particular, LeapFrog's own cashflow estimates predicted [Confidential][5]

12. The high likelihood of voluntary liquidation is supported by LeapFrog's public SEC filing statements and the fact that the LeapFrog management team had privately begun making the requisite preparations for entering the company into voluntary liquidation at the time of the Transaction.

I.1.2 Absence of any credible and timely purchaser other than VTech

13. In reaching the conclusion of likely liquidation but for the Transaction, the Board was cognisant of the fact that there was no credible alternative purchaser of LeapFrog besides VTech.

[5] See in [Confidential].

14. In particular, no other party was in a position to execute on an acquisition of LeapFrog on a timetable that would realistically forestall a decision to liquidate, and nor did any of the in-principle interested parties possess the requisite operational synergies and industry know-how to alter the financial prospects of LeapFrog. Any delay in concluding the Transaction risked LeapFrog's ability to survive its impending solvency issue. In particular, LeapFrog needed to be in a sufficiently stable position to [Confidential]

- [Confidential]was one bidder who was engaged in the early stages of a proposal at the time VTech finalised its acquisition of LeapFrog. However, the uncertainty of its non-binding offer (which never materialised into a firm offer), the incompleteness of its due diligence (reflected by its request to extend the diligence period in a revised non-binding offer), its lack of synergies [Confidential] and lack of experience in the toys market and the fact that it would not have been able to complete its acquisition before [Confidential] at the earliest, demonstrate that [Confidential]was not a realistic alternative purchaser for LeapFrog.
- The last-minute offer by L&M Acquisitions Inc. could not be considered viable as, apart from anything else, the Board considered that pursuing the L&M bid at this late stage, when appropriate financing had not yet been identified, risked LeapFrog's survival in terms of completing any transaction before the need to take protective action in the form of voluntary liquidation.
- All other interested parties which submitted serious proposals for the acquisition of LeapFrog, except VTech, withdrew or abandoned their bids.

I.1.3 A post-liquidation fire sale would not yield an outcome substantially more pro-competitive than VTech's rescue of LeapFrog

15. Third, but for the Transaction, the only viable (or, in any event, far and away most likely) option would have been to place LeapFrog into voluntary liquidation. Whichever party (if any) acquired LeapFrog's inevitably distressed assets out of liquidation, it cannot reasonably be expected that letting LeapFrog fail on a global basis, even in the event of a subsequent fire sale purchase of assets out of liquidation, was likely to yield an outcome substantially *more* competitive, i.e. *better* for UK consumers, than the demonstrable benefits of the Transaction.

I.2 In any event, the Transaction fails to raise substantive issues even against a more typical counterfactual

16. The preliminary and worst-case analysis of NPD share data employed in the Phase I analysis for so-called TEL and children's tablets presents a picture that, at first glance, is *prima facie* suggestive of market power and unilateral effects concerns.

17. This analysis is inappropriate for Phase II standards of investigation and review, and a proper Phase II analysis suggests no expectation of SLC concerns. This holds true even if, for sake of argument, a more typical pre-merger counterfactual of an independently viable and competitive target business were employed – implausible though this is on the facts of this case, and without prejudice to the Parties' submissions on the counterfactual.

I.2.1 Consumer substitution and retailer leverage prevents market power exercisable in a narrow NPD classification such as "TEL" or "child tablets"

18. A good quantitative sense-check on whether there is merit to the Parties' qualitative arguments that these NPD categories (while admittedly the best "share of supply" data available) are (i) static; (ii) narrow and under-inclusive of competing products; and (iii) introduce an element of arbitrariness into the analysis, is a margin-concentration analysis.

19. Specifically, CRA analysed the Parties' gross margins and shares for the sub-classes identified by the CMA in Phase I and found no evidence that higher shares or higher levels of concentration within a narrow NPD sub-class is associated with higher gross margins for the Parties. This finding is robust to both different measures of concentration and econometric analysis. [Confidential].

20. The explanation for why the Parties [Confidential] lies primarily in the following.

21. First, at the level of consumers responsible for the retail purchase decision:

- ***Consumer demand extends across product categories, consistent with how retailers organise their procurement.*** The majority of consumers do not make purchasing decisions based on a particular product or NPD sub-class in mind. This is reflected in the Parties' customers (retailers) purchasing decisions. Retailers tend to have aisles for infant/preschool toys, boys, girls, outdoor and games, with retailer displays being the number one cited reason for purchase decisions. This reflects the way the majority of end-consumers approach purchases of toys: looking at age appropriate toys rather than by narrow segmentations for learning/non-learning and electronic/non-electronic toys. In addition, most retailers' procurement teams are also split by the broad categories mentioned above, supporting a frame of reference covering at least the whole of infant/preschool toys. The above factors are reinforced by the fact that many consumer purchases are made on impulse and/or by gift givers outside of the child's household.

- ***Consumer tastes are dynamic.*** Consumer tastes in infant/toddler/preschool toys are highly trend driven and therefore change rapidly from toy to toy, independently of how any individual toy may be categorised. This is reflected in the huge range of products offered by manufacturers and the constant releases of new products in order to catch the latest trend. Around [Confidential] of products are new every year, and at least [Confidential] of those come from manufacturers who have not been present in the category in previous years. Furthermore the majority of products have short life cycles with nearly [Confidential] of all toys going from the top quartile of sales to the bottom (or exiting) within 2 years. This reflects the average life cycle of a toy being just [Confidential] years. The corollary of such an environment is that shares of supply at a given point in time are not reflective of true market power. New toys can come from anywhere, and a success in any given year is not predictive of any future successes (e.g. [Confidential]).

22. Second, at the level of UK toy retailers:

- ***Retailers leverage broad consumer demand with significant buyer power, by controlling critical access to shelf space allocation***

    - Retailers not only provide the necessary gateway to consumers (the Parties' direct sales are negligible), but also strongly influence manufacturers sales through placements and shelf space. This reliance on retailers is magnified given the Parties heavily rely on only a limited number of powerful retailers: the Parties' top 5 customers represent over [Confidential] of their sales.

- Retailers negotiate across a manufacturer's entire range – and do not generally negotiate on individual product lines. As such, even if the manufacturer had a strong position in a particular type of toy, it could not exploit this. Retailers would simply threaten to reduce that manufacturer's range and replace it for other toys where there is competition (whether from other manufacturers or by selecting other product lines within a given manufacturer's range). The fact that the Parties' directly overlapping toys account for substantially less than [Confidential] of their whole range is a testament to this. Retailers will still be able to substitute shelf/catalogue space across different toys categories and therefore the Parties are not in a position to exploit a particular temporary strong position in any one product or small group of products.

- Furthermore given the dynamics of the toy industry (akin to the fashion industry), where [Confidential] of products are new each year, and retail placement is so key for success in the seasonal rush, a manufacturer's control of a "hot" product in a given year is at most transient, and any attempt to exploit it would adversely impact a durable commercial relationship for the entire product range on which it is reliant.

23. Clearly, NPD data has a role to play in the CMA's assessment, in the absence of alternative data. However, not only should interpretation of NPD data be set against the above factors, but also against the fact that the candidate Phase II definition of TEL (without prejudice to the Parties' view on this as a market) is in any event a wider category than the NPD categories employed at Phase I. For example, some of the Infant Plush, Mobiles and Bath Toys NPD sub-classes, as well as some Toddler Figures and Playsets, Other Toddler Toys and Other Infant Toys have a learning and electronic component and consequently also match the CMA's definition of TEL but are not included in the TEL NPD sub-class.

I.2.2 **Third party constraints will replace any lost competition between the Parties in any overlap category, however defined on a desktop basis**

24. In this case, the Parties are not such close competitors, relative to other dynamic sources of competitive constraints, that the lost rivalry between them is somehow so "close" and "irreplaceable" so as to permit a lasting change in VTech's innovation or pricing that would adversely affect retailers (on wholesale prices) or consumers directly (on product innovation), or both.

– **LeapFrog®** ***and*** **VTech®** ***are differentiated and not "close brands".*** First, in respect of innovation, it is not the case that the Transaction merges particularly close brands that stand for two particularly close innovators that are "close" to each other and differentiated from the wider market. As shown during the Site Visit, [Confidential], the Parties' general product positioning is different. In broad summary:

  - LeapFrog's brand stands for a focus on a curriculum-based learning experience; VTech is focused on physical development and fun toys;

- In terms of aged range, VTech is stronger in the infant/0-3 years old category as well as 5 years old onwards, whilst LeapFrog's focus is in the 3-5 years category (preschool and early school range).

– ***A static view of closeness of competition or "recaptured diversion" is inappropriate***. Second, the Parties note that the CMA's theory of unilateral effects may be made out where the internalisation of rivalry between the Parties is so great so as to permit the acquirer *durably* to reduce innovation or quality, and/or raise prices. Even on a CMA assumption that the Parties are particularly close competitors, contrary to the brand positioning points above and the counterfactual, it does not follow that unilateral effects concerns arise in this case. The static models used for this purpose assume diversion ratios between the Parties (whether inferred from market shares (or in this case, from flawed NPD share data) or directly from consumer surveys, are relatively fixed. These models are a poor fit to capture innovation competition that characterises the global and in turn UK toy market. Put simply, consumers will not know, for example, what product they consider "hot" next season, and what their future (first, second or third) toy purchasing preferences will be (see paragraph 21 above); at the same time, nor will they address the issue of powerful retailer buyers as intermediaries (see paragraph 22 above).

I.2.3 **Specific overlap products are not an issue**

25. The number of products where the Parties overlap directly is limited and [Confidential]. For TEL toys in particular, there are several alternative options for the consumer, even (as became apparent from the Site Visit) when looking at head to head product overlaps (which is not how the Parties believe the Transaction should be assessed).

26. As regards TEL (to use the CMA's definition):

– The shares of supply used in Phase I which are based on the NPD TEL sub-class encompass a narrower product set than the CMA's own definition of TEL toys. In addition, the margin concentration analysis prepared by CRA for this sub-class is inconsistent with a finding of market power.

– Numerous competitors for TEL and other toys in the UK, including suppliers of own-label products, will remain post-Transaction to constrain VTech; and

– VTech will be constrained by an array of other toys for preschool/infant use; furthermore the merged entity's shares of supply in the Infant/Toddler segment or Infant/Toddler/Preschool super-categories are not concerning.

27. With respect to children's tablets/laptops, this is a declining segment:

– Demand for preschool electronic learning toys reached its peak in 2012 and in 2015 was approximately [Confidential] of the demand in 2012. [Confidential];

– This reduction in demand is also supported by evidence on the significant drop off in interest expressed by customers through Google search requests of the LeapPad and Innotab products;

– There have been a number of recent entries into children's tablets, with the Kindle Fire for Kids one of the most notable examples. At the peak of this segment in 2012 and 2013, new players launched children-specific tablets that were later withdrawn. If profitable opportunities arose going forward, new entry would be relatively easy via “white” label hardware providers in Asia;

- Due to the use of age-neutral (or so-called “adult”) tablets and other devices, there is an array of free and payable apps which are compatible with iOS (Apple) and Android and are easily accessible. In this regard, the current trend is for developing children’s content and apps which can be accessed from a number of children specific and non children-specific devices. [Confidential];
- Finally, the margin concentration analysis prepared by CRA with regard to the NPD Preschool Electronic Learning sub-class ([Confidential]) is inconsistent with a finding of market power. [Confidential].

I.2.4 **The potential overlap in child electronic reading systems is a non-issue**

28. In respect of potential competition for children’s electronic reading systems in the UK, VTech’s [Confidential] concept is very far from LeapFrog’s LeapReader and LeapStart. Furthermore VTech’s decision to abandon the launch of [Confidential] was not linked to the Transaction.

I.2.5 **Concerns as to loss of “general innovation” are misplaced**

29. Finally, as regards general innovation for toys in the UK, the Parties re-iterate that they are not the closest competitors in terms of their product focus and therefore this translates to a different focus from an innovation perspective. In particular, LeapFrog is focused on a curriculum-based learning experience whereas VTech is focused on physical development and fun toys. The Parties’ main points regarding competition in innovation are as follows.

- First, the particular trend-driven, supply-led nature of the toys sector translates into a high degree of product churn and disposability of new products, and this requires players to constantly innovate, which occurs on a global and not a UK-specific (UK-only) level. [Confidential] The Transaction has not reduced global innovation, rather it has preserved the core of LeapFrog’s development team (and particular expertise in educational content).
- Second, as emphasised during the Site Visit, innovation should not be viewed in a narrow and indeed static sense. Toy innovation can take many and varied forms: it is not limited to “high-tech” or content focused products (e.g. tablets, smartphones) but includes “low-tech” innovations such as Pie-Face, loom bands or (particular in the Infant/Toddler segment) variants on existing everyday items (e.g. cooking playsets, building blocks). Indeed the plethora of innovative new products and the fickle nature of consumer demand makes it imperative for companies to continue generating new ideas. The constraints on VTech to develop new toys will remain unchanged as a result of the Transaction.
- Third, and specifically in terms of the “high-tech” end of toy innovation, [Confidential]. LeapFrog’s rescue does not remove any important “high-tech” competitive constraints on VTech that would reduce, for the sake of argument, tablet-centric or “high-tech kids-toy” innovation. Technological progress in children’s tablets is driven by advances in their more sophisticated adult comparators, which toy industry suppliers will continue to consider and adapt for children’s use. In particular, in relation to LeapFrog’s contribution to innovation in the tablet space, for example:

- [Confidential];
- [Confidential]. In short, the tech sector dynamics of Amazon, Apple and Google, in a market where children's high-tech toys tend to follow adult devices with a time lag, can be expected to continue to subject VTech to dynamic innovative pressure as both itself and its rivals endeavour to adapt and translate such trends into the toy world.

30. Overall, VTech cannot relax and remain insulated from such consumer electronics – and in turn electronic kids toy dynamics simply by virtue of having rescued LeapFrog. Any reduction in innovation as a result of the Transaction would see the Parties' brands rapidly losing sales and retailer shelf space, thereby jeopardising their entire range.

31. In this context, the outcome of the Transaction provides a natural experiment which has already been positive. LeapFrog is planning on launching [Confidential] learning toys for the 2017 season compared to [Confidential] in 2016 and [Confidential] in 2015. Furthermore the fact that VTech and LeapFrog's [Confidential]. The Transaction cannot therefore realistically be regarded as substantially reducing innovation or the incentive for the combined VTech/LeapFrog to cease to innovate.

I.2.6 Barriers to entry and expansion are low

32. There are a wide variety of manufacturers with different positions within the Infant/Toddler/Preschool super-category with different propositions. LeapFrog filled a high quality content niche aiming to provide the very best products for learning and education. However this is far from the only successful (and then unsuccessful) business model in toys, and new entrants make up around [Confidential] of all manufacturers releasing new products each year. Such entry can take place because:

- Competition is based primarily on the ability to design and develop new toys, to procure licences for popular characters and trademarks and to successfully market products. There are limited technology, know how, or capital requirements, and manufacturer brand loyalty plays a minor role.
- Licences make it relatively easy to enter into a category/segment: Licensors have an incentive to widely license in order to ensure their product is widely seen, whereas there is no incentive to provide exclusive licences.
- Any opportunity is quickly duplicated by many toy companies – showing that barriers to expansion are low.

I.2.7 Demonstrable efficiencies in product innovation

33. The Transaction will provide significant efficiencies, specifically:

- [Confidential];
- [Confidential].

I.3 Conclusion

34. In light of the above, and as further detailed in this Submission, the Parties are confident that the only expectation that the CMA can reasonably form is that the Transaction will not result in a SLC on any plausibly-defined market or markets in the UK.

II. THE PARTIES

35. This Submission is submitted on behalf of VTech Holdings Limited (together with its subsidiaries, "**VTech**") in connection with the completed acquisition by VTech of LeapFrog Enterprises, Inc. (together with its subsidiaries, "**LeapFrog**") (the "**Transaction**"). Each of VTech and LeapFrog may be referred to as a "**Party**" and together, as the "**Parties**".

II.1 VTech

Global overview

36. VTech is a leading global supplier of corded and cordless phones and toys, including electronic toys,[6] as well as game cartridges, download applications ("**apps**") and content for some connected products and related accessories (e.g. carry bags).[7] For the purposes of this Submission, unless stated otherwise, references to VTech relate to its toys business. Please refer to section V.1.1 for more details on VTech's activities.

37. VTech was founded in Hong Kong in 1976 and was listed on the Hong Kong Stock Exchange in 1985. It is incorporated in Bermuda and its shares are publicly traded on the Hong Kong Stock Exchange.

38. With headquarters in Hong Kong and facilities in China, VTech's group business (including its toys division) currently has operations in 11 countries and regions, as well as offices and distributors in Asia Pacific, Europe, Latin America, Africa, the Middle East and North America. It employs approximately 27,000 employees, including around 1,500 research and development ("**R&D**") professionals in R&D centres in the USA, Canada, Germany, Hong Kong and China.[8]

39. For the financial year ended 31 March 2016, VTech achieved a global turnover in its toys division of approximately GBP 473.6 million[9] of which approximately [Confidential] (GBP [Confidential] million) relate to VTech's business in the UK.[10]

40. A pre-Transaction structure chart of VTech as at 31 March 2016 has been provided to the CMA as Annex A.4 to the consolidated response to the CMA's requests for information submitted on 29 June 2016 ("**Consolidated Response**").

41. [Confidential].

42. Annual accounts and reports for 2014 and 2015 for VTech Holdings Ltd and VTech (consolidated group) have been provided in hyperlinks in response to question 13.2 of the Consolidated Response.

43. VTech's annual report for the year ending 31 March 2016 is available at: https://www.vtech.com/ebook2016/ar/eng/index.html.

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6 Electronic toys have or operate with components such as microchips and transistors that control and direct electric currents.

7 For completeness, please note VTech is also a provider of contract manufacturing services.

8 This includes VTech's three business units (i) telecommunications products, (ii) toy products, and (iii) contract manufacturing services.

9 Based on VTech's financial report for the financial year ended March 2016 (available at https://www.vtech.com/en/investors/financial-reports/). Figures in GBP are based on the average exchange rate for the financial year ended March 2016 USD/GBP = 1/0.6841. Global turnover is approximately GBP 1,270 million. This figure includes VTech's three business units (i) telecommunications products, (ii) toy products, and (iii) contract manufacturing services.

10 VTech generated turnover of approximately GBP [Confidential] if including the revenues of all three of its business units in the UK.

UK overview

44. VTech has two subsidiaries in the UK, VTech Electronics Europe plc ("**VTech UK**") and VTech Communications Limited. Through these VTech supplies a wide variety of telephone products, business phones and hospitality products as well as toys for children, from baby walkers, rattles and soft toys, to educational learning products, smartwatches and gaming consoles.

45. In relation to its toys business, VTech supplies its products to retailers in the UK, but also sells to end-consumers directly via its website. In the UK, the sale of products is classified in two main categories: standalone products, of which there are various product ranges; and platform products which consist of various devices with cartridges and/or downloadable content[11] to enrich play experience.

46. VTech has no manufacturing facilities in the UK. [Confidential].[12]

47. [Confidential].

48. A brief non-exhaustive summary of VTech's history in the UK is as follows:

- VTech established its first European sales subsidiary in the UK in 1987, selling primarily electronic learning aids.
- In 1989, it successfully launched key products Small Talk and Little Smart Driver.
- In its financial year 1992/1993, turnover reached the milestone of GBP 10 million.
- In the following year, VTech started making Free-On-Board ("**FOB**") (direct shipments from the Far East) sales into the UK alongside domestic sales. Today, VTech ships products to retailers either on a FOB basis or locally.
- In 1995, VTech launched a second brand, IQ Builders, marketed as "*the fun and friendly way to build you child's IQ*".
- New products launched in 2000 introduced features such as PC links and internet connectivity, digital cameras and musical appreciation. In the same year, the first UK specific licensed products (Bob the Builder) were launched.
- The TV Learning system called V.Smile was launched in 2004, generating revenue growth for the UK business during the following two years.
- In 2007, the KidiCreative line of products was launched, including the Kidizoom Camera, which was named Preschool Toy of the Year 2008 by the Toy Retailers Association.
- The world's first children's smartwatch with a camera, Kidizoom SmartWatch, was launched in 2014.

49. Further information on VTech can be found at: https://www.vtech.co.uk.

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[11] Downloadable content is content that is downloaded on the internet (on a website or in an app-store), as opposed to cartridges, which are bought separately and physically inserted in the hardware device. Downloadable content can be free of charge, or can be purchased as one-off (unlimited use) or as a subscription (the purchaser pays a fee for use on an e.g. monthly basis). Furthermore there can be in-app purchases, where the purchaser pays an additional price to access the next level.

[12] [Confidential].

II.2 LeapFrog

Global overview

50. LeapFrog was founded in 1995 and has, ever since, developed a number of toys for children, primarily with an educational focus. LeapFrog's product portfolio consists of learning toys, reading and multi-media learning, including tablets and software. Please refer to section V.1.2 for more details of LeapFrog's activities.

51. LeapFrog is incorporated in the USA and has its global headquarters in California.

52. A pre-Transaction structure chart of LeapFrog as at 31 March 2016 has been provided to the CMA as Annex A.6 to the Consolidated Response. The corporate structure of LeapFrog has not changed post-Transaction.

53. The only acquisitions and disposals of LeapFrog within the last five years are as follows:

(a) the acquisition of Kid Zui in 2014; and

(b) the disposal of its French and Mexican businesses.[13]

54. LeapFrog's global turnover for the financial year ending 31 March 2016 was approximately GBP 146.5[14] million, of which GBP [Confidential] million ([Confidential]%) was achieved in the UK and Ireland.[15]

55. LeapFrog annual accounts and reports for the two most recent accounting periods have been provided as Annexes C.18A to C.18F of the Consolidated Response.

UK overview

56. In the UK, LeapFrog supplies a range of toys, including multi-media learning platforms (and related content) and learning toys, including tablets, developmental games, "learn to read and write systems" and other interactive toys.

57. LeapFrog's operations in the UK and Ireland are conducted by LeapFrog Toys (UK) Limited ("**LeapFrog UK**"), which is a wholly-owned subsidiary of LeapFrog, and which sells directly to retailers in the UK and Ireland. LeapFrog UK also sells content through an online "app centre", which is a web-based store via which customers can purchase and download digital content developed by LeapFrog and licensed third-party content that can only be downloaded to LeapFrog devices. This app centre is owned and operated by LeapFrog.

58. LeapFrog has no manufacturing facilities in the UK (or indeed elsewhere). LeapFrog's products are manufactured by third parties in the Far East. [Confidential]

59. There are two distinct routes for supplies of LeapFrog products in the UK: [Confidential]. In respect of both routes (i) and (ii), [Confidential].

60. A brief non-exhaustive summary of LeapFrog's key products history in the UK is as follows:

- In 1999, it launched the original LeapPad, an educational device that helped young children to read. The product accepted an insertion cartridge to be used with a book that was placed inside the device.

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[13] [Confidential]

[14] Based on the average exchange rate for the financial year ended March 2016 USD/GBP = 1/0.6841.

[15] This includes sales through the online App centre.

- In 2003, it successfully launched the Leapster, a portable learning system for children aged 4 years to 10 years with a large library of cartridge games and downloadable learning apps.
- In 2011, it launched the LeapPad Tablet – its first children's tablet.
- In 2013, it released the LeapReader which was the redesign of the Tag product launched in 2008, a specially designed stylus that reads audio books aloud and teaches basic writing skills.

61. In recent years, LeapFrog has experienced significant financial difficulties which culminated in comprehensive losses of USD 107.2 million for the nine month period ending 31 December 2015, reported in its most recent financial report prior to the merger.

62. Further information on LeapFrog can be found at: http://www.leapfrog.com.

III. THE TRANSACTION

III.1 Transaction structure

63. The Transaction concerns the acquisition by VTech of the entire outstanding common stock of LeapFrog at USD 1.00 per share through an all-cash tender. The Transaction was agreed on 5 February 2016 and, following the satisfaction of the conditions, completed on 4 April 2016. The press releases announcing the signing and closing of the Transaction have been provided as Annexes A.7 to A.10 of the Consolidated Response.

64. Following closing of the Transaction, LeapFrog became indirectly wholly-owned by VTech Holdings Limited. A post-Transaction structure chart of VTech as at 15 April 2016 has been provided as Annex A.5 to the Consolidated Response.

65. The corporate structure of LeapFrog has not changed post-Transaction and has been provided in Annex A.6 to the Consolidated Response.

III.2 A copy of the contractual agreements and/or documents forming and implementing the Transaction (i.e. (i) the Agreement and Plan of Merger and (ii) the Tender and Support Agreement) have been submitted as Annexes A.2 and A.3 to the Consolidated Response.

III.3 Transaction rationale

III.3.1 VTech

66. VTech's decision to acquire LeapFrog was driven by the following considerations:

(a) [Confidential];

(b) [Confidential];

(c) [Confidential];

(d) [Confidential].

67. Indeed the VTech and LeapFrog brands are very much complementary: the VTech brand focuses on technology-oriented products for the 0 to 3 year-old range primarily, which aim to develop motor skills and which are marketed as fun, whilst the LeapFrog brand is more focused on curriculum-based learning and educational content for children between 3 and 5 years of age.

68. In light of the synergies described above, VTech considers that the Transaction will have a positive impact on (i) the degree of innovation (and therefore the extent of consumer choice) the Parties are able to bring to the toys industry (indeed LeapFrog, under VTech ownership, is launching [Confidential] new learning toys in the UK in 2017, compared to [Confidential] in 2016, [Confidential] in 2015 and [Confidential] in 2014)[16] and (ii) on costs, since the merged entity will be able to capitalise on [Confidential].

69. [Confidential].

70. [Confidential].

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[16] See Annex 26D to the Phase II Market Questionnaire at slide 4.

III.3.2 LeapFrog

71. In light of the severe financial difficulties it experienced in 2016 and preceding years, [Confidential], as further described below in section IV.

72. In summary, from LeapFrog's perspective, the benefits of the Transaction included:

- [Confidential];
- [Confidential];
- [Confidential];
- [Confidential].

73. [Confidential].

74. [Confidential].

III.4 Transaction background

III.4.1 Circumstances leading to the Transaction: VTech

75. As set out in documents prepared by Morgan Stanley and the USA Securities and Exchange Commission ("**SEC**") filings, Morgan Stanley engaged in extensive marketing, and initially approached 53 different parties commencing on 21 July 2015.[17] The parties initially approached included 25 trade parties (consisting mainly of toy manufacturers and technology companies) and 28 private equity firms. When these parties failed to yield any offers, a further 12 parties were engaged. Of all these, no serious bidders other than VTech emerged with the capacity to close a transaction before LeapFrog's liquidity crisis was likely to have materialised.

76. VTech was first approached by LeapFrog's Vice Chairman, Tom Kalinske, on 1 November 2015 to discuss the potential acquisition of LeapFrog. Thereafter, LeapFrog's Chief Executive Officer John Barbour met with Mr Wong and Mr Pang of VTech in Hong Kong on 4 November 2015. [Confidential].

77. [Confidential].

78. [Confidential].

79. [Confidential].

80. It was VTech's strong preference to acquire LeapFrog prior to any liquidation process for the reasons set out above in paragraph 69.

III.4.2 Circumstances leading to the Transaction: LeapFrog

81. LeapFrog's severe financial difficulties which led to its near collapse and the resulting sale of the business to VTech are described in greater details in section IV below.

III.5 Internal documents relating to the Transaction

82. Annexes B.21A to B.21B, C.8A to C.8G and C.23B to C.23R to the Consolidated Response contain copies of all documents prepared by VTech or LeapFrog or its advisers relating to the Transaction.

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[17] See, for example: (i) LeapFrog's Schedule 14D-9 filing with the SEC dated March 2016, at page 14; and (ii) Annex C.23P to the Consolidated Response.

III.6 Changes since completion of the Transaction

83. The activities of the Parties in the UK (as described in section II above) have not changed following completion of the Transaction.

IV. COUNTERFACTUAL

IV.1 Standard for determining the counterfactual at Phase II

84. The Merger Assessment Guidelines (the "**Guidelines**") provide that, in the context of a Phase II investigation, the CMA:

- "*may examine several possible scenarios, one of which may be the continuation of the pre-merger situation; but ultimately only the most likely scenario will be selected as the counterfactual".*[18]
- should incorporate into the counterfactual adopted at Phase II "*only those aspects of scenarios that appear likely on the basis of the facts available to it and the extent of its ability to foresee future developments*".[19]

85. As the CMA is well aware, this approach is specific to Phase II and very different from Phase I. It is also clear from CMA guidance that while the invocation of an "exiting firm" scenario *does* in practice raise the evidentiary bar for the CMA to rule out a "realistic prospect" at Phase I (referring to "compelling evidence" so as to exclude scenarios as unrealistic) it does *not* change the statutory test or evidentiary bar at Phase II for the CMA to form an expectation that the post-merger outcome is likely, on the balance of probabilities, to be substantially less competitive relative to the (most likely scenario that forms the) counterfactual.

86. In other words, whether or not a case is formally labelled a "failing" or "exiting" firm case or argument or not, form does not prevail over substance: neither the statutory test of an expectation nor the CMA's general guidance above on the counterfactual is disapplied in favour of a special evidentiary regime for "failing firm" cases. While often referred in competition law circles (but not in CMA guidance) as the failing firm "defence", the evidentiary burden of forming an expectation of the most likely counterfactual scenario does not and should not be allowed implicitly to shift to the Parties in the manner of "defence" in litigation, and nor does it impose a higher burden on the CMA as to its fact-finding and judgement applicable to any other conclusion the CMA finds it necessary to reach to answer the statutory question.

87. All that changes with a formal "failing firm" analysis is that the CMA asks itself the overall counterfactual question broken down into the three well-known limbs set out below. The same balance of probabilities (expectation) standard applies throughout, as highlighted in the quotes at paragraph 84 above. CMA judgements can be formed as they routinely are on all other issues relevant to the substantial lessening of competition ("**SLC**") analysis, even these are "on balance" and/or cannot wholly exclude every conceivable scenario that might affect the conclusion.

88. Accordingly, it is not more difficult or subject to more probative evidence than otherwise for the CMA to clear a transaction through a "no SLC" finding for lack of likely causation of any (putative) loss of competition than it is to reach an expectation of no SLC on other grounds.

89. In the present case, the Parties will show that: (i) far and away the "*most likely scenario*" absent the Transaction was the voluntary liquidation of LeapFrog, and not the timely pre-liquidation sale of LeapFrog to a credible alternative purchaser; and (ii) on the balance of

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[18] Emphasis added. Merger Assessment Guidelines (CC2 (Revised)/OFT1254) available at https://www.gov.uk/government/uploads/system/ uploads/ attachment _data/file/284449/OFT1254.pdf, paragraph 4.3.6.

[19] Emphasis added. Guidelines, at paragraph 4.3.6.

probabilities, the failure of LeapFrog would have highly likely resulted in a competitive outcome *worse* – or in the extreme, in any event not *substantially more beneficial* – for customers and competition, compared to the post-Transaction outcome, such that the merger cannot be found to be the cause of or "result in" a putative SLC.

90. For LeapFrog's innovative potential and brand equity to remain, the LeapFrog business as a whole needed to be transferred pre-liquidation – and swiftly – leaving only one likely outcome in the best interests of consumers (and customers): a timely rescue by VTech.

IV.2 Overview of the Parties' submissions on the counterfactual

91. As the CMA is aware, the Guidelines provide for a three-stage analysis when considering a "failing firm" scenario[20] as the counterfactual. The CMA must be satisfied on the balance of probabilities that:

(i) It was inevitable that the firm would exit the market. The CMA will consider the firm's ability to meet its financial obligations in the near future and its ability to restructure itself successfully.

(ii) There was no substantially less anti-competitive alternative buyer for the firm or its assets. The CMA will look at available evidence that the merger under consideration was the only possible merger (i.e. that there was genuinely only one possible purchaser for the firm or its assets).

(iii) The failure of the firm was not a substantially less anti-competitive outcome (i.e. was not a substantially pro-competitive) relative to the merger.

92. The following is a condensed summary of the more detailed account of the failing firm criteria set out in **Annex 1** and **Annex 2**.

IV.2.1 Inevitable exit via voluntary liquidation but for the Transaction

93. LeapFrog was a "failing firm" for whom exit by [Confidential] was inevitable. As the CMA is aware, this has already been established on the cautious "compelling evidence" and "no realistic prospect" standard of CMA Phase I.

94. In terms of the timeframe and manner of its exit, had the Transaction not taken place, the weight of evidence suggest that LeapFrog would have been placed into pre-emptive voluntary liquidation by its Board of Directors (the "**Board**"), as early [Confidential] and in any event during a likely timeframe of between [Confidential]. The key drivers of this were the Board's awareness that:

- As from July 2016, LeapFrog's own cashflow estimates [Confidential]; and
- [Confidential].

95. [Confidential].[21]

96. [Confidential].

97. [Confidential].

98. [Confidential].[22]

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20 Merger Assessment Guidelines, paragraphs 4.3.8 to 4.3.18.

21 See in [Confidential].

22 [Confidential].

IV.2.2 Absence of any credible and timely alternative purchaser other than VTech

99. By early 2016, it was abundantly clear to LeapFrog's Board that there was no credible alternative purchaser to VTech. Two factors are particularly relevant.

100. The first factor is the *timeliness* of the interested parties' preparedness to submit a bid, given the fiduciary duties of the directors of LeapFrog to act in the knowledge that, but for a sale, voluntary liquidation was the course of action as early as [Confidential] was in the best interests of stockholders. Any delay in concluding a transaction risked the ability for LeapFrog to [Confidential].

101. In respect of non-trade purchasers, the second factor is the interested parties' lack of operational synergies and industry know-how to alter the financial prospects of LeapFrog in driving the *credibility* of the interested party in delivering an executable transaction in the required timeframe.

- [Confidential] was one bidder who was engaged in the early stages of a proposal at the time VTech finalised its acquisition of LeapFrog. However, the uncertainty of its non-binding offer (which never materialised into a firm offer), the incompleteness of its due diligence (reflected by its request to extend the diligence period in a revised non-binding offer), its lack of synergies [Confidential] and lack of experience in the toys market and the fact that it would not have been able to complete its acquisition before [Confidential] at the earliest and before LeapFrog's liquidity crisis took hold, demonstrate that [Confidential] was not a realistic alternative purchaser for LeapFrog.
- The last-minute offer by L&M Acquisitions Inc. ("**L&M**") could not be considered viable as, apart from anything else, the Board considered that pursuing the L&M bid at this late stage, when appropriate financing had not yet been identified, put LeapFrog's survival into greater uncertainty and introduced a risk of LeapFrog being unable to complete any transaction before it would have been forced to take protective action, such as voluntary liquidation.
- All other interested parties withdrew or abandoned their bids for LeapFrog.
- No doubt the LeapFrog directors would have welcomed timely competing bids from other (synergistic) toy industry bidders such as [Confidential]. – but none were forthcoming and bids from any other parties were being frequently revised (and only declining over time).
- Coupled with the financial reality that LeapFrog's cash reserves were swiftly declining, this meant that the timeliness and certainty of a bid was critical to LeapFrog's survival.

IV.2.3 A post-liquidation fire-sale would not yield an outcome substantially more pro-competitive than VTech's rescue of LeapFrog

102. As noted, but for the Transaction, the only viable (or, in any event, far and away most likely) option would have been to place LeapFrog into voluntary liquidation.

103. In particular, whether or not one were to speculate on the degree to which one or more purchasers were to pick up inevitably distressed assets out of liquidation (for which certain statements made by [Confidential], for example, are not sufficient to support this as a likely outcome), it cannot reasonably be expected that, even in the event of a fire sale purchase of selected LeapFrog assets, this was likely to yield an outcome substantially better for UK customers (i.e. substantially “more competitive”) by letting LeapFrog fail on a global basis.

104. In particular, as corroborated by VTech’s own actions to pre-empt liquidation and acquire an intact business, the LeapFrog brand – once the business had disintegrated, and without its R&D capabilities and staff – would not likely form the basis for any more than a shadow, at best, of the viable and innovative business that LeapFrog once was.

