

## **COMPLETED ACQUISITION BY VTECH HOLDINGS LIMITED OF LEAPFROG ENTERPRISES, INC.**

### **Summary of provisional findings report**

**Notified: 9 December 2016**

1. On 30 August 2016, the Competition and Markets Authority (CMA) referred the completed acquisition by VTech Holdings Limited (VTech) of LeapFrog Enterprises, Inc. (LeapFrog) (the Merger) for an in-depth (phase 2) merger inquiry. The CMA is required to address the following questions:
  - (a) whether a relevant merger situation has been created; and
  - (b) if so, whether the creation of that situation has resulted, or may be expected to result, in a substantial lessening of competition (SLC) within any market or markets in the UK for goods or services.<sup>1</sup>
2. VTech is a supplier of electronic learning toys for infant and pre-school children, incorporated in Bermuda but with its head office in Hong Kong. VTech's operations in the UK are limited to the import and distribution of toys, sold through VTech Electronics Europe PLC.
3. LeapFrog is a US corporation that develops and supplies educational entertainment for children, including multimedia learning platforms, related content and learning toys. LeapFrog's UK subsidiary is LeapFrog Toys (UK) Limited, which sells and distributes LeapFrog toys to retailers.
4. VTech and LeapFrog (the Parties) overlap in the supply of learning toys and child tablets and content in the UK.

#### **Relevant merger situation**

5. We have provisionally found that the Merger has resulted in a relevant merger situation within the meaning of the Act.

---

<sup>1</sup> Enterprise Act 2002 (the Act), section [35](#).

## **Counterfactual**

6. Before turning to our analysis of the competitive effects of the Merger, we considered what would have happened to LeapFrog in the absence of the Merger (the counterfactual). We provisionally found that LeapFrog's financial position had deteriorated and, absent additional funding, LeapFrog would have failed financially by June/July 2016 at the latest.
7. We then considered whether, in the absence of the Merger, there would have been an alternative purchaser for the firm or its assets.
8. Our provisional view is that absent the merger with VTech, on balance, it is likely that there would have been an alternative purchaser of LeapFrog.
9. We have provisionally concluded that the appropriate counterfactual against which to assess the effect of the Merger is prevailing conditions of competition (with LeapFrog remaining in the market under alternative ownership).

## **Market definition**

10. The purpose of market definition in a merger inquiry is to provide a framework for the analysis of the competitive effects of the merger.
11. We initially considered a market for Toddler Electronic Learning (TEL) toys, but we provisionally conclude from evidence provided to us (particularly from the consumer survey evidence and views from retailers) that our competitive effects assessment should consider a wider market to include other types of educational/learning toys. This market should include learning toys that are recommended for use for children aged 0 to 5 years, as the Parties target the majority of their toys at this age group. We note that the boundaries of this market are not clearly defined and have taken account of this in our competitive effects assessment.
12. When considering child tablets, our provisional view is that the market is likely to be wider than child tablets alone. However, our provisional view is that to include the diverse range of products that constrain child tablets would not aid the assessment of the competitive effects of the Merger. We have therefore not formally defined a wider market; instead, we have taken into account the constraint placed by these other products when we considered the competitive effects of the Merger.
13. We also considered whether child electronic reading systems should be assessed separately. We have provisionally concluded that child electronic reading systems are within the wider market for learning toys, and that the

potential overlap between the Parties is not close enough to warrant investigation under a separate theory of harm.

14. We have therefore provisionally concluded that the relevant markets in the UK on which to base our competitive assessment are: learning toys for children aged 0 to 5 years; and child tablets and content.

### **Competitive assessment**

15. We next turned to the assessment of the effects of the Merger on competition. We first examined the nature of competition in the toy sector, and considered how manufacturers and retailers contract with each other and what influences retailer demand. We have provisionally found the key dimensions to competition in this market are:
  - (a) Manufacturers and retailers conduct bilateral negotiations, which can either be across the whole range of that manufacturer's products or for individual products. These bilateral negotiations will determine the terms of sale, which typically include the wholesale price, advertising support and promotional activity.
  - (b) Retailers' purchasing decisions are based on their anticipation of consumer demand, but retailers also have some ability to influence consumer demand for certain products through promotional activity or the way products are displayed.
16. We focused our analysis on determining which outside options are available to retailers during their negotiations with manufacturers to determine if there are a sufficient number of close outside options available, such that there would not be scope for the Parties to deteriorate their offering as a result of the Merger.

