

RESEARCH PAPER

MARVEL COMICS TURNAROUND

MGMT-934 MANAGING TURNAROUNDS
PROFESSOR SHEIN

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PART I: THE CAUSES OF MARVEL'S DECLINE

Introduction

During the mid 1980s, Marvel Comics was well established as a market leader in the comic book industry. In January 1989, Ronald O. Perelman, the corporate raider best known for his hostile takeover of Revlon, bought Marvel for \$82.5 million, financed with only \$10.5 million of equity. With a reputation for buying and re-selling companies,¹ Perelman believed that Marvel could become a much more valuable enterprise than it was, and he moved quickly to eliminate unprofitable lines of business and streamline operations. In the first year under Perelman's control, Marvel's net income increased from \$2.4 million to \$5.4 million, while revenues increased from \$68.8 million to \$81.8 million. Then, in 1991, Perelman sold a 40% stake in an initial public offering that raised \$70 million. Roughly \$30 million was used to pay down debt, with the rest paid to Perelman's own holding company as a "special dividend." Concurrently, Marvel issued a debt offering, using its stock as collateral.²

Perelman's Mistakes, and the Resulting Decline and Fall of Marvel

While Ron Perelman's early financial moves at Marvel seemed successful, he embarked on four strategic shifts in the subsequent years which, we conclude, led to the eventual financial collapse of Marvel. First, he attempted to drive top line growth by increasing comic book prices numerous times – an obvious mistake since comics initially became popular during the Depression as a cheap form of entertainment for impoverished kids. Second, Perelman pushed forth the proliferation of titles and comics in an attempt to "expand the industry pie" and decrease marginal

¹ Through his MacAndrews & Forbes holding company and several subsidiary holding companies, Perelman owned a wide range of businesses including Revlon (an international cosmetics company), Coleman (an outdoor recreation equipment company), First Nationwide Bank (a California-based savings and loan association), Consolidated Cigar (a cigar company), and the Andrews Group (an entertainment and publishing holding company).

² Interestingly, Perelman was later sued by Marvel, alleging that he pocketed \$553.5 million in "unjust enrichment" from the junk bonds (Review of the book *Comic Wars* by Dan Raviv: <http://www.randomhouse.com/features/comicwars/highlights.html>)

costs, which instead only worked to distract Marvel from producing quality product. Third, in a fit of denial, Perelman blamed languishing sales on distributors of Marvel comics, and took several actions which hurt both the distributors and the retailers. And fourth, Perelman showed incredibly poor judgment in embarking on a series of ill-timed acquisitions aimed at building Marvel into an entertainment empire- but which only further distracted the company and eroded the balance sheet. We examine each of these causes in greater detail:

Increasing Comic Book Prices and Proliferating Titles

Over the years, collecting comic books became a lucrative hobby, as the scarcity of some old issues drove their market values into the thousands of dollars. Under Perelman, Marvel hoped to capitalize on the speculative frenzy of collectors by increasing the number of monthly titles from 45 to some 140³ and dramatically increasing prices over time from \$1.25 cents to \$2.25-\$4.00⁴ per comic book (The previous owner of Marvel had raised prices from around \$0.65 to \$1.00 in the three years before selling to Perelman)⁵. As a result, expensive and poorly written and illustrated comics flooded the market. Other tactics, inspired by Marvel and imitated by others, included premium comics and gimmicky covers in an effort to price differentiate. These included die-cuts (stiffer cardboard embossed with flashy, 3-D images), holograms, and other ways to make the cover more impressive. One publisher went so far as to issue a comic with 13 different covers.⁶ Comics were also sealed in bags with trading cards and other giveaways, or were pre-autographed by the writers/illustrators. Over the short term, this proliferation and price differentiation strategy was a financial success, as Marvel's stock price peaked in November 1994 at \$34.25 per share. However the prosperity didn't last long, as disappointed collectors learned the

³ "Wanted: Superhero" by Kemp Powers, *Forbes Magazine*, 11.12.01

⁴ Ibid

⁵ "How Ronald O. Perelman Caused Harm to the Comics Industry" By Chuck Rozanski:
<http://www.milehighcomics.com/tales/cbg37.html>

⁶ "Gimmicks and Covers" By Tom Zjaba: <http://www.tomheroes.com/justnewsprint/justnews20.htm>

laws of supply and demand and discovered that these new comic books were neither of high quality nor scarce. Thus, the speculative bubble burst, and comic sales fell 19% across all distribution channels in the following year. Effectively, comic fans felt as if they had been cheated by Marvel.

Distribution: Biting the Hand that Fed Marvel

Historically, comic books were sold at news-stands and drugstores, which had poor selections, with only a few hundred comic book shops sparsely located throughout the country in the early 1980's. With the increase in speculative demand, however, the number of U.S. comic book shops increased from several hundred in the 1980's to a peak of roughly 10,000 in the early 1990's. Concurrently, publishers like Marvel sought to improve their distribution networks because they believed that the distributors were a bottleneck in getting comics to interested consumers. The distribution industry underwent a period of consolidation with Capital City Distribution and Diamond Comic Distributors emerging as the two industry leaders with a majority of the market share. These companies, in part, increased share by seriously decreasing the capital/credit requirements needed to set up as a comic book dealer. Simultaneously, inexperienced entrepreneurs vastly increased the sales of comic books from distributors to stores.