105. As such, it cannot reasonably be expected that the mere acquisition of the brand and/or other assets out of liquidation by any likely purchaser would yield a substantially *more pro-competitive* outcome than the Transaction, not least when set against the verifiable product launch innovations under the LeapFrog brand associated with VTech’s plans for the new season – a feat only possible with an intact LeapFrog and carefully rescued and resuscitated business, and not the embers of one.

106. Each of these submissions on the counterfactual is discussed in more detail in **Annex 1**.

V. PARTIES' ACTIVITIES AND MARKET OVERVIEW

V.1 Overview of Parties' activities

V.1.1 VTech

107. VTech supplies a wide variety of toys for children, including baby walkers, rattles and soft toys, educational learning products, smartwatches and gaming consoles, globally and in the UK. VTech has a particular focus on (i) products which aim at fine and gross motor skills development, together with an emphasis on creativity and discovery, for children aged 0 to 3 years old, and (ii) various electronic gadgets (for example, cameras, selfie sticks etc.) for children aged 5 years old and above.

108. VTech's product catalogue for the year 2016 has been provided as Annex 3A to the response to the market questionnaire requested by the CMA in its second request for further information in relation to its Phase II merger inquiry into the Transaction (the "**Phase II Market Questionnaire**"). VTech's products are sold globally.

109. As regards VTech's current strategy in relation to the retail supply of toys in the UK, VTech regularly updates existing products and launches new products whenever it sees an opportunity to do so, and in particular, in light of existing and future trends (please refer to section V.2 below which explains the specific characteristics of the toys industry).

110. [Confidential].

111. [Confidential].

112. [Confidential].

113. [Confidential].

V.1.2 LeapFrog

114. As mentioned above, LeapFrog is active in the sale and distribution of toys primarily with an educational focus. Leapfrog's product portfolio consists of learning toys, reading and multi-media learning including tablets and software. LeapFrog has a particular focus on curriculum-based educational toys primarily for children between 3 and 5 years of age.

115. LeapFrog's product catalogue for the year 2016 has been provided as Annex 3B to the Phase II Market Questionnaire. LeapFrog's products are, in principle, available globally. However, LeapFrog's operations are relatively limited outside North America and primarily focused on English-speaking countries. Distributors in other markets (e.g. Asia) will select from LeapFrog's global English range.

116. LeapFrog has traditionally focused on a relatively narrow range of products with an emphasis on educational elements. As regards LeapFrog's current strategy, [Confidential].

117. [Confidential].

118. [Confidential].

119. [Confidential].

120. Finally, LeapFrog (under VTech ownership) intends to launch [Confidential] new learning toys in 2017.[23] This is a significant increase compared to previous years where the number of new learning toys was between [Confidential] and [Confidential] each year, and only

[23] See response to question 26 of the Phase II Market Questionnaire.

[Confidential] in 2016 and [Confidential] in 2015. Please refer to Annex 26C and Annex 26D to the Phase II Market Questionnaire for a list of products Leapfrog plans to launch in 2017. [Confidential].

121. [Confidential].

V.2 Supply-side characteristics of the Parties' products in the UK

V.2.1 **Key competitors**

122. Competition in the toys industry in the UK is particularly vigorous for the following reasons.

- First, the UK toy industry is large. In 2015, sales of toys in the UK represented more than USD [Confidential] million,[24] and VTech estimates that there are approximately [Confidential] toy stock keeping units ("**SKUs**") in the UK.
- Second, it is fragmented. No toy supplier accounted for more than [Confidential]% of the overall sales of toys in the UK,[25] with approximately [Confidential] toy manufacturers.
- Third, competition is very much trend-driven, with each player constantly trying to develop and sell the year's "hot" toy. Please refer to section V.1.1 for further details on the role and influence of trends on competition and innovation in the toy industry.
- Fourth, the Parties compete with a number of strong global competitors. In the UK, these include: Mattel (Fisher-Price), Lego, Hasbro, Spin Master, Tomy, Character Options, Chicco, Clementoni, Flair Preziosi Group, Golden Bear, IMC Toys, KD Group, Kids II, MGA Entertainment and Trends UK.

123. The Parties' top 10 competitors in the overall toy sector in the UK has been provided as Annex B.34.2 to the Consolidated Response. Please also refer to Annex 22 to the Phase II Market Questionnaire for a description of the Parties' main competitors.

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24 Based on NPD data. See Annex C.2A to the Consolidated Response.

25 See Annex C.2A to the Consolidated Response. For completeness, VTech and LeapFrog [Confidential] and [Confidential] respectively of the overall toys market by value, and [Confidential] and [Confidential] by volume.

V.2.2 **Supply chain and product life-cycle**

Inputs

Intellectual property rights

124. The toy industry relies heavily on character licensing[26] (i.e. the use of a character from cartoons, films, books or comics, to promote a product) for at least three reasons.

- First, the use of licensed characters allows the licensee to leverage the high level of exposure (via TV, books, videos, films or a combination of media) that a character has and generate immediate brand awareness and recognition. By contrast, where a manufacturer creates its own character, more financial and time resources are required from the manufacturer to grow the character's reputation organically, without any certainty as to whether the character will successfully penetrate the market.
- Second, as a licensee, a manufacturer benefits from the activity of other licensees as a character can generate a playground "must have" factor.
- Third, a character may contribute to parental approval, as parents may be familiar with it from their youth or other life experiences (e.g. as with Star Wars) and therefore feel that they can "trust" the product bearing the licensed character.

125. The licensor carefully selects (and limits the number of)[27] licensees which it deems are best placed to strike a balance between maximising the licensor's revenue from trademark and brand licensing, while preserving the integrity of the character, avoiding brand dilution, and/or reputational damage caused by defective or dangerous licensed toys. The licensor might also impose stringent requirements on the licensee to ensure that the visual integrity of the character is preserved, through, for example artwork approval requirements and that the products bearing the licensed characters comply with applicable health and safety requirements.

126. Consequently, by deciding which manufacturers are granted or denied a licence, or by deciding whether to revoke a licence, the licensor has a significant degree of power in determining the success of a product and can transform an otherwise ordinary toy into the "must have" of the season. For example, [Confidential] ranked as the third most sold item (by value) in 2015. Other [Confidential] licensed products also made it to the top 20 most sold items in 2015 (i.e. [Confidential] ranked sixth, [Confidential] ranked tenth, [Confidential] ranked twelfth, [Confidential] ranked thirteenth and [Confidential] ranked twentieth).[28] In fact, according to NPD Group, Inc. ("**NPD**") data, [Confidential] out of the "top 20" toys in 2015 were licensed products.

127. [Confidential].[29] In 2015, [Confidential] of all toys sold were licensed products, with [Confidential] as the best selling merchandise by value for the second year in a row,

[26] VTech estimates that circa [Confidential] of toys for infants/toddlers/preschool (and [Confidential] for toys generally) has licensed content.

[27] [Confidential].

[28] See page 19 of Annex B.23B to the Consolidated Response.

[29] See section VII.2.3 below.

followed by [Confidential] also owned by [Confidential].[30] This corresponds to a [Confidential] growth of the use of licences compared to the previous year.[31]

Raw materials / components

128. Generally speaking the raw materials required to produce toys can be obtained from a wide range of suppliers (e.g. plastic, fabric, electronic components etc.).[32]

The Parties' supplier contact details have been provided to the CMA by email correspondence on 13 May 2016 at 14:06.

Product development, manufacturing, marketing and advertising

129. [Confidential]. Products are then manufactured in China either by VTech companies or third-party vendors.

130. [Confidential].

131. [Confidential]. Pre-Transaction, LeapFrog products were manufactured by third parties in the Far East. Post-Transaction, LeapFrog products remain primarily manufactured at those facilities where they were manufactured before the Transaction. [Confidential].

132. [Confidential].

Distribution channels

133. In the UK, the Parties supply toys to customers who sell and distribute these toys via multiple channels across the UK; in particular:

(a) (pure) online retailers, such as Amazon;

(b) brick and mortar retailers (and their online stores), which include:

- large department store chains (such as John Lewis);
- generalist retailers (such as Argos);
- major supermarkets, pharmacies or grocers (such as Tesco, Asda/Walmart, Sainsbury, Boots);

(c) specialist toy retailers (and their online stores), such as Smyths and Toys'R'Us;

(d) mail order businesses (such as ShopDirect); and

(e) end-consumers directly via their website.[33] [Confidential].[34]

134. In addition, the Parties develop their own applications ("**apps**"), which are sold through their own app stores, Learning Lodge (VTech) and LeapFrog App Centre, which features a number of educational and entertainment games, e-books, music and videos.

135. As mentioned above, all retailers are constrained by limited shelf or catalogue space, and limited warehouse space.[35] However this is to a degree less the case for specialist retailers

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[30] See pages 21 to 26 of Annex B.23B to the Consolidated Response.

[31] See page 85 of "2015 review of toy market" provided as Annex C.1E to the Consolidated Response.

[32] With the exception of central processors, a key component of every electronic learning toy which are supplied by specialist suppliers.

[33] [Confidential].

[34] See response to question 13 of the Phase II Market Questionnaire.

who only sell toys, and aim to offer the widest range possible, compared to grocer retailers (as an example) who have even more limited shelf space allocated to toys, and who wish to tempt consumers with an add-on toy purchase whilst shopping for e.g. food and who will therefore be more likely to list particularly "hot" products and/or high margin/high volume products (e.g. low price points products).

136. Retailers therefore attract different types of consumers and hence face different consumer decision-making preferences or considerations. For example, toy purchases made at a grocer retailer may have more of an "impulse" characteristic (i.e. a spur of the moment decision to buy a toy) than purchases made at a specialist or online retailer, where consumers take more time to browse and compare toys (either with a specific purchase in mind or simply looking for inspiration). As a result, a grocer retailer is less likely to list a wide range of products, given the likely wider product substitution preferences of impulse customers, and may focus on high margin/high volume products or "hot" toys that they know they can sell quickly.

137. A list of VTech's top 20 customers in the UK, and their respective share of 2015 UK sales, has been provided as **Annex 3**. Corresponding contact details have been provided as Annex 12A to the Phase II Market Questionnaire.

138. A list of LeapFrog's top 20 customers in the UK, and their respective share of 2015 UK sales, has been provided as **Annex 4**. Corresponding contact details have been provided as Annex 12B to the Phase II Market Questionnaire.

139. A brief description of the Parties' main customers is set out in **Annex 5**.

Range selection, pricing and customer negotiations

140. [Confidential].

141. [Confidential].

VTech

142. [Confidential].

143. VTech's 2016 price list in the UK has been provided as Annex B.25 to the Consolidated Response.

144. VTech endeavours to deliver a [Confidential]% margin for each retailer between the list price and the recommended retail price and such margin is typically expected by retailers in order for them to agree to list the products.

145. [Confidential].

146. [Confidential].

147. [Confidential].

148. [Confidential].

149. [Confidential].

150. As regards promotional activity, VTech funds [Confidential] categories of promotional spend:

- [Confidential].

[35] Save for Amazon.

- [Confidential];
- [Confidential];
- [Confidential];
- [Confidential].

151. Copies of VTech's trading terms with its top 10 customers has been provided in Annex 15A to Annex 15J to the Phase II Market Questionnaire.

LeapFrog

152. [Confidential]. LeapFrog's 2016 price list in the UK has been provided as Annexes E.7A to E.7C of the Consolidated Response.

153. The range selection, pricing and customer negotiation calendar is as for VTech, as set out at paragraph 145 above.

154. [Confidential].

155. As regards promotional activity, retailers may have specific promotional calendars (e.g. the "baby events" at Tesco's), which may overlap with LeapFrog's (or any other manufacturer's) own promotional calendar. As a result, LeapFrog products may be on promotion at a given retailer at a particular point in time, which may or may not overlap with the retailer's own promotional calendar (e.g. a "3 for 2" promotion across different products or brands). [Confidential].

156. [Confidential].

157. A summary of LeapFrog's contractual terms with its top 10 customers has been provided as Annex 15K to Annex 15T to the Parties' response to the Phase II Market Questionnaire.

158. [Confidential].

159. [Confidential].

160. [Confidential].

After-sale

161. Customer support for UK end-users of VTech products is handled by a consumer services team base in VTech UK's offices, and LeapFrog UK uses a third party ([Confidential]) for providing support services to end-consumers.

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162. Please refer to **Annex 6** for further details on the lifecycle of the Parties' products in the UK.

V.3 Demand-side characteristics of the toy industry

163. As discussed at the visit of the CMA at LeapFrog's offices on 5 October 2016 (the "**Site Visit**"), the toy industry (which has grown at a rate of about 5% since 2015)[36] can be distinguished from many other consumer goods industries due to a number of key characteristics.

[36] See http://www.toysnplaythings.co.uk/news/14205-npd-traditional-toys-still-top/1.

Gift-derived industry

164. First, unlike most products, the end-consumer demand for toys is predominantly gift derived. This gift-based nature means that the purchaser of the toy is very seldom the actual user of the toy. Nevertheless, the extent to which the user influences demand will vary according to age. Whilst a baby will generally be unlikely to express a particular preference for a specific toy, an older child may be more likely to be exposed to *ad hoc* trends (e.g. the latest Disney movie, the latest popular toy at school or nursery) and thereby able to voice a preference (e.g. in a Christmas wish list). Indeed, market research shows that requests from children now account for almost half the money spent on toys in the UK for the first half of 2016, suggesting that the toys children see or hear about and therefore request are more likely to become top sellers.[37]

165. As a result, whilst purchases for baby toys are nearly entirely adult-led, the push to purchase toys for older children may be shared between the adult and the child. However unlike other consumer goods, even if the child expresses a preference, it will not be a preference based on the cost of the product, as an infant or preschool child will not have this information nor the concept of cost. As such, even if the child expresses a preference, the purchaser may well be budget-constrained and therefore price sensitive. Furthermore, whilst parents may be in a position to listen to a child's demand, [Confidential].

[Confidential].

166. Depending on their profile (whether a first-time parent, a second-time parent, a grandparent or a gift buyer, etc.)[38] the gift giver may well choose to switch between other products suitable for the child given the very wide array of choice on the shelves.

167. Whilst there are some purchases in which the child has expressed a preference, there are many purchases in which the child has not expressed a preference. In these types of purchases, it is the adults that the manufacturer must attract, where the adult may not have a strong pre-conceived idea for what type of gift they will buy. This is why having a prominent space in a retailer's display is often the key determinant of success. [Confidential].

[Confidential].

Trend-driven industry

168. Second, the toy industry is characterised by a constant and significant stream of new toys coming into the market reflecting the quick changes in the trends of consumer demand. In many ways this makes the toy industry much more similar to the fashion industry than a typical consumer product.

169. These consumer demand trends can come from a variety of sources, all of which make it difficult to predict which type of toys are likely to be a success and which types of toys will fail in any given year. For example there are:

(a) Current consumer trends that are observed in adults as children often express the desire to copy what their parents/adults are doing and what they see in mainstream media. For example when tablets were popular for adults, toy manufacturers started manufacturing children's tablets; the same, applies to smartphones. The latest "hot" toy, as published by Toys'R'Us' Christmas wish list for 2016 is a selfie

[37] Source: http://www.toysnplaythings.co.uk/news/14205-npd-traditional-toys-still-top/1/.

[38] [Confidential].

stick,[39] which is very much reflective of current adult trends. However not all adult trends successfully make it into children's toys and therefore there is significant uncertainty as to what trend can be successfully imported. A concrete example of this are the "i-toys", toys that are played in association with an iPhone or iPad, that several toy brands launched a few years ago. This was intended to capitalise on the popularity of these Apple products. In both the USA and the UK, none of the toys were successful and soon disappeared from the market.

(b) Media trends to which a child can be exposed, e.g. the latest movie/cartoon, new (or "refreshed") Disney characters and the like.[40] Indeed, the toy industry is heavily reliant on following and predicting trends in the entertainment industry as evidenced from the NPD list of "top 5" best selling toy products (provided at Annex 2B to the Phase II Market Questionnaire) where toys featuring characters from the [Confidential] were among the 5 most popular products in 2015 in all 12 countries surveyed by NPD, whilst toys featuring characters from the 2013 film [Confidential] have continued to make it to the list of 5 most popular products in 2015 in 9 out of 12 countries surveyed. Consequently, obtaining licences to popular content is a relatively safe way of obtaining success for toy manufacturers given that it relies upon an established media brand rather a manufacturer's brand.

(c) Feedback loops – like the fashion industry, the trends in the level of popularity or prevalence of a toy tends to have a reinforcing element for some period. The trendier the toy, the more children will want to have it and the more children that have it the trendier it becomes (and so on). However the reverse also applies, once a toy becomes 'non trendy' it can quickly fall from in terms of sales.

170. The direct result of these constant changing trends is two-fold. First, unlike many consumer goods industries, toy products have a very short life-cycle.

171. As shown in **Annex 7** many of the Infant/Toddler/Preschool toys (the main NPD super-category where the Parties' products overlap) that are considered "hot" in one year, quickly fall from the top 20 within a short period of time. For example looking at the Infant/Toddler NPD segment, on average only [Confidential] of the year's top 20 toys were still in the top 20 toy list in the next year. Indeed after two years, just under [Confidential] toys on average are still in the top 20. Within the NPD category of preschool toys, on average only [Confidential] of the top 20 toys in a given year were still in the top 20 toys in the subsequent year. Indeed across the top 20 Infant/Toddler/Preschool toys in NPD, nearly [Confidential]% of them had falling sales within less than two years of them being in the top 20.

172. This short life cycle is not just for the most popular top 20 toys, but is also seen across all toys regardless of whether they are the most successful. The figure below illustrates the movement of newly introduced toys from the first quartile of all toy sales, to the lower quartile in just a short amount of time.

[39] SelfieMic Selfie Stick Microphone. See https://www.thesun.co.uk/news/1816170/toys-r-us-reveal-2016s-must-have-christmas-toys-from-furby-connect-to-chip-the-robot-dog.

[40] For completeness, please note that the factors determining which toy is a "hot" toy will be less relevant for toys targeted for babies, given that the purchase is likely to be more parent-led, compared to an older child who is more likely to want to follow trends and add a toy to a wish list.

[Confidential]

173. The graph shows that over [Confidential] of the toys in the Infant/Toddler NPD segment in the top quartile in 2014 either featured in the bottom quartile or exited the market within two years. Within the Preschool toys NPD segment, the pattern was even more pronounced with just under [Confidential] of all Preschool toys in the top quartile in 2014 subsequently being in the bottom quartile or exited within two years.

174. Second, in order to compensate for the short life cycle of products, and in order to try and catch upcoming trends, toy manufacturers release a very substantial number of new products every year.

175. As shown in **Annex 7** the number of new product releases per year varies from [Confidential] of all products in the Infant/Toddler/Preschool NPD super-category at any one time to [Confidential] of all products. The diagram shows the proportion of new products to previously existing products within the NPD Infant/Toddler and Preschool segments from 2014 to 2016 YTD. It also shows the number of manufacturers of all products and the number of manufacturers with new products in the two segments during the same period.

[Confidential]

176. As seen, the proportion of new toys is very high, with nearly [Confidential] of all products being new releases. Not only are there a large number of new releases, but there are a large number of manufacturers releasing new toys. Of the [Confidential] manufacturers present in the Infant/Toddler or Preschool NPD segment, [Confidential] of them are releasing new products in any given year. Furthermore of the [Confidential] manufacturers releasing new products each year, on average [Confidential] of them were entirely new manufacturers who had not been present in the segment in the previous two years.

177. The result of the short lifespan coupled with the constant stream of new products is that successes in toys are both volatile and short lived. The table below shows the ranking of all Infant/Toddler toys that ranked amongst the top 10 sales (by number of items) in any given quarter from 2013 to Q3 2016 (Please see **Annex 7** for further details).

[Confidential]

178. As can be seen many of the most popular toys entered to become popular, and then subsequently fell down the rankings in a very short amount of time. Indeed the number of toys that have stayed popular throughout the period is very small – with [Confidential] being the significant exception to the extensive volatility. Unlike [Confidential], the majority of toys that feature amongst the top 10 in any given quarter have quickly fallen out of fashion. For example [Confidential] was amongst the top 5 in Infant/Toddler toys in 2014 but its ranking fell to 800 by Q3 2016, just six months after. In addition the table shows that there have been a significant number of new releases going in straight to the top 5 shortly after launch, this includes toys from newly entering manufacturers such as [Confidential] by new entrant [Confidential] who launched it in Q4 2014 and made it to the top 10 of the Infant/Toddler NPD segment in the first half of 2016.

179. Other evidence of the highly volatile nature of toy demand is shown in the following examples:

– Cheong Choon Ng's Loom Bands were particularly "hot" in 2014; however these have now gone out of fashion and are no longer being stocked by retailers,[41] though remaining inventory may be sold. To the best of the Parties' knowledge, neither Cheong Choon Ng, nor any other manufacturer have launched new Loom products;

– LeapFrog and VTech tablets/laptops were "hot" products between 2011 and 2013, and then fell out of fashion in 2014 onwards;[42]

– Another example is Hasbro's Furby which was very popular and on the "hot" products list in 2012 and 2013 and which has now gone out of fashion;[43]

– A compelling example is included at **Annex 8**, which shows how significantly the offer of tablets has been reduced in Argos' catalogue between 2016 and 2013; in 2013, the front cover displayed a LeapFrog catalogue and included a wide choice of tablets.

180. The trend-driven nature of the toys industry is further evidenced by the existence of hot toys lists for a given year. The Toy Retailers Association publishes a list of "hot" toys each year, which is called "Dream" toys and which is put together by a panel of toy buyers from various retailers like Argos, ToyMaster, and The Entertainer. Furthermore, Argos publishes a list of top toys for Christmas. These lists illustrate the diversity of toys that can be considered "hot" a given year and fall out of trend the following year. These lists, covering the past five years, are attached as **Annex 9**.

181. It follows that:

(a) to remain successful, and given the high disposability of toys, manufacturers are under pressure to:

(i) anticipate and keep track of new trends;

(ii) constantly innovate to launch new products (i.e. when the concept is new, e.g. Pie Face);[44] and

(iii) constantly innovate to renew their product offering,[45] either with new versions of existing products (e.g. an upgraded toy, or simply different in some aspect) or reinvigorate "comeback" products (e.g. the Teletubbies or Bob the Builder, are being (re-)launched on at least a seasonal basis);

(b) any share of supply at a given point in time may not necessarily be reflective of any durable market power, as a toy may be considered "hot" at a given point in time, only to be tossed aside the following season (see examples above in paragraph 179);

(c) retailers are a critical partner for toy manufacturers to display their products and access end-consumers, and consequently can have significant influence over the

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41 For example, Cheong Choon Ng's Loom Bands are not featured in Argos' 2016 autumn/winter catalogue.

42 See **Annex 9**.

43 See **Annex 9**.

44 Reference to this toy was made during the Site Visit. A father excogitated the concept and tools required, before posting a video of him and his son playing the game on social media.

45 VTech estimates that approximately [Confidential] of toys are "refreshed" each year, meaning that they are being re-launched with new or different characteristics or features.

ultimate success of a manufacturer's product(s). Some retailers publish their own list of top toys which can influence how a manufacturer's toys perform too; and

(d) entry, expansion and exit are commonplace with new products, new versions and "comeback" products. For example, Paw Patrol merchandise was developed by Spin Master in May 2014 and became one of the fastest growing range of toys in the sector in 2015.

Seasonal industry

182. The third important characteristic of toy manufacturing is the highly seasonal nature of demand, and the resulting importance of retailers in order to capture that demand. VTech estimates that approximately [Confidential] of toy sales in the UK are achieved in the last three months of the year.

[Confidential]

183. This short window of very intense demand places huge emphasis on being successful during the short window of Christmas. Missing this window means that the majority of sales for the year are also missed. Therefore whilst many of the factors that influence success relate to the exogenous trends described previously, there are also important factors involving being ready for the Christmas window which are within manufacturers' control.

184. First, in order to be successful toy manufacturers must have their products in the consumers' vision and awareness. The level of advertisement given to it by the manufacturer and by retailers therefore has an impact on the success of a toy, as toys that are frequently advertised on television are more likely to become the next "hot" toy simply because children who watch television will be more likely to request that toy.

185. Second, and most importantly, as discussed previously, the extent to which the toy manufacturer's products can be seen in a wide variety of retailer distribution channels is key to success. Having their product prominently displayed across all retailers helps to create a "buzz" around the product and generate consumer trends that will push a product into the top 20 products at Christmas.

186. For these reasons toy manufacturers negotiate fiercely with retailers to have as large a space as possible dedicated to their brand in order to sell as many of their products as possible during the high season (which is generally from September to January). Similarly, placement in retailers' catalogues or flyers in the run up to Christmas is a key part of retailer discussions with manufacturers given the importance of these tools as a means for consumers' recognition in a space with so many different products and manufacturers.

187. Given the importance of the Christmas season to overall sales, toy manufacturers simply cannot afford not to be listed (or have a reduced shelf or catalogue space) during this period, and will therefore make all efforts to offer the most competitive terms to retailers. However retailers face constraints such as (a) limited shelf or catalogue space, and (b) limited warehouse space. This is particularly the case for retailers with relatively limited shelf space to dedicate to toys such as grocer retailers (e.g. Tesco). Even online retailers (such as Amazon for example) will not have unlimited constraints within their warehouses and will not be able to list a manufacturer's entire range.

188. With limited space, retailers will wish to prioritise products (a) which are likely to achieve the highest margin, and/or (b) which are expected to generate the greatest volume of sales.[46] Therefore, whilst end-consumer demand is a key driver of the seasonal peak, toy manufacturers are heavily reliant on retailers in order to facilitate that demand. This means that retail negotiations around the Christmas range and promotional support are particularly intense.

189. These negotiations in terms of list price, recommended retail price, and more generally, contractual terms are described in detail in section VII.3.1. However, the reliance on retailers for consumer awareness has significant implications for the issue of customers' buyer power and the ability of manufacturers to raise prices or reduce their terms.

46 Equally, as mentioned in response to question 25 of the Phase II Market Questionnaire, a decrease in end-consumer demand for a specific product will influence retailers' shelf/catalogue space decisions, often resulting in underperforming toys being moved to less appealing shelves or de-listed entirely. The Parties note that this dynamic applies across the entire toys sector, including TEL toys, child tablets/laptops and child electronic reading systems.

VI. MARKET DEFINITION

VI.1 Product market

For the reasons set out below, the Parties strongly disagree with the segmentation of the market adopted in Phase I and the choice of relevant NPD sub-classes for market share calculations (which is not always consistent with the CMA's own definitions in Phase I – see section VII.1.1 below). In particular:

- Market definition is a means to an end, to frame the competitive assessment. In this case, it is particularly hard to make market definition a useful tool for the following reasons:
  - The market and consumer tastes are very dynamic, and shift across categories;
  - Different retailers use different navigational distinctions on their websites; and
  - NPD data is the only measurement source, but has a significant degree of arbitrariness in allocating products to sub-classes, and also is materially incomplete insofar as it does not include certain own-brand sales (e.g. Amazon-brand products such as Kindle) as well as those of non-participating retailers (e.g. Smyths).
- From a demand-side perspective, retailers do not view and segment their purchasing decisions based on the segments/markets identified by the CMA. Indeed, their procurement teams (and store displays) are generally organised by infant/preschool, boys, girls, outdoor and games. Similarly, end-customers are influenced by a number of factors including trends, movie characters and what's on display in stores/websites and, within an appropriate age range, consider a number of alternatives/options when making purchasing decisions.
- From a supply-side perspective, toy manufacturers constantly renew their product offering in order to anticipate changes in consumer trends. Furthermore, the development and manufacture of toys, including electronic toys, is not a technology-intensive industry and manufacturers can switch across categories to take advantage of trends/opportunities.
- Accordingly, while an "all toys" market may not be an appropriate basis for the CMA to assess the impact of the Transaction, the Parties are of the view that the narrow segments identified in Phase I are not appropriate either and do not correspond with relevant economic markets. In particular, the evidence supports at least a wider frame of reference, looking at the broader Infant/Toddler/Preschool category.
- With regard to tablets, the CMA Phase I approach failed to consider the degree of substitutability with adult products, including smartphones, and the fact that parental controls and sufficient device robustness are available for non children-specific tablets too.
- A market for "child electronic reading systems" limited to LeapFrog's reading device is unduly narrow and does not take into account the variety of choices and considerations faced by parents/gift givers when looking at toys with a reading

element. Laptops and tablets would for example be an alternative to an audio reading system.

- The above is supported by CRA's margin concentration analysis at **Annex 10**, which shows that high market shares in particular NPD sub-classes do not necessarily lead to higher margins.

VI.1.1 Decisional practice

190. The CMA (and its predecessor the Office of Fair Trading ("**OFT**")) and the European Commission (the "**Commission**") have considered the toys sector in a number of merger control cases involving toy retailers (but not, to the Parties' knowledge, toy manufacturers).

191. In the UK, both in *GUS/Littlewoods*[47] and *Mothercare/Chelsea Stores Holding,*[48] due to the parties' high market shares in the retail sale of toys, the OFT adopted a conservative approach and analysed the relevant transactions both on the basis of the supply of all toys and by category of toy[49] (although in *Mothercare/Chelsea Stores Holding* the OFT did not reach a definitive conclusion on the relevant product market definition). Equally in *Eagle Retail Investments Ltd/Early Learning Centre,*[50] the OFT assessed the effects of the transaction both on the basis of an overall market for the retail sale of traditional toys and games, as well as based on a narrower segment for preschool toys for children from 0 to 6 years.[51]

192. In other cases, where the transaction involved large generalist retailers supplying many different products (including toys), the CMA (or its predecessor the OFT) adopted a broader market definition, such as the overall market for the retail supply of non-foods products[52] – emphasising the existence of some degree of supply-side substitution[53] – or the overall market for the retail sales of toys.[54]

193. At EU-level, the Commission has considered toys and games as either forming part of a broader non-food retail market, or as a separate market without any further distinction by segments. For example, in *Rewe/Deltavita*,[55] toys and games have been considered to belong to the broader market for the retail sale of non-food products. A slightly narrower product market definition was adopted in *Otto/Primondo Assets*,[56] where toys and games were considered part of a separate market within the market for the retail sale of non-food

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47 OFT decision of 28 June 2005 *Anticipated acquisition by GUS plc of part of the Index Business of Littlewoods Ltd*.

48 OFT decision of 11 June 2007 *Anticipated acquisition by Mothercare plc of Chelsea Stores Holding*.

49 In particular, in *GUS/Littlewoods* the OFT analysed the effects of the merger in each of the following segments: (i) infant/preschool, (ii) boys, (iii) girls, (iv) games & puzzles, (v) creative toys, (vi) building sets and (vii) soft toys. In *Mothercare/Chelsea Stores Holding*, the transaction was instead analysed in each of the following categories (where the parties' post merger shares were highest): (i) ride-ons, (ii) creative toys, and (iii) preschool toys.

50 OFT decision of 11 May 2004 *Eagle Retail Investments Ltd and Early Learning Centre*.

51 For completeness, the Parties point out that a narrower market definition has in the past been considered by the OFT in cartel cases. For example, in the OFT decision of 21 November 2003, A*greements between Hasbro UK Ltd, Argos Ltd and Littlewoods Ltd*, for the purpose of assessing the level of fines, the OFT considered the relevant parties' turnover based on ten different categories of toys and games: (i) infant and preschool games, (ii) boy's toys, (iii) girls' toys, (iv) games and puzzles, (v) creative toys, (vi) construction games, (vii) soft toys, (viii) ride-ons, (ix) electronic learning aids and (x) hand-held electronic games, although the OFT did not take a definitive view as regards the exact product market definition.

52 Including stationary, books, clothing, magazines and toys.

53 OFT decision of 2 August 2007 *Anticipated acquisition by Tesco Holdings plc of Dobbies Garden Centres plc*.

54 CMA decision of 22 July 2016 *Anticipated acquisition by J Sainsbury plc of Home Retail Group Plc.*

55 Case No COMP/M.4590 of 25 April 2007.

56 Case No COMP/M.5721 of 16 February 2010.

products, with a possible further distinction between the retail sale of toys and the retail sale of games.

VI.1.2 The approach at Phase I

194. The Parties submit that the SLC assessment of this case need not turn on market definition. For the reasons set out below, it is difficult to make market definition work particularly effectively so as to frame the competitive assessment. Further, irrespective of market definition, the removal of LeapFrog (even if disregarding its failing state) does not constitute a substantial relaxation of the competitive constraints facing VTech in its dealing with UK retailers, and brand licensors such as Disney, and its attempts to pre-empt or follow dynamic consumer tastes for toys.

195. Notwithstanding its diminished usefulness for the purpose of this case, the Parties note that the CMA at Phase I has analysed the Transaction on the basis of the following narrow segments that are difficult to delineate in a practical sense (particularly in relation to TEL, as defined below).[57] For Phase I purposes, the Parties understand that the CMA takes the available NPD data, identifies the segments with the highest share of supply and (despite some notional application of caveats), more or less assumes that any sub-class with a high share of supply is or may be a relevant market. While this reverse-engineering of high shares of NPD categories into market definition is not necessarily inappropriate for Phase I, given the time and resource constraints and seriousness with which the CMA analysed the failing firm argument, it is not an acceptable basis for conducting a Phase II inquiry. In any event, by way of recap, the Phase I approach can be summarised as follows:

- Toddler electronic learning ("**TEL**") toys, defined by the CMA as toys with an electronic element and a learning purpose, targeted at children aged 0 to 3 years. This includes number/alphabet learning toys, fine motor skills toys (e.g. shape sorters or stacking toys), role play toys, musical toys, soft (or plush) toys, tablets/laptops, electronic books etc.;
- Child tablets/laptops, and related software, which according to the CMA are targeted at children aged 3 years and older, and are similar visually to adult tablets/laptops, but differ significantly from adult tablets/laptops in functionality and safety features;
- Child smartwatches, i.e. wrist-mounted devices targeted at children aged 3 and older which, beside telling the time, incorporate other functions such as playing games, taking photos and tracking activity; and
- Child electronic reading systems, i.e. electronic systems that involve the audio (electronic) narration of an accompanying physical book, targeted at children aged 3 and older. These typically use electronic devices that trigger the audio narrative (e.g. electronic pen or figurine).

196. However, for the reasons set out below, the Parties disagree with the CMA's proposed approach to market definition in Phase I.

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[57] See the CMA's paper setting out the competition issues it considers arise out of the Transaction (the "**Issues Statement**").

(i) TEL toys

<u>NPD categorisation</u>

197. The CMA relies on the NPD classification, which identifies a TEL toys segment, which is not an ordinary course term for either Party or, the Parties believe, any toy manufacturer (please see section VII.1.1 below for more details on NPD and its classification). However, TEL toys is only a single sub-class of the NPD Infant/Toddler toys segment, which itself is a subset of the broader NPD Infant/Toddler/Preschool category. Moreover, many other NPD super-categories also provide for age ranges that overlap with the Infant/Toddler/Preschool age-defined category. Examples include the categories Action Figures, Arts and Crafts, Construction, Dolls, Outdoor and Sports and Vehicles.

198. Despite retaining TEL toys as a relevant frame of reference, the CMA notes in its decision to refer the Transaction to an in-depth merger inquiry (the "**Reference Decision**") that "*the CMA was unable to use the NPD data for the purposes of segmenting the market as <u>similar toys were not always allocated to the same segments</u>*"[58] (emphasis added).

199. Indeed, the Parties submit that, whilst NPD data is informative as to the different categories of toys that exist, such nomenclature cannot be used as a means of segmenting the market in an economically meaningful way which would reflect competitive dynamics and in particular demand-side and supply-side substitutability (see below), given the high degree of overlap between the different NPD categories. For example:

- Ravensburger's Pull Along Engine has been classified as [Confidential] while its Push Along Fire Truck has been classified as [Confidential];
- VTech's Baby's First Smartphone and Clementoni's Minnie Mouse Baby Smartphone belong to the [Confidential] sub-class whilst KD Group's Peppa Pig Smartphone, Disney Frozen Smartphone and Thomas & Friends Smartphone pertain to the [Confidential] sub-class. The Parties submit that the classification is not only arbitrary, but erroneous, as for example, KD Group's Peppa Pig is marketed to be suitable from 18 months on (and therefore could also fall in the [Confidential] sub-class).

