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Rising Costs Seen Troubling Mattel, Hasbro Into 2006

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NEW YORK -- The cost of making toys for large manufacturers Mattel Inc. (MAT) and Hasbro Inc. (HAS) could take a larger bite out of profits next year as both companies continue to struggle with weak consumer demand.

With the majority of toys made in China, that country's revaluation of the yuan could lead to higher manufacturing costs. Also, the rising price of crude oil - a key ingredient in making plastic resin - makes the production of plastic dolls and other toys more expensive. Add to that the rising price of paper, used in toy packaging.

While Mattel and Hasbro might have been hedged on the costs of plastic, paper and computer chips by making larger orders early, the "specific challenge [in 2006] will be the price of oil because the industry is so plastics driven," said toy industry consultant Chris Byrne.

It might be difficult for Mattel or Hasbro to pass costs on to retailers because the stores are already cutting back on orders to better manage their inventories against weak consumer demand. And some smaller toy companies won't be able to afford to make some products because "they can't be sold at appropriate prices," Byrne said.

Consumer "skittishness" might be amplified this holiday season because of higher prices for gasoline and home heating oil, as well as rising interest rates, that cut into discretionary income, said Harris Nesbitt analyst Sean McGowan.

Then there is the threat that the cost of making products in China will go up. A further upside revaluation of the yuan could hurt earnings and margins for Mattel and Hasbro, J.P. Morgan analyst Dean Gianoukos wrote in an August research note. China strengthened the currency on July 21 with a

2.1% revaluation against the dollar. Gianoukos said in a research note that J.P. Morgan is forecasting an additional 5% rise against the dollar by year-end and then 7% to 8% in 2006.

Gianoukos figured that a 10% increase in the yuan could take 180 basis points off Mattel's gross and operating margins and cut earnings by 17 cents a share. The same increase in the yuan could reduce Hasbro's gross and operating margins by 150 basis points and also shave 17 cents a share from earnings.

However, Usha Haley, professor of international business at the University of New Haven, said that, given the wide margins on toys created in China, Mattel and Hasbro have some leeway.

She put the cost of producing a Barbie doll, for example, at $1.00. "So even if the yuan improved by 50% against the dollar, the import price would only go to $1.50," Haley said. "And if oil prices rise by 100%, that cost of producing a Barbie shouldn't double," because of low labor costs, excellent infrastructure and other efficiencies. Mattel could sell a Barbie for about $10 and "comfortably" reduce its profit margin by not raising the price.

It is weak sales of Barbie that pose the most problems for Mattel, according to McGowan. He downgraded Mattel to neutral from outperform earlier this month based on a lack of signs of a recovery in Barbie sales.

He noted that sales of competing Bratz dolls remained strong in 2005 and the allocation of shelf space ahead of the holiday season at major retailers like Toys R Us Inc. and Wal-Mart Stores Inc. (WMT) has left Barbie with less space on store shelves - and Bratz dolls with more - than they had a year ago.

The dollar's continued strengthening against the euro, which makes currency translations on sales in Europe weaker, could also continue to hurt Mattel's sales this year and next, McGowan said.

Hasbro has lower exposure to higher resin costs than Mattel because of its board-game business, said Ryan Beck & Co. analyst Margaret Whitfield. She added that changes in the valuation of the yuan won't hurt Hasbro as much as Mattel because Hasbro sources its toy production from various manufacturers in Asia - whereas Mattel has company-owned plants in Asia - giving Hasbro a greater ability to negotiate pricing.

Banc of America analyst Gary Cooper estimated that resin represents about 6% to 8% of Hasbro's annual revenue while transportation costs, which will be affected by rising fuel prices, make up about 3% to 4% of Hasbro's revenue.

Cooper, who has a neutral rating on Hasbro, said in a research note that the outlook for 2006 remains challenging because of rising commodity costs, a tougher currency environment and tough comparisons with sales of "Star Wars" merchandise in 2005, when the last "Star Wars" film was released.

Calls to Mattel and Hasbro weren't immediately returned.

In a filing with the Securities and Exchange Commission, Mattel said that, in the first half of 2005, it experienced pressures from oil-based resin costs, transportation costs, and employee-related costs. The company added that those cost pressures should continue "for at least the remainder of 2005."

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