Overproduction was a resultant byproduct of the proliferation of distributors. Since unsold comics cannot be returned to the publisher, the publishers were unable to differentiate between comic books that went home with collectors and comics that started building up in store inventories, so they merrily continued to increase their production. As these shops began to go out of business, sales began to suffer, causing publishers to trim their comic lines. By the mid 1990's, there were only about 4000 shops still in business.⁷

⁷ "Comic Superheros Battle Just to Survive" By James Hudnall:
<http://www.comicscommunity.com/boards/hudnall/?noframes;read=1161>

In a fit of denial, Perelman blamed the distributors, rather than overproduction, high prices and poor quality comics, for this trend- so he purchased Hero's World, a smaller comic distributor, and soon made it the sole distributor of Marvel comics. In response, most of the other major publishers signed exclusivity deals with Diamond, forcing nearly every other distributor out of business. Marvel soon saw the folly of its decision to alienate established distributors, and quit the distribution business, leaving Diamond as the only player left standing with distribution contracts with Marvel, DC, Dark Horse, and Image Comics – four of the largest players in the industry.⁸

Acquisitions

Perelman further distracted Marvel from its core competency by attempting to spur growth through acquisition in the mid 1990's. Perelman set out to build a diversified youth entertainment company using the comic book business as a foundation. First, he acquired Fleer, the second largest manufacturer of sports and entertainment trading cards in July 1992 for \$286 million, followed by the March, 1995 purchase of the smaller Skybox Trading Card Company for \$150 million. After the bankruptcy, these companies were sold for a combined total of \$26 million.⁹ Incidentally, while SkyBox cards were sold with comics, Fleer, as well as other sports trading card companies, began the same trends that were hurting the comic industry (multiple producers, "limited edition" cards, gimmicky holograms, etc). In March 1993, Perelman acquired a 46% interest in Toy Biz, a designer and retailer of children's toys, in exchange for an exclusive, perpetual, royalty-free license to use all of Marvel's characters. Then, in July 1994, he acquired the Panini Group, an Italian producer of sports and entertainment stickers, for \$150 million. Other acquisitions include 51% of Welsh Publishing Group, which produced Barbie and Muppet Magazines among others, and had a Joint Venture with Bongo Comics Group, publisher of the

⁸ Hudnall

⁹ Powers

Simpsons comic lines. In 1994, Marvel also purchased Malibu Publishing, an independent producer of comics based off of movie and television series, such as Planet of the Apes, Deep Space Nine, and Alien Nation. Malibu was also the distributor of Image comics, a large, independent publisher founded by several ex-Marvel employees.

Other ventures included the creation of Marvel Software to enter the growing software market and a Joint Venture with Planet Hollywood to establish a series of themed restaurants. All of these transactions, while envisioned as smoothing out the cyclicity of comic book sales, were funded with large amounts of debt and increased Marvel's debt burden considerably. Note the steady increase in debt with the huge spike in 1995 below¹⁰.

Marvel Debt Analysis - Pre-Bankruptcy

	Marvel Entertainment Group			
	1992	1993	1994	1995
Debt	236.3	250.2	384.3	586.5
Equity	84.7	147.3	243.0	207.8
Interest/Net Income				
Debt/Equity	2.79	1.70	1.58	2.82
Debt/Total Capital	74%	63%	61%	74%

Of the aforementioned acquisitions, the Toy Biz agreement looks particularly ill-advised in hindsight. Perelman entered into an agreement with Toy Biz where Marvel received just under 50% of Toy Biz in exchange for exclusive rights to toy production of all Marvel characters. Although Toy Biz only produced action figures, the agreement covered all toy lines, and Marvel cancelled its contracts with other toy makers. Since Toy Biz didn't replace these lost toy sales, and didn't have to pay royalties for their own toy production, Marvel lost an important stream of income. Furthermore, this agreement required an up-front transfer of Toy Biz stock for the perpetuity of toy licensing. It is ironic that Toy Biz eventually became the company that helped

¹⁰ From Marvel Entertainment Group annual reports on Form 10-K for years 1992-1995

Marvel out of its later bankruptcy through an acquisition. Nevertheless, these acquisitions helped to disguise Marvel's financial woes and gloss over declining comic sales.

Despite its financial problems, Marvel had, indeed, achieved its goal of becoming a diversified entertainment company: 1. Sports and Entertainment Cards (Revenue 22%), 2. Toys (22%), 3. Children's Activity Stickers (21%), 4. Publishing (18%), 5. Confectionery (11%), and 6. Consumer Products and Licensing (6%). Although diversification was, in theory, supposed to protect against downturn, Marvel lost \$48.5 million in 1995, mainly due to the losses in its comic book and publishing segments for the reasons already mentioned. In the case of Marvel, the denial of a problem lasted into 1996 – the year Marvel filed for bankruptcy.

Signs of the Decline

Using the analytical tools from our class, we could see Marvel's decline in terms of numbers¹¹. Most notable was the fact that Marvel's Z score fluctuated quite a bit over this four year period and went in the 1.10-2.60 range in 1994, which for Non-Manufacturing Industries, meant that Marvel needed to be closely monitored. Marvel finally went below the 1.10 mark in 1995, which predicted insolvency within 12 months. That was the same year that Marvel took a net loss for the first time in a long time.

Generally speaking, Marvel's financial status eroded considerably on every variable from the end of 1992 to the end of 1995. Total expenses grew 419%, inventory turns shrank by 26%, days sales in inventory grew 37%, and total inventory grew 406%. Even more dramatic, Marvel's accounts payable grew 603% over the period- surely a sign that Marvel was actively lengthening the payment cycle to avoid a cash crunch. While one could surmise that Perelman was blinded to the troubles Marvel faced in 1992 or 1993. Marvel undoubtedly knew that it was in a crisis state by the end of 1995: a full year before filing for bankruptcy.