200. Furthermore, NPD categorisation is not static and has evolved over time. For example, NPD has recently renamed [Confidential].[59] This illustrates the looseness of the NPD categories, which do not constitute a robust basis for any market definition exercise.

<u>Demand-side perspective (consumers)</u>

201. First, whilst some consumers may have pre-set views on what type of toy they want to buy, many other consumers will not shop with a specific type of toy in mind but rather more general goals, including entertainment, development and any combination of such attributes. As discussed in section V.3, the fact that a significant proportion of consumers does not have a strong preconception of which product they want is evidenced by the importance of retailer's displays in the purchasing decision of consumers. For example, [Confidential] – see Figure 6 below.

[58] Footnote 46 of the Reference Decision.

[59] See also slides 31 and 32 of LeapFrog's Site Visit presentation on 5 October 2016.

[Confidential]

202. The Parties do not consider the distinction between learning (or educational) and non-learning (or non-educational) toys to be robust in respect of toys intended for infants and toddlers. The Parties submit that the words "learning" or "developmental" are buzz words used by the industry to sell their products. In fact, the Parties submit that any toy has, in itself, a learning/educational value, especially for the 0 to 3 years category, where infants and toddlers discover the world through play.[60] This is recognised throughout the toy industry and education sector in the UK (and elsewhere):

- Education Scotland, which is the national body in Scotland which supports quality and improvement in learning and teaching), indicates that "*Play is how young children make sense of the world. There is also evidence to show that play in early childhood can influence the way your child's brain develops, helping to co-ordinate their mental and physical capabilities. Through play, children and young people of all ages develop problem-solving skills, imagination and creativity, language and observation skills, and memory and concentration. Children and young people use play to test their theories about the world and their place in it*".[61]

- The British Toy and Hobby Association ("**BTHA**") stresses that: "*Play is crucial to your child. It can provide the time for discovery, exploration and growth as well as fun. The most important thing for parents to remember is that through fun and play a child can learn about the world around them, whilst developing key skills needed throughout life*". Please see **Annex 11**. The BTHA also runs a campaign called Make Time 2 Play because '*BTHA Members are committed to promoting the value that play has in children's development and in their enjoyment of life.'*[62]

- The Value of Play leaflet published by the National Toy Council (see **Annex 12**) also emphasises the value of play. It lists a wide range of toys which are considered to help with a child's development, including puppets, dolls, block letters and shape sorters, which are not per se "electronic learning" toys. The leaflet also stresses that "*play is an essential part of growing up. Through play children hasten their own development while they learn about the world around them.*" Furthermore it indicates that a baby's first toys are important in teaching about size, shape, colour and texture. In one study, the availability of toys in infancy was strongly related to the child's IQ at the age of 3.

203. More practically, VTech's Little Love doll, which is in itself a doll (and categorised in the [Confidential] segment in the [Confidential] super-category, and not in the [Confidential] segment despite being battery-powered), has a learning/educational value, as per the product description.[63]

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60 Learning through play is a term used in education and psychology to describe how a child can learn to make sense of the world around them. Through play children can develop social and cognitive skills, mature emotionally, and gain the self-confidence required to engage in new experiences and environments.

61 See http://www.educationscotland.gov.uk.

62 http://www.btha.co.uk/csr/value-of-play/make-time-2-play/.

63 "*Talk to your baby! The more your little one talks to Baby the more words and phrases she will learn and repeat! A perfect way to introduce your little one to nurturing role play. Use the 3 colourful baby books to teach her to read and listen to her as she coos and sings along to nursery rhymes*".

Figure 7: VTech's Little Love doll

204. Furthermore, the Parties consider that there is demand-side substitutability between electronic and non-electronic toys for infants and toddlers. In particular, given that purchases of toys for children under 3 years of age are primarily adult-led, a parent will essentially purchase a toy that will entertain their infant or toddler, and that may very well include toys which are not necessarily electronic. For example, Tomy's Hide'n'Squeak Eggs are particularly popular amongst parents of infants and toddlers.[64] The same goes for Early Learning Centre's stacking cups, Fisher-Price's Chatterbox Telephone, Playmobil figures and Lego's Duplo building blocks.

205. The Parties note that, to support the distinction between TEL toys and non-TEL toys, the CMA relied on market analysis by VTech from 2014 and 2015[65] which, in the CMA's view, would show that VTech primarily considers competition from other TEL toys suppliers. The Parties point out that [Confidential].[66] In addition, in paragraph 112 of the Reference Decision, the CMA concedes that a number of other internal documents suggest that the Parties may consider competitive constraints from non-electronic toys. By way of example, VTech considers such toys, for example Fisher-Price's non-electronic stacking toys, to be the closest competition to its electronic stacking toys.

206. The Parties further submit that, although the toys market could, in general terms, be segmented according to ages, a rigid segmentation by age, according to precise age cut-offs, would be arbitrary.

207. First, many toys are graded and suitable for use for wide age bands, (e.g. from 3 to 11 years old). More importantly, although each toy would normally be attributed a "recommended age" range, which may comprise a number of months (e.g. 9 to 30 months) or years (e.g. 3 to 7 years), the Parties note that toys are not mutually exclusive by age and the differentiation of toys by age is blurred, as for example children at a less advanced developmental stage may use toys normally "recommended" for a younger age band and *vice versa*. Another example of this is the fact that around [Confidential] of the toys classified by NPD in the Infant/Toddler segment have an age recommendation of 1 to 5 years.

208. Second, as detailed in section V.2 above, the toys industry is very much a trend-driven and seasonal business, where products are highly differentiated and constantly renewed. As a result, consumer demand in relation to toys is particularly "capricious" and trend-driven, as different toys fall in and out of fashion within short timeframes. The fact that these trends exist across all sub-classes is evidence that substitution patterns are wider than just the sub-classes.

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[64] See e.g. the customer reviews at http://www.mumsnet.com/reviews/toys-and-gifts/toys-for-babies/11632-tomy-hidensqueak-eggs.

[65] See Annex I.2A to the Consolidated Response (i) "2015_Core Learning_0314_NO_appendix_final.ppt", and (ii) "Core-learning-no appendix 20150326 (Macau final presented)" referenced at footnote 57 of the Reference Decision.

[66] See for example [Confidential].

209. Third, there is no commonly accepted standard, among retailers, for segmenting the toys market in their product offering/display. For example, in relation to retailers' online offering:

- Sainsbury's website allows its customers to search by option ("new" or "offers"), by brand or by type but it does note have a category for electronic learning toys;
- Amazon has a number of toy categories, including an "electronic" toys category, as well as a segmentation by age, character, price and seller, with importantly, some of the toys appearing in more than one category.
- Toys'R'Us classifies toys by age, brands, outdoor and sports, video games etc., but does not have an "electronic" toys category, let alone a TEL category.
- Smyths' website has an overall "preschool & electronic learning" toy category in addition to other categories such as "creativity, music & partyware".

210. The Parties submit that all retailer websites typically facilitate the consumer's browsing experience by allowing the consumer to filter their search according to very narrow criteria (e.g. by age, by brand, by type, etc.). However, this is not reflective of how consumers (and therefore retailers) view the competitive dynamics. The categorisation can help gift buyers but experienced consumers are very familiar with how to navigate in-store and online offerings.

211. In brick-and-mortar retailer stores, in-store offerings tend to focus on displaying toys for a particular (wide) age group, regardless of their classification by NPD. For example, a Smyths toy store in Slough displays toys pertaining to the NPD TEL category right next to toys not pertaining to the TEL category, as illustrated in **Annex 13**.

Demand-side perspective (retailers)

212. Whilst end consumers are an important determinant of the Parties' demand, the retailers are actually the manufacturers' direct customers. An important indicator of the demand-side perspective for retailers is the fact that they generally have procurement teams with substantially broader purchasing responsibility than just TEL toys and typically do not structure procurement decisions based on whether a toy is electronic and/or educational. As noted in the Consolidated Response,[67] if they do segment the procurement of toys, it is more likely to be based on gender, age or broader usage, for example, infant/preschool toys, outdoor toys, girls' toys, boys' toys or board games.[68] This holds true for all types of retailers, whether grocers, toy specialists or others. In any case, there is no such thing as a specialist procurement team for TEL toys.

213. The Parties note that, in response to the CMA's merger investigation in Phase I, a number of third parties (retailers and competitors) indicated that they had an "electronic toys" segment, and some third party respondents also indicated that they had a segment for toys with a developmental, learning and/or educational purpose.[69] However the Parties would like to emphasise that:

- it is not clear what proportion of third party respondents were retailers; product classification used internally by toy manufacturers does not prejudge how retailers view the toys market(s) and their substitution patterns;

[67] See paragraph 273.

[68] [Confidential].

[69] See paragraph 101 (c) of the Reference Decision.

- the Parties emphasise that whilst third party respondents had a segment for electronic toys on the one hand and educational/developmental/learning toys on the other hand, no third party indicated having a segment for electronic *and* educational/developmental/learning toys (emphasis added); and
- finally, simply because retailers identify such categories (e.g. as a matter of convenient reference in the industry) does not mean that they do not substitute their purchase volumes between narrower categories that target a broader consumer set (i.e. by dedicating more or less shelf-space to electronic toys within their infant/toddler section) to maximise their own return.

214. Although retailer preferences will, to some extent, be derived from end-consumer behaviour, as mentioned above, retailers focus on maximising limited shelf/catalogue space by prioritising products (a) which achieve the highest margin, and (b) which will sell the most (i.e. generally products which are considered "hot"). In these instances, the patterns of substitution and the range of alternative options may differ at the end-consumer-level and the retailer-level, such that retailers have an even broader substitution pattern. Indeed, it is the volatile and trend-focused nature of end-consumer demand which encourages retailers to list the most popular toys on their shelves, which therefore results in a high degree of churn and product substitutability across the toys industry.

215. The Parties note that specialist retailers may seek to offer a wide range of toys (given that consumers go to specialist retailers for the choice available) and may therefore seek to list at least some type of toddler and/or electronic and/or learning toys. However grocer retailers have much less of an incentive to offer a wide choice of toys to the consumer given that consumers visiting grocers primarily go there to purchase food products, clothes or other items, and the purchase of a toy is very likely to be an add-on impulse purchase.

216. That being said, given the very narrow definition of TEL toys (that is, the toy having to be (i) electronic, (ii) with a learning component, and (iii) for children under 3 years old) the Parties submit that, in the event of a 5-10% increase in the price of TEL toys, retailers would either switch to other types of infant/toddler toys or other types of toys more generally (as would be the case, for example, for grocer retailers), or otherwise at least reduce shelf and catalogue space allocated to TEL toys (as would perhaps be the case for specialist retailers).

217. In its Phase I merger investigation, the CMA indicated that, "*if the price of the Parties' TEL toys increased by 5-10%, [retailers] would switch to other competitors […] who supply similar TEL toys as well as other toddler toys*" (emphasis added).[70]

Supply-side perspective

218. From a supply-side perspective, toy manufacturers constantly renew their product offering in order to anticipate changes in consumer trends. Furthermore, the development and manufacture of toys, including electronic toys, is not a technology-intensive industry nor one that would require a high degree of know-how, such that suppliers in other infant/toddler categories can easily switch to supplying TEL toys (and in a timely fashion) in the event of a 5-10% price increase of TEL toys.

219. In other words, a supplier of soft toys could easily insert a battery-powered voice box that sings the alphabet to make it an electronic soft toy and market it as a "learning" soft toy. For example, Clementoni's Baby Minnie Cuddle and Learn is a Disney character soft toy

[70] Reference Decision paragraph 110.

with added electronic components to enable children to "*Press his tummy and listen to rhyming phrases and cute songs to discover the first numbers*".[71] In a similar vein, it is relatively easy to add a learning component to an existing product range (or indeed position existing products in that way).

220. From a broader perspective, toy manufacturers can also switch between seemingly more distinct categories. By way of illustration, in 2014 VTech launched its Little Love dolls in the UK, following initial success in France as a completely new entrant in the dolls segment. [Confidential].

[Confidential]

221. [Confidential].

222. Section VII.3.2 further describes the reasons why barriers to entry/expansion with respect to TEL toys (and more generally within the toy industry) are considered low.

(ii) Child tablets/laptops and related software

223. The Parties note at the outset that, child tablets/laptops and related software is not a category used by the toys industry, nor is it an NPD category. Rather, it is a bespoke segment specifically defined by the CMA for the purposes of assessing the Transaction (and one which the CMA has not previously considered).

224. The Parties also wish to point out that their "child tablets/laptops and related software" fall within different NPD categories.[72] This highlights the arbitrary nature of using NPD categorisation for TEL toys when the CMA clearly accepts that it is not suitably accurate for "child tablets/laptops and related software".

Demand-side perspective (consumers)

225. First, the Parties submit that from a consumer's perspective, demand for children's tablets/laptops may be satisfied not only by devices specifically targeted at children but also by non child-specific tablets/laptops and by tablets that are designed for children but not captured as part of the NPD audit or definition, such as Amazon's Kindle products. Indeed, this ability is most clearly demonstrated by parents simply allowing their children to use their devices.

226. As a preliminary remark, the Parties question the CMA's use of the term "adult tablets/laptops", which is neither defined by the CMA in its Reference Decision or Issues Statement, nor a term used by the industry. The Parties consider that there is no such thing as an "adult tablet/laptop" given that (i) tablet/laptop suppliers such as Apple do not specifically market their tablets/laptops for adults[73] and (ii) children often use their parents' tablet/laptop (or have their own).

227. Though tablets are the device most often used by children aged 3 to 11 years to access the internet after laptops, only 11% of children aged 3 to 4 years and 29% of children aged

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71 See http://www.clementoni.com/en/61221-baby-minnie-cuddle-and-learn/.

72 Namely: (i) Toddler Electronic Learning (which includes electronic items that have a basic learning feature (colours, counting 123's, ABC's) that are intended for toddlers (12 months and up to 36 months of age), including toddler tablets, (ii) Preschool Electronic Learning (which includes learning type toys that have an electronic feature and are designed for preschool children. These may or may not resemble a laptop/tablet however the keyboard has larger buttons that are usually sorted in alphabetical order); (iii) Education Learning Aid Hardware/Software and Accessories (which includes any electronic learning toys that are geared to children who are 5 years of age and up; and (iv) Kids' Tablets (which includes tablets that typically have an exaggerated toy-like appearance and are packaged with a child-proof case).

73 See http://www.apple.com/uk/education/, where Apple markets its "iPad" tablets as an educational tool for children.

5 to 7 years have their own tablet.[74] The CMA noted this statistic at paragraph 122 of its Reference Decision but found that it does not assist in determining whether adult tablets are a substitute for child-specific tablets. The Parties, however, submit that this statistic shows that 2 in 3 children are using tablets provided by parents, schools, or other third parties. These tablets are less likely to be child-specific, demonstrating that child-specific and non child-specific laptops/tablets are interchangeable.

228. In addition, technology is becoming more and more accessible to all tranches of the population, including children, and at increasingly lower prices. According to research commissioned by the education technology charity "Tablets for Schools", 68% of primary schools and 69% of secondary schools in the UK use tablet computers, with 9% of schools having one tablet per student.[75]

229. The Parties disagree with the CMA's observation that "non child-specific" tablets/laptops differ significantly from children's tablets/laptops. In particular, the CMA mentions (i) the special safety features that specific children's tablets/laptops are equipped with (e.g. parental control and kid-safe web functions), and (ii) their robust case, as the main points of difference with "non child-specific" tablets/laptops.

230. The Parties consider that such consumer concerns or focus on such parameters as a point of differentiation are more reflective of the market dynamics when the LeapFrog/VTech products were introduced in 2012/2013 [Confidential] than the reality of market conditions today (and hence the declining sales).

(i) As regards special safety features, the vast majority of tablets (including those running Android and iOS (Apple) operating systems which together represent more than 90% of all mobile/tablet operating systems)[76] allow the setting up of restricted profiles enabling the device administrator (i.e. a parent) to control the app permissions of each user profile. In fact, taking advantage of such settings, many tablets such as Hudl 2 (now discontinued, but which was running the Android operating system) have been advertised as having a child-safe mode and marketed as a family tablet. Please see **Annex 14** for examples of reviews commenting on Hudl 2's child-friendly features.

In addition, several child-safe applications exist, which are easily downloadable from the internet (some of which are free) and which ensure an appropriate level of parental control. For example, both Apple's AppStore and GooglePlay offer numerous free parental control apps, targeted for different age groups, including Symantec's Norton Family parental control, McAfee (Intel Security)'s McAfee Family Protection or kiddoware's Kids Place – Parental Control, which even offers in-app purchases for child-appropriate content.[77]

(ii) As regards the robustness of the case, the Parties submit that several child-proof frames or cases are available and are easily transposable to non child-specific tablets/laptops. Fisher-Price even launched a tablet case in its Laugh and Learn

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[74] See OFCOM report, "Children and Parents: Media Use and Attitudes Report", pages 6, 47, available at http://stakeholders.ofcom.org.uk/binaries/research/media-literacy/children-parents-nov15/childrens_parents_nov 2015.pdf.

[75] See S Coughlin, BBC News, "Tablet computers in '70% of schools'", available at http://www.bbc.co.uk/news/education-30216408.

[76] See https://www.netmarketshare.com/operating-system-market-share.aspx?qprid=8&qpcustomd=1.

[77] See https://play.google.com/store/apps/details?id=com.kiddoware.kidsplace.

series for Apple iPads.[78] For example, Tesco's online shop stocks a variety of shock-proof children's hard protective covers for various Apple iPad models. These cases come in numerous shapes and colours appealing to children.[79] Similarly, numerous colourful hard protective cases for a variety of non child-specific tablets are available on Amazon.[80] The Spiky and Sea Kids EVA Tablet hard shell case for Android and Apple devices has a sea life motif,[81] whereas Dynamo's Heavy Duty Children's Rugged Tough Bumper Hard Protective Case Cover[82] available in blue, green, orange, pink, blue, purple and black has a handle, stand and built-in screen protector. It is available to suit a variety of Apple, Samsung and Android devices. In fact, consumers appear to have more choice of children's cases for non child-specific tablets than for child-specific tablets by entering keyword searches on Amazon's e-commerce platform.

231. Furthermore, given the wide selection of educational, learning, children's gaming, children's video content and safety applications available on the market free of charge, "traditional" tablets can be used in an identical way as the Parties' tablets, which have pre-loaded (or downloadable) learning content and applications.[83] By way of example, Reading Eggs and Mathseeds are very popular subscription-based services. In terms of apps, Mr Thorne's Grammar School, Mr Thorne's Times Table Terra, Nemo's Reef, Frozen Free Fall, CBeebies Playtime, CBeebies Storytime, Noobie ABC and YouTube Kids, and many others, are very popular.

232. Furthermore, the 20 most commonly downloaded free apps from the UK Apple AppStore in September 2016 in the category "Kids – 5 & Under" included Fisher-Price Laugh & Learn Animal Sounds for Baby – UK by Mattel, abc PocketPhonics Lite by Apps in My Pocket Ltd and Meet the Alphablocks! by Blue-Zoo. Each of these game apps, as their names suggest, contain a learning element. GooglePlay's most downloaded apps in the same category included Teach Your Monster to Read by Teach Monster Games, JollyPhonics Letter Sounds by Jolly Learning Ltd, 16 Learning Games for Kids by MAGE.[84] This has resulted in a drastic decline of children-specific tablets/laptops since 2014, which are no longer amongst the list of "hot toys" and been a significant contributing factor to the financial difficulties encountered by LeapFrog (please see section VII.2.2 below).

233. With respect to the CMA's argument that "traditional" tablets/laptops are priced significantly higher than child tablets/laptops, Annex 4 to the Phase II Market Questionnaire provides evidence that with the exception of certain premium products such as the iPad, traditional tablets are in fact not more expensive than child-focused tablets. For example, the recommended resale price for LeapFrog's cheapest tablet, LeapPad 3, is GBP 89.99, which is more expensive than Amazon's Fire (sold at GBP 49.99), Asus ZenPad 7 (sold at

[78] See http://www.ebay.co.uk/itm/Fisher-Price-Laugh-Learn-Case-For-Ipad-Pink-Computers-Tablets-Lock-Your-Ipad-/282018895056?hash=item41a9a2d4d0:g:3JIAAOSwKfVXILIbhttp://www.ebay.co.uk/itm/Fisher-Price-Create-Learn-Apptivity-Case-For-Ipad-Boys-Computers-Tablets-New-/391368048098?hash=item5b1f5a7de2:g:sUQAAOSwa-dWnorp

[79] See http://www.tesco.com/direct/technology-gaming/cases-covers/cat29430010.cat?catId=4294776046&.

[80] See https://www.amazon.co.uk/s/ref=nb_sb_noss?url=search-alias%3Delectronics&field-keywords=child+tablet+hard+case.

[81] See https://www.amazon.co.uk/Spiky-Tablet-Shell-Universal-Android/dp/B00IDEK6U4/ref=sr_1_1?s=electronics&ie=UTF8&qid=1475159404&sr=1-1&keywords=child+tablet+hard+case.

[82] See https://www.amazon.co.uk/COOPER-DYNAMO-Childrens-Protective-Protector/dp/B018QSELVQ/ref=sr_1_58?s=computers&ie=UTF8&qid=1475159333&sr=1-58&keywords=child+hard+protective+tablet+case.

[83] See paragraphs 78-81 of the Response to the Issues Statement (the "**Issues Statement Response**").

[84] See https://play.google.com/store/apps/category/FAMILY/collection/topselling_paid?age=1, accessed on 29 September 2016.

£79.99), Acer 7 inch Tablet (which can be found at £49.99)[85] or Linx 7 (sold at GBP 69.99), and within the similar price range of Hudl 2 (sold at GBP 99.99) and Samsung Galaxy Tab 3 (whose recommended resale price starts at GBP 119.99). In addition, where price differences do exist, the CMA has failed to consider the following factors:

(i) many providers of traditional tablets/laptops such as Samsung offer a range of products from entry-level tablets (which directly compete with child tablets) to high-end tablets (which are aimed for professional use such as digital drawing);

(ii) traditional tablets/laptops would normally satisfy dual needs, i.e. children's entertainment and learning as well as traditional functions, which may well justify a higher price and with no overall disadvantage for consumers; and

(iii) the price of the Parties' tablets/laptops do not represent the final price of these products as there are additional software/cartridge sales which would mean the products are in the same price range as traditional ones which have many free comparable applications available.

234. The Parties point out that the results of the CMA's market enquiry in Phase I confirmed the substitutability of non child-specific tablets/laptops with children's tablets/laptops.[86] The CMA's view is that child tablets/laptops differ significantly from adult tablets/laptops on account of special safety features such as parental controls.[87] However, independent research shows that only 12% of parents of 5 to 15 year-olds give their children access to the internet via devices with parental controls built into the device by the manufacturer.[88] A larger percentage of parents used parental control software, content filters and password protection.

235. As already mentioned in previous submissions,[89] the Parties provide several examples showing that children's tablets may be interchangeable with "traditional" "adult" tablets such as Samsung, Acer, Lenovo and Apple tablets.[90] For example, customers who viewed LeapFrog's children's tablets on John Lewis' website also viewed Amazon's Fire Kids Edition and Fire 7 tablet, the Lenovo Tab3 7 tablet, the Samsung Galaxy Tab E tablet and the Apple iPad mini 2.[91] Furthermore, children's education apps are being widely downloaded on non child-specific tablets and smartphones using Android and Apple operating systems. The apps Kids preschool games by pescApps, ABC Flash Cards for Kids by TeachersParadise.com, Kids Math by Mobiloids and ABCmouse.com by Age of Learning each have been downloaded more than one million times, with Kids learn to read by Intellijoy Educational Games for Kids having over 5 million downloads.[92]

236. Finally, the Parties note that there is also a significant degree of substitutability with other types of toys. The arguments made above in relation to TEL toys in respect of the toy

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85 http://www.tesco.com/direct/acer-b1-770-7-inch-tablet-1gb-ram-16gb-white/539-2597.prd?skuId=539-2597&pageLevel=sku&sc_cmp=ppc_sh-_-sh-_-tesco-_-539-2597&gclid=CIbzp4Lqys8CFUqNGwodDsgM1g&gclsrc=aw.ds&source=others.

86 See paragraph 126 of the Reference Decision.

87 See paragraph 117 of the Reference Decision.

88 See OFCOM report, "Children and Parents: Media Use and Attitudes Report", page 42, available at http://stakeholders.ofcom.org.uk/binaries/research/media-literacy/children-parents-nov15/childrens_parents_nov2015.pdf.

89 See the Consolidated Response, paragraphs 384-387.

90 See e.g. examples of Argos catalogue displays, as reported in paragraph 118 of the Reference Decision.

91 See http://www.johnlewis.com/leapfrog-epic-android-based-kids-tablet-ages-3-9yrs/p2763443.

92 See paragraph 397 of the Consolidated Response.

industry being a trend-driven and seasonal business, where products are constantly being renewed also apply here, such that there is a high degree of substitutability across different types of toys.[93]

237. Indeed electronic devices developed for children (such as children's tablets and laptops) follow wider technological trends such that new toys may arise and replace others as technology evolves and new products in the traditional technology markets are developed. For example smartphones, smartwatches and selfie sticks are now becoming more prevalent than tablets, which were "hot" products between 2011 and 2013, and have since fallen out of fashion. The above-mentioned list of "hot" toys,[94] which included tablets in 2012-2013, then replaced in 2014 with smartwatches, provides evidence of this. The rapid decline of UK "child" tablet segment in 2014 to 2015, as explained in more detail in paragraph 414 below, further shows how electronic devices for kids can easily be replaced, within a short time frame, by new products in the traditional technology markets. [Confidential].[95]

Demand-side perspective (retailers)

238. The arguments put forward above in relation to retailer demand-side substitutability for TEL toys also apply for children's tablets/laptops and software.

239. In essence, (i) procurement teams at retailers have substantially broader purchasing responsibility than just children's tablets/computers and (ii) retailers focus on maximising limited shelf/catalogue space, which results in them having a wider range of acceptable options.

Supply-side perspective

240. The Parties point out that the relevant hardware (including any child-proof plastic protective case) may be easily sourced from Asia. Indeed, LeapFrog's products have always been manufactured by third party manufacturers based in Asia.

241. As regards software specifically, the Parties submit that there exist several pre-loaded learning content and applications available for download on the internet and app stores. Furthermore as mentioned above, there exist several kid-safe applications which are easily downloadable from the internet.

242. Therefore from a supply-side perspective, manufacturers (in particular) of non child-specific tablets (that can be adapted relatively easily by making minor alterations), or manufacturers of other toys, can easily start producing child-specific tablets should the Parties increase prices or otherwise deteriorate product quality. For example, the website of the Hong Kong Trade Development Council ("**HKTDC**"), which allows for browsing of suppliers of "learning computers/systems", lists 250 laptops and tablets for children, with 183 companies supplying such items.[96] The HKTDC website does not even cover all potential sources for such products.

243. Further details on why barriers to entry and expansion are low for children's tablets and laptops are provided in section VII.3.2 below.

[93] See also the Issues Statement Response, paragraphs 41-43.

[94] Please refer to **Annex 9**.

[95] Please refer to Annex 26A to the Phase II Market Questionnaire.

[96] See http://www.hktdc.com/sourcing/product_searchresult.htm?bookmark=true&query=learning%2520computers/systems&locale=en.

(iii) Child smartwatches

244. The Parties do not consider that child smartwatches constitute an economically meaningful product market.

245. However as the CMA did not find any competition concern in relation to the supply of child smartwatches in the UK,[97] even on the basis of such narrow frame of reference, the Parties submit that the appropriate frame of reference does not need to be defined, but nevertheless remain at the CMA's disposal should any further information be required in that respect.

(iv) Child electronic reading systems

246. The CMA has assessed the Transaction on the basis of the supply of child electronic reading systems in the UK purely on a cautious basis, considering there was a lack of evidence to substantiate a wider frame of reference.

247. At the outset, and as discussed in greater detail in Section VII.2.3, it is important to note that VTech does not supply an electronic reading system but rather had been considering [Confidential]. Further, VTech's concept product is vastly different from LeapFrog's LeapReader.

248. In any event, the Parties consider that the narrow market definition identified by the CMA in its Reference Decision is not an appropriate basis on which to assess the effects of the Transaction and does not take into account the economic and commercial realities of the toy industry.

249. First, notwithstanding the caution of reliance on industry categories as accurately summarising demand-side substitutability, child electronic reading systems is not a category used by the toys industry. This classification is exclusive to LeapFrog and adopted by Argos on its website, where only LeapFrog products are advertised as electronic reading systems. Nor is it an NPD category, it is a bespoke segment specifically defined by the CMA for the purposes of assessing the Transaction. Indeed, the CMA's definition is essentially based on the features of the Parties' own products (one of which was only in the concept phase).

250. Second, the products which constitute child electronic reading systems are a sub-sub set of the NPD sub-class Preschool Electronic Learning, which is clearly an extremely narrow product category, which, for the reasons set out below, does not constitute a relevant market.

251. The Parties consider that child electronic reading systems should be assessed at least together with other electronic devices with a reading component such as child tablets/laptops, as this more suitably reflects the dynamics of competition in which the Parties current (and planned) products would interact (if ever brought to market).

<u>Demand-side perspective (consumers)</u>

252. Child electronic reading systems are electronic devices that recognise letters, words or other elements in dedicated electronic books (depending on the age of the child and his or her literacy skills) and speak aloud to teach children how to recognise and say letters or words, and how to write them, or otherwise aid or enhance the reading experience.

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[97] See paragraphs 151 and 226 of the Reference Decision.

253. The Parties submit that, from a consumer's perspective, demand for children's electronic reading systems arises in the context of a much broader decision making process. First and foremost, the consumer is looking for an entertainment device that can occupy the child's attention. In this regard, consumers will be assessing a variety of toy products before selecting a reading device.

254. Indeed, the reading component itself can be delivered through a variety of mediums which also fall outside the traditional toy retail sector, including books themselves, content delivered over tablets or e-readers and a host of "learn to read" products. All these products would fulfil a bespoke reading need and satisfy demand for a developmental toy that provides a reading experience. [Confidential].

255. Child electronic reading systems may also satisfy a demand for wanting to help a child to learn, read and write. The Parties submit that this need may very well be satisfied online.

Demand-side perspective (retailers)

256. The arguments put forward above in relation to retailer demand-side substitutability for TEL toys also apply for children's electronic reading systems.

257. In essence, (i) procurement teams at retailers have substantially broader purchasing responsibility than just children's electronic reading systems and as such represent one of thousands of options for retailers to have on their shelves and (ii) retailers focus on maximising limited shelf/catalogue space, which means that the Parties are required to keep their prices competitive (*vis-à-vis* a broad range) otherwise retailers will simply not stock the product.

Supply-side perspective

258. From a supply-side perspective, and as mentioned above, toy manufacturers constantly renew their product offering in order to anticipate changes in consumer trends. Furthermore the development and manufacture of toys, including electronic toys, (and including children's electronic reading systems) is not a technology-intensive industry nor one that would require a high degree of know-how, such that suppliers could easily switch to supplying children's electronic reading systems (and in a timely fashion) in the event of a 5-10% price increase.

259. Assuming a manufacturer can get access to the necessary content [Confidential],[98] the device itself is relatively simple to develop. Further, as evidenced by the significant difference in the approach taken by the Parties' two products, there is a multitude of potential options as to how to deliver a so called child reading device.

260. Section VII.3.2 further describes the reasons why barriers to entry/expansion in children's electronic reading systems are considered low.

261. In light of the above, it would be incorrect to consider the relevant reference market as only capturing so called "electronic reading systems" as broadly described by the CMA based on the features of LeapFrog and VTech's (concept) products. Rather, there is a myriad of other existing products with the same type of functionality or purpose as the Parties' products, all of which would be substitutable. In particular, there is a:

(i) wide variety of reading applications for tablets and websites which aid with reading and writing in the same way as LeapReader and LeapStart, such as Reading

[98] As further detailed below, [Confidential].

Eggs, Bo Books, Reading Raven, Montessori Crosswords and Marbleminds Phonics, Bug Club, Mister Thorne and Jolly Phonics; and

(ii) wide variety of audio narration applications for tablets and audio books which provide the similar narrative function to the [Confidential], such as Farfaria and Reading Rainbow.

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(v) CRA's analysis on margin and concentration evidence shows that the relevant markets are wider than NPD sub-classes

262. A relevant product market should be associated with two main predictions. First, higher levels of concentration within a relevant market should be associated with higher gross margins. This is because higher concentration should result in lower competition and therefore one would expect this to be manifested in higher profitability as measured by gross profits. Second, higher shares within a relevant market should also be associated with higher gross margins. If gaining a high share of a sub-class was to bestow market power, and allow the firm that enjoys higher share to increase prices, then one would expect higher gross margins to be associated with higher sub-class shares.

263. These two testable hypotheses have been examined by CRA in **Annex 10**. In summary they reject the finding of a relevant market based on NPD sub-classes. [Confidential].

[Confidential]

264. Second, even when looking at broader definitions of concentration – the Herfindahl-Hirschman Index (HHI), or the number of firms present in a sub-class, there is no relationship between the measure of concentration within the sub-class and either of the Parties' margins within that sub-class.

265. These two findings are inconsistent with the TEL sub-class being a relevant market according to the CMA's Merger Guidelines. However it also suggests that a market that encompasses only children's tablets/laptops should also be rejected. [Confidential].

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266. In conclusion, and for the reasons set out above, the Parties disagree with the CMA's proposed approach to market definition in Phase I.

267. First, market definition is a means to an end, to frame the competitive assessment. In this case, it is particularly hard to make market definition be a useful tool for the following reasons:

(i) The market and consumer tastes are very dynamic, and shift across categories;

(ii) Different retailers use different navigational distinctions on their websites; and

(iii) NPD data is the only measurement source, but has a significant degree of arbitrariness in allocating products to sub-classes, and also is materially incomplete insofar as it does not include certain own-brand sales (e.g. Amazon-brand products such as Kindle) as well as those of non-participating retailers (e.g. Smyths);

268. Accordingly, any attempt to frame the immediate competitive constraints on any given class of products is subject to the objection that it excludes a large number of "out of market" constraints. This is empirically supported by the CRA margin-concentration analysis (please see **Annex 10**) that shows no relationship between putative narrow markets and either high concentration in the sub-class, or a large share of supply of a sub-class.

269. While a market of all toys has some justification, the Parties recognise that it may be too broad to assist the CMA's assessment. At the same time, the Phase I categories or NPD sub-classes are too narrow to be economically meaningful from a demand-side perspective.

270. Even if market definition is imperfect and imprecise outside the formal textbook setting of a SSNIP test, in this case the most sensible approach is to consider how retailers organise their product selection to stock shelves to sell to consumers. Despite the proliferation of ways they arrange their in-store shelving and website navigation, UK retailers almost universally divide toy procurement into 5 specialist categories, each with one buyer (although none of these categories is binary and non-overlapping either). These are:

(i) Infant/Preschool;

(ii) Girls;

(iii) Boys;

(iv) Outdoor; and

(v) Games

271. The Parties suggest that these are more appropriate lenses for market definition purposes than NPD-based ones. Mapping the Phase I sub-classes against these, TEL, children's tablets/laptops and child reading systems would all fall within the Infant/Preschool procurement category.

VI.2 Geographic market

VI.2.1 Decisional practice

272. As mentioned above in section VI.1.1, to the Parties' knowledge, the CMA (or its predecessor the OFT) and the Commission have only considered the toys sector in a number of merger cases involving toy retailers (but not toy manufacturers).

273. In those cases, the market for the retail sale of toys has generally been defined as national in scope (or, in some instances, possibly local), given that retailers traditionally operate national pricing policies and have national advertising campaigns. The decisional practice points out that the most important parameters of competition including pricing, product range, product quality and promotion, are determined on a national basis.