### ***Learning toys for children aged 0 to 5 years***

17. We considered whether the removal of one party as a competitive constraint in the supply of learning toys would allow the merged entity to deteriorate elements of its competitive offering profitably in the UK (such as price or quality).
18. For learning toys, we found there were a number of current and potential competitors, including in particular the Fisher Price brand (owned by Mattel) as well as several other strong brands and own-label toys. Both retailers and consumers regarded these other brands as alternatives to the Parties' learning toys.

19. Our provisional view is therefore that the Parties' products are sufficiently similar that they are close competitors in learning toys, but that there are other suppliers who compete just as closely.
20. We then looked at alternatives to the Parties' products available to retailers and consumers. We found that there were a significant number of competitors supplying products which were in some ways similar to the Parties' products. This includes other well-known brands, which could expand given the opportunity. We found that retailers had outside options to which they could switch, which acted as constraints on the Parties. This was corroborated by the consumer research undertaken for this inquiry. This research indicates that consumers were looking for age-appropriate toys which are educational and/or interactive, and would consider a number of different products and suppliers as alternatives to the Parties' products.
21. We also looked at whether new or lesser known brands would be able to grow in the marketplace. We found that although branding is important, in terms of getting products stocked, this can be mitigated by the use of licences, which are prevalent in the industry, and through which a new entrant can in effect buy into a licensed brand. In addition, the churn rate in products is high with many new products being introduced each year, which is likely to make it easier for a new entrant.
22. Our provisional view is therefore that retailers (and consumers) have credible alternatives to the Parties' products to which they could switch.
23. Lastly, we looked at countervailing buyer power. It is our provisional view that as retailers have credible alternative options to the Parties' products, they have a degree of countervailing buyer power that is likely to act as a competitive constraint on the merged entity.
24. We have provisionally concluded that the Merger has not resulted, and may not be expected to result, in an SLC in the supply of learning toys for children aged 0 to 5 years.

### ***Child tablets and content***

25. We considered whether the removal of one party as a competitive constraint in the supply of child tablets and content could allow the merged entity to deteriorate elements of their competitive offering profitably in the UK. The ability of the Parties to do this will depend on how closely the Parties compete with each other and the strength of outside options available to retailers during their negotiations with manufacturers.

26. We found that the Parties supply child tablets that are functionally similar, aimed at the same age group and with the same price point, although we note that there may be some differences in the content. The functional similarity suggests that the Parties' tablets may be close substitutes, although we note that other tablets exist which are functionally similar to the Parties' products. Our consumer research indicated that they were close competitors, with Amazon Fire Kids Edition as a close substitute. However, we note that this survey was backward looking and the market is evolving rapidly.
27. Our consumer research also indicates that child tablets are constrained by a range of products, including other toys as well as standard tablets. Retailers have indicated that they do not view child tablets as a 'must have' category, and there is no requirement for them to stock either VTech or LeapFrog's child tablets. We have provisionally concluded that retailers have alternative options to stocking the Parties' toys in the event of the merged entity worsening its offering.
28. We looked at how the child tablet market was evolving, and found that sales of the Parties' child tablets have declined substantially in recent years. This has coincided with the launch and growth of new products delivering content to children through a wide range of electronic devices. The evidence provided to us indicated that the child tablet market is evolving with content being separated from hardware. We therefore expect additional constraints on the Parties as non-child-specific hardware can be used to deliver child-specific content.
29. We also looked at countervailing factors, including new entry and buyer power. While we note that a contracting market may make entry less attractive, barriers to entry are not particularly high for existing players in the toy industry, and there continues to be new entry into the supply of child tablets.
30. We have provisionally concluded that the Merger has not resulted, and may not be expected to result, in an SLC in the supply of child tablets and content.

### ***Future innovation in toys***

31. We looked at whether the Merger would have a negative effect on the number of innovative new toys in the future.
32. If the main driver for innovation was the competition between VTech and LeapFrog, then the Merger could lead to less innovation in toys. We have not received evidence to indicate this is the case. The evidence indicates that

innovation comes from competition between the Parties and other toy manufacturers.

33. As regards learning toys, we have provisionally concluded that the Merger has not resulted, and may not be expected to result, in an SLC. Therefore continuing competition between the merged entity and other toy manufacturers post-merger is likely to prevent the Merger from leading to a reduction in innovation and product development within learning toys. The same is true for child tablets and content, where the merged entity will face continued pressure to innovate (including from non-toy manufacturers) in a rapidly evolving market.
34. We also note that competition to bring such developments to children's toys occurs at a European or global level rather than in the UK.
35. We have therefore provisionally concluded that the Merger has not resulted, and may not be expected to result, in an SLC in respect of future innovation in toys.

#### **Provisional findings**

36. We have provisionally concluded that the Merger has not resulted, and may not be expected to result, in an SLC in any of the markets considered in this inquiry.