¹¹ From Marvel Entertainment Group annual reports on Form 10-K for years 1992-1995

Marvel Financial Status - Pre-Bankruptcy

	Marvel Entertainment Group			
	1992	1993	1994	1995
Net Income	32.6	56.0	61.8	(48.4)
Revenues	223.8	415.2	514.8	828.9
Expenses	167.1	325.3	422.4	866.9
A/R	69.0	77.9	189.5	240.0
Receivables turnover	3.2	5.3	2.7	3.5
Days' sales in receivables	112.5	68.5	134.4	105.7
Inventory	16.3	23.2	51.0	82.4
Inventory turnover	13.7	17.9	10.1	10.1
Days' sales in inventory	26.6	20.4	36.2	36.3
A/P	14.9	19.9	69.6	104.8
Payable turnover	6.9	9.3	5.4	6.5
Days' COGS in payables	52.8	39.3	67.6	56.4
Working Capital	70.4	81.2	170.9	217.6
Z Score	3.1	4.9	1.6	0.9

PART II: THE BANKRUPTCY AND HOW IT WAS HANDLED

Fast Forward to December, 1996

In 1996, Marvel reported a huge loss of \$464M. On October 8, 1996, Marvel announced that it would violate specific bank loan covenants due to decreasing revenue and profits. A third of its work-force was fired. Then, on Dec 27, 1996, the publisher of Marvel Comics filed for Chapter 11 bankruptcy protection in New York. While under Chapter 11 bankruptcy, Marvel was expected to pay all its bills and maintain normal schedules and credit terms with its suppliers and licensors.

Bankruptcy provided an opportunity for all the major stakeholders to evaluate their options regarding their investment and control of Marvel. This section of the paper identifies and reviews potential scenarios for three major stakeholders (Note: While there are many stakeholders, this paper focuses on three primary stakeholders):

1. Marvel – a company, not individual management, perspective
2. Toy Biz – a major license holder that heavily depends on Marvel’s fortunes
3. Creditors – “investors” in Marvel including banks, bondholders, and others

Upon review of the different scenarios, this paper attempts to qualitatively assess what the best option from each stakeholder’s perspective would have been from a strategic standpoint, and compare that to what actually happened to assess who ended up winning/losing the most and determine whether the judge's ruling reasonably satisfied the competing needs of the various parties.

Marvel Perspective – Next Steps?

Bankruptcy alleviated Marvel’s immediate cash shortage, protected it from creditors and some litigation, and provided Marvel with a ‘fresh start.’ However Chapter 11 also had a negative

impact on Marvel’s employees, customers, and suppliers. Marvel needed a plan that would regain faith from its stakeholders. A number of options were available, including (but not limited too):

- A. Divest Non-Core Assets and Loss-Generating Units
- B. Sell Entire Company, including Core Assets of Comic Characters
- C. Consolidate with Another Company
- D. Negotiate Existing Financing Terms (of Debt)

Marvel Option A: Divest Non-Core Assets and Loss-Generating Units

By the time of the bankruptcy, Marvel consisted of five major divisions, which include:

- Publication and sales of comic books and other children publications
- Consumer products, media advertising, promotion and licensing of Marvel characters
- Marketing and distribution of sports and entertainment trading cards and activity sticker collections
- Design, marketing and distribution of toys
- Manufacturing and distribution of adhesives and confectionery products

Marvel could divest businesses by their performance and strategic value. Businesses not directly related to the development of Marvel’s core asset (the comic book characters) would be sold. Selling the trading cards, stickers, toys, and other products divisions would allow Marvel to build the brand value of their characters through key channels (comics and licensing).

Benefits and Risks of Marvel Option A - (Divest Certain Assets)

Benefits	Risks
<ul style="list-style-type: none"> ▪ Focus on original strength – the development of comic book characters ▪ Ability license characters to companies that sell trading cards, stickers, shows, etc. (basically outsource businesses of current divisions) ▪ Creates leaner organizational structure; allows the management and employees to focus entirely on the comic character development ▪ Removes businesses with bleak outlooks (i.e., sports trading cards), which negatively impact Marvel’s financial performance in the future 	<ul style="list-style-type: none"> ▪ Unable to find suitable buyers for their non-core businesses ▪ Sell divisions at below market prices (Marvel’s current bankruptcy position diminishes Marvel’s bargaining power) ▪ Increases volatility of Marvel’s total revenues (Marvel’s businesses becomes concentrated) ▪ Divest wrong businesses, given market decline of comic books

Marvel Option B: Sell Entire Company, including Core Assets of Comic Characters

Marvel could sell the entire company, including the publishing/comic book divisions. Marvel’s major business segments (publishing and trading card divisions) were at a relative low. Any sale at this time would be at a steep discount relative to the long run potential market value of the company. Therefore, it would be more likely that parties to the bankruptcy proceeding would be motivated to find alternatives to this option that unlock greater value, given the strong brand and history of the Marvel franchise.