VI.2.2 The Parties' views on geographic market definition

274. Past decisional practice accord with the CMA's findings in its Reference Decision that the geographic scope for the supply of toys (and any relevant sub-segments therein) is at least national in scope.

275. Furthermore, the Parties submit that the following factors means that competition, and in particular product innovation, cannot be viewed solely at the national level and instead must be considered under a wider lense. Indeed, the number of products launched by either Party specifically for the UK, and in no other country, are negligible. More generally:

(i) the supply, development and production of most toys occurs at a global level with manufacturing taking place in the Far East and product being shipped throughout the world;[99]

(ii) in respect of electronic toys specifically (i.e. relevant for TEL, children's tablets/laptops and children's electronic reading systems), the relevant voice element of the toy suits products marketed in all English-speaking countries; other toys without a voice element may be marketed more widely;

(iii) other functions such as advertising and marketing strategy (at least at a concept level) is primarily determined at supra-national level such as the EEA to aid in containing costs and ensuring consistency for brand purposes;

(iv) some of the powerful retailers centralise the procurement of toys at a European level (notably Toys'R'Us; Amazon are also in the process of centralising procurement);

(v) product development occurs, for the most part, at a global level and is not tailored or directed towards a specific market, this reflects that fashion/entertainment trends are relatively ubiquitous throughout the western world and consumer tastes are relatively homogenous in this regard;

(vi) for products involving licensed content or characters, toy manufacturers will typically try to secure licences for as many countries as possible;

(vii) while safety/quality standards may vary (only in rare cases and for relatively smaller markets, such as Japan), the requirements are essentially similar and do not materially alter the nature of the Parties' products (i.e. subject to language variations, the Parties' products are available globally and meet all relevant standards, as do those of their major competitors); and

(viii) as a rule of thumb, the prices of the Parties' products in Europe at retail level tend to be comparable, [Confidential].[100] [Confidential].

276. Ultimately, the CMA should take into account UK consumer preferences, and UK retailer buyer power, which are UK-specific factors, while at the same time recognising that innovation is a global process that features UK input (as is evident from each Party's business practice) but cannot sensibly be regarded in isolation at UK level, as if the merger took place between retailers or in a different and less dynamic consumer goods market.

277. For this reason, defining the market at either extreme i.e. as either global (based on innovation) or UK-wide fails to capture some of the relevant dynamics and supply and demand-side considerations facing VTech post-Transaction. For this reason, the Parties suggest that the CMA examine the impact of the Transaction at both a UK and global level.

[99] This has been confirmed by the CMA's merger investigation in Phase I – see paragraph 142 of the Reference Decision.

[100] [Confidential].

VII. NO EXPECTATION OF UNILATERAL EFFECTS

VII.1 Overview

278. This section provides the CMA with (i) information as to what market data is available to the Parties and (ii) an overview of the Parties' overlapping products and how those overlaps do not lead to a SLC.

VII.1.1 Available market data

279. The Parties do not have access to any market reports (or other market studies) prepared by UK or EU industry associations.

280. The Parties use data obtained from market research company NPD.

281. NPD gathers sales data directly from a large number of retailers in the UK (e.g. supermarkets and specialist retailers such as Argos and Toys'R'Us). This data is then aggregated and included in market research reports, which are released on a yearly, monthly, and weekly basis.

282. NPD sales data covers approximately 75% of toy sales in the UK. The remaining 25% of toy sales relate to retailers with a specific type of business model that have not agreed to supply sales data to NPD (e.g. Costco, TK Maxx and Smyths Toys), as well as own-label and branded products that have limited distribution. VTech considers that if the additional 25% of sales data were included, the change to the Parties' shares of supply would be minimal. In addition, VTech considers that any change to the Parties' shares of supply would be minimal if sales to end-consumers directly from VTech and LeapFrog websites were included, as such sales represent a small proportion of their respective sales.[101]

283. NPD data is based on 11 super-categories, further sub-divided into 22 segments, and further sub-segmented into 106 sub-classes.

284. NPD data is available at a per country level, but does not aggregate data at a wider level (e.g. covering the whole of the EEA or global data). Furthermore, NPD only covers major jurisdictions in Europe such as the UK, France, Germany, Belgium, Italy, Spain and Russia.

285. The Parties emphasise that:

(i) Neither VTech nor LeapFrog (nor, VTech believes, any other toy manufacturer) use the NPD categorisation internally; for comparison, LeapFrog's own internal categorisation is as follows: (i) reading, (ii) multi-media learning and (iii) learning toys (for children aged 6 months to 4 years), whilst VTech categorises its products as (i) standalone, of which there are various product ranges, and (ii) platform products which consist of various devices with cartridges and/or downloadable content to enrich play experience.

(ii) Similarly, NPD nomenclature is not used by retailers' procurement teams for toys. Retailers generally have procurement teams with specific purchasing responsibilities, which are typically[102] broken down as follows: (i) infant/preschool toys, (ii) outdoor toys, (iii) boys' toys, (iv) girls' toys and (v) games. For example,

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[101] See Parties' response to question 13 of the Phase II Market Questionnaire.

[102] Whilst retailers' procurement teams broadly follow the above division of responsibilities in substance, the precise nomenclature of the categories may differ from retailer to retailer.

please see **Annex 15**, which sets out the differing buyers' responsibilities at Smyths.

(iii) NPD nomenclature is therefore NPD-specific – it serves the wider purpose of providing detailed sell-through data for toy manufacturers' internal performance measurement; it does not necessarily reflect an economically meaningful way of representing the relevant markets – please refer to section VI for further details as to the Parties' views on relevant market definition. Finally, NPD is a commercial company whose incentive is to sell data to companies; and the more detailed it is, the more returns it is likely to obtain.

(iv) There is a mismatch between (i) the share of supply data the CMA is relying on (NPD share of supply data for NPD sub-classes), and (ii) the CMA's definition of what the sub-classes include. For example, the CMA's definition of TEL toys in its Reference Decision[103] is much broader than what the TEL NPD sub-class actually encompasses.[104] Therefore the CMA is relying on NPD share of supply data which has been calculated on the basis of an extremely narrow sub-class, whilst qualitatively presenting the sub-class in much broader terms.

(v) Retailer own-label products and sales are aggregated by NPD, which means that whilst the data is included in the total figure for a sub-class or segment, third parties do not have access to a breakdown by brand or by product and the total size of each sub-class does not take into account own-label product sales. However this shortcoming should not lead to an underestimation of the role and strong competitive constraint played by own-label products (particularly those of well established and market-leading retailers).

(vi) With regard to children's tablets/laptops specifically (which, as further described below, is not an NPD category but a bespoke category proposed by the CMA), NPD data does not include Amazon's Kindle for Kids and other Android tablets. Therefore the data significantly overestimates the Parties' shares.

(vii) Finally NPD categories are constantly evolving, with new categories being created, others disappearing, and others being merged together.[105] Therefore NPD categorisation should not be blindly relied on to segment the market in an economically meaningful way.

VII.1.2 **Overview of Parties' overlapping activities**

286. While noting the above deficiencies associated with using NPD classification as the basis for market definition (and assessing the Transaction), to assist the CMA in navigating the NPD data the Parties have identified areas of overlap on the basis of NPD categories.

287. The Parties overlap in two NPD super-categories: (i) Infant/Toddler/Preschool Toys and (ii) Youth Electronics. These are the two main super-categories where VTech is active in the UK and hence the only two super-categories on which VTech receives reports for the UK, as part of its NPD subscription.[106]

[103] See paragraph 107 of the Reference Decision.

[104] [Confidential].

[105] [Confidential].

[106] For completeness, VTech also supplies some toys in the Dolls super-category but does not purchase data from NPD in that respect.

288. The breakdown of these two NPD super-categories is set out in the table below. The NPD super-categories, segments, and sub-classes where the Parties overlap have been highlighted.

289. In relation to the NPD sub-class Walkers, the Parties did not overlap in 2016 and in previous years the increment represented by LeapFrog was negligible (less than [Confidential] by value). In consequence, the supply of Walkers in the UK will not be further addressed in this Submission, although VTech remains at the CMA's disposal should any further information be required.

290. As regards the NPD sub-class Other Infant Toys, the Parties' combined share of supply in each of 2014, 2015 and 2016 was extremely low (circa. [Confidential] by value at most). In consequence, the supply of Other Infant Toys in the UK will not be further addressed in this Submission, although VTech remains at the CMA's disposal should any further information be required.

291. In respect of NPD sub-class TEL toys, the Reference Decision has raised concerns that the Transaction may lead to a substantial lessening of competition. The Parties strongly disagree with this conclusion, for the reasons set out in section VII.2.1 below.

292. In relation to the NPD sub-class Preschool Musical Instruments, the Parties' combined share of supply in each of 2014, 2015 and 2016 was extremely low (less than [Confidential] by value, and almost nil in 2016). In consequence, the supply of Preschool Musical Instruments in the UK will not be further addressed in this Submission, although VTech remains at the CMA's disposal should any further information be required.

293. In relation to the NPD sub-class Electronic Entertainment Excluding Tablets, the increment represented by LeapFrog was small ([Confidential] by value in 2016). In consequence, the supply of Electronic Entertainment Excluding Tablets in the UK will not be further addressed in this Submission, although VTech remains at the CMA's disposal should any further information be required.

294. In relation to the NPD sub-class Electronic Learning Aid Hardware/Software and Accessories, the Parties did not overlap in 2014 and 2015. In 2016 there is an overlap, due to LeapFrog's re-launch of LeapStart (a refreshed version of LeapFrog's original LeapPad which [Confidential] as explained during the Site Visit). However the Parties' products included in this NPD sub-class relate exclusively to children's tablets and laptops, and will therefore be assessed as part of the CMA's Children's Tablets/Laptops bespoke category. Please refer to section VII.2.2 below.

295. Finally, in respect of the NPD sub-class Preschool Electronic Learning, the CMA has split this sub-class even further into sub-sub classes, including: Baby Phones, Child Tablets/Laptops, Dolls, Cameras, Alarm Clocks, Software, Platforms, Child smartwatches, Child TV platforms and Child Electronic Reading Systems.

Table 3: Parties' overlaps in bespoke sub-sub classes considered by CMA

Bespoke CMA sub-sub classes within Preschool Electronic Learning	**Corresponding NPD sub-class (or sub-set thereof)**	**2016**	**Comments**
Baby Phones	[Confidential] [Confidential]	**Overlap**	Please refer to paragraph 297
Child Tablets/Laptops and Software (3y+)	[Confidential] [Confidential] [Confidential]	**Overlap**	Please refer to paragraph 296
Child Smartwatches (3y+)	[Confidential] [Confidential]	**Overlap**	Please refer to paragraph 297
Child TV Platform (3-8y)	[Confidential]	**Overlap**	Please refer to paragraph 297
Child Electronic Reading Systems (3y+)	[Confidential]	No overlap	Please refer to paragraph 296

Source: the Parties, based on NPD data and CMA requests for information in Phase I[107]

296. As regards child tablets/laptops and child electronic reading systems, the Reference Decision has raised concerns that the Transaction may lead to a substantial lessening of competition. The Parties strongly disagree with this conclusion for the reasons set out in sections VII.2.2 and VII.2.2(vii) below.

297. The CMA did not find any competition concerns in relation to the supply of other toys in the UK.[108] Therefore the supply of other toys in the UK will not be further addressed in this Submission, although the Parties remain at the CMA's disposal should any further information be required.

[107] For Baby Phones, Child Tablets/Laptops, Dolls, Cameras, Alarm Clocks, Software and Platforms, see question 4 of Section 109 Notice of 20 May 2016.

[108] In particular for Child TV Platforms, the CMA did not consider these further in its Reference Decision, noting that the Parties overlapped but that [Confidential] (see footnote 73 of the Reference Decision). For Child Smartwatches, the CMA did not find any competition concern in that respect (see paragraphs 151 and 226 of the Reference Decision).

VII.2 No loss of actual or potential competition

298. Considering that, absent the Transaction, LeapFrog would have been extremely likely to exit the UK market (as is shown in greater detail in section IV), the Parties wish to emphasise that by resorting to a traditional and static assessment of the competition dynamics (and in particular, analysing historic shares of supply) the CMA fails to take account of the relevant future counterfactual against which the Transaction should be assessed.

299. The Parties consider that, irrespective of whether the CMA accepts that LeapFrog would have ultimately exited the market, it is not appropriate to assess the competitive constraint imposed on VTech by LeapFrog as it was during LeapFrog's successful period in 2012 to 2014. This is a historical snapshot that is manifestly out of date and distortive for the purposes of a prospective assessment of merger effects.

300. Rather, the competitive assessment must – without prejudice to the Parties' position that there is a far lack of causation of any loss of competition (see section IV) – consider a much weaker LeapFrog proposition [Confidential]. In this respect, [Confidential].

301. The CMA's Issues Statement refers to four possible theories of harm that may result in a substantial lessening of competition:

(i) horizontal unilateral effects through the loss of actual competition in TEL toys;

(i) horizontal unilateral effects through the loss of actual competition in child tablets/laptops;

(ii) horizontal unilateral effects through the loss of potential competition in child electronic reading systems; and

(iii) general loss of future competition in innovation.

302. VTech submits that it is unrealistic, let alone meeting the balance of probabilities standard that any theories of harm identified above can be expected to arise, and that it would therefore follow that the Transaction can be expected to result in a substantial lessening of competition. VTech addresses each of these points in turn below.

VII.2.1 No loss of actual competition in TEL toys

303. VTech submits that, for the reasons set out below, the Transaction will not lead to any loss of actual competition in relation to the supply of TEL toys in the UK.

- The supply of TEL toys in the UK (as defined by the CMA) does not constitute a relevant market;
- Even if the supply of TEL toys in the UK (as defined by the CMA) were to constitute a relevant market:
  - The shares of supply used in Phase I which are based on the NPD TEL sub-class encompass a narrower product set than the CMA's own definition of TEL toys;
  - Numerous competitors for TEL and other toys in the UK, including suppliers of own-label products, will remain post-Transaction to constrain VTech;
  - VTech will be constrained by an array of other toys for preschool/infant use; furthermore the merged entity's shares of supply in the Infant/Toddler

segment or Infant/Toddler/Preschool super-category are not concerning;

- The Parties are not particularly close competitors;
- Retailer buyer power will continue to constrain VTech; and
- New entry and/or expansion is likely, timely and sufficient.

(i) The supply of TEL toys in the UK does not constitute a relevant market

304. As already set out above, VTech strongly disagrees with the CMA's contention that the supply of TEL toys in the UK – as defined by the CMA in Phase I – constitutes a relevant frame of reference – please refer to section VI.

305. In a nutshell:

(i) Although the category Electronic Learning may to some extent be used by some professionals in the industry (including retailers), this is not a term consumers would know or use whilst browsing for toys and therefore does not reflect how consumers view the market.

(ii) From a demand-side perspective: (i) the Parties do not consider that the distinction between learning and non-learning products is robust or readily identifiable, as all toys have some degree of learning component (particularly for infants/toddlers); (ii) a rigid age segmentation is arbitrary; (iii) most electronic toys have a non-electronic version; (iv) consumers are price sensitive and weigh off allocating their spend to different categories of toys depending on relative features (i.e. willingness to pay for an additional component); and (v) retailers will seek to maximise limited shelf/catalogue space; and

(iii) From a supply-side perspective, toy manufacturers constantly renew their product offering in order to anticipate changes in consumer trends. Furthermore the development and manufacture of toys, including electronic toys, is a concept driven industry not one that requires a high degree of know-how to manufacture the product (which can be outsourced as LeapFrog has done), such that suppliers can easily switch to supplying TEL toys (and in a timely fashion) in the event of a 5-10% price increase of TEL toys (particularly if already supplying other forms of infant/toddler toys which do not strictly fall within the CMA's narrow definition).

306. Furthermore **Annex 10** investigates whether there is evidence that the Parties face wider constraints than simply those products within an NPD sub-class. Specifically, if the theory of harm is correct, and the Parties only competed with those products that they are closest to, one would expect higher levels of concentration within a narrow sub-class to be associated with higher gross margins.

307. As previously discussed there is no positive relationship between either Party's share of a given sub-class and its margins (either gross or net) within that sub-class. This is the case even when one of the Parties has a high share of a given sub-class. This is consistent with the existence of other constraints or countervailing factors on both Parties' behaviour beyond the degree of competition narrowly defined within a sub-class.

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308. The Parties do not consider that the CMA's definition of TEL toys constitutes a relevant market for the purposes of competition law for the various reasons set out above. However, even if the supply of TEL toys in the UK were to constitute a relevant frame of reference (quod non), VTech submits that the Transaction is unable to raise any competition concern for the supply of TEL toys in the UK for the reasons set out below.

(ii) The shares of supply used in Phase I and based on the NPD TEL sub-class encompass a narrower product set than the CMA's own definition of TEL toys

309. As mentioned above, the Parties only have access to NPD data as a means to estimate shares of supply. However the Parties have on several occasions in Phase I highlighted the limitations of using the NPD dataset to estimate shares of supply.

310. To name only a few examples:

(i) the NPD categories are arbitrary and not necessarily indicative of what would constitute a relevant frame of reference. TEL is only a sub-class (of the Infant/Toddler segment, which is itself a sub-set of the super-category Infant/Toddler/Preschool) used by NPD;[109]

(ii) the NPD data is not exhaustive (not all retailers record their sales and own-label products are aggregated); and

(iii) the allocation of certain products to certain NPD categories is inconsistent and arbitrary:

- The CMA noted in its Reference Decision that, specifically in relation to TEL toys, "*segments under NPD do not appear to be comprehensive, i.e. there [is] no clear and systematic pattern as to why certain products have been allocated to certain segments and why similar products have been excluded*".[110]
- To illustrate this point the Parties highlight the following: (i) certain products which would fall within the CMA's definition of TEL toys are not categorised

[109] [Confidential].

[110] See footnote 74 of the Reference Decision.

in the NPD TEL sub-class;[111] (ii) conversely, some products pertaining to NPD's TEL sub-class would not meet the CMA's criteria for TEL toys.[112]

(iv) more importantly, and as mentioned above, the CMA's definition of TEL toys is qualitatively broader than what the NPD sub-class TEL encompasses.

311. Although these shortcomings have been partially acknowledged by the CMA,[113] the CMA continues to refer to these shares of supply throughout its Reference Decision without attempting to account for the imperfections of the NPD data or at least allowing reasonable doubt as to the probative value of such data.

(iii) Numerous competitors for TEL (as defined by NPD) in the UK will remain post-Transaction to constrain VTech

312. Following the Transaction, the Parties will continue to compete with a large number of alternative suppliers for the supply of TEL toys in the UK (as defined by NPD).

Mattel

313. As further described in section V.2.1 above, Mattel is a very strong competitor in the toys sector in the UK, with Fisher-Price being a particularly popular brand amongst infant/toddler toys. With over 2.5 million votes from parents across the UK, Fisher-Price won the Best Baby Toy Brand award at last year's Tommy's Awards.[114]

314. Mattel continues to be a particularly strong alternative competitor and will continue to vigorously compete with VTech.

315. Pre-Transaction Mattel was the number two supplier of TEL toys in the UK (after VTech), and the Parties competed fiercely with Mattel in their negotiations of their trading terms with retailers. [Confidential]. This was provided as part of the response to question 21 of the initial fact finding request of the CMA first day letter of 30 August 2016, also provided as **Annex 16** for convenience.

316. Mattel has consistently achieved a share of supply in the range of [Confidential] in the very narrow sub class of TEL toys in the UK since 2012, and supplied [Confidential] products allocated to the TEL sub-class in 2016.[115]

317. Following the Transaction Mattel will remain the number two supplier with approximately [Confidential] of the UK TEL segment (as per NPD), and will continue to exercise a strong competitive constraint on the Parties in the supply of TEL toys in the UK. As of December 2015, Mattel supplied [Confidential] of the top 20 TEL products by value ([Confidential]).[116]

MGA, Clementoni, Kids II and KD Group

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[111] For example: Bright Starts supplies the Learn & Giggle Activity Station for children aged 4 months onwards; it is electronic and has a learning component, although it is part of the [Confidential] NPD sub-class. Other examples include VTech's 2-in-1 Trike to Bike and Fisher-Price's Laugh and Learn Smart Stages Scooter, which both contain electronic learning elements but are classified as [Confidential].

[112] For example: KD Group supplies the Peppa Pig Zap and Learn Remote which is recommended from age 4 years to 10 years, although it pertains to the NPD [Confidential] category. Similarly, VTech supplies products such as Digger the Wolly Mammoth which is suitable for children above 3 years of age and the Create and Discover Learning Desk which is not suitable for children under 3 years.

[113] For example please refer to footnotes 46 and 74 of the Reference Decision.

[114] See https://www.tommys.org/company-award-winners.

[115] Mattel products allocated to the TEL NPD sub-class include the [Confidential].

[116] The NPD Group, Inc., "UK Toy Market: 2015 Year in Review", FY 2015, LeapFrog, slide 58 (attached as Annex C.1E to the Consolidated Response).

318. In addition to Mattel, the Parties face competition from a number of other suppliers with a strong presence in the TEL sub-class. Each of these suppliers are capable of expanding their range in order to take advantage of shifting consumer preferences and achieve market share growth:

(i) MGA, which supplies Little Tikes Activity Garden Plant N Play (and others) as part of the TEL sub-class and which had a share of supply of [Confidential] in value in 2015;[117]

(ii) Clementoni, which supplies at least [Confidential] products in the TEL sub-class through the brands Brights Starts and Baby Einstein and which had a share of supply of [Confidential] in value in 2015.[118] Clementoni is a leader in Europe in the scientific toys segment, offering a wide range of toys starting from early childhood and including puzzles and games, tablets and mini computers;[119]

(iii) Kids II, which supplies at least [Confidential] products in the TEL sub-class and which had a share of supply of [Confidential] in value in 2015.[120] Kids II manufactures a wide range of infant and toddler toys, both electronic and non-electronic (but excluding tablets);[121] and

(iv) KD Group, which supplies at least [Confidential] products in the TEL sub-class and which had a share of supply of [Confidential] in value in 2015.[122]

Further significant competitors

319. In addition to Mattel, MGA, Clementoni, Kids II and KD Group, a number of other players supply TEL toys in the UK, the majority of which benefit from a strong brand in the UK and offer a broad range of high quality toy products, notably: Tomy, Chicco, Hasbro, Golden Bear, Blue Box, East Coast Nursery, HTI, IMC Toys, Keenway Industries, Kiddieland, Learning Resources, Lexibook, Mamas and Papas, Redbox, Tolotoys, Trends, Wilton Bradley, Winfat, Winfun and John Crane's B Times Square Cube Toy.

320. Therefore, post-Transaction the Parties will continue to compete with (i) Mattel and (ii) at least 26 other suppliers for the supply of TEL toys in the UK.

321. Although these suppliers' shares of supply based on the TEL NPD sub-class may be considered somewhat low compared to the Parties' and Mattel's respective shares of supply, they clearly exercise a competitive constraint on the Parties given that:

(i) From a retailer's perspective, due to shelf/catalogue space limitations (as explained above in section V.2), a retailer will choose which products to list according to expected margin and volumes sold. Consequently, having a wide array of alternative TEL products (more than [Confidential] based on the TEL NPD sub-class) and a wide array of alternative suppliers (at least 26) to choose from provides retailers with sufficient bargaining power to ensure that the Parties will continue to provide a competitive offer. If not, retailers will be able to either reduce

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[117] MGA products allocated to the TEL NPD sub-class in 2015 include: [Confidential].

[118] Clementoni products allocated to the TEL NPD sub-class in 2015 include: [Confidential].

[119] With the Baby Clementoni, Disney Baby and Clemmy Lines.

[120] Kids II products allocated to the TEL NPD sub-class in 2015 include: [Confidential].

[121] Its best known brands also include Bright Starts, Baby Einstein, Ingenuity and Disney baby.

[122] KD Group products allocated to the TEL NPD sub-class in 2015 include: [Confidential].

shelf/catalogue space attributed to the Parties' products, move underperforming toys to less appealing shelves or de-list these entirely.

This holds true as the toys industry is a supply led market in which consumers choose between the significant range of toys which are on offer (i.e. displayed on shelves and/or catalogues) from a variety of suppliers. There is no specific demand originating from the consumer; rather, consumer demand is reactive. This means that consumers will primarily buy what is offered to them on shelves; and as a result, retailers are free to list whatever products achieve a satisfactory return, as they are much less subject to direct consumer diktats, as could be the case in other markets.

(ii) From the consumer's perspective, the wide array of products available on shelves/catalogues from a range of manufacturers means that the Parties need to constantly innovate and renew their product offering to remain attractive and differentiate their products from competing products. Furthermore, given that at least 26 suppliers (in addition to Mattel) are already active in the TEL sub-class, the Parties are under constant threat that any such supplier will develop the next "hot" toy or concept, and therefore achieve a significant increase in market share in a short time frame. This is evidenced by the 2015 list of top 20 toys in the UK by value in which [Confidential] of top-selling toys ([Confidential] out of 20) are all newly-launched toys.[123] For example, Trends UK have entered the sub-class by obtaining the licence for the Peppa Pig character, which is predicted to be successful given the popularity of Peppa Pig. Another example is the Fisher-Price Bright Beats Dance and Move Beat-Bo, which was launched in July 2015 and was a relatively "hot" toy during the Christmas season 2015. [Confidential], and Fisher-Price have launched several line extensions for the Christmas 2016 season based on this success.

322. 3 out of the 5 competitors who responded to the CMA's merger investigation in Phase I in respect of TEL toys confirmed that they exercise some competitive constraint on the Parties:[124]

(i) *"[the competitor's] products are similar to those of VTech and LeapFrog";*

(ii) *"[the competitor's] TEL toys [are] similar to the Parties' products in terms of educational value, content and quality";*

(iii) *"[the competitor's] TEL toys [are] similar to the Parties' products in terms of their ability to support early development".*

323. Out of the remaining two competitors who did not explicitly confirm that they compete with the Parties, it is worth flagging that one did not deny competing with the Parties but merely indicated that its products were "*simpler in design and function*" and that its range of products was smaller,[125] which does not in itself defeat the proposition that it indeed competes with the Parties.

[123] Annex B.23B to the Consolidated Response, page 19.

[124] See paragraph 178 of the Reference Decision.

[125] See paragraph 179-a of the Reference Decision.

Own-label constraints from Argos, Mothercare, Hamleys, John Lewis, Tesco and Toys'R'Us

324. Furthermore, the Parties face some degree of competitive constraint from the retailers' own-label products. For example:

- Argos supplies the Chad Valley label, which includes a wide selection of toys; in the TEL sub-class specifically Argos supplies (among others) the Baby Tablet, the Teddy Bear Laptop, Pull Along Caterpillar and Electronic SmartPhone toys under the Chad Valley brand;
- Mothercare supplies the Early Learning Centre own-label, which includes toys with electronic and/or learning features. In the TEL sub-class specifically Mothercare (among others) supplies the Mirror Laptop and Little Learning Phone toys under the Early Learning Centre brand;
- Hamleys supplies a range of own-label toys, including some of which would pertain to the TEL category as defined, including: Hamleys Gigantic Keyboard Playmat, Hamleys Drum Kit Playmat, Hamleys Clever Cogs and Hamleys Sound and Activity Cube;[126]
- John Lewis supplies own-label toys, including some which would pertain to the TEL category as defined, including: John Lewis Walk With Me Musical Dinosaur, John Lewis Musical Bathtime Alligator, John Lewis My First Camera, John Lewis Talk and Pull Phone and John Lewis My First Little Robot;[127]
- Tesco supplies own-label toys under the Carousel range, some of which would pertain to the TEL category as defined: for example, the Drum Set (amongst others); and
- Toys'R'Us supplies own-label toys under the Bruin range (Babies'R'Us), including some which would pertain to the TEL category as defined: for example, the Pink Piano and ABC Shape Sorter Set (amongst others);

325. Although these may have, at first glance, a relatively modest share of supply (as explained above the shares of supply of own-label products are aggregated into the 'Other' category by NPD), the "Other" category nevertheless represents between [Confidential] of the total TEL supply in the UK ([Confidential] by value and [Confidential] by volume for 2016 YTD).

326. In addition, and as mentioned in response to question 34 of the Phase II Market Questionnaire, the Parties consider that retailers enjoy a key competitive advantage compared to toy manufacturers, which is secure and easy access to end-consumers.

327. In its Reference Decision the CMA expressed the view that the competitive constraint exercised by own-labels is limited given that (i) they are only being sold at a specific retailer; and (ii) having an established brand was an important factor in relation to TEL toys.[128]

328. The Parties disagree with this conclusion.

(i) First, a retailer's own-label toys are not necessarily sold only by that retailer. For example, Mothercare's Early Learning Centre brand is sold at Mothercare but also

[126] http://www.hamleys.com/preschool-learning-toys.irc

[127] http://www.johnlewis.com/browse/toys/toys/toys-by-brand/john-lewis/baby-pre-school-toys/_/N-fevZ1z141ilZ1z0rn7s.

[128] See paragraph 180 of the Reference Decision.

at Boots. In addition, online retailers such as Amazon or Ebay, which are not constrained by limited shelf space, offer a wide range of other retailers' own-label toys (e.g. John Lewis, Hamleys).

(ii) Second, the retailers which have own-labels in the TEL sector include:

- Argos[129] (VTech's [Confidential] customer, representing [Confidential] of its sales in 2015 and LeapFrog's number [Confidential] customer, representing [Confidential] of its sales in 2015);
- Toy'sR'Us (the Parties' [Confidential] largest customer, representing [Confidential] of VTech's sales in 2015 and [Confidential] of LeapFrog's sales in 2015);
- Tesco's (the Parties' [Confidential] largest customer, representing [Confidential] of VTech's sales in 2015 and [Confidential] of LeapFrog's sales in 2015);
- the more modest John Lewis, Mothercare, Hamleys.

329. These customers will therefore have an even stronger bargaining position vis-à-vis the Parties when negotiations to fill shelf/catalogue space occur. That is particularly the case as retailers generally buy their own-label products FOB in Hong Kong, which means that the stock risk lies with them, and as a result, retailers with own-label products are often more risk-averse in terms of committing to buying branded products. Retailers which also supply their own-label toys, will seek to maximise their own-label sales and profit margins. In this respect, such retailers are less dependant on branded manufacturers and can cherry-pick/minimise their depth of range according to their retail profile and can simply supplement their own product range with branded products. Such retailers plan their purchases for the year in advance on an FOB basis. Equally, the Parties' are not able to ignore the impact of the relative pricing of such products (even only in a single retailer) as such pricing will affect consumers' willingness to pay for their own products. Additionally, these own-label products are typically retailed at a lower price than comparable branded counterparts, as retailers buy them bulk as imports, from manufacturers who do not bear marketing expenses.

330. Second, the Parties submit that from the consumer's perspective, retailer brand awareness is as important, if not more important, than manufacturer brand awareness. As explained above in section V.2, the purchasing decision for TEL toys is almost entirely adult-led (as opposed to child-led). Therefore, for a consumer wishing to buy a TEL toy (this could be for example a first-time parent, a family member or friend making a gift) product brand awareness (e.g. VTech/LeapFrog versus Mattel, versus Clementoni, versus an own-label product) is highly likely to be substantially lower than high street retailer brand awareness (e.g. Toys'R'Us, Amazon, Argos etc.).

331. In other words, a consumer is much more likely to first decide where to go and buy a toy (e.g. Argos) and only then decide which toy and which brand to buy. Also, as pointed out in response to question 24 of the Phase II Market Questionnaire, end-consumers will often rely on the fact that a particular toy is on the retailers' shelf as sufficient confirmation that the brand is of acceptable quality. This is particularly so for new parents, relatively unfamiliar with toy choices and who will trust the product that specialist retailers (e.g.

[129] Home Retail Group, the holding company of Argos, also owns Chad Valley, a popular toy brand among UK consumers, which Home Retail Group acquired from Woolworths when it went into liquidation in 2009.

Mothercare) or general retailers (e.g. Tesco) choose to put on their shelves, rather than basing their decisions specifically on the toy brand. As a result, what matters in the end is putting the product on shelves/catalogues.

332. The Parties further submit that, as pointed out in response to question 24 of the Phase II Market Questionnaire, unlike many traditional "adult" markets (e.g. cars, clothes, luxury goods etc.) where brand and brand loyalty play a defining role, end-consumer choice in the toy industry (and particularly in relation to younger children) is mainly driven by the functions embedded in or associated with a particular toy and the possibility to use a toy according to particular entertainment or educational purposes. The impact of the manufacturer's brand may be further diluted by the association of a particular range of toys with a popular television show or a movie character. In this regard, rather than being attracted to the manufacturer's brand, end-consumers are seeking products that satisfy the child's demand for their favourite characters.

Conclusion

333. In conclusion, post-Transaction the Parties will continue to face strong competition from a very large number of existing TEL toys suppliers, in particular from Mattel and including retailers' own-label brands.

(iv) The Parties face wider competitive constraints from an array of other toys for preschool/infant use; furthermore the merged entity's shares of supply in the Infant/Toddler segment or Infant/Toddler/Preschool categories are not concerning

334. Notwithstanding the Parties' view that it is not appropriate to assess the effects of the Transaction on the basis of TEL toys only, the Parties consider that, even on such a narrow basis, the Transaction will not substantially lessen competition in the UK for the following reasons.

335. First VTech will be constrained by an array of other toys for preschool/infant use. In this respect, end-consumers do not necessarily go into a store with a specific product in mind but rather are looking for a toy to achieve a certain broader purpose (e.g. entertaining and/or educating their child) from a vast range of alternatives. This is evident from the fact that retail shelves stock a variety of TEL and non-TEL (albeit the boundary is blurry) side by side, as shown in **Annex 13**.

336. It is often immaterial to end-consumers whether a product has an electronic component or not or indeed whether the toy has explicit or implicit learning qualities (although the Parties consider that all toddler/infant toys have a learning element to them). In addition, end-consumers might simply be looking for a toy to celebrate a special occasion, such as Christmas or birthdays, and might not even have a specific purpose in mind when going into a store. These consumers are likely to interchange between any age-appropriate toy that is in line with the child's interest (e.g. a pirate-themed toy for preschool/infant use) and appeals to them on the shelf (e.g. due to theme, features or creativity).

337. Second, the merged entity's shares of supply in the Infant/Toddler segment or Infant/Toddler/Preschool super-category are not concerning.

338. **Annex 17** provides shares of supply data for all NPD segments and sub-classes where the Parties overlap between 2011 and 2016 YTD. As can be seen from this Annex, the Parties' shares of supply in Infant/Toddler/Preschool toys and Infant/Toddler toys in the UK are modest and clearly incapable of leading to a substantial lessening of competition:

(i) As can be seen from the share of supply data for 2015 in Table 4 below, in the Infant/Toddler/Preschool super-category:

- The combined entity only accounted for [Confidential] by value and [Confidential] by volume of the supply of Infant/Toddler/Preschool toys in the UK in 2015, with an increment of [Confidential] by volume and [Confidential] by value.
- Post-Transaction there will remain numerous (at least 10) toy manufacturers able to constrain the merging Parties, with Mattel as the number one supplier ahead of the merged entity, with [Confidential] by value and [Confidential] by volume in 2015.
- Therefore the Transaction is clearly unable to raise any competition concern in this super-category.