Benefits and Risks of Marvel Option B – (Sell Company)

Benefits	Risks
<ul style="list-style-type: none"> ▪ Avoids any future losses to all shareholders (assuming that the company has little potential to turnaround) ▪ Saves certain businesses by selling to companies that can effectively manage the unit 	<ul style="list-style-type: none"> ▪ Lose a pioneer in the comic book industry ▪ Lose (or damage) a unique asset – no ‘experienced’ buyers are found to continue the development of the Marvel characters ▪ Generates little or no return for the stakeholders ▪ Lose options to turnaround the company ▪ Overcome resistance to divestiture

Marvel Option C: Consolidate with another Company

Marvel could merge with another company, potentially a competitor such as DC Comics, Time Warner or Disney. Such companies have experience building character brands and know how to use such assets to generate value (DC develops Superman, Batman, etc.; Warner Brothers owns Looney Tunes; Disney owns Mickey Mouse and friends). Another option for Marvel could be to merge with a buyer – companies that currently pay to license Marvel’s characters. For example, a toy company or movie studio could merge with Marvel and acquire the entire comic character base. A third category of potential merger targets are companies that don’t fit within the prior two. Companies, such as McDonalds or AOL, that currently don’t use Marvel characters or have their own set of characters, could purchase the comic book assets and use Marvel characters to enhance their businesses.

Benefits and Risks of Marvel Option C – (Merger)

Benefits	Risks
<ul style="list-style-type: none"> ▪ Leverage financial resources and experience to maintain their comic book character asset ▪ Creates enormous benefits to the acquiring/target company (new businesses, etc.) ▪ Generates a feasible plan to salvage the Marvel characters ▪ Creates distribution, cost and licensing synergies and cross-selling opportunities ▪ Provides immediate avenue of return to existing stakeholders 	<ul style="list-style-type: none"> ▪ Unable to identify “qualified” company for merger; “inexperienced” company takes control of Marvel ▪ Continues decline of Marvel characters’ image/value ▪ Lose control (Marvel’s stakeholders) ▪ Loss value (Marvel’s stakeholders) ▪ Creates conflicting issues/goals with merging company, which may lead financial instability, lack of synergies, culture clash, etc. ▪ Merging company may fall into Marvel’s current downward spiral

Marvel Option D: Negotiate Existing Financing Terms (Debt)

Marvel could also attempt to negotiate new favorable terms with their existing creditors (banks, bondholders, suppliers, etc), which would help Marvel rise from bankruptcy without significantly changing their existing businesses.

Benefits and Risks of Marvel Option D – (Renegotiate Debt)

Benefits	Risks
<ul style="list-style-type: none"> ▪ Allows Marvel to restructure the firm without additional outside assistance (beyond the existing stakeholders) ▪ Provides an opportunity for Marvel to focus on growing the company, rather than selling businesses or potential merger scenarios 	<ul style="list-style-type: none"> ▪ Negotiating new terms with debt holders is unlikely, given the losses they have already incurred ▪ Overcoming the political hurdle that may favor other options (i.e., divesting the company) ▪ Preventing the bond sales of existing debt holders

Discussion of Marvel’s Options

After considering the benefits and risks of these four options, Marvel’s most likely options at the time (those that create the highest value) were: divesting non-core businesses (Option A) and

merging with another company (Option C). Complete company liquidation (Option B) and finance renegotiations (Option D) are very unlikely.

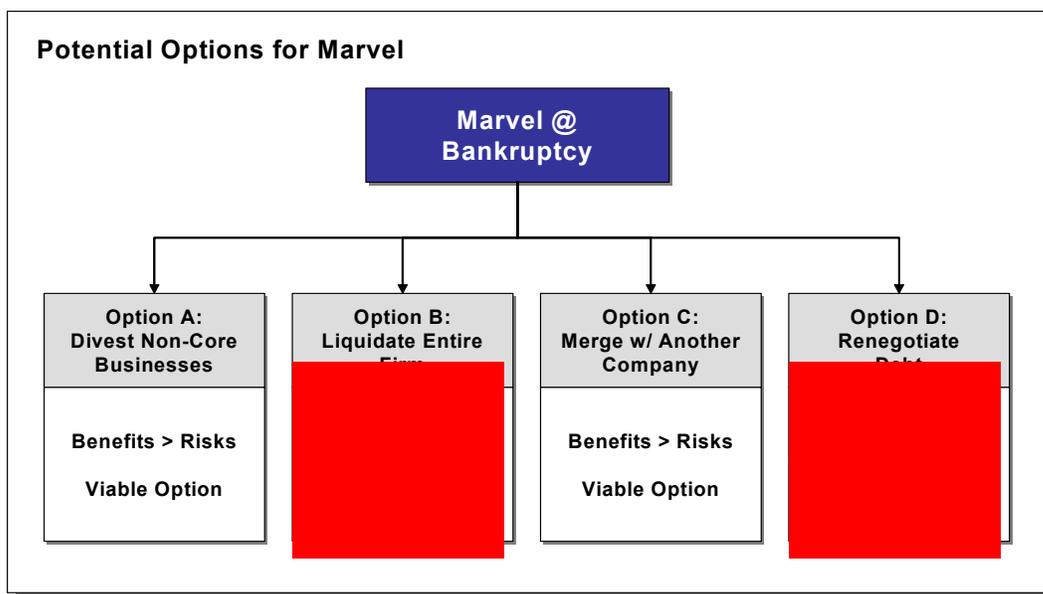
Divesting non-core businesses (Option A) would have allowed Marvel to maintain their core business and implement a turnaround strategy that may have gained the approval of its stakeholders. Removing businesses, such as stickers and trading cards, would have allowed Marvel to focus on what they do best – build powerful comic characters and storylines which could have been licensed in a variety of new businesses. However, key concerns of this scenario included: Marvel’s ability to determine correctly which businesses are critical versus expandable, the sale of non-core assets at a fair price, identification of potential buyers, and growth of a successful publishing business in a declining market.