Table 4: Parties' share of supply of Infant/Toddler/Preschool Toys in the UK in 2015

Manufacturer	**2015**	
	Value	*Volume*
VTech	[10-20%]	[5-10%]
LeapFrog	[0-5%]	[0-5%]
Mattel	[10-20%]	[10-20%]
Spin Master	[0-5%]	[0-5%]
Playmobil	[5-10%]	[0-5%]
MGA Entertainment	[0-5%]	[0-5%]
Character Options	[0-5%]	[0-5%]
TOMY	[0-5%]	[0-5%]
Kids II	[0-5%]	[0-5%]
Golden Bear	[0-5%]	[0-5%]
Flair Preziosi Group	[0-5%]	[0-5%]
Hasbro	[0-5%]	[0-5%]
Others	[0-5%]	[0-5%]
Total	100%	100%

(ii) As can be seen from the share of supply data for 2015 in Table 5 below, in the Infant/Toddler segment:

- The combined entity only accounted for [Confidential] by value and [Confidential] by volume of the supply of Infant/Toddler toys in the UK in 2015, with a very modest increment of approximately [Confidential] by value and [Confidential] by volume;
- Post-Transaction there will remain numerous (at least 10) toy manufacturers able to constrain the merging Parties, with Mattel closely

behind the merged entity with [Confidential] by value and [Confidential] by volume in 2015.

- Therefore the Transaction is clearly unable to raise any competition concern in this segment.

Table 5: Parties' share of supply of Infant/Toddler Toys in the UK in 2015

Manufacturer	2015	
	Value	*Volume*
VTech	[20-30%]	[10-20%]
LeapFrog	[0-5%]	[0-5%]
Mattel	[10-20%]	[10-20%]
Kids II	[0-5%]	[0-5%]
MGA	[0-5%]	[5-10%]
TOMY	[0-5%]	[0-5%]
Golden Bear	[0-5%]	[0-5%]
Chicco	[0-5%]	[0-5%]
Lindam	[0-5%]	[0-5%]
Vulli	[0-5%]	[0-5%]
Character Options	[0-5%]	[0-5%]
Hasbro	[0-5%]	[0-5%]
Others	[30-40%]	[40-50%]
Total	100%	100%

(v) The Parties are not particularly close competitors and other suppliers, coupled with retailer buyer power, will replace the loss of any LeapFrog constraint

339. The Parties submit that (i) they are not particularly close competitors whether based on the NPD's narrow sub-class or the CMA's own definition of TEL in the TEL toys sub-class in the UK and that (ii) other TEL suppliers are just as close. Indeed, for those of the Parties' products that have similar features there are numerous competing alternatives.

Differentiated product characteristics

340. From a product perspective, in addition to VTech having a broader range than LeapFrog, the TEL products of the Parties are differentiated on the following bases:

(i) VTech's products are more focused on fun and physical development, whilst LeapFrog's products are more learning-oriented and curriculum-based;

(ii) generally speaking VTech views itself as stronger than LeapFrog for the 0-3 years category, as LeapFrog's focus is more on curriculum-based toys for older children;

(iii) the Parties both sell to the main retailers in the country; however recently LeapFrog as a whole (or some of its products) [Confidential]. In addition, and as mentioned in section VII.3.2, one of the reasons why VTech decided to acquire LeapFrog was the complementarity of the two companies' product focus. In VTech's view, the VTech and LeapFrog products (and consequently brand) have a different positioning. VTech has a more diverse range of products aimed at fine and gross motor skills development and which focuses on creativity and discovery rather than curriculum-based learning, whilst LeapFrog is more curriculum-based and focuses on educational content such as alphabets, numeracy and reading skills.

341. As can be seen from Annex 4 to the Phase II Market Questionnaire, there are a number of other competing TEL toys supplied in the UK which are just as "close" to the Parties' products. For completeness, please note that the competing products listed in Annex 4 to the Phase II Market Questionnaire are not exhaustive.[130]

342. The Parties however stress that the products listed in this Annex (and partially listed below) fall within the CMA's definition of a TEL toy i.e. they are (i) targeted at the 0-3 years range (ii) electronic and (iii) have a "learning" component (note the Parties' submission above in respect of the lack of robustness of any segmentation based on learning versus non-learning products), although they are not all classified in the NPD TEL sub-class.

343. For example, in terms of tables and activity centres pertaining to the CMA's definition of TEL toys:

- VTech supplies the Play & Learn Activity Tables at a recommended retail price of GBP 45.00, for children aged 6-36 months:

- LeapFrog supplies the Learn & Groove Musical Table at a recommended retail price of GBP 29.99, for children aged 6-36 months:

- Fisher-Price (Mattel) supplies the Silly Safari Activity Table at a recommended retail price of GBP 39.99, for children aged 6 months onwards:

[130] For example, Chad Valley's Teddy Bear Laptop is not included, nor is Chad Valley's Fun Phonics Bus.

- Bright Starts supplies the 3-in-1 Around We Go Activity Centre at a recommended retail price of GBP 99.99, and for children aged 4 months onwards, as well as the Learn & Giggle Activity Station ([Confidential]) at a recommended retail price of GBP 49.99, for children aged 6 months onwards:

 

- Baby Einstein (Kids II) supplies its Discovering Music Activity Table at a recommended retail price of GBP 46.99, for children aged 6-36 months:

- Chicco supplies its Music Band Table (again, [Confidential]) at a recommended retail price of GBP 39.99, for children aged 9 months onwards:

- Golden Bear supplies its In the Night Garden Explore and Learn Musical Activity Table Music Band Table at a recommended retail price of GBP 59.99, for children aged 12 months and older:

344. The same goes for other types of TEL toys (e.g. pull along toys, cat toys, turtle toys etc.) as can be seen in Annex 4 to the Phase II Market Questionnaire.

345. It is clear from the above that the Parties' products are not any closer than other competitors' products e.g. Fisher-Price (Mattel), Bright Starts, Chad Valley or ELC.

346. Indeed even if the Parties were close competitors in the small number of products stated above and in Annex 4 to the Phase II Market Questionnaire, these products account for a tiny proportion of the TEL sub-class, and an even smaller proportion of the Infant/Toddler NPD segment. Indeed based on NPD data for FY16, the Parties' overlapping products accounted for about [Confidential] (by units and by value) of all toys in the NPD TEL sub-class.[131] The clear implication is that even within the TEL sub-class, the vast majority of their products are not directly overlapping and there are a large number of rivals for which both Parties are competing. This would not change post-Transaction.

Internal documents

347. In its Reference Decision, the CMA refers to a discrete set of internal documents provided by the Parties, which according to the CMA, demonstrate that VTech and LeapFrog are close competitors in the TEL segment.

348. The Parties believe the CMA's analysis in this regard is not only partial but also unfounded.

349. In particular, it is clear from the VTech internal documents in question that [Confidential]

350. [Confidential].[132]

351. The CMA has also referred to 8 product concept reviews submitted by LeapFrog that analyse potentially competing products in respect of TEL toys, [Confidential].[133] The other [Confidential] refer to [Confidential].

352. More importantly, these internal documents referred to by the CMA relate to the USA and not the UK. Given the CMA has identified a national frame of reference limited conclusions should be drawn from documents prepared for the US-American market (where the LeapFrog brand is particularly strong in comparison to its position in the UK).

353. The Parties submit that:

- if the CMA indeed considers that the development and production of toys occurs at an international level such that it may draw conclusions on the UK market based on observations made more than 4,000 miles away, then for the sake of consistency the Parties would invite the CMA to consider widening the geographic scope of the frame of reference to a global market;

- furthermore if the American competitive conditions are considered to be probative of the UK market (which is the CMA's position in its Reference Decision), then the

131 VTech's overlapping TEL products in the NPD data are assumed to be [Confidential].

132 See page 60 of "2015 review of toy market" provided as Annex C.1E to the Consolidated Response.

133 See Annex 2B to the Consolidated Response.

Parties would urge the CMA to consider that that the Federal Trade Commission ("**FTC**") opened an investigation into the Transaction and subsequently closed the case after a month.

354. Finally the Parties have submitted several other internal documents which [Confidential]. For example:

- Market analyses by VTech from 2014 and 2015[134] also show that VTech considers competition from other TEL toy manufacturers such as [Confidential].
- UK toy market reviews conducted by VTech for the financial years 2014[135] and 2015[136] illustrate that VTech monitors [Confidential].[137] No other competitor was analysed on that basis.
- A survey conducted by VTech in 2012 in 4 European countries including the UK assesses brand awareness of toy manufacturers among mothers of children aged under 35 months old; it illustrates that [Confidential].[138]

<u>*Third party views*</u>

355. In its Reference Decision, the CMA indicates that third party views provided in the course of the Phase I investigation (in particular retailers) provided evidence that the Parties' products were close substitutes and that the Parties competed closely. In particular, the CMA notes that:

- "*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*";[139]
- The Parties submit that their TEL products are indeed similar and do compete; however the Parties equally submit that other competitor products, in particular Fisher-Price (Mattel), Bright Starts, Clementoni, Vivid, Chad Valley (Argos) and ELC (Mothercare) are as close substitutes, as can be clearly observed from paragraph 341 above and Annex 4 to the response to the Phase II Market Questionnaire.
- "*two retailers said that LeapFrog is slightly more focused on educational toys, while VTech is more focused on toys for entertainment (play)*";[140]
- VTech confirms that, in its view, VTech has a more diverse range of products which aims at fine and gross motor skills development and which focuses on creativity and discovery, whilst LeapFrog is more curriculum-based and focuses on educational content such as ABCs, reading skills and tablets. [Confidential].

356. The Parties therefore submit that third party views only confirm that VTech and LeapFrog have competing products, although the two brands have a different focus. The Parties

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[134] See Annex I.2A to the Consolidated Response (i) "2015_Core Learning_0314_NO_appendix_final.ppt", and (ii) "Core-learning-no appendix 20150326 (Macau final presented)" referenced at footnote 57 of the Reference Decision.

[135] See pages 49 and 51 of Annex B.23A to the Consolidated Response.

[136] See pages 42 and 43 of Annex B.23B to the Consolidated Response.

[137] See page 50 of Annex I.23A to the Consolidated Response.

[138] See page 9 of "Awareness assessment 4 European countries" of Annex 19 to the Response to the questions 1 to 21 of initial factual information request of 30 August 2016.

[139] See Reference Decision paragraph 169.

[140] See Reference Decision paragraph 170.

have provided evidence (Annex 4 of the Phase II Market Questionnaire and during the Site Visit toy demonstration) that other products can be viewed as equally close substitutes.

357. This is consistent with third party views received in Phase I:

- "*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 prices but less closely with LeapFrog as LeapFrog's products tend to be more educational in nature*".[141]
- "*One competitor mentioned own brand products as possible alternatives to the Parties' products" although "an established brand is important in relation to TEL toys" and "own brand products are only available at a specific retailer*".[142]

358. However, and as further explained in paragraphs 328 and 330, the Parties submit that (i) from the consumer's perspective, retailer brand awareness is as important, if not more important, than manufacturer brand awareness and (ii) from the retailer's perspective, having an own-label reinforces its buyer power *vis-à-vis* the Parties. Indeed, as shown in Figure 2, retailer store display accounts for circa [Confidential] of value spend (compared to media, advertising, and other marketing means). In fact, what constitutes a brand to a consumer is not dictated by whether they are a manufacturer or a retailer; Chad Valley, Bruin and ELC are brands, regardless of the nature of their owner. This also shows that manufacturer brand only accounts for [Confidential] of the reasons why consumers purchase a particular toys, compared to products features ([Confidential]) and price ([Confidential]).

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359. In conclusion, the Parties believe that the above evidence supports the view that LeapFrog and VTech were not particularly close competitors in respect of TEL toys in the UK, and that other competitors (notably Mattel), were just as close.

360. In any event the Parties stress that, even if one were to find that LeapFrog and VTech competed closely in respect of TEL toys in the UK in the years before the Transaction, it is indisputable that given LeapFrog's financial situation in 2015 and 2016 it would not have remained a close competitor in respect of TEL toys in the UK absent the Transaction (assuming it would not have exited the market altogether). LeapFrog's financial distress was apparent as early as 2014 and by 2016 its position had weakened thus making it a much less significant competitor to VTech. As explained in paragraph 299, [Confidential].

(vi) The Parties are constrained by substantial buyer power

361. As set out in more detail below in section VII.3.1, the Parties consider that the toy market is characterised by significant buyer power for a number of reasons. These include:

- the indispensability of retailers for manufacturers to access consumers. It is critical for a manufacturer to ensure that as many of its products are on retailers' shelves because (i) a significant number of end-consumer purchases are influenced by

[141] See Reference Decision paragraph 178.

[142] See Reference Decision paragraph 179.

instore displays; and (ii) end-consumers do not necessarily go into a store with a specific product in mind but rather are looking for a toy to achieve a certain purpose (e.g. entertaining their child) from a vast range of toys displayed on the retailers' shelves or catalogues.

- the majority of the Parties' sales being attributable to a few major retailers. As can be seen in **Annexes 3** and **4** (referred to in section VII.3.1 below) VTech's top 5 customers account for [Confidential] of its total sales in 2015, while LeapFrog's top 5 customers account for [Confidential] of its own total sales.
- the ability for retailers to substitute across a wide range of toys. In order to determine their optimal product mix and maximise expected returns, retailers substitute across a range of products, brands and categories (either by allocating more or less shelf space or dropping a line entirely). This can include substitution for own-label and less-well known third party products, meaning that the Parties must offer attractive packages in order to remain on retailers' shelves.
- [Confidential] coupled with the need to encourage retailers to take as many products within the Parties' range as possible. In this respect, the Parties risk losing support for their products, or the removal of their range entirely, if they cannot respond positively to retailers' requests for promotional packages, campaign funding, and/or list price decreases.
- the ability of retailers to (i) develop their own-label products, which they can sell not only through their own retail stores but also through other retailers; or (ii) support less well known brands at attractive margins. The appeal of this is especially so because end-consumers generally do not differentiate between retailers' toy brands and manufacturers' toy brands.

362. Consequently, buyer power is a feature of the toys market and will continue to pose a significant and unavoidable constraint on the Parties' ability to raise their prices (or impose onerous terms on retailers) as a result of the Transaction.

(vii) New entry and/or expansion is likely, timely and sufficient

363. As set out in more detail below in section VII.3.2, the Parties consider that the toy industry has no significant barriers to entry. Competition is based primarily on the ability to design and develop new toys, to procure licences for popular characters and trademarks and to successfully market products.

364. In a nutshell, the Parties consider that:

- capital, technology and know-how requirements are low;
- brand loyalty does not constitute an impediment to entry/expansion;
- new entry/expansion can be timely (12-18 months); and
- new entry/expansion can be sponsored by large retailers or licence holders such as Disney;

365. Please refer to section VII.3.2 for more details. The arguments put forward in this section also apply to TEL toys, as TEL toys do not differ from traditional toys other than the use of an electronic component as part of the toy.

366. The CMA points out that two competitors told the CMA that developing new TEL toys was difficult "*given the expertise required*".[143] The Parties can only assume that all the other respondents agreed that new entry in relation to TEL toys in the UK did not require any particular expertise (or capital, know-how or technological requirement), as the CMA remains silent on this point. The Parties disagree with the contention that particular expertise would be needed to enter the TEL segment: the products are not sophisticated and expertise would not be essential to produce, for instance, a plastic toy with batteries playing a recorded voice and with flashing lights.

The CMA further refers to three retailers who have indicated that having a strong brand is important to compete effectively in the TEL segment.[144] However, as mentioned above, the Parties consider that (i) retailer brand awareness (e.g. Toys'R'Us) is as important if not more important than manufacturer brand awareness, given that this is where consumers go to buy toys, without necessarily having a pre-conceived idea of what they are planning to buy; (ii) given the seasonality and trend-driven characteristic of the toy industry, a new entrant coming in with the next "hot" toy, or entering the market with a similar toy at a better value for money ratio (or better margin for retailers) is certain to gain market share and catalogue/shelf space irrespective of its brand; (iii) retailers which also offer own-label toys (e.g. John Lewis) can leverage on the strength of their retail brand and extend such brand awareness and recognition to their own-label toys and (iv) NPD research shows that only [Confidential] of consumers factor in brand when making purchasing decisions (see Figure 2 above).

367. There are numerous examples of successful entry/expansion in the TEL toys segment in the UK, such as:

- Trends UK began producing toddler toys, including electronic letter boards, microphones and laptops after obtaining the Peppa Pig licence in 2015;
- Golden Bear, one of the UK's leading toy manufacturers started producing toddler toys with the launch of the "In the Night Garden" collection in 2007;[145]
- Character Options has recently commenced supply of toddler toys with a range of Teletubbies toys in the UK in 2016;[146]
- MGA Entertainment has entered the toddler toy category following the acquisition of the Little Tikes business in 2006;[147]
- Bright Starts, a US-American toy manufacturer, entered the toys sector in 2011 with mainly electronic toys;[148] and
- Blue Box acquired the toys brand Infantino in 2014, which includes musical touch pads and smart-phone books.[149]

VII.2.2 No loss of actual competition in child tablets/laptops

[143] See paragraph 247 of the Reference Decision.

[144] See paragraph 247 of the Reference Decision.

[145] http://www.toynews-online.biz/news/read/golden-bear-renews-in-the-night-garden-master-toy-license/045873.

[146] http://www.toynews-online.biz/news/read/character-options-to-launch-toy-range-based-on-new-teletubbies-series/043069.

[147] https://www.newspapers.com/newspage/75538745/.

[148] http://www.kidstodayonline.com/article/365038-bright-starts-launches-new-line-of-toddler-toys.

[149] http://www.kidstodayonline.com/article/493253-blue-box-acquires-infantino-expands-international-products-business.

368. VTech submits that, for the reasons set out below, the Transaction will not lead to any loss of actual or potential competition in relation to the supply of child tablets/laptops in the UK.

- The declining demand for child tablets/laptops in the UK as consumers substitute away would not meet the "hypothetical monopolist" test;
- Even if the supply of child tablets/laptops in the UK were to constitute a relevant market:
  - Several alternative suppliers of child tablets/laptops remain in the UK post-Transaction (in what is an increasingly competitive landscape);
  - The Parties face wider competitive constraints (including non child-specific tablets/laptops; and other toys);
  - The Parties are not particularly close competitors [Confidential];
  - Retailer buyer power, will offset the loss of any LeapFrog constraint on VTech; and
  - New entry and/or expansion is likely, timely and sufficient.

(i) The declining demand for child tablets/laptops in the UK as consumers substitute away would not meet the "hypothetical monopolist" test

369. The Parties disagree with the CMA's Phase I contention that the supply of child tablets/laptops in the UK constitutes a relevant frame of reference – please refer to section VI above.

370. In a nutshell:

- Child tablets/laptops is not a category used by NPD; it is a bespoke descriptor used by the CMA for the purposes of analysing the Transaction, which encompasses products found in three distinct NPD sub-classes (Preschool Electronic Learning, Education Learning Aid Hardware/Software and Accessories, and Kids' Tablets);
- From a demand-side perspective, the Parties consider that (i) electronic devices developed as, essentially, toys for children follow wider technological trends such that new toys will arise and replace others as technology evolves, (ii) other non child-specific tablets/laptops exercise considerable competitive constraint on child tablets/laptops; (iii) other types of toys, particularly electronic toys, constitute a reasonable substitute products for child tablets/laptops (e.g. smartwatches, smartphones etc.); (iv) consumers have limited spending to allocate to toy purchases and choose from a wide range of alternative options (across different categories) to satisfy their child's needs; and (v) retailers will seek to maximise limited shelf/catalogue space; and
- From a supply-side perspective, toy manufacturers constantly renew their product offering in order to anticipate changes in consumer trends. Furthermore the development and manufacturing of toys, including electronic toys does not require a high degree of know-how. Though the development and manufacturing of tablets does require a certain degree of sophistication in electronic systems, both

hardware and system software for tablets are nowadays highly standardised. A new entrant to this category can easily find "standard solutions" and can indeed buy "readily made" products and simply market and promote them as branded. Further, there is a wide choice of downloadable content available online such that the software does not need to be manufacturer specific, meaning that suppliers could easily switch to supplying child tablets/laptops (and in a timely fashion) in the event of a 5-10% price increase of child tablets/laptops.

371. [Confidential]

- As shown, the current margins on child tablets/laptops [Confidential].
- In summary, CRA's findings are consistent with the Parties' marketplace experience that their products face constraints which emanate from a wider array of toys types than either the relevant NPD sub-classes, or a narrow definition of their product types.

(ii) Even if the supply of child tablets/laptops in the UK were to constitute a relevant market, several alternative suppliers of child tablets/laptops remain in the UK post-Transaction (in what is an increasingly competitive landscape)

372. In the event that the CMA were to conclude that child tablets/laptops constitute a relevant product market the Parties stress that, as mentioned above in section IV and in paragraph 298, prior to the Transaction LeapFrog was in great financial difficulty, and therefore analysing historic market shares does not take account of the appropriate future counterfactual.

373. In addition, the Parties submit that post-Transaction there will remain several strong alternative suppliers of children's tablets/laptops, such as Amazon, Mattel, KD Group, Dragon Touch, Samsung and Lexibook.

374. Please refer to Annex 4 to the Phase II Market Questionnaire for further specifications on these competitor products.

375. The dynamic was most clearly summarised by a former LeapFrog shareholder who noted: "*the competitive landscape for toddler tablets now includes Amazon Fire Kids Edition, Nabi Jr, Dragon Touch, ProntoTec, and InnoTab, among others. The broader tablet offering is even more competitive, which includes manufacturers such as Apple, Samsung, Sony, Hewlett-Packard, LG, Dell, Toshiba, and Microsoft, to name a few. In fact, there are over thirty (30) manufacturers of tablets today and penetration rates are very high. We find it difficult to envision an outlook that suggests this intense level of competition is going to change any time soon […]*".

376. "*Developing educational and entertainment content and apps has become intensely competitive. Dozens of new industry participants have started offering apps and content for free or at very low prices with seemingly little or no profit motive, which is making the industry incredibly difficult to compete in profitably.*

377. *The old "razor and razor blade" model of pairing hardware and software is significantly challenged in today's world. There isn't money to be made on the razor (i.e. the tablet), and* *with the plethora of free to low cost apps, there is little if any money to be made on the "razor blade" now either*".[150]

378. Indeed, this dynamic (coupled with a general decline in the popularity of tablets/laptops specifically intended for children) is a fundamental reason behind the ultimate downfall of the LeapFrog business.

(iii) The Parties face wider competitive constraints (including from non child-specific tablets/laptops; and other toys)

<u>*Constraint from non child-specific tablets/laptops*</u>

379. The Parties submit that the competitive constraint exercised by non child-specific tablets/laptops should be taken into account.

380. Please refer to paragraphs 225 to 237 for the reasons why the Parties consider that non child-specific tablets/laptops form part of the same relevant market as children's tablets/laptops, or at least exercise a significant degree of competitive constraint (given their wider application also for older family members). This point is evident from LeapFrog's development of its Epic product which is more akin to open Android based tablets than the traditional closed LeapFrog system.

381. According to one of its former shareholders, it was the rapid evolution of the tablets/laptops business, which saw devices traditionally used by adults being increasingly used by children with the development of internet-based content, that precipitated LeapFrog's financial difficulties: "*Today, not only is the market flooded with both new and used tablets for people of all ages, but adults are often sharing their tablets with their children in light of the increased access to content geared toward children. There are now hundreds of apps for tablets available for less than USD 5 (and often free) that compete directly with LeapFrog's content, which LeapFrog is still trying to sell for USD 25 to USD 30".*[151]

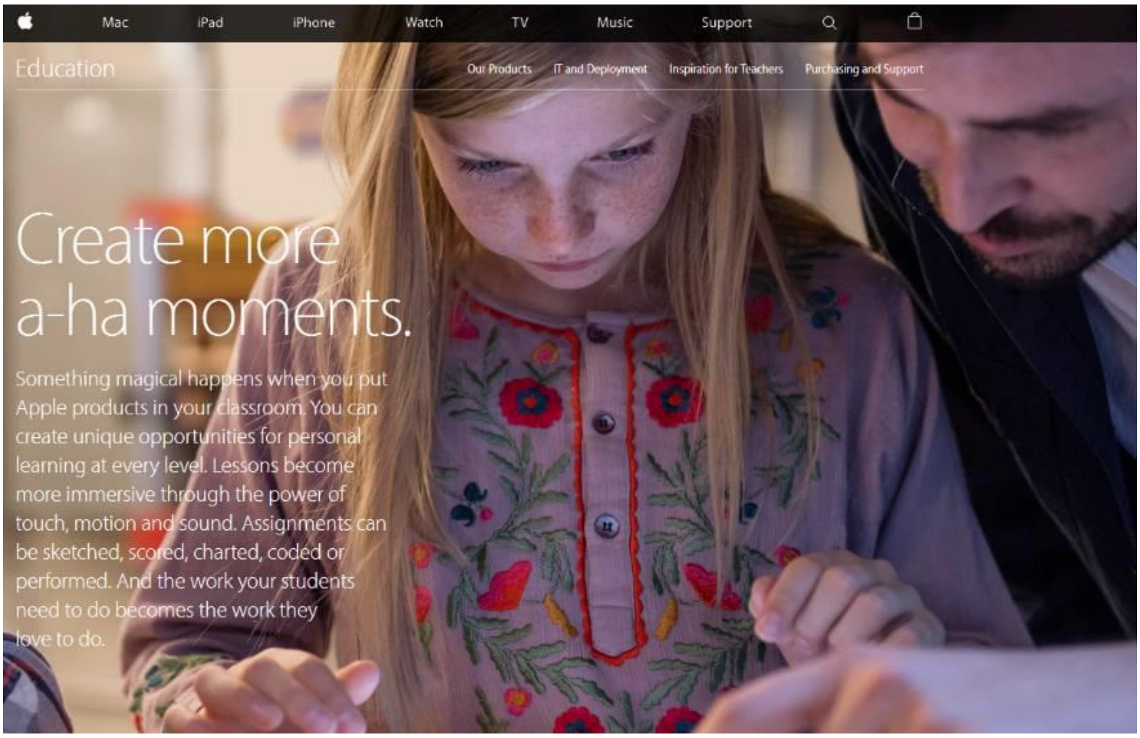
382. In this regard, VTech estimates that the Parties' combined share of tablets owned by children in the UK (i.e. including tablets handed down by adults) would be below [Confidential].

383. Indeed the Parties' tablets/laptops compete with tablets and smartphones manufactured by more traditional tablet manufacturers such as Apple, Amazon, Samsung and Microsoft as well as other Android tablet suppliers and retailer own-label tablet brands such as Argos' Eluma, in relation to which NPD data is not available. VTech notes that each of Apple and Microsoft are also promoting the use of their tablets by children, including for educational purposes. See, for example, a screenshot of Apple UK's education webpage in Figure 11 below.

<u>Figure 11: Screenshot of Apple UK's education homepage</u>

[150] Open letter from Blue Pacific Partners LLC to the Board of Directors of LeapFrog dated 15 July 2015.

[151] Open letter from Blue Pacific Partners LLC to the Board of Directors of LeapFrog dated 15 July 2015.



Source: Apple UK (http://www.apple.com/uk/education/).

384. This is further demonstrated by consumer reviews, which list the iPad mini as the number 2 "best tablet for kids" as early as 2013.[152]

- Amazon Kindle is number 1;
- iPad mini is number 2;
- Samsung Galaxy is number 3;
- Fuhu's nabi® (now Mattel) is number 4;
- LeapFrog only number 5; and
- VTech is not even listed.

Constraint from other toys

385. Furthermore the competitive constraint exercised by other types of toys (e.g. smartwatches, smartphones etc.) should also be taken into account. From the consumers' perspective, children's demand for toys is not specific to tablets/laptops but can be satisfied by a range of products depending on what is popular at the time.

386. As an example, the Parties' tablets/laptops face increasing competition from video games consoles such as Wii, PlayStation, Nintendo DS; all of which provide games and interactive entertainment.

(iv) The Parties are not especially close competitors compared to other suppliers

387. First, the Parties submit that (i) they are not particularly close competitors in the child tablet/laptop segment in the UK and that (ii) assuming they are close competitors, other

[152] https://www.gazelle.com/thehorn/2013/12/06/the-7-best-tablets-for-kids/.

suppliers are just as close. Indeed, as noted in the previous section, there will remain at least 6 other suppliers of child oriented tablets.

Product characteristics

388. From a product offering perspective, the Parties' child tablets/laptops are differentiated based on their captive content. With LeapFrog's content being heavily focused on curriculum based learning and child development while VTech's content is more generally for entertainment purposes.

389. As can be seen from Annex 4 to the Phase II Market Questionnaire and was demonstrated during the Site Visit, there are a number of other competing child tablets/laptops supplied in the UK, which are as "close" to the Parties' products than the Parties are to each other. For example:

- VTech supplies the Innotab at a recommended retail price of GBP 99.99, for children aged 3-9 years:

- LeapFrog supplies the LeapPad 3, LeapPad Platinum (both running on the Brio operating system) and the LeapPad Epic (operating Android) at a recommended retail price of GBP 89.99, GBP 99.99, and GBP 119.99 respectively, for children aged 3-9 years:

- Amazon supplies the Fire Kids Edition at a retail price of around GBP 99.99, for children aged 3 years onwards:

- Kurio supplies Kurio 2 Tab and the Kurio Smart Student at a recommended retail price of GBP 89.99 and GBP 159.99 respectively, for children aged 4 years onwards and 8 years onwards respectively:

- Samsung supplies the Samsung Galaxy Tab 3[153] at a recommended retail price of GBP 119.99, for children aged 3 years onwards:

- Dragon Touch supplies the Dragon Touch at a recommended retail price of GBP 49.99:

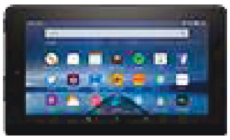
- Mattel supplies the nabi® 2 at a recommended retail price of GBP 99.99, for children aged 3-9 years:

390. It is clear from the above that there are numerous competitors in the very narrow segment of child tablets/laptops and that competition is fierce. The above also shows that the Parties are no closer competitors than they are to a number of other players.

391. Furthermore, Annex 4 to the Phase II Market Questionnaire also highlights that non child-specific tablets closely compete with child tablets/laptops in terms of their price point, features and (typically greater and with wider age group appeal) functionalities. The CMA's Phase I concerns, with which the Parties strongly disagree, relating to (i) breakability of mainstream tablets/laptops and (ii) their lack of parental control or kid-safe content have been addressed in paragraphs 229 above.

[153] However this product is being discontinued.

- Amazon supplies the Fire and Fire HD 8 at a recommended retail price starting at GBP 49.99 and GBP 89.99 respectively:




- Apple supplies the iPad mini at a recommended retail price starting at GBP 219.00:

- Tesco supplies the Hudl 2[154] at a recommended retail price starting at GBP 99.99:

- Linx supplies the Linx 7 at a recommended retail price starting at GBP 69.99:

- HTC supplies the Nexus 9 at a recommended retail price of GBP 250.00:

Internal documents

392. The CMA Reference Decision[155] refers to the Parties' internal presentations, from which the CMA infers that VTech and LeapFrog are each other's closest competitor in the supply of child tablets/laptops.

393. The Parties believe the CMA's analysis in this regard is not only partial but also unfounded. It is clear from these internal documents that [Confidential]. Equally, care should be taken

[154] However this product is being discontinued.

[155] See paragraphs 192 and 194.

to avoid relying on documents relevant in 2013/2014 which do not reflect the current market situation.

394. [Confidential].

395. [Confidential].

396. [Confidential].[156]

397. [Confidential].

<u>*Third party views*</u>

398. In its Reference Decision, the CMA indicates that third party views provided in the course of the Phase I investigation provided evidence that the Parties' products were close substitutes and that the Parties are two of the principal innovators in the supply of child laptops/tablets with few alternatives.

399. As noted above, the Parties submit that their tablets/laptops do indeed compete; however the Parties equally submit that other competitor products are as close substitutes, as can be clearly observed from paragraph 389 above. Indeed, the Parties consider that there exists a plethora of alternatives to the Parties' products including, increasingly, adult tablets/laptops with online/downloadable content specifically for children (e.g. the Disney app).

400. The CMA also noted that "[*t]wo 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*".[157] However, as explained above, such concerns are not supported by the facts and the way the tablets segment has evolved.

401. Indeed, the vast majority of tablets (including those running Android and iOS (Apple) operating systems which together represent more than 90% of all mobile/tablet operating systems) allow the setting up of restricted profiles enabling the device administrator (i.e. a parent) to control the app permissions of each user profile. Accordingly, in the event of a price increase by the Parties child safety concerns would not restrict customers' ability of purchasing alternative tablets/laptops. Further, it is difficult to reconcile this view with the fact that LeapFrog's latest tablet offering Epic was brought to market with an expected margin of [Confidential]. Clearly the Parties have limited scope to implement a price increase given the wide competitive constraints and declining sales.

402. Finally, the CMA observes that "*[o]ne 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"*.[158] As explained in paragraph 396, Kurio Tabs (among others) are unambiguously being marketed for, and used by, children around the age of 4, or even younger, therefore the comment by the competitor's comment is evidently not reflective of the choices available to consumers on the tablets/laptops market in the UK.

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[156] See for example reviews of Kurio Tab 2 by Argos customers, available at http://www.argos.co.uk/static/Product/partNumber/4985877.htm#pdpFullDesc.

[157] See Reference Decision paragraph 205.

[158] See Reference Decision paragraph 206.

403. In conclusion, the Parties believe that the above evidence supports the view that LeapFrog and VTech are no closer competitors in respect of child tablets/laptops in the UK, than a number of other competitors (most notably Kindle for Kids, but also Kurio, Mattel, Samsung and Dragon Touch) with both Samsung and Amazon becoming more important because they have greater expertise in the technology sector.

404. Even if one were to find that LeapFrog and VTech competed closely in respect of child tablets/laptops in the UK prior to the Transaction, the Parties submit that it is indisputable, given LeapFrog's financial situation in 2015 and 2016 that it would not have remained a close competitor in respect of child tablets/laptops in the UK absent the Transaction (assuming it would not have exited the market altogether). LeapFrog's financial distress, and declining sales, were apparent as early as 2014 and it would not have been in a position to closely compete with VTech absent the Transaction.

(v) The child tablet/laptop segment is in decline

405. The Parties submit that the supply of child tablets/laptops in the UK has been declining since 2014. This is illustrated by the following:

- [Confidential]. This is evidenced by the promotions that retailers are having to resort to in order to sell child tablets/laptops, such as Smyths in Slough, which was running a 25% discount promotion on LeapFrog tablets on 5 October 2015 as seen during the Site Visit. Such promotions are usually fully or partially funded by the manufacturers.
- As can be seen from **Annex 9**, tablets were listed as "hot" products for the years 2011, 2012 and 2013 but then fell out of favour disappearing from the list entirely by 2014 and remaining this way in both 2015 and 2016. As explained above, the toy industry is seasonal and trend-driven; accordingly it is not uncommon for some toys/segments which were previously "hot" to disappear altogether.
- When tablets/laptops were a "hot" product in 2012 and 2013, VTech estimates that approximately [Confidential] retailers stocked a VTech tablet/laptop. However in 2015, this fell to about only [Confidential] retailers.[159]
- As shown in the Consolidated Response,[160] the comparison of catalogue space allocated to child tablets/laptops over time, clearly indicates that child tablets/laptops quickly fell out of fashion;
- The Parties estimate that for 2016, the sale of child tablets/laptops in the UK will only amount to approximately GBP [Confidential] million, compared to GBP [Confidential] million in 2013. More generally and as described in the Consolidated Response, the Preschool Electronic Learning sub-class ([Confidential]% of which corresponds to the Parties' child tablets/laptops) has been declining rapidly since 2012:

[Confidential]

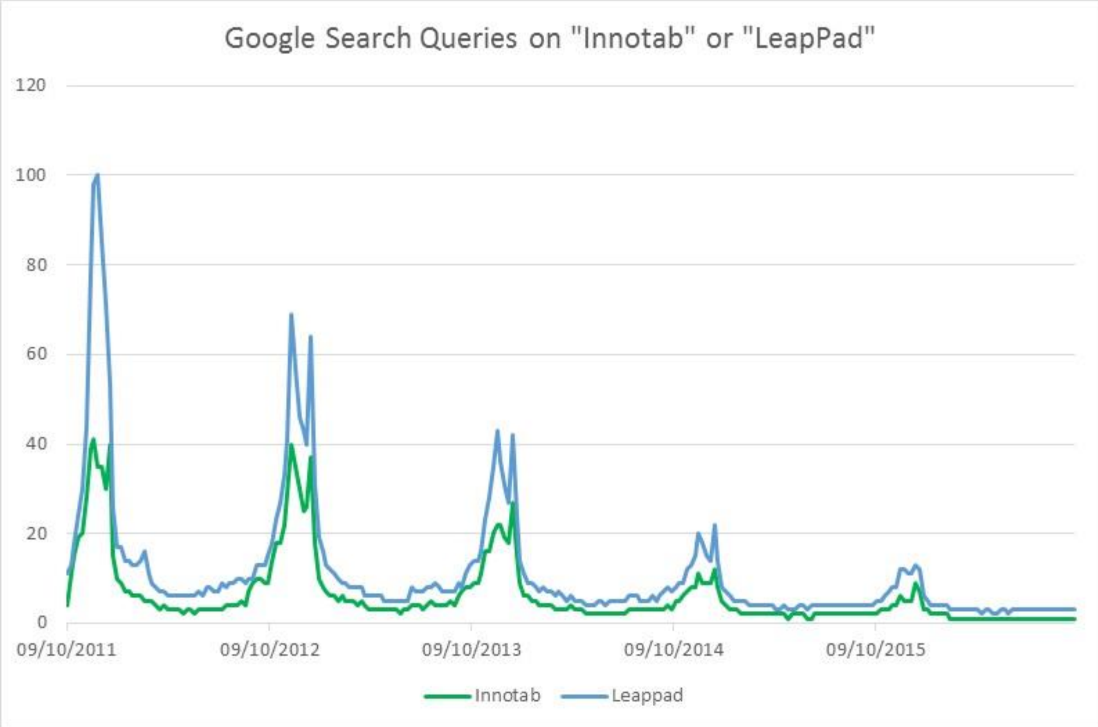
406. As can be seen from Figure 12 above compiled from NPD data, demand for Preschool Electronic Learning toys reached its peak in 2012 and in 2015 was approximately [Confidential] of the demand in 2012. This reduction in demand is also supported by

[159] For example, John Lewis decided to no longer list children's tablets/laptops due to its policy of being "never knowingly undersold", which led to retail price erosion.