Merging with another company (Option C) was a very viable option for Marvel. Depending on the company, a merger provided Marvel with a “fresh” set of resources – assuming the company has resources, particularly working capital, to spare. Merging with companies like DC or Disney provided an opportunity for Marvel to continue to grow under the experience and resources of these firms, i.e. they knew how to build valuable characters and create stable businesses. Other key factors regarding this option included identifying potential companies willing to purchase/merge with Marvel, defining the relationship and strategy between the two companies, and validating the merger for Marvel’s existing shareholders.

Liquidating the entire company (Option B) was very unlikely because of the strong passion and support from various stakeholders and the management team, including Ron Perelman and Stan Lee, Marvel’s creative mind. Marvel had core assets that were unique (not easily replicable). While the market may not have been increasing for publishing (comic books), the market continued to have a strong affinity for Marvel characters, such as Spiderman and X-men. In

addition, liquidating the entire company during bankruptcy would have generated very little return for all stakeholders, since the company would be sold below its market value.

Renegotiating better financing terms with the debt holders (Option D) was also a very unlikely option. Given the fact that Marvel’s main lines of businesses were declining, debt holders would have wanted to minimize their current loses. The debt holders would have favored either Option A or C because it provided Marvel with a chance to survive and the debt holders to make more money. Current debt holders may have even preferred liquidating Marvel entirely before negotiating new terms in order to salvage what they can.



Toy Biz Perspective – Merge or Else?

Marvel’s set of characters was Toy Biz’s lifeline, and its success depended on the success of Marvel’s ability to develop and maintain the value of Marvel’s comic characters. Given this relationship and Marvel’s bankruptcy status, Toy Biz was in serious trouble and needed to explore a number of options, which include (not complete list):

- A. Purchase of Character Rights from Marvel
- B. Consolidation with Marvel

C. New Strategic Direction

Toy Biz Option A: Purchase Character Rights from Marvel

Toy Biz could have purchased Marvel’s core assets – the comic book characters given that Marvel might cease to exist and the key input for Toy Biz’s products may expire. Key factors that would have determined the viability of this option include: determining the appropriate purchase price, evaluating the willingness of Marvel to sell their core asset, and assessing Toy Biz’s abilities to continue to maintain and improve the brand value of the comic characters (through which channels). Other considerations included how the purchase impacts Marvel’s current stake in Toy Biz.

Benefits and Risks of Toy Biz Option A – (Rights Purchase)

Benefits	Risks
<ul style="list-style-type: none"> ▪ Purchase Marvel’s core assets at a relatively ‘cheap’ price, since Marvel is in bankruptcy ▪ Reducing Toy Biz’s dependency on third-party suppliers (no longer dependent on Marvel) ▪ Expanding Toy Biz’s businesses, such as additional licensing of characters to other third-parties ▪ Access to premium and popular characters ▪ Reduce costs (eliminate costs of licensing) ▪ Control development of the characters 	<ul style="list-style-type: none"> ▪ Unable to convince Marvel to sell core asset (comic character) ▪ Overpay for character asset ▪ Unable to leverage core character asset for new businesses ▪ Declining market demand for Marvel characters ▪ Unable to develop/maintain characters’ value/brand in the market

Toy Biz Option B: Consolidate with Marvel

Toy Biz could merge with Marvel, given that Marvel already owned a majority stake in the company¹². Merging the two companies would have provided many benefits for Toy Biz, including some of the benefits described in Toy Biz Option A. It would have significantly helped Marvel, by alleviating its financial pressures. However, such a merger would have to be examined

¹² Raviv, Dan. Comic Wars. Broadway Books, NY. p. 41, 49

with extreme scrutiny, since Toy Biz would be taking on the responsibility of helping turnaround Marvel.

Benefits and Risks of Toy Biz Option B – (Merge with Marvel)

Benefits	Risks
<ul style="list-style-type: none"> ▪ Purchase Marvel at a relatively ‘cheap’ price, since Marvel is in bankruptcy ▪ Expands Toy Biz’s businesses ▪ Access to premium and popular characters ▪ Reduce costs (eliminate costs of licensing) ▪ Provides ability to influence development of the characters ▪ Capitalize on the synergies and core competencies between the two companies ▪ Provides avenue of growth for both companies (acquisition) ▪ Creates more stable revenues, through diversification 	<ul style="list-style-type: none"> ▪ Unable to convince Marvel to merge ▪ Overpay for Marvel ▪ Declining market demand for Marvel characters ▪ Unable to materialize expected synergies ▪ Hinders value of Toy Biz (merger has negative impact) ▪ Unable to cross-sell or develop new businesses with the characters ▪ Transfers financial burden of Marvel onto Toy Biz

Toy Biz Option C: Embark On A New Strategic Direction

Under this scenario, Toy Biz would completely sever ties with Marvel and develop new businesses, based on new sources of characters/ideas – internal or external sources. Toy Biz could develop toys based on another company’s character base, such as McDonalds or Geico. Movies, such as “Austin Powers” (released in 1997), or sports could also provide a source of characters that prove favorable in the toy market. A key factor would have been identifying the new source that fits with Toy Biz’s new strategic direction.