[160] See figures 1-3 page 97-100 of the Consolidated Response.

evidence on the significant drop off in interest expressed by customers through Google search requests.

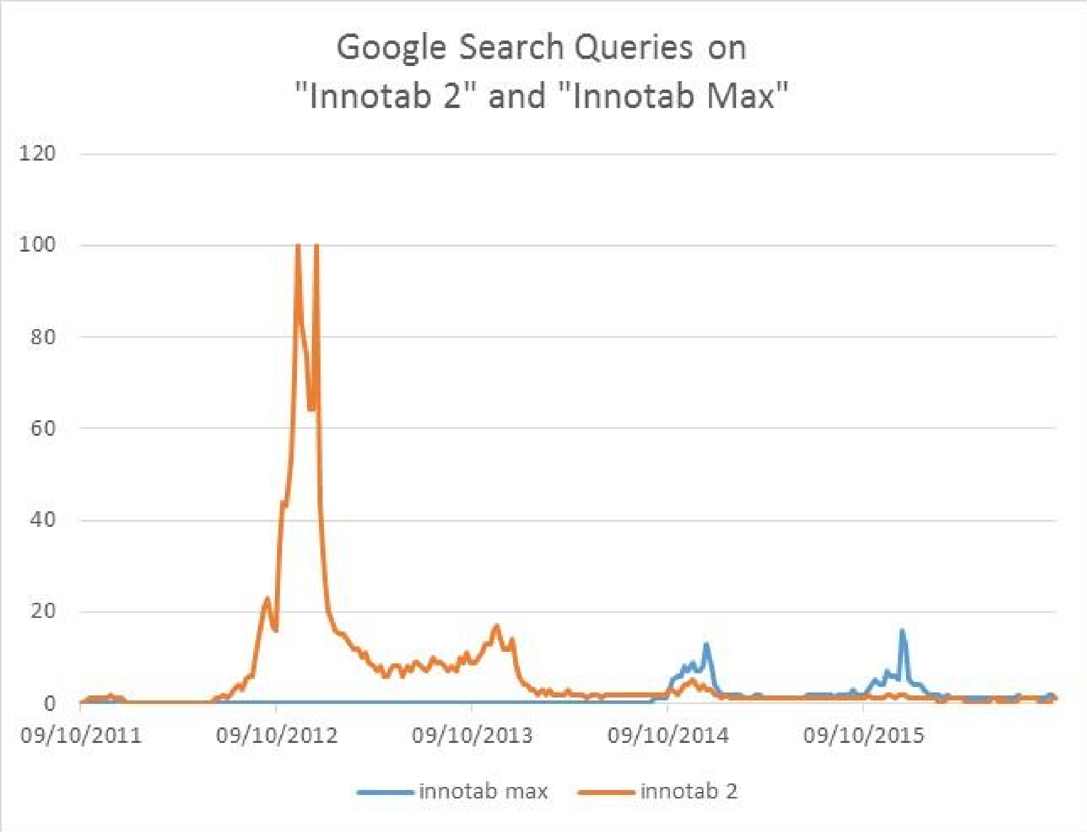
Figure 13: Google search queries on Innotab or LeapPad:



Source: Google Trends

407. As seen above the level of consumer interest has declined hugely over the last five years, to the point where the number of consumers searching for either of the Parties' products is only a fraction of the point at which it was. Similarly when comparing the interest in VTech's new tablet release in 2012 (the Innotab 2) versus its new tablet release in 2014, the Innotab Max, it is clear how much less interested consumers are.

Figure 14: Google search queries on Innotab 2 and Innotab Max:



Source: Google trends

408. The source of the decline in the supply of child tablets/laptops is two-pronged:

- First, from a demand-side perspective:
  - demand for child tablets/laptops and tablets/laptops in general is saturated, as most households own, or have access to, a tablet or laptop, though there is low penetration of children's specific tablets/laptops (understandably given the range of alternatives available both in terms of tablets/laptops and other forms of child entertainment).[161] Furthermore, every year around 700,00 children fall out of the older end of the age range for children's tablets, and a similar amount enters at the younger end. Contrary to the first 2 to 3 age years for this category, the market is predominantly dependent on new children entering the age range to fuel demand.
  - the toy industry is seasonal and trend-driven; accordingly whilst child tablets/laptops were "hot" in 2012 and 2013, other technology-based toys have now supplanted tablets/laptops. For example, the rise of smartwatches, smartphones, selfie sticks etc. all follow adult world trends. As a similar illustrative example, toy manufacturers used to produce toy cassette players and toy DVD players when these were popular in the wider technological world, but that is no longer the case.

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[161] See OFCOM report, "Children and Parents: Media Use and Attitudes Report", page 34, available at http://stakeholders.ofcom.org.uk/binaries/research/media-literacy/children-parents-nov15/childrens_parents_nov 2015.pdf.

- as mentioned in the response to question 1 of the Phase II Market Questionnaire, the proliferation of apps (downloadable on any Android or iOS device) available to children for little or no cost has drastically altered the nature of demand for child specific tablets/laptops. Children are growing up in a new world of easily accessible (and low cost) technology and, anecdotally, are increasingly using their parents' smartphones and tablets/laptops. With Google and YouTube now offering safe worlds for kids, along with a host of child specific app based content (e.g. Disney's app), parents' concerns about the web are reducing rapidly. Indeed, Apple has run marketing campaigns to attract parents with younger children promoting the use of their devices for purposes ranging from use as a baby monitor to the array of apps that are available and appropriate for children on their devices.

- Second, from a supply-side perspective:
  - as mentioned in the response to question 2 of the Phase II Market Questionnaire, the increase in the number of tablets on the market in recent years has reduced the costs of many key components like screens, memory and chips. This has allowed tablet manufacturers to reduce prices and it has also further reduced the barriers to entry for other competitors who flooded into the market with cheap tablet offerings for children and extremely low priced adult/family tablets. The barriers to entry for such tablets is also very low, as standard designs and ready/made products are easily available. [Confidential].
  - tablets/laptops have become a mere route to the market for content and consumer demand is shifting from cartridges to digital (i.e. directly downloadable) content.[162] Consequently suppliers are adapting to changing consumer demand and are in the process of making their content more widely available, including on other devices/platforms (which emphasises the fact that other devices are becoming more and more substitutable with child-specific tablets/laptops). [Confidential].

409. As a result, a high number of new entries (and exits) have occurred in recent years in the child tablet/laptop sector. In most cases, suppliers were able to enter relatively easily, however, as demand in the UK declined and in light of the fierce competition in the segment, the products were then discontinued.

410. The Parties provide in paragraph 414 below several examples of recent exits and entries in the child tablets/laptops segment.

411. Furthermore, as a result of the severe decline in child tablets/laptops, as mentioned above [Confidential]. For the avoidance of doubt, this was also the plan pre-Transaction.

(vi) New entry and/or expansion is likely, timely and sufficient

412. As set out in more details below in section VII.3.2, the Parties consider that there are no significant barriers to entry in the supply of tablets/laptops specifically targeted at children.

[162] The Parties note that there are a number of companies that are only active in the development and supply of software or applications (as opposed to also supplying the hardware). For example, "ABCmouse" is a subscription-based online curriculum for children aged 2 to 7, which provides a safe and secure online educational environment. Sales data for these suppliers is not collected by NPD.

This is particularly so for the plethora of existing tablet/laptop manufacturers who can easily adjust their product to tailor it for children. In particular the Parties note that:

- the hardware can be sourced from a range of suppliers based in Asia and China (as LeapFrog has done);[163]
- there exists a large choice of software for kids which can easily be downloaded and used on an "adult" tablet; there is an increasing number of software developers who launch specific applications and software for kids, many of which are free or offer in-app purchases. In addition, many of the specialist content for children is provided by the licence holder e.g. Disney which sells its own games and apps on Google Play or iTunes available for all tablets rather than specifically for children toys; and
- there are also very limited entry barriers for existing "adult" tablet manufacturers to develop a specific child version of the tablets/laptops which in most cases is carried out by the simplification of the existing tablets/laptops with only a limited addition of new features. There are many examples of such an entry, including Amazon Fire Kids Edition, Samsung Tablet for children launched in 2013, Oregon Scientific Meep, Kurio and Kidstar/Appstar (by Binatone).

413. There are numerous examples of successful entry/expansion (and subsequent exits as the market declined) in the children's tablets/laptops segment in the UK. This illustrates that, should the opportunity arise, significant and timely entry could occur again.

414. Samsung, Oregon Scientific, Meroncourt, Amazon and Microsoft are all recent new entrants in the supply of children's tablets in the UK. In particular, as submitted in response to question 29 of the Phase II Market Questionnaire, the following entries/exits have occurred in the last five years in the child tablets/laptops sector.

- Entry in 2012:
  - **Binatone**, a supplier of telecommunication products including Motorola branded baby monitors sold through Argos, entered the child tablet/laptop sector with the launch of Kidzstar/Appstar in 2012, which was sold through Argos under an exclusive arrangement. The tablet was then dropped from Argos' catalogue in 2014.
  - **Oregon Scientific** launched its Meep child tablet in 2012. Before launching the Meep tablet, Oregon Scientific was already active in the toy industry with child laptops and computers. At launch, Oregon's Meep tablet was mainly marketed by Smyths. However, the Parties note that due to quality issues and high consumer returns levels this product has not been successful.
  - **KD Group** launched its Kurio child tablet in 2012. However, the KD Group was unable in the first year to satisfy demand for the Kurio tablet due to capacity issues. Following a change in the company's ownership, there has been a shift in focus to the development of kid tech brands, such as kid smartwatches and phones.

[163] See for example, http://www.globalsources.com/trdshw/T/csf-HONGKONG-MOBILE-ELECTRONICS-2016-Oct/mp/2808800037452/Smart-Watches/0.htm?source=GSE_GooglePPC_HK001&WT.mc_id=8002025&WT.srch=1&_sm_au_=iVV64FSRVwQM3S33.

- Entry in 2013
  - **Tesco** introduced its low-cost Hudl family tablet in 2013. Its success and the experience prompted the launch of Hudl 2 – see below.
  - **Samsung** launched a child tablet, the Galaxy Tab 3 Kids, in 2013. Before launching this product, Samsung had no history in the toy industry. This tablet was targeted at kids aged 3 and above and was designed to attract consumers who were looking for a children's tablet with adult performance and brand credibility. Retailers selling Samsung's kids tablet included John Lewis, Amazon, Toys'R'Us and Argos. Due to its kids' content being poor, Samsung decided to discontinue production and sell excess inventory at discounted prices. The tablets segment is both highly competitive and a declining segment. However, if either dynamic were to change it would clearly be open to Samsung, as hardware supplier, to partner with a third party software developer with expertise in kids' content to succeed on the second attempt.
- Entry in 2015
  - **Tesco** launched Hudl 2 in 2015. The Hudl tablet was designed to appeal to its existing consumers with a value for money offering. Tesco developed two models of its Hudl tablet before it recently discontinued production due (the Parties believe) to a decline in tablet demand. The Hudl 2 came with a built-in child safety app allowing users to tailor permissions and profiles for up to seven different users. The child safety app controlled three types of use: web safety, app safety and time limits. Users were able to switch off access to specific games, search engines or entertainment services. Consequently, the Hudl 2 was particularly popular with parents before being discontinued.
  - **Amazon** launched a child version of its Fire tablet, the Fire Kids Edition in 2015. Before launch of the Fire Kids tablet, Amazon had no history in the toy industry. However, thanks to its presence in the retail market, it benefits from secure access to a distribution channel. The Parties have no data on Amazon's penetration level but undoubtedly Amazon's aggressive pricing and marketing strategy has secured Amazon a competitive position in the child tablet sector. Amazon can also benefit from large economies of scale from demand for its traditional and well-established tablets.
  - Finally, **Clementoni**, an Italian toy manufacturer that supplies preschool and educational games under the Sapientino brand and whose range includes tablets and mini computers, has recently entered the UK market more deeply.
- Entry in 2016
  - **Amazon** has also just launched Amazon Video Direct,[164] which is intended to compete with YouTube. This shows there are many options available to consumers which they can download/use on any given tablet, computer or smartphone (or in the case of Amazon, on a TV).

[164] In May 2016 – please see http://phx.corporate-ir.net/phoenix.zhtml?c=176060&p=irol-newsArticle&ID=2166929.

415. A further example of the child tablet/laptop segment being highly dynamic with several opportunities arising for potential new entrants, is the recent acquisition of Fuhu Inc. (“**Fuhu”**) by Mattel. In January 2016, Mattel acquired Fuhu, a children’s tablet manufacturer sold under the brand nabi®, which was ranked by Forbes magazine as the most promising company in America in 2014 but which went bankrupt in December 2015.[165]

416. On 14 September 2016, Mattel launched three new children’s tablets in the USA under the nabi® brand, which include digital content, experiences and accessories specific to each brand:[166]

- Barbie™ Tablet Powered by nabi®: this tablet features dozens of Barbie™ themed apps, games and videos, including apps that will let the child explore potential careers with Barbie™ and create their own Barbie™ super-hero comic, as well as a video series called Barbie™ Spy Squad. The tablet also comes with a custom pink bumper, fun Barbie sound effects that come alive as the user unlocks the tablet, swipes through different screens and open different folders;

- Hot Wheels™ Tablet Powered by nabi®: this tablet teaches children about the science of Hot Wheels[167] car and tracks such as resistance, friction and gravity. It includes more than 25 apps and games for hours of play. The tablet also comes with a custom bumper and fun racing sound effects; and

- American Girl® Tablet Powered by nabi®: this tablet includes circa 70 apps, videos and games featuring both American Girl® characters and creative craft ideas. The tablet also comes with a berry coloured bumper and has American Girl® specific sound effects.

[165] Please see press release on 21 January 2016, available at http://www.wsj.com/articles/mattel-wins-auction-for-bankrupt-nabi-tablet-maker-1453407742.

[166] Please see press release on 14 September 2016, available at http://www.nasdaq.com/symbol/mat/press-releases.

[167] Please see www.hotwheels.com. Children may collect Hot Wheels cars and play related car games and racing games. YouTube videos also offer Hot Wheels car and track videos.

417. All three tablets are reported to be available as of October 2016 in the USA and will be sold at a retail price of USD 79.99. It is therefore at least plausible that Mattel could very easily enter the UK market.

(vii) The Parties are constrained by substantial buyer power

418. As set out in more detail below in section VII.3.1, the Parties consider that the toy market is characterised by significant buyer power for a number of reasons. These include:

- the indispensability of retailers for manufacturers to access consumers. It is critical for a manufacturer to ensure that as many of its products are on retailers' shelves because (i) a significant number of end-consumer purchases are influenced by instore displays; and (ii) end-consumers do not necessarily go into a store with a specific product in mind but rather are looking for a toy to achieve a certain purpose (e.g. entertaining their child) from a vast range of toys displayed on the retailers' shelves.

- the majority of the Parties' sales being attributable to a few major retailers. As can be seen in **Annexes 3** and **4** (referred to in section VII.3.1 below) VTech's top 5 customers account for [Confidential] of its total sales in 2015, while LeapFrog's top 5 customers account for [Confidential] of its own total sales.

- the ability for retailers to substitute across a wide range of toys. In order to determine their optimal product mix and maximise expected returns, retailers substitute across a range of products, brands and categories (either by allocating more or less shelf space or dropping a line entirely). This can include substitution for own-label and less-well known third party products, meaning that the Parties must offer attractive packages in order to remain on retailers' shelves and cannot adopt a selective approach to their tablet offering.

- [Confidential].

- the ability of retailers to (i) develop their own-label products, which they can sell not only through their own retail stores but also through other retailers; or (ii) support less well known brands at attractive margins. The appeal of this is especially so because end-consumers generally do not differentiate between retailers' toy brands and manufacturers' toy brands.

419. Consequently, buyer power is a feature of the toys market and will continue to pose a significant and unavoidable constraint on the Parties' ability to raise their prices (or impose onerous terms on retailers) for tablets as a result of the Transaction.

VII.2.3 **No loss of potential competition in child electronic reading systems**

420. VTech submits that, for the reasons set out below, the Transaction will not lead to any loss of potential competition in relation to the supply of child electronic reading systems in the UK.

- VTech's decision to abandon the [Confidential] concept is not linked to the Transaction;
- The Parties' products are significantly different;
- Other products exist which are more similar to LeapFrog's;
- In any event, looking at this segment by reference to the Parties' products is overly narrow and does not reflect wider constraints from tablets and other reading devices;
- Barriers to entry are not significant; and
- Buyer power substantially constrains the merged entity.

421. As set out above, the Parties do not consider that child electronic reading systems represent a separately definable market. In particular, such a market definition fails to take into account of the wide range of considerations that go into both consumer and retailer decision making when it comes to product choice.

422. Indeed, from a consumer perspective, depending on the specific goal the consumer had in mind when purchasing the product (e.g. purely entertainment purposes, reading development etc.) there exist a wide range of alternatives from which consumers will choose.

423. Nevertheless, in order to assist the CMA in its review the Parties have considered the theoretical overlap in respect of LeapFrog's LeapReader identified by the Phase I review. In this regard, the Parties consider that the Transaction cannot plausibly lead to loss of potential competition given that:

- VTech had unilaterally determined not to proceed with its [Confidential] concept for reasons clearly unrelated to the Transaction and thus cannot be considered a potential competitor;
- [Confidential] and LeapReader/LeapStart constitute two completely different propositions and there are other products which are (or would be) closer competitors to LeapReader/LeapStart; and
- VTech is no more likely to develop an alternative reading concept than any other participant in the toy industry.

(i) VTech's decision to abandon the [Confidential] concept is not linked to the Transaction

424. In March 2016, VTech decided not to proceed with the development of the [Confidential] concept. While this decision was relatively contemporaneous with the Transaction the two were not related (indeed occurring before closing on 4 April 2016). Rather, the decision not to proceed with the [Confidential] concept was made [Confidential]. A copy of this email can be found at **Annex 18**.

425. In its Reference Decision, the CMA asserts that even if it were the case that the product launch was cancelled due to failure to find a licensor, it is plausible that, in the absence of the Transaction, [Confidential].[168] As the CMA knows, [Confidential].

426. VTech considers that, in order for a platform to be successful, it is critical to have access to [Confidential] as this is what children (and their parents) are looking for.[169] Indeed, in the last five years VTech has never launched a platform product without [Confidential].[170] Consequently, having failed to obtain [Confidential] for the concept VTech determined that it was not worth pursuing its development. VTech also considers that it was not simply a matter of amending [Confidential] in order to proceed. Rather, [Confidential] considered that the concept was unlikely to be something that consumers were willing to pay for.

427. The CMA also observed that VTech had been considering the [Confidential] product [Confidential] and had detailed plans for its pricing and launch.[171] VTech considers that its plans were not particularly developed but rather consisted of conceptual appearance/features and a possible retail price (which [Confidential]. This amount of work is typical for products at concept stage – many of which never ultimately come to fruition. The version of the [Confidential] picked up by the CMA in the Reference Decision consisted of the last concept in a long string of many concepts developed and considered to address this category. Some earlier concepts had been very different.

428. [Confidential]. This is similar to product development costs for any number of other concepts that were ultimately abandoned. Further, no other quantifiable costs of developing the [Confidential] concept were incurred, no marketing cost has been or will be incurred, and there is no advertising plan.

429. It is therefore incorrect to assert that VTech has incurred considerable costs and/or developed detailed plans which would suggest that VTech would likely have proceeded with product development, absent the Transaction. On the contrary, VTech determined independently of the Transaction that the concept was unlikely to be suitably successful and focused its development efforts elsewhere.

(ii) The Parties' products are significantly different

430. Except to the extent that both involve a story and associated book, VTech's [Confidential] concept was not comparable with LeapFrog's LeapReader and LeapStart. As is evident

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[168] Reference Decision of 18 August, paragraph 234(e).

[169] VTech notes that all [Confidential] proposals in the Presentation from [Confidential] (previously provided to the CMA as Annex 1H to the Response to Fourth Section 109 Notice of 15 July 2016) use [Confidential] (see page 38). Accordingly, it is clear from the presentation that [Confidential].

[170] For completeness, we note that in 2009 VTech launched its reading pen product Bugsby. However, the market conditions were very different then. The launch of Bugsby in 2009 was done without support of television commercials. Therefore, the decision barrier for launching the product was a lot lower. If VTech was to launch a new electronic reading product in 2016, television commercials would be a must, and [Confidential], the size of the business would not be able to justify the expenses of television advertising.

[171] Reference Decision, paragraph 234(c).

from the descriptions below, LeapFrog's products are more complex with a range of features targeted at developing children's reading and writing capability (coupled with in-built learning activities) while VTech's concept was [Confidential]:

LeapFrog

- LeapFrog's LeapReader reading and writing system is an electronic pen with a library of reading, activity and audio-books. Using the electronic pen, users touch letters, words and undertake activities in dedicated printed LeapFrog books to hear how letters and words are pronounced, undertake comprehension exercises and to learn how to write letters.

- The LeapReader Junior is similar to the LeapReader, except that the electronic pen is shaped like a puppy). LeapReader Junior interacts with dedicated printed board books, allowing children to hear a selection of words, songs and sound effects.

- LeapFrog's LeapStart is different to the LeapReader and LeapReader Junior. It is an interactive learning system that includes a literacy aspect within multiple different activities (see below). LeapStart utilises a stylus pen that recognises elements in dedicated physical books and speaks aloud to aid reading or for other educational purposes. Children can tap a page to activate audio responses and play activities.

VTech

- [Confidential]

(iii) Other products exist which are more similar to LeapFrog's

431. While the Parties consider that LeapFrog's products represent a relatively unique proposition in the market at present, they note that there are similar products available in the UK and elsewhere.

- Learning Resource's Hot Dots Pen, which is an electronic pen similar to LeapFrog's LeapReader and functions by interacting with dedicated Hot Dots content (books, flashcards, etc.):

- Learning Resource's 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 cute animal, also function by interacting with dedicated Hot Dots content (see below):



- Learning Resource's Hot Dots Jolly Phonics Inky Mouse Pen, which is an electronic pen and functions by interacting with dedicated Hot Dots content, with a particular focus on phonics (see below).

432. Finally, as noted previously, Ravensburger (a German manufacturer) also makes an electronic pen-based "child electronic reading system" similar to LeapFrog's products, the TipToi, which although not yet available in English language could be made available without significant costs or delays.

(iv) Given the clear difference between the Parties' products the CMA must consider a wider product set

433. As noted in response to section VI above, it would be incorrect to consider the relevant reference market as only capturing so called "child electronic reading systems" as broadly described by the CMA based on the features of LeapFrog and VTech's products. In the view of the Parties, there is a myriad of other existing products with the same type of

functionality or purpose as the Parties' products, all of which would be substitutable. In particular, there is:

- a wide variety of reading applications for tablets and websites which aid with reading and writing in the same way as LeapReader and LeapStart, such as Reading Eggs, Bo Books, Reading Raven, Montessori Crosswords, Bug Club, Mister Thorne and Jolly Phonics and Marbleminds Phonics; and
- a wide variety of audio narration applications for tablets and audio books which provide the similar narrative function to the [Confidential], such as Farfaria and Reading Rainbow.[172]

434. In light of the above considerations, if the CMA remains minded to assess an overlap between the Parties' products on this basis then the CMA must also consider other book/text based audio systems which fulfil the same (or similar) function as in the Parties' products either as simple entertainment devices or specifically developing their reading and writing skills.

(v) Potential entry

435. As set out in previous sections, category entry and expansion in the toys industry is relatively easy. [Confidential].

436. In this regard, VTech considers that it is no more a potential entrant than any other company in the toy industry that comes up with a similar (presumably better) concept. Should sufficient demand be identified the Parties consider that a number of companies would indeed consider developing products.

437. The Parties note that Ravensburger (a German toy manufacturer) has a product that is similar to LeapFrog's available in Germany and France (in local language). The Parties consider that it would be relatively straightforward for Ravensburger (already active in the UK) to introduce a UK version if it saw an opportunity for similar results to its success on the German market.

VII.2.4 **No "general loss" of future competition in innovation**

438. VTech submits that, for the reasons set out below, the Transaction will not lead to any loss of future competition in innovation across the toys sector in the UK.

- The trend driven nature of the toys market requires all industry players to constantly innovate;
- There are low barriers to entry as innovation in toys is not capital and knowhow intensive; and
- The Transaction will result in a boost to the Parties innovation efforts which will be passed on to customers and end-consumers.

(i) The toys market is driven by innovation and new ideas

439. In its Competition Policy Brief, the Commission recognised that in order for a horizontal merger to raise serious competition concerns in relation to innovation, it needs to be

[172] Examples of competing phonics toys include: Chad Valley's Phonics Bus and Phonics Board, KD Group's Peppa Pig Alphaphonic board and Peppa Pig Fun Phonics, ELC's Phonics Alphabet Desk and Spin Master's Paw Patrol Fun Phonics. Examples of e-books available on Apple's iTunes and GooglePlay include Hooked on phonics, Kids Learn to Read, Read-Along, Reading Raven, Bob Books and Dr Seuss.

established that, amongst others, there are not enough actual or potential competitors to maintain the necessary competitive pressure after the merger.[173]

440. The Parties submit that innovation is a key feature of the toys market which requires all industry players to constantly innovate. Indeed, as already noted above, approximately [Confidential] of all products are churned on a yearly basis (replaced either by new concepts or retakes on older products). The goal of innovation in the toys industry is to develop a novel concept (which may consist of a completely new concept or an updated one) and drive a marketing message to the consumer that in doing so creates or answers a need.[174] It is, essentially, a fashion-led industry.

441. As recognised by a report written by the European Competitiveness and Sustainable Industrial Policy Consortium on the competitiveness of the toy industry which was prepared for the Commission's Directorate General on Enterprise and Industry (the "**ECSIP Report**"), innovation focuses on introducing novelties which can consist of completely new toys that involve a new concept or functionality or new themes and updated concepts.[175]

442. Given the trend-driven and supply-led nature of the toys industry as described in paragraphs 159 to 181 above, there is a short product life-cycle of toys, a high degree of product churn and competition for children's preferences. This is reflective of the fact that consumers tastes are fickle, that concepts become boring quickly or the world simply moves on. The impact of this phenomenon is starkly observable in respect of the rapid ascent and subsequent decline in the popularity of the Parties' tablets. It is also evident from the high degree of churn amongst the "hot" toys lists (see **Annex 9**) and under-performing and out-dated products being constantly abandoned by the toy manufacturers and the retailers alike.

443. Hence, the very nature of the toys industry requires all market participants to constantly innovate and adapt to changing trends in consumer preferences. Across the industry, manufacturers, independent of their size, develop thousands of new products each year. It is, essentially, a fashion-led industry. The following table highlights the significant number of manufacturers and extent of new product development taking place. This dynamic is entirely unaffected by the Transaction.

[Confidential]

444. Under-performing and out-dated products are abandoned. This is evident from the high degree of churn amongst the "hot" toys lists (see **Annex 9**).

445. In order to maintain their attractiveness to consumers and thereby their retail catalogue and shelf presence, the Parties strive to bring new and exciting concepts or ideas to the market in recognition that a failure to do so will ultimately lead to a declining business. Indeed, VTech launches approximately [Confidential] new products each year.

446. Given the plethora of suppliers and the ease with which new suppliers can enter with a concept, the Parties have every incentive to maintain their current levels of innovation (if

[173] See Directorate-General for Competition: Competition Policy Brief of April 2016, available at http://ec.europa.eu/competition/publications/cpb/2016/2016_001_en.pdf, page 3.

[174] For further details, please refer to section 2.2.6 of the European Competitiveness and Sustainable Industrial Policy Consortium's report on the competitiveness of the toy industry of 30 August 2013 (the "**ECSIP Report**") which was prepared for the Commission's Directorate-General on Enterprise and Industry, available at http://ec.europa.eu/DocsRoom/documents/6653/attachments/1/translations/en/renditions/native.

[175] European Competitiveness and Sustainable Industrial Policy Consortium, "Study on the competitiveness of the toy industry: Final Report", 30 August 2013.

not enhance them – see below). As such, innovation competition will remain extremely fierce.

(ii) Successful innovation can be achieved at a relatively low cost

447. In the Competition Policy Brief referred to above, the Commission also notes the importance of barriers to entry when assessing whether a merger gives rise to competition concerns in relation to innovation.[176] A detailed overview of barriers to entry in the toys industry is included in section VII.3.2 but for completeness the Parties also submit the below arguments which apply more specifically to innovation.

448. Despite its criticality, innovation in the toy industry is relatively simple and can be achieved at a relatively low cost. Innovation requires successful product development which depends on both (i) investment in market and technological research to create concepts (R&D) and (ii) investment in advertising:

(i) In relation to the former, the ECSIP Report recognises that R&D investment in the toys industry is not significant, and typically only amounts to between 0-5% of a toy manufacturer's turnover.[177] This is very low in comparison with other R&D intensive industries such as pharmaceuticals, where R&D typically amounts to up to 18% of sales revenue, or the semiconductor industry where major firms regularly spend approximately 25-28% of revenues on R&D.[178] By way of comparison, VTech's overall group expenses for R&D are [Confidential] of its revenue, with market research expenses being below [Confidential].[179]

(ii) In relation to marketing, the ECSIP Report also observes that investments in advertising are small in comparison to revenues.[180] Indeed, a significant amount of advertising is undertaken by retailers rather than suppliers themselves. This is particularly the case given the importance of online sales channels which offer new, inexpensive ways for smaller toy manufacturers to increase their exposure, *inter alia*, by displaying products on websites and engaging in social media promotions. In addition, a significant amount of advertising in the toys industry is undertaken by retailers rather than suppliers themselves.

449. The low cost of R&D and advertising in the industry evidences that creating innovative toys does not require large expenditure. In addition, innovation in toys also requires only limited technological expertise as toy manufacturers typically take advantage of developing technological trends that can be simplified and incorporated into toy products (e.g. smartphones, smartwatches and cameras). Essentially, innovation in the toy industry involves devising an attractive design concept. This is particularly the case for those suppliers that utilise third party manufacturers.

450. Post-Transaction, manufacturers both small and large, including established manufacturers such as Mattel, which combines (with its own manufacturing constituting less than 50% of its products and the remainder coming from third-party manufacturers and purchases from unrelated entities) will remain able to compete effectively with the Parties.

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[176] ECSIP Report, at page 3.

[177] ECSIP Report, at page 46.

[178] See http://www.investopedia.com/ask/answers/060115/how-much-drug-companys-spending-allocated-research-and-development-average.asp.

[179] LeapFrog's net R&D expense globally usually amounts to circa [Confidential] of its net sales.

[180] At page 46.

An example of the ease and simplicity of innovation is the story behind the currently very popular game Pie Face. It was launched by Rocket Games in 2014, and a consumer posted a video of him and his son playing the game on social media. The video "went viral" in early 2015 and became so successful that Hasbro bought the idea, transferred production to itself and now supplies it to the market.[181] Indeed, if there is a particularly successful toy anywhere else globally, it will be proactively sought by companies like Vivid Imaginations, Character Options and Trends (to name but a few) to distribute that item in the UK market. In this case, there are no barriers to entry; these best-seller toys can come into any area of the market.

(iii) The Transaction is pro-competitive on innovation relative to any reasonable counterfactual

451. The Parties note that there is no firm ground in economic doctrine for presuming anticompetitive reduction in innovation resulting from a merger or other reduction in the number of competitors attempting to innovate. On the contrary, a body of economic literature supports the notion that collaboration may be preferable to competition in furthering innovation, given the efficiencies and enhanced interchange of ideas that result from sharing resources.[182] Indeed the current best view of the economic literature is that there exists an "inverted U" relationship between competition and innovation, only when there is very limited competition will innovation tend to be adversely affected.[183] Unfortunately the literature provides little evidence on where the point at which less competition results in less innovation begins. However, given that the preceding sections show that there is no reduction in competition, there can be no presumption that there will be a reduction in innovation. In this respect, the Parties also refer to Chairman Muris' statement in the FTC's investigation of Genzyme's previously completed acquisition of Novazyme at paragraphs 5 to 6 that:

> "*neither economic theory nor empirical research supports an inference regarding the merger's likely effect on innovation (and hence patient welfare) based simply on observing how the merger changed the number of independent R&D programs. Rather, one must examine whether the merged firm was likely to have a reduced incentive to invest in R&D, and also whether it was likely to have the ability to conduct R&D more successfully*".[184]

452. The Parties submit that, contrary to any detrimental effect, the Transaction will rather enhance the level of R&D and innovation being undertaken by the Parties. In its Horizontal Merger Guidelines, the Commission recognises that one of the efficiency gains of a merger may relate to R&D and innovation.[185] Indeed, [Confidential].

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[181] See http://www.cbsnews.com/news/why-the-pie-face-game-is-flying-off-shelves/.

[182] See for example Dennis W. Carlton & Robert H. Gertner, Intellectual Property, Antitrust and Strategic Behavior, University of Chicago, National Bureau of Economic Research (Abstract, May 2002) at 13, reprinted in Adam Jaffe & Joshua Lerner, 3 Innovation Policy and the Economy 13 (2003) and Richard Gilbert & Willard Tom, Is Innovation King at the Antitrust Agencies? The Intellectual Property Guidelines Five Years Later, 69 Antitrust L.J. 43, 83 (2001).

[183] Philippe Aghion, Nick Bloom, Richard Blundell, Rachel Griffith and Peter Howitt, "Competition and Innovation: An Inverted-U Relationship" The Quarterly Journal of Economics, Vol. 120, No. 2 (May, 2005), pages 701-728.

[184] Statement of Chairman Timothy J. Muris in the matter of Genzyme Corporation/Novazyme Pharmaceutcals, Inc., File No. 021 0026.

[185] Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings, 2004/C 31/03, paragraph 81.

453. As set out in greater detail in **Annex 1**, LeapFrog was struggling financially and heading for bankruptcy. But for the Transaction, LeapFrog would likely have exited the market[Confidential]

454. VTech's acquisition of LeapFrog therefore ensures continuity of the LeapFrog brand, fostering the R&D of LeapFrog products and innovation. As mentioned above at paragraphs 66 to 67, VTech's rationale for the Transaction includes [Confidential]. An example of this is the successful acquisition of Fisher-Price by Mattel. Mattel integrated the Fisher-Price business but kept the R&D office in East Aurora, which enabled the brand to remain separate and successful within the Mattel portfolio, in contrast to its experience with Radica, which was acquired in 2006 but was not successful and is therefore no longer perpetuated, though it remains in Mattel's ownership. In order for both brands to remain competitive, the Parties will be required to ensure that their product offering, product quality, price and level of innovation are maintained. Given Mattel's [Confidential]% market share in the Infant/Toddler/Preschool super-category in 2016 to date (see **Annex 17**), the VTech and LeapFrog brands, with market shares of [Confidential] and [Confidential]%respectively, will need to ensure that they continue to develop new products that capture consumer attention, for which on-going successful innovation is key.

455. In fact, the Parties submit that the Transaction has already delivered on increased innovation, with LeapFrog (under VTech stewardship) set to launch [Confidential].

VII.3 Existence of countervailing factors

456. Should the Panel be minded to find that the Transaction may give rise to a substantial lessening of competition, the Parties submit that there are countervailing factors which will prevent any finding of a substantial lessening of competition.

VII.3.1 Buyer power

Indispensability of retailers

457. The toy industry is supply-driven with around [Confidential] manufacturers offering thousands of different toys to end-consumers. Indeed, last year alone saw [Confidential] new toys introduced in the UK. Further, toy manufacturers (other than retailer own-label) do not operate their own retail outlets and typically make only limited direct sales via their own websites.

458. In order to reach end-consumers, and thereby sell their product, manufacturers therefore require access to retailers' stores. If a toy is to have any chance of success it must be able to reach as many consumers as possible. Further, a significant proportion of end-consumers make impulse purchase decisions simply while browsing the range of available products in-store.

459. In this regard, Figure 2 illustrates that a significant number of end-consumer purchases, even to a degree those purchases made online, are influenced by instore displays. This highlights the critical importance to a manufacturer of having as many of its products as possible on retailers' shelves.

460. It follows that end consumers do not necessarily go into a store with a specific product in mind but rather are looking for a toy to achieve a certain purpose (e.g. entertaining and/or educating their child) from a vast range of alternatives. This makes retailers an indispensable trading partner to toy manufacturers, but not *vice versa*.

Major UK retailers represent a significant majority of the Parties' sales

461. As can be seen from **Annexes 3** and **4**, the Parties' top 5 customers accounted for [Confidential] (VTech) and [Confidential] (LeapFrog) of their total sales in 2015. Reflective of the importance of retailers to the Parties' business, the Parties' major customers also comprise the UK's top retail chains.[186] These major retailers are therefore critical to the Parties in ensuring that their products reach the widest possible consumer audience.

462. Each of these retailers represent trusted brands in the eyes of consumers and, as a result, consumers will trust the products that are on their shelves (including own-label). This gives the retailers significant scope to determine their product range and means that the Parties' products (particularly across their wider range) are not indispensable.

Retailer substitution can be wide and varied

463. Retailers have limited space (in terms of shelving, catalogue or both) on which to display products and therefore optimise this space by choosing products that generate the greatest return on the available space from the wide variety of manufacturers' available. If a particular product or brand is less profitable, either because it sells less volumes or generates a lower margin, then all else equal it makes sense to devote a lower amount of shelf space to this product in favour of higher margin, higher selling products.[187] This is especially the case in toy retailing given the key role that retail displays play in driving customer purchase decisions.

464. In this regard, retailers have a significant amount of freedom in their ability able to substitute across a range of products, brands and categories (either by allocating more or less space or dropping a line entirely) to determine their optimal product mix and maximise their expected return (including, in particular, own-label and less-well known third party products). By way of example, **Annex 8** (referred to above in paragraph 179) shows clearly the changing space in an Argos catalogue from 2013 to 2016. In a similar vein the Parties note that child tablets would once occupy a number of bays within a retail premises but now are lucky to receive half a bay.

465. This position is true of both specialist toy retailers, who select between a wide variety of toys and can reduce or increase the space dedicated to certain categories, as well as generalist retailers who not only have more limited shelf space to dedicate to toys but who can substitute not only between toy categories but also other consumer goods. This ability can be clearly seen in the Parties' negotiations with retailers, as exemplified in the Annexes summarised below:

- **Annex 19** illustrates [Confidential].
- **Annex 20** suggests that [Confidential].
- **Annex 21** [Confidential].

466. Consequently and as seen in **Annex 20**, the Parties must offer retailers attractive packages in order to have not only their more popular products selected but also encourage retailers to take their wider range. The importance of promoting toys through

[186] See the latest quarterly IMRG comScore Retailer Ranking: https://www.imrg.org/media-and-comment/top-50-retailer-ranking/imrg-top-50-retailer-ranking-jun-2016/

[187] This ability to substitute across products, brands and categories will be constrained by the expectation of end consumers to be able to find the product they are looking for. For example consumers value the ability to see a range or products and therefore the retailer will want to ensure that this range exists. However on the margin, a retailer can easily switch out a product or brand without significantly affecting this consumer expectation.

retailers, and the retailers' ability to choose from a wide range of options in defining their product mix, means that toy manufacturers continuously strive to achieve the most favourable listings and support possible.

467. This is done both by demonstrating the commercial attractiveness of their products (from an end-consumer perspective) but also in terms of retailer margin and promotional support. Indeed as discussed below, the importance of the range can clearly be seen by the fact that retailer negotiations occur on the full range of products rather than individual products. This places the Parties in an unequal bargaining position *vis-à-vis* retailers given the need to have their range placed, regardless of whether they have one of the season's "hot" toys within their product range.

468. Reflective of this dynamic, in setting its list prices VTech for example endeavours to achieve a [Confidential] margin for the retailer. However, due to ease of substitution by retailers and the inequality of bargaining position which this brings, VTech is either unable or has no incentive to increase its list price to retailers (and consequently lower the retailer's margin):

- where the product is "hot" and therefore on a consumer's wish list. While the retailer is likely to want to stock it, VTech cannot increase list price as it needs to encourage the retailer to take other products in its range as well as protect the goodwill of their on-going commercial relationship;[188] and
- where the product is not "hot". In this scenario the retailer simply won't accept a price increase or reduction in margin as it will merely decide not to list the product and fill the shelf/catalogue space with alternative products.

Prices/terms are negotiated across the product range

469. [Confidential]:

- [Confidential].
- [Confidential].

470. [Confidential] Even when a manufacturer has a "hot" toy, it is unable to significantly exploit this fact with retailers given that it still wants to place as much of its range as possible with the retailer. Because retailers have many alternatives to manufacturers' toys across the range, the threat not to take the full range is more than sufficient to discipline the manufacturer in its pricing of "hot" toys.

471. In this context, retailers have the power and the ability to choose not to stock the Parties' products and switch to competing toys in the event of a price increase, deterioration of terms or reduction in quality by the Parties. While this may not manifest itself in a complete removal of the Parties' products from the retailers' shelves it is common that retailers simply take a narrower range and refuse to support certain of the Parties' products. This asymmetric nature of the dynamics of price negotiations reflects the strong bargaining position of retailers, a position which the Transaction does not change.

472. Correspondence provided in response to question 21 of the CMA's letter to VTech dated 30 August 2016 commencing Phase II (the "**CMA's First Day Letter**") illustrates that retailers exert pressure on the Parties to improve the retailer's margin across the range:

[188] It is worth noting that at the time VTech is in discussions with retailers on trading terms/product range it does not necessarily know whether a particular product is likely to be a "hot" product.

- **Annex 22** [Confidential].
- **Annex 23** [Confidential].
- **Annex 24** [Confidential].
- **Annex 20** [Confidential].
- **Annex 25** [Confidential].
- **Annex 26** [Confidential].
- **Annex 27** [Confidential].
- **Annex 28** shows [Confidential].

473. Furthermore, Annexes C.5B19 – C.5B20 to the Consolidated Response show a [Confidential].

474. [Confidential].

- **Annex 29** shows [Confidential].
- In **Annex 30** [Confidential].
- In **Annex 31** [Confidential].
- **Annex 32** shows that [Confidential].
- **Annexes 33A and 33B** clearly [Confidential].

475. Similarly, as referred to in response to question 14 of the Phase II Market Questionnaire, [Confidential].

476. The above illustrates that while the Parties may not agree to every individual request made by a retailer, they face constant pressure to deliver better margins/promotional support to maintain their listings and mitigate the effects of underperforming products. In order to continue to encourage retailers to take as much of their product as possible the Parties are required to show flexibility and work with the retailers as part of an on-going trading relationship.

477. Furthermore, from the above it can be concluded that in the event of a price increase, the retailers would easily be able to delist some or all of the Parties' products such that associated lost volumes would render any attempted price increase unprofitable. Similarly, retailers could choose to penalise the Parties by delaying product launches, withholding access to promotional periods or displaying the Parties' toys in a less prominent place on the shelf or in a catalogue.

Retailers' ability to develop their own white-label products or encourage a new entry significantly strengthens their buyer power

478. As noted above, a critical element to making sales is access to shelf space sufficient to reach the widest audience possible. Consequently, larger retailers have the ability and the power to make shelf space available (and agree favourable terms) to a new toy entrant or to promote their own-label brand. Further, as retailers can generate better margin on such products they have every incentive to do so.

479. For example, with respect to tablets the Parties note that:

- Binatone, a supplier of telecommunication products, entered the child tablet sector in 2012 with the launch of Kidzstar/Appstar, which was sold through Argos under an exclusive arrangement. The tablet was subsequently dropped from Argos' catalogue in 2014.
- Tesco launched a range of low-cost tablets Hudl in 2013 and Hudl 2 in 2015 which were particularly popular with parents before it recently discontinued production.
- Amazon launched a child version of its Fire tablet, the "Fire Kids Edition" in 2015. Before its launch, Amazon had no history in the toy industry but their presence in the retail market, aggressive pricing and marketing strategy have secured them a competitive position in the child tablet sector.

480. With respect to infant/toddler toys the Parties note that each of their key customers have their own product lines operating under successful and well-known brands:

- Mothercare's Early Learning Centre brand, which includes toys with electronic and/or learning features;
- Argos's Chad Valley brand, which includes a wide selection of toys including basic child tablets, smartphones and other electronic learning toys;
- Tesco's Carousel brand, which includes toys with electronic and/or learning features;
- Sainsbury's own-label, which includes toys with electronic and/or learning features;
- John Lewis's own-label, which includes toys with electronic and/or learning features; and
- Toys-R-Us Bruin brand, which includes a wide selection of toys including basic child tablets, smartphones and other electronic and/or learning toys.

481. Further, retailers will also stock a range of unbranded (or relatively less well-known) toys produced by manufacturers based in the Far East alongside their own-label and manufacturer branded products.

482. The comparatively attractive margins *vis-à-vis* manufacturer branded products means that retailers are heavily incentivised to devote significant (and prominent) shelf space to their own-branded (or non-branded) products as end-consumers generally do not differentiate between retailers' toy brands and manufacturers' toy brands. Further, as noted above, as major retailers are trusted consumer brands, consumers will trust that the toys put on the retailers' shelves and hence own-branded products are not at a disadvantage. This is illustrated by Figure 15 below which shows that brand/manufacturer play a relatively limited role in purchase selection.

[Confidential]

483. Rather, all that is important is that the product features and appearance sufficiently appeal to consumers. In addition, given the retailer is able to capture greater margin, the prices of their own-branded (or non-branded) products is highly competitive. Retailers' ability, incentive and advantageous position in promoting their own-branded products (or sponsoring less known brands) puts additional pressure on the Parties to meet retailer demands for better terms/improved margins.

Conclusion

484. In summary, the Parties submit that the toys market is characterised by significant buyer power for a number of reasons, including:

- the indispensability of retailers for manufacturers to access consumers;
- the majority of the Parties' sales being attributable to a few major retailers;
- the ability for retailers to substitute across a wide and varied range;
- [Confidential] coupled with the need to encourage retailers to take as many products within the Parties' range as possible; and
- the ability of retailers to develop their own-label products (or support less well known brands) at attractive margins.

485. Such buyer power is a feature of the toys market and will continue to pose a significant and unavoidable constraint on the Parties' ability to raise their prices as a result of the Transaction.

VII.3.2 **Barriers to entry and expansion are not significant**

486. The toy industry has no significant barriers to entry. Competition is based primarily on the ability to design and develop new toys, to procure licences for popular characters and trademarks and to successfully market products.

487. There are a wide variety of manufacturers with different positions within the Infant/Toddler/Preschool segment with different propositions. [Confidential]. Such entry can take place because:

- Competition is based primarily on the ability to design and develop new toys, to procure licences for popular characters and trademarks and to successfully market products. There are limited technology, know how, or capital requirements, and manufacturer brand loyalty plays a minor role.
- Licences make it relatively easy to enter into a category/segment: Licensors have an incentive to widely license in order to ensure their product is widely seen, whereas there is no incentive to provide exclusive licences.
- Any opportunity is quickly duplicated by many toy companies – showing that barriers to expansion are low.
- Limited technology and/or know how required:
  - the development and manufacturing of toys is not a technology intensive industry. It is not necessary to rely on any proprietary technology, patents or intellectual property owned by other manufacturers;[189]
  - furthermore when the technology in the wider world becomes affordable and appropriate for children, toy manufacturers endeavour to develop new products and attempt to bring that idea to the toy industry. In this regard, toy manufacturers are able to "piggy-back" on developments in the core technology (i.e. the more sophisticated product) without the need to conduct their own extensive R&D.

[189] See response to question 30 of the Phase II Market Questionnaire.

- Low capital requirements: capital requirements for the R&D, manufacturing, advertising/marketing and supply/distribution phases in the manufacture of a toy are low.
- Manufacturer brand loyalty:
  - given the existence of changing consumer preferences, brand loyalty plays a less important role in the toys industry. As mentioned above, from a consumer's perspective, retailer brand awareness is as important if not more important than manufacturer brand awareness.
  - furthermore as consumer preferences can change fairly quickly, in many cases it is the smaller toy manufacturers or new entrants to the toys market which are able to more quickly spot the latest trends rather than the existing toy suppliers. For example, smaller manufacturers such as IMC Toys, Bandai and Esdevium Games all increased their sales over GBP [Confidential] million in the financial year 2015 according to data from NPD.[190]
  - finally, given that [Confidential], and (iii) all retailers multisource toys from a large number of suppliers, there are no significant costs for retailers to switch the supply of certain toys to a new supplier.

488. Furthermore new entry and/or expansion in the toy industry may occur within a short space of time:

- The developmental phase for VTech products tends to be between [Confidential] months whilst for LeapFrog it is normally approximately [Confidential] months. The developmental phase does not require extensive resources or access to technology;
- Following the development of a toy prior to its production, toy manufacturers normally solicit orders for a prospective toy from the retailers who indicate the number of anticipated orders for that particular toy. Products with sufficient demand from retailers would then be sent for manufacturing (whilst products which did not see sufficient orders would not). Accordingly, manufacturing involves only limited risk of oversupply for the toy manufacturer.
- Following the launch of a product, "hot" new toys are able to gain a substantial share of supply relatively quickly and certainly within 12-24 months. For example, in 2015:
  - Spin Master experienced a [Confidential] growth in sales value, predominantly based on the popularity of its Paw Patrol products which were launched in 2013;[191] and
  - the Flair Preziosi Group experienced a [Confidential] growth in sales value, predominantly based on its distribution in the UK of its Shopkins products which are developed by Australian-based Moose Toys and which were launched in the summer of 2014.[192]

[190] Annex B.23B to the Consolidated Response, page 18.

[191] See NPD report submitted as Annex B.23B to the Consolidated Response, at page 15.

[192] See NPD report submitted as Annex B.23B to the Consolidated Response, at page 15.

The two examples mentioned above involved relatively unsophisticated toys requiring low expenditure and time required for design and manufacture:

– Paw Patrol products, include a selection of basic plastic vehicles and soft toys; and

– Shopkins products include a selection of moulded plastic food-related characters and products. In 2015, [Confidential] alone generated more revenue in the UK than the entire Preschool Electronic Learning NPD sub-class – approximately GBP [Confidential] million and GBP [Confidential] million, respectively, a year-on-year increase of [Confidential]. This is an example of a company proactively seeking a toy that was a best-seller elsewhere; the Flair Preziosi Group merely distributed an already-developed line of products.

489. In addition to developing new products from scratch, entry and/or expansion is also possible by using "white-label" products which can be sourced from third-party manufacturers. In such cases, no plant or machinery is required, therefore no capex need necessarily be incurred in relation to fixed assets. It is also not necessary to rely on any specific proprietary technology, patents or intellectual property and, if required, product design and development can be outsourced to a third party design agency. VTech estimates that the working capital to purchase 50,000 white-label products at GBP 10.00 each, combined with the other costs such as safety certification and the like, would be [Confidential].[193]

490. Finally, larger customers would also be able to (and have in the past) sponsor new entry or expansion by guaranteeing shelf-space/listing prominence to a new entrant. New entry can also be sponsored by licence holders such as Disney. For example:

- [Confidential] of the overall "top 20" toys in 2015 according to sales value (as per NPD sell-through data) was made up of Disney licensed toys, which evidences Disney's strong bargaining position *vis-à-vis* manufacturers who need such licence due to its well-known set of Disney characters (e.g. Frozen and Star Wars).[194]
- In 2015, [Confidential] out of 23 of VTech's UK software cartridges were Disney licensed products. Given its brand strength, Disney could easily sponsor new entry in any segment of the toys market.
- Furthermore, the Parties also understand that the entry by Binatone in children's tablets/laptops in the UK in 2012 may have been sponsored by Argos who, at the time already had an existing contractual relationship with Binatone.[195]
- In its Reference Decision, the CMA notes that only one retailer who replied to the question on new entry sponsorship during the Phase I investigation indicated that it had sponsored new entrants in the UK.[196] However the Parties note that in total only five retailers responded to that question, meaning that "*the majority of respondents did not answer these questions*" as highlighted by the CMA. Therefore one is unable to draw robust conclusions given the lack of engagement from third parties.

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[193] Based on an exchange rate of 1/0.8069 on 10 October 2016.

[194] See NPD report submitted as Annex B.23B to the Consolidated Response.

[195] See response to question 33 of the Phase II Market Questionnaire.

[196] See paragraph 246 of the Reference Decision.

491. In conclusion, the Parties submit that barriers to entry in the toy sector are low. This also applies to barriers to expansion.

492. Manufacturers are able to easily switch between product categories within the toys market. For example, VTech launched its Little Love dolls in the UK in 2014, following initial success in France as a new entrant in the dolls segment of the toys market. In 2015, VTech achieved a [Confidential] share of the dolls segment in France, and a [Confidential] share in the UK. VTech's entry into the dolls segment followed a development period of approximately two years, at an estimated product development cost of approximately USD [Confidential].

493. Switching between categories is also possible by acquisition. For example, in January 2016 Mattel acquired Fuhu, manufacturer of the child's nabi® Android tablet. The nabi® tablet was launched in the USA in September 2016.

494. Similarly, expansion also occurs by manufacturers not traditionally present in the toy industry. For example, in Q4 2013 Samsung launched the Galaxy Tab 3 Kids Android tablet based on its popular Galaxy Tab 3 tablet. Similarly, in Q4 2014 Amazon, the world's largest online retailer, launched the Fire Kids Edition, a fully-featured Android tablet based on its popular Fire tablets.

495. The seamless expansion of manufacturers into different toy segments confirms that any finding of a substantial lessening of competition in any of the product markets identified by the CMA would be offset within 12-24 months by new entry or expansion.

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496. The CMA recognises in its Merger Assessment guidance that any entry or expansion which might prevent any substantial lessening of competition must be:[197]

- timely: as noted above, the developmental and manufacturing phase for new toys is normally 12-24 months;
- likely: as noted above, capital and technology/know-how requirements are low, and brand loyalty plays a minor role. Furthermore as mentioned above there are numerous examples of successful new entries/expansion; and
- sufficient: as children's tastes change rapidly, there is scope for new entrants to supply products addressing the latest trends not covered by existing toy suppliers, and for existing suppliers to expand/adjust their product range. Such entry can be significant depending on the demand for the particular product.

497. For the reasons set out above, the Parties submit that any potential substantial lessening of competition resulting from the Transaction would be counteracted by the ability of rivals (both actual and potential) to enter and expand in the relevant segments.

VII.3.3 The Transaction will create efficiencies

498. The primary consumer benefit resulting from the Transaction is the survival and continuation of LeapFrog – as part of VTech – in the UK (please see section III.3 above). Had LeapFrog exited the UK, as was highly likely absent the Transaction, consumer choice would have been reduced.

[197] See paragraph 5.8.3.

499. Moreover, as mentioned above in section VII.2.4 consumers will benefit from rejuvenated new product development, which had stalled as part of LeapFrog's attempts to cut costs. Consumers will benefit from greater innovation and higher quality products than if the Transaction had not taken place.

500. VTech's decision to acquire LeapFrog was driven by the expectation that the Transaction would create efficiencies. These efficiencies will be passed on to consumers:

(a) [Confidential].

(b) [Confidential].

(c) [Confidential].

(d) [Confidential].

501. These efficiencies will be passed through to consumers given the continued competitive constraints, retailer buyer power and ability for strong rivals to enter or expand as described above.

VIII. CONCLUSION

502. The Parties submit that, as described in detail throughout the above sections, the Transaction cannot plausibly be considered to have the effect of substantially lessening competition on any market in the UK. On the contrary, the Transaction represented an opportunity to rescue the LeapFrog brand and capabilities from certain bankruptcy and provides VTech with a largely complementary offering focused on educational content that it intends to develop further.

503. The key factors on which the Parties base the above conclusion are as follows:

(a) LeapFrog was clearly a failing firm. Without a significant, and immediate, injection of capital LeapFrog would have declared bankruptcy as early as [Confidential]. VTech represented the only credible purchaser that could execute a transaction in the time required to avoid further significant losses for shareholders.

(b) Absent the Transaction, the Parties consider that LeapFrog would have exited the market with, at best, another company picking up the LeapFrog brand on liquidation. VTech considers that it was uniquely placed to best preserve the LeapFrog brand, reputation and expertise and indeed executed the Transaction prior to bankruptcy to ensure this. In either scenario, LeapFrog as an already significantly reduced competitive force at the time of the Transaction would have ceased to exist.

(c) Irrespective of the above, the Parties consider that the market definitions used by the CMA in its Reference Decision are too narrow and do not reflect the competitive dynamics in which the Parties (and their various competitors) operate. Such narrow definitions fail to take into account the multi-faceted demand stemming from both consumers (who make decisions based on a wide variety of considerations) and retailers (who seek to maximise their return on limited shelf space from a multitude of alternatives).

(d) Further, the toy industry is extremely dynamic with consumer preferences changing rapidly and new trends developing. Indeed, approximately [Confidential] of products are refreshed/replaced each year as suppliers continue to develop new concepts to keep up with consumer demand. In this regard, the Parties must constantly innovate in order to remain successful. This incentive will be just as strong as a result of the Transaction and, in fact, the Transaction represents an opportunity for VTech to expand its focus on innovation.

(e) Even looking at the narrow segments which the CMA identified in Phase I, the Transaction does not give rise to a substantial lessening of competition. In particular, the Parties have already explained the limitations of using NPD data by sub-class to calculate market shares:

(i) With regard to their infant/toddler toys (primarily TEL products) the Parties face strong competition from a significant number of existing competitors (including, Mattel, Tomy, Clementoni and Hasbro), unbranded lowcost Chinese manufacturers as well as numerous strong retail brands (including Argos' Chad Valley, MotherCare's ELC and Tesco's Bruin Bear). Further, the Parties' are also constrained by the ease with which suppliers in other toy categories can adjust their product mix to supply the Infant/Toddler category.

(ii) With regard to their tablets/laptops, the Parties are faced with a declining market replete with numerous competitors offering tablets specifically targeted at children (such as Kurio, Amazon, DragonTouch, Samsung and Mattel) as well as wider constraints from non child-specific tablets (including the iPad and a host of Android based devices) coupled with now widely available child safe content across all such devices. Further, should the opportunity once again arise, additional suppliers could re-enter the market on the back of widely available hardware from a plethora of Asian manufacturers.

(iii) With regard to so called “child electronic reading systems”, the Parties do not have a competing offering. VTech had independently determined to abandon the development of its [Confidential] concept due to [Confidential]. In any event VTech’s concept is a far cry from LeapFrog’s LeapReader product with a significantly different focus (entertainment rather than education) and functionality.

(f) Finally, the Parties will continue to be significantly constrained by their retailer customers who essentially act as gate keepers to consumers and without which the Parties cannot make sales. The 5 main retailers represent around [Confidential]% of the Parties’ sales and are thus critical trading partners Retailers seek to maximise their return on limited shelf space and their ability to substitute across a wide range of products/suppliers enables them to discipline any purported price increase on the part of the Parties.

504. The Parties therefore consider it evident that the Transaction will not have the effect of substantially lessening competition on any plausible market or markets in the UK.

Linklaters LLP

11 October 2016

Annex 1: Detail on the Appropriate Counterfactual[1]

1. As the CMA is aware, the Guidelines provide for a three-stage analysis when considering a "failing firm" scenario[2] as the counterfactual. The CMA must be satisfied on the balance of probabilities that:

(i) It was inevitable that the firm would exit the market. The CMA will consider the firm's ability to meet its financial obligations in the near future and its ability to restructure itself successfully.

(ii) There was no substantially less anti-competitive alternative buyer for the firm or its assets. The CMA will look at available evidence that the merger under consideration was the only possible merger (i.e. that there was genuinely only one possible purchaser for the firm or its assets).

(iii) The failure of the firm was not a substantially less anti-competitive outcome (i.e. was not substantially pro-competitive) relative to the merger.

I. Limb 1: LeapFrog would have exited the global market but for the Transaction

2. The Securities and Exchange Commission ("**SEC**") filings on behalf of LeapFrog relating to the Transaction, internal Board documents, materials produced for the Board by Morgan Stanley (LeapFrog's advisors in the sale process) and the analysis undertaken by CRA demonstrate that LeapFrog was, in every sense of the word, a failing firm. In particular:

- LeapFrog became a consistently loss-making business in FY2015. [Confidential].
- [Confidential][3].
- LeapFrog's share price fell below USD 1 in September 2015 which put in jeopardy its listing on the New York Stock Exchange.
- LeapFrog's own cashflow estimates predicted [Confidential].
- [Confidential].

I.1 Existential financial distress and failed restructuring attempts

3. It is clear from LeapFrog's own internal financial statements, the statements made in SEC filings and by its Board of Directors and the analysis conducted by CRA, that LeapFrog was in serious financial distress in 2015, due [Confidential]. The commercial history is not recounted in further detail in this Annex, as the most salient point for purposes of the counterfactual is not how LeapFrog arrived in its precarious state, but the precariousness of its condition itself.

4. In its most recent financial report prior to the Transaction, LeapFrog reported comprehensive losses of USD 107.2 million for the nine-month period ending 31 December 2015[4]. This followed losses of USD 145.5 million for the same period in 2014.

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[1] Terms have been defined as in the Submission.

[2] Merger Assessment Guidelines, paragraphs 4.3.8 to 4.3.18.

[3] See Discussion Materials for Board of Directors Presentation by Morgan Stanley, 4 February 2016 (Annex 8G of the Response to Section 109 Notice of 20 May 2016).

[4] See LeapFrog Quarterly Report on Form 10-Q, 9 February 2016 ("**LeapFrog 10-Q**"), available at: http://www.sec.gov/Archives/edgar/data/1138951/000114420416080034/v429658_10q.htm.

5. LeapFrog's grave financial issues and perceived mismanagement were noted and criticised by at least one stockholder, Blue Pacific Partners, in an open letter to the Board dated 15 July 2015[5]. The letter concluded that "*LeapFrog is not positioned to withstand multiple years of large financial losses*" and demanded a change in the strategy and management of the company.

6. LeapFrog's quarterly SEC report emphasised the substantial risk that it would not be able to continue normal business operations beyond mid-2016:

> "*[LeapFrog] currently believe that liquidity available to fund its operations during the first two quarters of fiscal 2017 [i.e. from April 2016], when its use of cash increases as it builds inventories and experiences seasonal declines in revenue, may be insufficient to permit it to continue normal operations, and there is substantial doubt about [LeapFrog's] ability to continue as a going concern*".[6]

7. Despite numerous and multi-pronged attempts to restructure its business, LeapFrog had not been successful in reducing costs. LeapFrog attempted to restructure its business through measures such as:

- reducing its headcount by approximately 45% between January 2015 and March 2016, from [Confidential] to [Confidential] persons[7];
- reducing worldwide inventory to USD [Confidential] million by March 2016, compared with USD [Confidential] million a year earlier;
- subleasing (i) approximately 50% of LeapFrog's global headquarters in Emeryville, California; and (ii) warehouse space, to generate additional income and offset rental expenses;
- [Confidential];
- deferring the development of new products[8];
- reducing other budgeted spend, such as advertising costs;
- [Confidential];
- general reductions in overheads and expenses, [Confidential].

8. Even after undertaking this extensive cost-cutting programme designed to [Confidential], LeapFrog still expected [Confidential].

9. In short, LeapFrog's attempts to restructure its business were unsuccessful and it continued to make losses despite these actions. Furthermore, LeapFrog considered that alternative approaches to improving liquidity, such as making changes to vendor terms and accelerating the collection of receivables, were unlikely to compensate for the liquidity impact of its poor performance.[9]

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5 See http://www.prnewswire.com/news-releases/blue-pacific-partners-delivers-letter-to-leapfrog-board-300113435.html.

6 LeapFrog 10-Q. at page 7.

7 [Confidential].

8 LeapFrog 10-Q, at page 7.

9 LeapFrog 10-Q, at page 7.

I.2 Appointment of Morgan Stanley to conduct sales process

10. In light of the desperate situation of LeapFrog, Morgan Stanley was retained in 2015 to administer the process of soliciting offers for the acquisition of the business as a means to recovery.

11. As discussed in further detail below, Morgan Stanley marketed the LeapFrog business to more than 60 potential purchasers, including trade parties and private equity firms. With the singular exception of VTech, none of the parties ultimately made a firm bid or could have completed the necessary due diligence to implement a transaction before LeapFrog would have been placed into voluntary liquidation by its board of directors in as early as [Confidential]. These points are set out in more detail under Limb 2 below.

12. Ultimately, an acquisition by VTech was considered to be likely to provide an outcome [Confidential] demonstrating the depth of LeapFrog's financial difficulties.[10] VTech was similarly concerned that the LeapFrog brand and business would suffer irreparable damage as a consequence of business disintegration inherent in the liquidation process. It was also cognisant that capitalising on the brand alone, in isolation from the assets that had made the brand what it was, would be too difficult, even for such an otherwise synergistic purchaser as VTech.

13. LeapFrog acknowledged the seriousness of its financial condition in its February 10-Q SEC filing, stating that:

> "*If the [Transaction] or another transaction providing [LeapFrog] with substantial liquidity is not completed, [LeapFrog] will likely face substantial difficulties in generating sufficient liquidity to continue normal operations over the first two quarters of Fiscal 2017 [i.e. from April 2016]*".[11]

14. The need for immediate action was reiterated in a separate SEC filing made on 25 March 2016, ten days before the closing of the Transaction. In that filing, the Board recommended that stockholders reject an alternative proposal made by L&M because of the time it would have taken to complete that transaction, discussed further below:

> "*Concerning timing, a significant delay in the completion of the merger could put at risk the ability of [Leapfrog] to continue operations. The draft merger agreement submitted with the [L&M proposal] suggested a closing date of May 23, 2016 [...] [LeapFrog] disclosed in its Form 10-Q filed on February 9, 2016 that if the VTech transaction or another transaction providing [LeapFrog] with substantial liquidity were not completed, [LeapFrog] would likely face significant difficulties in generating sufficient liquidity to continue normal operations over the first two quarters of Fiscal 2017, from April 1 through September 30, 2016. The Board considered advice from senior management that <u>[LeapFrog] would have insufficient liquidity</u> <u>to continue normal operations, including building inventories for the 2016 holiday season,</u> <u>beginning in late May or June, 2016</u>. Consequently, <u>any possible delay in the timetable for</u> <u>closing a transaction with [L&M] could seriously jeopardize the survival of LeapFrog</u> and its ability to complete any transaction. In addition, the [Transaction] is scheduled to close as early as April 4, 2016. The Board concluded that pursuing the [L&M proposal], as proposed, at this late date would <u>expose [LeapFrog's] stockholders to additional, significant</u>*

[10] See page 2 of Annex C.8H to the Consolidated Response and Minutes of the Board of Directors' Meeting of LeapFrog of 4 February 2016.

[11] LeapFrog 10-Q, at page 26.

risk of losing the premium implied by the [Transaction] and the ability to close an alternative transaction"[12] (emphasis added).

I.3 Position of Bank of America as LeapFrog's only lender

15. As noted in the CRA report, LeapFrog's month-end cash balance forecasts were projected [Confidential]. In order for LeapFrog to continue trading during and after that period of overdrawn bank positions, immediate funding or credit facilities sufficient to cover the negative bank balances would have been required. LeapFrog had noted in its quarterly results that there was "*substantial doubt about [LeapFrog's] ability to continue as a going concern*".[13]

16. LeapFrog's only credit facility or borrowing in place at the announcement of the Transaction was an August 2009 facility agreement with Bank of America ("**BofA**") for a loan up to USD 75 million, which had not been utilised, and was formally due to expire on 1 May 2017.

17. The facility had already been reduced to USD 50 million during the months of January to August 2016.[14] [Confidential].

18. [Confidential].

I.4 [Confidential]

19. [Confidential]. He updated the Board at least once to inform them that he had begun to speak with [Confidential] to understand the options. The fact that the [Confidential] is further evidence that LeapFrog's position was dire by early-2016.

I.5 [Confidential]

20. [Confidential].

I.6 Voluntary liquidation in lieu of becoming cash flow negative

21. As such, the prospect of LeapFrog's bankruptcy was likely to materialise at the point at which its [Confidential] because [Confidential]. LeapFrog did not expect that it could enter into a new financing agreement,[Confidential].

22. As such, LeapFrog considered that its only option to cover its [Confidential] was an acquisition by a third party that was in a position to cover the [Confidential]. Failing this, LeapFrog's forecasted [Confidential] beginning in [Confidential] would have been fatal to its liquidity and its only one remaining option would have been to enter into voluntary liquidation as early as [Confidential]. The Board is likely to have taken action to preserve some value before this date and before the worst of the [Confidential] were reached [Confidential] (i.e. in order to preserve any remaining value for stockholders). As discussed further below, such a course of action would have represented a safer and more profitable option than a sale to any party that expressed interest in LeapFrog other than VTech, none of which had submitted viable or binding offers to LeapFrog in any event.

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12 See LeapFrog Schedule 14D-9 filed with the SEC on 25 March 2016, available at: http://www.sec.gov/Archives/edgar/data/1138951/000110465916107507/a16-5335_4sc14d9a.htm., ("**LeapFrog SC14D9**").

13 LeapFrog 10-Q, at page 7.

14 See in CRA Report, Exhibits 3 and 4: Bank of America Borrowing Base Certificate, 31 January 2016 and 29 February 2016.

23. In conclusion, LeapFrog was a failing firm for which the most likely outcome but for the Transaction, and notwithstanding its comprehensive restructuring efforts, would have meant exiting the market as early as [Confidential] by way of voluntary liquidation.

II. Limb 2: No credible alternative purchaser

II.1 Exhaustive marketing efforts by Morgan Stanley

24. As set out in SEC filings and in documents prepared by Morgan Stanley, Morgan Stanley engaged in extensive marketing of LeapFrog. It initially approached 53 different parties, commencing on 21 July 2015[15]. The parties initially approached included 25 trade parties (mainly toy manufacturers and technology companies) and 28 private equity firms (see **Annex 1A**). When these parties failed to yield any offers, a further 12 parties were approached. Of all these, no serious bidders other than VTech emerged with the capacity to close a transaction before LeapFrog's liquidity crisis was likely to have materialised.