Benefits and Risks of Toy Biz Option C – (New Strategy)

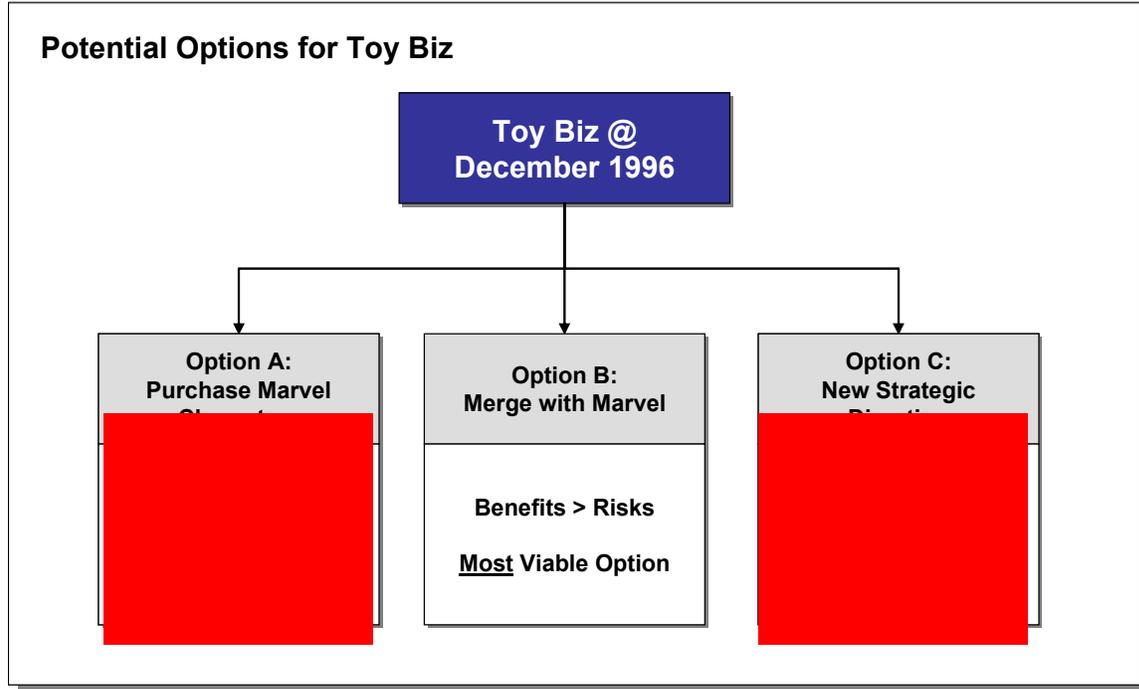
Benefits	Risks
<ul style="list-style-type: none"> ▪ Removes Toy Biz’s dependency on Marvel entirely ▪ Creates greater flexibility for Toy Biz ▪ Provides an opportunity to develop a more ‘promising’ line of businesses ▪ Provides Toy Biz with an opportunity to develop new characters/toys 	<ul style="list-style-type: none"> ▪ Unable to identify new source of characters ▪ Unable to develop own or new line of promising toys/characters ▪ Selects poor source of characters for toys (chosen movies, sports, etc. are not well-accepted in the market) ▪ Lose option to capture value of Marvel’s characters if Marvel successfully turns around

Discussion of Toy Biz's Options:

Given the risks and benefits, all three options were viable. However, Toy Biz's dependency on Marvel's core asset, the lack of experience in developing comic characters, and limited ability in identifying new character assets or strategic direction should have been the key strategic factors, in our assessment, in motivating Toy Biz to look into merging with Marvel (Option B) as the best option.

While purchasing the core assets of comic characters was feasible (Option A), Toy Biz stakeholders would have questioned its ability to develop and maintain the value of Marvel characters - given that Toy Biz had no experience in this arena. Purchasing the core assets of Marvel alone would have forced Toy Biz to develop experience in building and developing the brand/value of the characters. Without this simultaneous promotion of the characters, the demand for Toy Biz's products would have declined. This was a very difficult skill to build/acquire, given the fact that incumbents (Marvel and DC) had spent decades building their franchise of comic characters.

Creating a new strategic direction (Option C) was also viable, yet very difficult given Toy Biz's history. Identifying a new source of characters or toy ideas that had the deep history and broad market appeal of Marvel would have been difficult. Certain new movies, sports or entertainment ideas may have provided Toy Biz with immediate "fresh" sources of characters for new toys, but stakeholders would have questioned the sustainability of these sources.



Debt Holder's Perspective – Invest in a Sinking Ship?

From the perspective of Marvel's debt holders, they had two overall options:

- A. Continue to Hold/Invest in Marvel
- B. Sell/Liquidate Holdings

The risks were high for both. The key questions that the debt holders needed to have addressed were:

- Under which option are we (stakeholders) better-off?
- Are we investing in a sinking ship?
- Can Marvel develop and execute a viable restructuring plan?
- Should what we can through liquidation?"

The key to understanding whether the debt holders choose Option A or B depended on their risk profile.

Debt Holders Option A: Continue To Invest/Hold in Marvel

Assuming that Marvel presented a viable restructuring plan, the debt holders could hold their existing stakes in hopes that Marvel turned around successfully. Marvel did have several options, from divesting non-core assets and/or merging with another company. Such moves may have proved viable in helping Marvel turnaround. However, the debt holders already faced a massive loss today along with a very real possibility that they would not fully recover their losses in the future; it would have been their risk profile that determined whether they wanted to continue to hold in Marvel.