II.2 Morgan Stanley's Illustrative Liquidation value

25. The Guidelines state that the CMA will in any event only take into account the prospects of alternative offers above liquidation value.[16] Morgan Stanley's "Illustrative Liquidation Analysis" of 12 November 2015 indicated that the liquidation value of the business was [Confidential]. However, irrespective of Morgan Stanley's assessment of liquidation value (which was by its own admission a non-expert assessment, albeit the only one available to LeapFrog management) there were no other credible offers that were timely.

II.3 Position of LeapFrog stockholders

26. By way of context to the approval process of an interested party, the balance of power to approve an acquisition of LeapFrog rested in the hands of Class B stockholders. Without their approval of a proposed offer, an acquisition of LeapFrog could not proceed. This point was made in LeapFrog's 10-Q noting that:

> "*[t]his significant influence by a few stockholders could deter, delay or prevent a change in control of LeapFrog; or affect other significant corporate transactions that otherwise might be viewed as beneficial for other stockholders*"[17].

27. See **Figure 1** for an illustration of the relative rights attaching to Class A and Class B stockholders. In short, Class B common stock carry ten votes per share on all matters. Class B common stockholders have various additional voting rights, including the right to approve the issuance of any additional shares of Class B common stock and any amendment to the certificate of incorporation that adversely affects the rights of Class B common stockholders.

Figure 1: Structure chart to show stock ownership and voting power[18]

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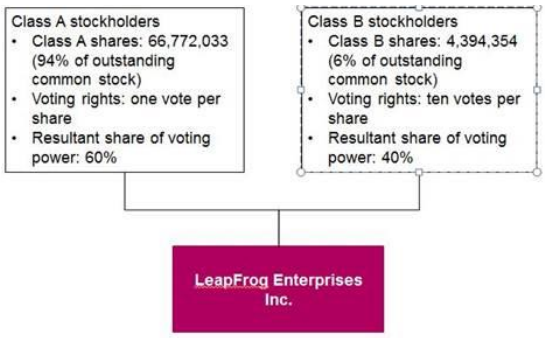
[15] See, for example: (i) LeapFrog SC14D9, at page 14; and (ii) Annex C.23P of the Consolidated Response.

[16] Merger Assessment Guidelines (CC2 (Revised)/OFT1254), available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/284449/OFT1254.pdf, paragraph 4.3.17.

[17] LeapFrog 10-Q, at page 32.

[18] Source: Tender Offer Statement under Section 14(d)(1) or 13(e)(1) of the Securities Exchange Act of 1934, as at 29 February 2016, available https://www.sec.gov/Archives/edgar/data/910016/000104746916010701/a2227537zscto-t.htm.



28. Due to LeapFrog's capital structure, a few stockholders control a significant percentage of voting power. If they had failed to support an offer from a bidder, the transaction could not have been completed. For instance, Class B stockholders represented approximately 40% of the overall voting power of all stockholders (as at 26 February 2016)[19]. This demonstrates the importance of the Class B stockholders' views in determining whether a proposal for the acquisition of LeapFrog would be considered viable from a stockholder perspective.

29. As explained below, the Class B stockholders did not consider any of the offers for LeapFrog to be viable alternatives to VTech's offer.

30. Despite contacting a large number of parties, Morgan Stanley received non-binding indications of interest[20] from only four parties (as of 14 September 2015), two toy companies and two private equity firms:

(i) [Confidential],

(ii) [Confidential],

(iii) [Confidential],

(iv) [Confidential].

31. Each of these indications of interest were either withdrawn by the relevant party undertaking due diligence of LeapFrog or otherwise abandoned as unsuitable.

II.4 Assessment of the credibility and timeliness of other purchasers' interest

II.4.1 [Confidential]

32. [Confidential] had made an unsolicited, non-binding, approach for LeapFrog in March 2015 of USD 4.19 to 4.90 per share. However, by the time [Confidential] submitted a non-binding indication of interest on 10 September 2015 in response to Morgan Stanley's approach, its offer had decreased to USD 2.20 per share. Following due diligence in September and October 2015, [Confidential] halved its offer on 30 October 2015 to USD 1.10 per share. On 6 November 2015, [Confidential] withdrew its non-binding indication of interest and terminated discussions with LeapFrog, stating:

> "*the resources required to stabilize [LeapFrog's] business could be very substantial in addition to the purchase price, and that [[Confidential]] was not willing to accept*

[19] Tender Offer Statement under Section 14(d)(1) or 13(e)(1) of the Securities Exchange Act of 1934, as at 29 February 2016, available https://www.sec.gov/Archives/edgar/data/910016/000104746916010701/a2227537zscto-t.htm.

[20] In the USA, an indication of interest is a preliminary proposal to purchase a business based on limited public information that is not legally binding. These proposals are subject to and conditioned upon the completion of due diligence and negotiation and execution of a definitive acquisition agreement.

the business risks associated with an undertaking of this magnitude. [[Confidential]] further indicated that it might be prepared to agree to purchase assets from [LeapFrog] in a bankruptcy proceeding if the opportunity were to arise in the future”.[21]

II.4.2 [Confidential]

33. [Confidential] submitted a non-binding indication of interest on 14 September 2015 at USD 1.22 to 1.26 per share. Following due diligence in September and October 2015, [Confidential] stated on 31 October 2015 that it “*was unwilling to consider an acquisition of the entire [LeapFrog company]*”.

34. [Confidential] stated that it would “*potentially be interested in an asset acquisition of [LeapFrog's] brand, toy business and interactive reading business for a total consideration of [USD] 25 to [USD] 30 million*”.[22] Morgan Stanley's “Illustrative Liquidation Analysis” of 12 November 2015 indicated that the liquidation value of the business was [Confidential] meaning that [Confidential] offer for LeapFrog's brand, toy business and interactive reading business was below the liquidation value of the business, as calculated by Morgan Stanley, which would have served as the reference point for the LeapFrog board.[23]

35. As such, this offer should not realistically be considered a viable alternative, as voluntarily liquidation would have been expected, by the LeapFrog directors, to produce a better result for stockholders).

II.4.3 Private equity bidders: [Confidential] and [Confidential]

36. In relation to private equity firms, [Confidential] submitted a non-binding indication of interest on 10 September 2015 at USD 1.13 to 1.27 per share. Following due diligence in September and October 2015, [Confidential] terminated discussions with LeapFrog, “*expressing concerns about [LeapFrog's] ability to execute on its product pipeline and the scale of [LeapFrog's] infrastructure relative to its existing and potential revenues*”.[24]

37. [Confidential] was not invited to conduct due diligence as its offer of USD 0.92 per share or market price represented the lowest bid received at the time, below each of [Confidential], [Confidential] and [Confidential].[25]

38. Following the withdrawal of [Confidential] from the process on 6 November 2015, no other offers remained for LeapFrog from the 53 parties approached by Morgan Stanley initially. Each party that conducted diligence concluded that it did not want to acquire the LeapFrog business, or would only acquire certain LeapFrog assets below the business' estimated total liquidation value.

II.4.4 Additional parties with which LeapFrog met in November 2015

39. Following Board discussions in early November 2015, the Chief Executive Officer of LeapFrog, Mr John Barbour, met with 12 additional strategic parties and private equity firms in Beijing and Hong Kong, including 4 parties which ultimately made non-binding proposals, [Confidential] and VTech bringing the total number of parties approached in the process to 65[26].

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[21] See LeapFrog SC14D9, at pages 12-16.
[22] See LeapFrog SC14D9, at pages 14-15.
[23] [Confidential].
[24] See LeapFrog SC14D9, at pages 14-15.
[25] See LeapFrog SC14D9, at page 15.
[26] See LeapFrog SC14D9, at pages 16 and 17.

40. Each of the offers from the parties mentioned above were ultimately dismissed (apart from VTech), primarily due to the time period required by these companies to complete a transaction, by which time LeapFrog would have had insufficient liquidity to continue operations as a going concern.

II.4.5 [Confidential] (also referred to as Firm A in SEC filings)

41. On 23 December 2015, [Confidential], an investment firm owned by [Confidential] submitted a non-binding indication of interest to acquire LeapFrog for USD 0.85 per share. Following due diligence of the electronic data room in January 2016, [Confidential] withdrew its non-binding indication of interest and on 29 January 2016 submitted a revised non-binding proposal to purchase a majority stake in and control of LeapFrog in exchange for a new series of preferred stock issued by LeapFrog for USD 0.85 per share[27], together with a request for a three week extension for negotiation and due diligence. In short, as a consequence of this extension and SEC rules and Delaware law which in combination are likely to have required a period of at least three months after the signing of a sale agreement, LeapFrog's liquidity crisis would have materialised and LeapFrog would not have been able to continue operations by the time [Confidential] could have completed a transaction.

42. [Confidential] proposal was not a viable alternative to VTech's for the following reasons:

- First, [Confidential] initial and revised proposals were not firm bids (in contrast to VTech's). Its proposals noted that they constituted "*only an indication of our interest, and does not constitute any binding commitment with respect to the Proposed Transaction. It is not an offer or proposal capable of acceptance and it is not intended to create, infer or imply, and does not create, infer or imply, in any respect, any legally binding obligations on the parties whatsoever*"[28]. The frequent revision of [Confidential] bid and request for extensions for the due diligence process also illustrates that as the sales process continued, the value of the LeapFrog business was declining both as its financial situation worsened and as [Confidential] (and other bidders) continued to learn more about the reality of that situation.

- Second, [Confidential] appears not to have any investments or operations in the toys industry and it failed to provide LeapFrog with a proposed operating plan or details of a management team going forward, or provide a budget for costs [Confidential] expected to incur in restructuring and stabilising LeapFrog.[29] This is a significant omission because the acquisition of LeapFrog, as a loss-making business, would result in a short-term negative effect on cashflow on the acquiring party (discussed further below). It is not clear that [Confidential] had engaged with this, which may be one reason it requested an extension of its due diligence period. In response to Morgan Stanley's request for a business plan, [Confidential] had provided very high-level detail on its plans for investment in LeapFrog, which indicated to both Morgan Stanley and LeapFrog that the proposal was not viable at that stage.[30]

- Third, by the time of VTech's firm bid, [Confidential] had not conducted its full due diligence, nor had it proposed revisions to the transaction documents. As such, in

[27] With the preferred stock having a liquidation preference over the common stock of LeapFrog. See LeapFrog SC14D9, at page 19.

[28] [Confidential] letter to Morgan Stanley, 29 January 2016. Attached as Annex 2 to the Response to Issues Statement.

[29] See LeapFrog SC14D9, at pages 17 to 19.

[30] See Morgan Stanley Board update, 4 February 2016 (Annex 1A to the Response to 6th Request for Information of 7 July 2016), at pages 21-24: [Confidential].

the absence of a firm bid, the Board did not consider its non-binding proposal a viable alternative to VTech's firm offer, especially because LeapFrog was not confident that [Confidential] would make a firm offer and [Confidential] had requested a three week extension of its due diligence and negotiation period, indicating that its proposal as at that time should not be considered by LeapFrog as complete. Morgan Stanley considered that a longer time period than three weeks would have been required for [Confidential] to reach a final decision on LeapFrog.[31]

- Fourth, any transaction with [Confidential] would have required a meeting of stockholders. Due to the need to prepare and file a proxy statement with the SEC relating to such meeting and respond to any comments from the SEC on the preliminary proxy statement, the period between signing of a definitive agreement with [Confidential] and holding a stockholder meeting likely would have been at least three months. Therefore, and in particular taking into account the time that would be required for [Confidential] to complete diligence, negotiate transaction documents and prepare a sufficient turnaround plan before any potential signing, there would likely not be a stockholders' meeting until at least [Confidential] (if not later), by which time LeapFrog's liquidity crisis would have materialised and LeapFrog would not have been able to continue operations.

- Fifth, a key aspect of [Confidential] proposal, a USD 65 million cash injection, was too speculative to be considered a viable alternative to VTech. [Confidential] conditioned its proposal on LeapFrog's [Confidential] LeapFrog's credit facility [Confidential] contained a change of control provision, meaning that [Confidential] proposal (i.e. to acquire control) would have required negotiation with BofA in order to extend the term of its line of credit to LeapFrog in the event of [Confidential] proposal materialising. The chances of obtaining such an extension or renewal from BofA were considered extremely low[32], and this negotiation would likewise "*take additional time to process*"[33].

- Finally, [Confidential] proposal would have required LeapFrog's Class B stockholders' consent which was highly unlikely as the [Confidential]. It is unlikely that the Class B stockholders would have been supportive of [Confidential] proposal which offered zero liquidity to the Class B stockholders (i.e. their shares would not be purchased by [Confidential]) and which had no turnaround plan. In addition to that, Class B stocks would be diluted by [Confidential] proposal by around [Confidential][34].

43. The considerations outlined above demonstrate that a [Confidential] transaction would not have been able to be finalised [Confidential]. During the interim period, it is most likely that the Board would not have allowed its [Confidential] position to continue to degrade and LeapFrog would have been likely to exit the UK market. In all likelihood this would have occurred either by way of voluntary liquidation or through [Confidential] restrictions imposed

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31 See Morgan Stanley Board update, 4 February 2016 (Annex 1A to the Response to the Sixth Request for Information of 7 July 2016).

32 See Consolidated Response, at page 48.

33 See Morgan Stanley Board update, 4 February 2016 (Annex 1A to the Response to the Sixth Request for Information of 7 July 2016), at page 22.

34 See Morgan Stanley Board update, 4 February 2016 (Annex 1A to the Response to Sixth Request for Information of 7 July 2016), at pages 22-23.

by BofA on its facility which would have prevented LeapFrog from covering its [Confidential] issues during the due diligence and negotiation phase of [Confidential] bid.

44. At the time of VTech's firm offer, [Confidential] still needed to complete due diligence, negotiate and execute transaction documents, seek a renegotiation with LeapFrog's primary creditor (BofA), and convince Class B stockholders to consent to its transaction structure. For these reasons, on 4 February 2016, the Board concluded that [Confidential] proposal was not sufficiently certain and not a viable alternative to VTech in light of the time critical circumstances with which they were presented[35].

II.4.6 [Confidential] (also referred to as Firm B in SEC filings)

45. On 13 January 2016, [Confidential] submitted a non-binding proposal for LeapFrog to issue equity to [Confidential] at USD 1.00 per share, under which [Confidential] would gain economic and voting control over LeapFrog. [Confidential] indicated that its proposal was subject to the approval of several governmental and regulatory agencies. It said that the timeline to receive necessary approvals and complete a transaction would be at least five to six months.

46. Following submission of its proposal, [Confidential] was invited to engage in further due diligence in LeapFrog's electronic data room and to schedule informational and diligence sessions with senior management of LeapFrog. However, representatives of [Confidential] performed limited diligence in LeapFrog's electronic data room and did not conduct on-site diligence meetings with LeapFrog's senior management. Further, due to the fact that [Confidential] had devoted limited resources to the transaction to date, requested additional time to complete the transaction, not provided any update on its efforts to identify potential sources of financing, had not actually identified any financing source and could reduce its proposed purchase price after completing due diligence time, the proposal was not considered a viable alternative to VTech. This decision is reflected by the discussion held with Morgan Stanley and others at a Board meeting on 30 January 2016.

47. [Confidential] proposal was not a viable alternative to VTech's for the following reasons:

- First, [Confidential] initial and revised proposals were not firm bids (in contrast to VTech's). Its firm proposal was due to be received by LeapFrog on 16 February 2016, but an extension was requested to the end of February 2016, long after VTech's had already met with senior management at LeapFrog, had reviewed and marked up a form of the transaction document and had undertaken a series of due diligence meetings in Palo Alto, USA. As VTech and LeapFrog had already signed the transaction documentation on 5 February 2016, LeapFrog could not solicit any other offers unless the proposal was superior to that of VTech. This is because the merger agreement that VTech and LeapFrog signed contained a non-solicitation covenant that would have prohibited LeapFrog from soliciting alternative proposals except under certain circumstances. There was a real risk that, had LeapFrog refrained from accepting VTech's bid on the basis of [Confidential] non-binding proposal, then [Confidential] may have (a) requested a further extension; increasing the likelihood of any bid then being provided too late to avoid LeapFrog's liquidation; (b) offered a bid which was inferior to that of VTech; or (c) retracted any possibility of a firm bid for the reasons explored in more detail below.

[35] See LeapFrog SC14D9, at page 20, and Annex C.8H to the Consolidated Response (Minutes of LeapFrog Board Meeting, 4 February 2016).

- Second, at the time of VTech's firm bid, [Confidential] had not identified a source of financing for the transaction. It had failed to provide LeapFrog with a proposed operating plan or details of a management team going forward, or provide a budget for costs [Confidential] expected to incur in restructuring and stabilising LeapFrog.[36] This is a significant omission because the acquisition of LeapFrog, as a loss-making business, would result in a short-term negative effect on cashflow on the acquiring party (discussed further below). It is not clear that [Confidential] had engaged with this, which may be one reason it requested an extension of its due diligence period.

- Third, by the time of VTech's firm bid, [Confidential] had devoted limited resources to the transaction. Representatives of [Confidential] performed limited diligence in LeapFrog's electronic data room and did not conduct on-site diligence meetings with LeapFrog's senior management. As such, in the absence of a firm bid, the Board did not consider its non-binding proposal a viable alternative to VTech's firm offer, especially because LeapFrog was not confident that [Confidential] would make a firm offer.[37]

- Fourth, [Confidential] indicated that its proposal was subject to the approval of several governmental and regulatory agencies and said that its timeline to receive necessary approvals and complete a transaction would be at least five to six months.[38] On the assumption that [Confidential] could have signed a definite agreement by the end of March 2016 (which is an extremely conservative estimate), this would have meant that completion would not have been possible before [Confidential] at which point LeapFrog would have already exited the market, either due to bankruptcy or the Board having entered it into voluntary liquidation in anticipation of bankruptcy.

- Fifth, a transaction with [Confidential] would likely have required a meeting of stockholders. Due to the need to prepare and file a proxy statement with the SEC relating to such meeting and respond to any comments from the SEC on the preliminary proxy statement, the period between signing of a definitive agreement with [Confidential] and holding a stockholders' meeting likely would have been at least three months. Therefore, and in particular taking into account the time that would be required for [Confidential] to complete diligence, negotiate transaction documents and prepare a sufficient turnaround plan before any potential signing, there would likely not be a stockholders' meeting until June 2016 (at the earliest), by which time LeapFrog's liquidity crisis would have materialised and LeapFrog would not have been able to continue operations.

- Finally, [Confidential] proposal would have likely required LeapFrog's Class B stockholders' consent which was highly unlikely as [Confidential] It is unlikely that the Class B stockholders would have been supportive of [Confidential] proposal which offered zero liquidity to the Class B stockholders (i.e. their shares would not be purchased by [Confidential]) and which had no turnaround plan.

- The considerations outlined above demonstrate that a [Confidential] transaction would not have been able to be finalised before [Confidential], by which time LeapFrog was likely to have exited the UK market. At the time of the VTech firm offer,

[36] See Annex C.8H to the Consolidated Response (Minutes of LeapFrog Board Meeting, 4 February 2016), page 2.

[37] See Annex C.8H to the Consolidated Response (Minutes of LeapFrog Board Meeting, 4 February 2016), page 2.

[38] See LeapFrog SC14D9, at page 17.

[Confidential] still needed to complete due diligence, identify and arrange a source of financing, negotiate and execute transaction documents and convince Class B stockholders to consent to its transaction structure. For these reasons, on 4 February 2016, the Board concluded that [Confidential] proposal was not sufficient and not a viable alternative to VTech.[39]

II.4.7 [Confidential] (also referred to as Firm C in SEC filings)

48. On 14 January 2016, [Confidential] submitted a non-binding indication of interest to acquire LeapFrog for a purchase price of USD 1.20 per share. [Confidential] indicated that it did not have the capability of financing its offer but was exploring alternative approaches to financing.

49. Following submission of its proposal, as a matter of course, [Confidential] was invited to engage in further due diligence in the Company's electronic data room and to schedule informational and diligence sessions with senior management. However, [Confidential] failed to engage in this process to any great extent and had requested an extension to the end of February in order to submit a more definitive proposal. It appeared that by the time [Confidential] could have completed due diligence and submitted a definitive proposal (if at all based on the lack of financing arrangements and equivocation), LeapFrog's liquidity crisis would have materialised such that it is highly likely that LeapFrog would have been entered into voluntary liquidation.

50. [Confidential] proposal was not a viable alternative to VTech's for the following reasons:

- First, [Confidential] proposal was not a firm bid (in contrast to VTech's). The company and had requested an extension to the end of February to submit a more definitive proposal.[40] There was a real risk that, had LeapFrog refrained from accepting VTech's bid on the basis of [Confidential] non-binding, non-definite proposal, then [Confidential] may have (a) requested a further extension, increasing the likelihood of any bid then being provided too late to avoid LeapFrog's liquidation; (b) offered a bid which was inferior to that of VTech; or (c) retracted any possibility of a firm bid for the reasons explored in more detail below.

- Second, at the time of VTech's firm bid, [Confidential] had not indicated a source for financing the transaction. It had failed to provide LeapFrog with a proposed operating plan or details of a management team going forward, or provide a budget for costs [Confidential] expected to incur in restructuring and stabilising LeapFrog. This is a significant omission because the acquisition of LeapFrog, as a loss-making business, would result in a short-term negative effect on cashflow on the acquiring party (discussed further below at II.5). It is not clear that [Confidential] had engaged with this, which may be one reason it requested an extension of its due diligence period.

- Third, by the time of VTech's firm bid, [Confidential] had devoted limited resources to the transaction. Although it had identified professional advisors, it had not scheduled a meeting with LeapFrog's senior management. The form of purchase agreement was provided to [Confidential] but no further action was taken by this party. As such, in the absence of a firm bid, the Board did not consider its non-binding

[39] See LeapFrog SC14D9, at page 20, and Annex C.8H to the Consolidated Response (Minutes of LeapFrog Board Meeting, 4 February 2016).

[40] See LeapFrog SC14D9, at page 19.

proposal a viable alternative to VTech's firm offer, especially because LeapFrog was not confident that [Confidential] would make a firm offer and had requested an extension to the end of February for its final proposal, indicating that its proposal as at that time should not be considered by LeapFrog as complete.

- Fourth, although [Confidential] proposal offered a higher price than VTech, at a board meeting on 30 January 2016 the directors also considered that LeapFrog's stock price might decline substantially upon reporting the results of LeapFrog's fiscal quarter, which included the disclosure of a potential shortfall in cash available for operations. There was concern that such a decline in the stock price and perception of weakness in LeapFrog's outlook, could lead VTech, the only viable purchaser at that time, to reduce its offer price below USD 1.00 per share. In a similar way, this was also likely to result in an amended offer, inferior to VTech's, by [Confidential] at the end of February.

51. The considerations outlined above demonstrate that there are serious doubts as to whether (i) [Confidential] initial proposal was likely to have materialised into a definitive offer; and that (ii) if it did materialise into a definitive proposal, whether a transaction would have been able to be finalised before LeapFrog was likely to have exited the UK market.

52. In short, at the time of VTech's firm offer, [Confidential] had chosen to conduct minimal diligence activities. In light of the lack of effort and resources that [Confidential] had devoted to the process so far, its failure to demonstrate its ability to finance a transaction with LeapFrog or to make a proposal to LeapFrog, the fact that it had requested an extension to the end of February 2016 to submit a more definitive proposal and the relative uncertainty of its non-binding indication of interest LeapFrog did not, at this late stage, consider the proposal as a viable alternative to VTech. This decision is reflected by the discussion held with Morgan Stanley and others at the board meetings on 30 January 2016 and 4 February 2016.

II.4.8 L&M

53. A proposal made by L&M on 22 March 2016, more than six weeks after the Board accepted VTech's bid and signed a definitive merger agreement with VTech, was ultimately rejected by the Board because LeapFrog was not confident that L&M would be able to close a transaction before the need to take protective action in the form of voluntary liquidation materialised.

54. On 22 March 2016, L&M submitted a 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 USD 1.10 per share.[41] L&M's proposal was conditioned on the termination of the VTech transaction.

55. L&M is an acquisition vehicle of Isaac Larian, the owner of MGA Entertainment, Inc ("**MGA**"). MGA is a children's toy manufacturer, producing Bratz dolls, Little Tikes toys (including roll play and outdoor toys), Air Wars remote controlled toy drones, Gel-a-Peel gel jewellery, and Georgie branded interactive puppies. MGA was one of the 25 potential strategic partners that had initially been contacted by Morgan Stanley over the summer of 2015, however, as

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[41] MGA were one of the trade parties approached initially by Morgan Stanley as early as July 2015, and which had signed a non-disclosure agreement with LeapFrog. See Annex C23R to the Consolidated Response (Morgan Stanley Board update, 30 October 2015), at page 3.

at 12 September 2015 it had not submitted a bid and had been ruled out of the process, along with 43 other firms. At the time of its bid, L&M did not itself have any assets.[42]

56. The Board discussed L&M's offer on 24 March 2016, and rejected it for several reasons, set out at length in LeapFrog's SEC filings and Board minutes.[43] In short, L&M's offer was made at a very late stage, at a time when LeapFrog's liquidity was imminently approaching the point at which LeapFrog could no longer sustain operations and the proposal offered little certainty as it raised concerns as to the financing of L&M and potential recourse in the event of default by L&M.

57. L&M had submitted a draft of a limited personal guarantee by the CEO of specified obligations of L&M under the draft merger agreement, subject to a cap of USD 78 million, an amount less than the purchase price of the outstanding shares of LeapFrog. The guarantee covered only payments due on closing of a transaction, and not any damage claims that LeapFrog might have against L&M in the event of a default. The structure of a guarantee would require LeapFrog to file a lawsuit against the CEO of L&M to recover, as opposed to seeking relief from an operating company or one with its own assets. In addition, the amount of cash included in the assets identified in the support letter provided by the independent brokerage firm was not specified, leaving open the possibility that the value of the asset could decline, or be unrealizable for liquidity reasons. The Board unanimously concluded that significant concerns existed regarding the adequacy of the financing proposed by L&M.[44]

58. [Confidential].

59. For these reasons, the Board decided that pursuing L&M was not a viable alternative option to VTech's definitive offer.

60. Rather, the only viable purchaser of LeapFrog, VTech, submitted its indication of interest to acquire LeapFrog for USD 1.00 per share on 15 December 2015. It prepared a detailed mark-up of the transaction document on 22 January 2016 and executed a definitive transaction agreement on 5 February 2016. The VTech Transaction was completed swiftly on 4 April 2016.

II.5 The significant financial impact of acquiring LeapFrog limited the pool of credible bidders to VTech

61. The acquisition of LeapFrog, as a loss-making business, would result in a short-term negative effect on cashflow of the acquiring party. As such, the viability of other bidders should also be assessed by reference to their ability to absorb this negative effect.

62. As part of its due diligence, VTech estimated that the impact of acquiring the loss-making LeapFrog business on VTech's financials would be substantial due to the fact that it expected LeapFrog to report [Confidential].[45] This is in addition to the [Confidential] that was incurred by LeapFrog in around March 2016. VTech's payback analysis identified that VTech could structure the LeapFrog business in a similar way to the existing VTech business, for example

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[42] See Amendment No.2 of 25 March 2016 to LeapFrog SC14D9, and Annex C.8J of the Consolidated Response (Minutes of LeapFrog Board Meeting, 24 March 2016).

[43] See Amendment No.2 of 25 March 2016 to LeapFrog SC14D9, and Annex C.8J of the Consolidated Response (Minutes of LeapFrog Board Meeting, 24 March 2016).

[44] See Amendment No.2 of 25 March 2016 to LeapFrog SC14D9, and Annex C.8J of the Consolidated Response (Minutes of LeapFrog Board Meeting, 24 March 2016).

[45] See Annex B.21A to the Consolidated Response (Payback Analysis with FY16 to FY21 Forecast), at page 23.

[Confidential],[46] and that VTech could utilise the synergies of the two businesses to control the costs and operations of the LeapFrog business more efficiently and more successfully than LeapFrog itself. For example, this could be achieved by [Confidential].[47] In essence, the structure of the VTech business and the synergies with LeapFrog allowed VTech to absorb the financial impact of acquiring and sustaining the loss-making LeapFrog business more viably than others without comparable structure and synergies.

63. In contrast, [Confidential], following diligence, acknowledged the "*magnitude*" of "*the resources required to stabilize [LeapFrog's] business*", and withdrew its interest in acquiring LeapFrog on that basis.[48] Similarly, [Confidential] and [Confidential] also withdrew their offers following diligence on LeapFrog.[49]

64. [Confidential] L&M and the two other [Confidential] parties involved in the second round of Morgan Stanley's marketing process did not engage in a comprehensive diligence process, and as such had not fully registered the financial impact acquiring LeapFrog would have on their businesses or portfolios. Notwithstanding the long amount of time that proper due diligence would have required for these parties (and the fact that this delay would have coincided with the insolvency of LeapFrog), the Parties submit that, had the bidders conducted more in-depth diligence on LeapFrog, they would have become aware of the negative financial impact of acquiring and sustaining the LeapFrog business, and that factor would have contributed to the withdrawal of their non-binding proposals.

65. As a result of the absence of a viable alternative purchaser, the Board accepted VTech's formal offer for the purchase of LeapFrog on 5 February 2016 and signed a definitive merger agreement that day.

III. Limb 3: Failure would not have resulted in a substantially better competitive outcome for UK retailers and consumers

66. As demonstrated above, as no other viable alternative purchaser existed, given LeapFrog's inevitable and impending financial failure, the only viable option would have been for the Board of directors to put the company into liquidation.

67. Liquidation would inevitably have entailed an immediate if not pre-emptive departure of the Emeryville-based education specialists and other US- and UK-based staff that formed the R&D and innovative potential of LeapFrog, the dissolution of the supply chain that puts LeapFrog product on retailer shelves, and develops new and upgraded products for the new season, which would in turn have affected the value of the LeapFrog brand.

68. While the Guidelines frame the third limb question as an inquiry into where the sales would have gone if the firm had failed (applicable in e.g. commodity market), the more pertinent question in this dynamic market -- given the (appropriate) innovation focus throughout the CMA's theories of harm given LeapFrog in particular and its differentiated brand proposition -- is what would have happened to LeapFrog's *innovation with an educational focus* as its signature competitive constraint*:* could the CMA form an expectation that innovation (or put differently, the particular competitive constraint posed by LeapFrog) is likely to be

[46] See Annex B.21A to the Consolidated Response (Payback Analysis with FY16 to FY21 Forecast), at page 22.

[47] See Annex B.21A to the Consolidated Response (Payback Analysis with FY16 to FY21 Forecast), at page 20.

[48] See paragraph 31 above.

[49] See paragraphs 33 and 36 above.

substantially higher in a counterfactual of LeapFrog failure and asset purchases out of liquidation, compared to the post-merger outcome?

69. The answer is that it could not tenably do so for the following reasons.

- First, in the post-merger outcome, the demonstrable fact is that LeapFrog has had [Confidential] (as a measure of innovation) under VTech stewardship than [Confidential] when LeapFrog was still an independent going concern let alone under this hypothesis no more than a collection of distressed "fire sale" assets in bankruptcy.
- Second, it is therefore fanciful to suggest that it is likely that a fire sale purchase of assets would have led to innovation under the LeapFrog brand to a level substantially greater than what VTech can show it actually has done – and not merely alleges it could do – post-Transaction.
- While VTech could in theory also have waited until liquidation to obtain the LeapFrog brand at a discounted price, it did not do so [Confidential]
- In addition, waiting until after liquidation to obtain the LeapFrog brand would have resulted in the loss of a year's worth of sales during the peak Christmas season. Retailers would have been committed to LeapFrog's inventory promises but LeapFrog would not have met these commitments, which is likely to have damaged the LeapFrog brand significantly in the eyes of retailers and consumers.
- Indeed, in order for a toy brand to survive, it needs to have shelf presence, that is, products on retailer shelves and signage inside stores to attract and lead consumers to the shelves. If LeapFrog went into liquidation, whoever purchased its assets would not have been able to revive the production of existing and 2016 products to hit retailer shelves for the upcoming new product season. The purchaser would also have had to invest substantial time and resources with retailers to preserve the brand's shelf presence. Only with a company like VTech, and only through its fast track schedule and synergy-based approach, could the production and supply of products to the channels be continued with minimal disruption. For example, [Confidential].
- As a consequence of the above, VTech did not wait for liquidation, even though it suspected there were no other credible purchasers, because of the leaching of the equity in the brand and loss of Emeryville staff that it wanted to preserve. No other hypothetical candidate purchaser of selected assets out of liquidation could likely have reassembled the lost brand equity in a liquidated LeapFrog, post-disintegration as a business, any more than VTech could have hoped to – and this includes [Confidential], or any other industry player.
- Indeed, the weight of evidence favours the opposite conclusion: no other outcome is likely remotely to have preserved the innovative LeapFrog value proposition, which suggests the Transaction is *pro*-competitive, and not substantially anti-competitive, relative to the most likely counterfactual (the requirement of CMA guidance) -- and indeed relative to the only realistic counterfactual.

70. To the extent that the CMA remains interested in the question of where LeapFrog's sales would have gone but for the Transaction – as a proxy for competitive constraints upon VTech absent the merger – it follows therefore, that due to this likely outcome, LeapFrog's innovative potential would have been hollowed out by liquidation process, and what sales it otherwise would have made [Confidential]. The putative bare survival of the LeapFrog brand bought out of liquidation must not therefore be confused with the preservation of the value proposition and competitive constraints brought to the market by LeapFrog as a historically going concern.

71. VTech's actions in rescuing LeapFrog pre-liquidation, and preserving Emeryville and pursuing a dual-brand strategy in the US and UK, are therefore consistent with and supportive of the Parties' submissions on the third limb of failing firm.

72. In the alternative and without prejudice to any of the foregoing contentions, if the CMA forms the view that absent the Transaction, LeapFrog would likely have been acquired pre-liquidation by one of the firms still interested in it at the time of the Transaction, it is important to note that none of [Confidential] had, to the best of the Parties' knowledge, either (i) any experience running a toys company; or (ii) a plan to turn LeapFrog's business around beyond a mere cash injection. Accordingly, it is likely that LeapFrog's struggles would have continued under any new ownership, and that the particular competitive constraint posed by LeapFrog could not possibly be judged as likely to be substantially higher in a counterfactual of LeapFrog's purchase by a [Confidential] compared to the post-merger outcome.

IV. Conclusion

73. The Parties submit that it is abundantly clear that the "most likely" counterfactual to VTech's acquisition of LeapFrog would have been its voluntary liquidation by the Board, and certainly not the pursuit of other offers lacking timeliness and/or credibility to execute, in the best interests of Leapfrog stockholders.

74. In the event of voluntary liquidation, this would inevitably be associated with the dissolution of the value proposition that underlies the LeapFrog brand. Accordingly, it is fanciful to suggest that a fire sale purchase of the brand (and/or other assets out of liquidation) would yield a putative counterfactual market outcome so innovative and pro-competitive that it would be reasonable to characterise the post-merger outcome (with [Confidential] product launches in 2017 compared to [Confidential] in 2016) as "anti-competitive". On the contrary, the VTech rescue ensures that the historical benefits of LeapFrog to UK consumers were preserved and extended; in any event, it cannot be suggested that it would have been better to let Leapfrog fail. As the Guidelines' definition of SLC is a loss of rivalry *expected to lead to customer harm*, this would imply that a rejection of the exiting firm scenario by the CMA would be a conclusion that UK customers will be *substantially better off had LeapFrog been liquidated and disintegrated*, with all the uncertainties that flow from this, than they are in the Transaction outcome, featuring [Confidential] new product launches plus ancillary products.

75. In the Parties' view, any such counterfactual conclusion that yields an SLC outcome would represent a triumph of abstract speculation over both the weight of available evidence and common sense.