Benefits and Risks of Debt Holders Option A – (Continue to Invest/Hold)

Benefits	Risks
<ul style="list-style-type: none"> ▪ Capitalize on Marvel’s turnaround (assuming it is successful) ▪ Provides Marvel’s team with faith and backing ▪ Creates greater returns in the future ▪ Reduces current losses if sold stakes during Marvel’s bankruptcy ▪ Avoids liquidation of Marvel’s assets (potentially sold significantly under value) 	<ul style="list-style-type: none"> ▪ Increase in losses because Marvel may never successfully turnaround ▪ Lose option to minimize losses

Debt Holders Option B: Sell/Liquidate Holdings

Under this option, the debt holders would have sold their stake or collected immediately on the remaining assets. This was a very plausible option given the fact that things did not look favorable for Marvel, especially if the bondholders had low-risk tolerances and wanted to minimize any further losses.

Benefits and Risks of Debt Holders Option B – (Sell/Liquidate)

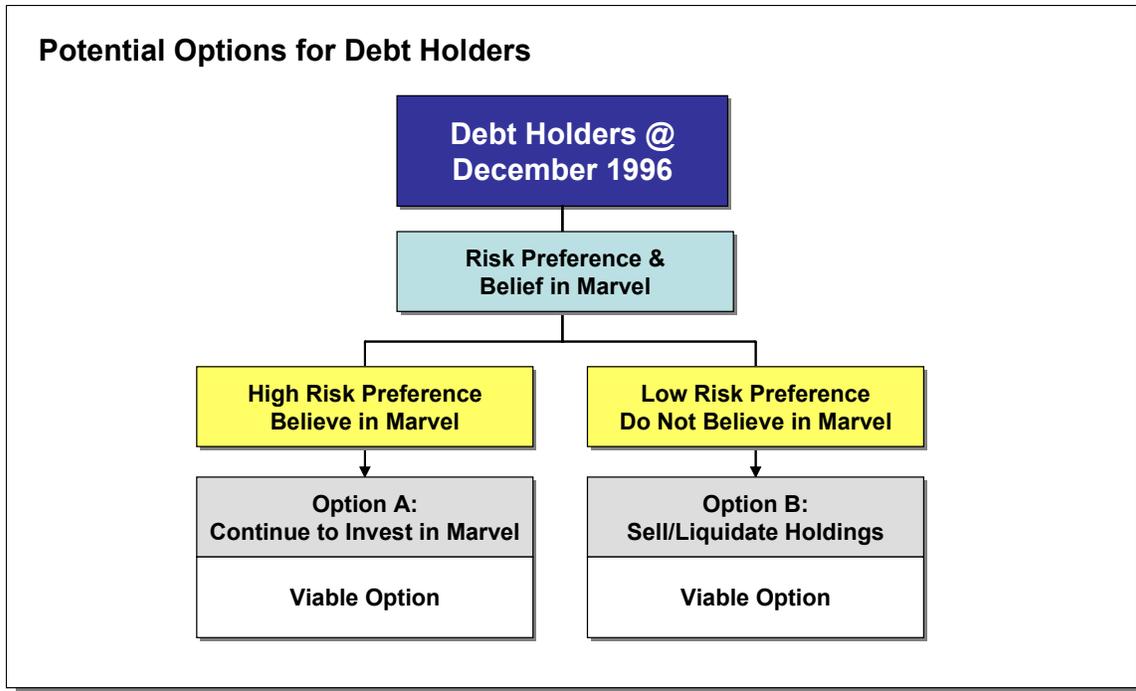
Benefits	Risks
<ul style="list-style-type: none"> ▪ Minimize further losses ▪ Capture any remaining value of the assets 	<ul style="list-style-type: none"> ▪ Lose option to capitalize on Marvel’s turnaround (assuming it is successful) ▪ Lose the opportunity to gain higher returns in the future ▪ Forces Marvel into liquidation of assets, potentially limiting Marvel from successfully turning around

Discussion of Debt Holders’ Options:

Based on our analysis, both options were equally viable – neither option was out-and-out superior to the other. Both options had clear benefits and risks. As mentioned before, the key factor in determining the right option was dependent on the risk profile of each debt holder.

Continuing to hold/invest in Marvel (Option A) was an option preferable for debt holders who were willing to take risks, could afford to provide Marvel another chance, and believed that Marvel could execute a viable turnaround option. By providing Marvel time to restructure, the debt holders would have had opportunity to recoup their investment. However, under this option, the debt holders lose the option to minimize losses.

Liquidating current holdings is the right option for debt holders who fear any further losses and those who believe that Marvel will be unable to turnaround. Debt holders with low risk preferences should liquidate their holdings. However, under this option, the debt holders lose the opportunity to recoup their full investment if Marvel is successful.



In Reality – The Winners and Losers

From our analysis, we argued that the two most likely options for Marvel were to sell non-core businesses or merge with another company. The question was – if they merged/were acquired, who it would be with. We argued that Toy Biz had only one viable option – to merge with the company that they were intricately tied with. Finally we argued that depending on their risk preferences, different debt holders/creditors would choose either of the two options of holding or selling.

In reality, the creditors were split into two major camps – the banks who were the secured creditors and the bondholders, who were the unsecured creditors who had helped Ron Perelman finance investments while he was CEO of Marvel. The bondholders were led by the corporate raider Carl Icahn who bought up \$100M (face value) of bond debt with \$70M of his own money to

try to gain a controlling interest in Marvel so that he could gut it and sell its assets¹³. The estimates of Marvel's net worth both under a liquidation plan and as a "going concern" were not enough to satisfy both creditor groups, so they fought in bankruptcy court¹⁴. Just as the courts were about to award the bondholders with the lion's share of Marvel, Toy Biz's CEO Ike Perlmutter struck a deal with the banks to back a reorganization plan that involved a merged Toy Biz/Marvel entity, whose combined assets could provide greater value than Marvel alone. After several rounds of legal battles, the bankruptcy court eventually ruled in Perlmutter's favor and the two companies were allowed to merge into a new company called Marvel Enterprises.

In the end, Marvel was able to overcome the key hurdle regarding the option to merge, which was identifying a suitable company to merge with – it ended up merging with the company that it was most closely tied with. The same could be said for Toy Biz. From the perspective of the bank creditors, the merger increased the amount that they could recover and potentially earn in the future with a viable, combined new company. The bond holders, who were unsecured, lost the most, but even there, the bankruptcy court approved a very creative suggestion – that they would be able to recover a large percentage of any money won in a lawsuit targeted at Ron Perelman for corporate negligence and fraud. The thinking was that the bond holders had taken a calculated risk in buying the risky bonds that Perelman had issued during his stint at Marvel and that any recovery should be at the hands of the man from which they bought the risk. In the end, the bond holders did not win the lawsuit because the courts ruled that Perelman had not broken any laws.

Ultimately, the big winners were the banks and Toy Biz. The banks received \$232M cash, 13M common shares, 8M preferred shares at an 8% dividend plus the right to buy more shares,

¹³ Raviv, Dan. *Comic Wars*, Broadway Books, NY. p. 61

¹⁴ Raviv, Dan. *Comic Wars*, Broadway Books, NY. p.81. In December 1996, total outstanding debt for Marvel was \$725M from banks, \$1B from bondholders. The estimated liquidation value was \$447M and the estimated "Going Concern" value was \$520-\$660M.

\$617M in claims at \$0.70 on the dollar, and a small share of the litigation winnings against Ron Perelman. Toy Biz won because it preserved itself from what seemed like an inevitable Carl Icahn-led fire sale, and maintained its lucrative relationship with Marvel. The equity owners even got a little something – 12M warrants to purchase Marvel shares in the future. The bond holders got to take the lion’s share of winnings from the Perelman suit, although they ended up not winning anything in the end. Carl Icahn himself got \$3.5M for his legal bills plus some preferred shares for the new Marvel.¹⁵

Overall, the ruling by the bankruptcy courts amounted to the most equitable, reasonable, settlement that could have been achieved because it ended up being consistent with the kind of “rational” analysis that we conducted on what would have been the best outcomes for all parties, upheld the law, and made all parties share some of the pain and compromise that is common to all bankruptcy proceedings.

¹⁵ Raviv, Dan. *Comic Wars*. Broadway Books, NY. p. 247-248

PART III: THE QUALITY OF THE TURNAROUND

Introduction

On the whole, we believe that Marvel's transformation from a bankrupt to a profitable company during 1997-2000 was skillfully handled by the management team that was eventually led by F. Peter Cuneo (the appointed CEO of Marvel from 1999-2001) and Ike Perlmutter (the CEO of Toy Biz and a Marvel director). Our analysis of the turnaround is organized across three time periods, which represent significant milestones in its turnaround effort: (1) the "Bankruptcy Years" from 1997-1998, (2) the "Repositioning Years" from 1999-2000, and (3) the "Stable but Uncertain" Years from 2001-present. Across these three time periods, we assess whether the company's turnaround decisions along financial, operational and managerial dimensions were "Good" or "Poor".

The "Bankruptcy Years" from 1997-1998

During this period, the management team spent much of its effort trying to meet its bankruptcy covenants while trying to fix obviously broken parts of the company. We believe that during this period, management should have:

- Shed as many unprofitable and/or all non-core businesses (ones not directly related to the creation and marketing of Marvel superheroes) as quickly as possible to save/generate cash.
- Renegotiated all major business contracts to maximize cash-favorable terms.
- Articulated a clear, coherent vision of the company to set future investment direction.

Upper management succeeded in doing some of these things, but often did not go far enough, or retained parts of the business that they should have ceased. As a result, the management team was reshuffled twice in two years by the Board of Directors¹⁶.

¹⁶ From Marvel Enterprises, Inc. annual reports on Form 10-K for years 1997-1998, Management Sections.

Good Decisions

First, Marvel's management team wisely divested several unprofitable and inactive entities, the most important of which were:

- Heroes World Distribution, Inc. – the exclusive, wholly owned distributor of Marvel's comic books, which had become unprofitable over the years as comic book demand fell. In its place, Marvel's management established a contractual relationship with an alternative distributor with more favorable financial terms.
- Fler Confections – the candy arm of the trading card company was sold at a loss over 1997 and 1998, which resulted in a decrease of \$7.1M in revenues.
- Unprofitable children's magazines, which resulted in a decrease of \$15M in revenues.

Next, Marvel's management cut operating costs by¹⁷:

- Laying off 300 people, most of whom were highly compensated people, administrative personnel, and editorial staff.
- Reducing SG&A by \$55.4 million (\$183M to \$127M) from restructuring the comics, distribution, trading cards and confections divisions of the company.
- Reducing depreciation expenses from \$16M to \$11M as result of write-downs of fixed assets associated with the sale of unprofitable business units.
- Renegotiated expensive artist contracts.

Finally, while doing this, management kept as much of the business going as possible:

- It maintained its comic book, licensing and toy businesses.

¹⁷ From Marvel Enterprises, Inc. annual reports on Form 10-K for years 1997-1998, MD&A Section

- It entered into a film contract for the motion pictures “Men in Black” and “Blade”.

However, Marvel was unable to fully exploit the licensing opportunities from both of these movies due to its bankruptcy.

Poor Decisions

Despite its efforts, we believe that Marvel’s management could have done even more to shed unprofitable business units. In particular, it should have divested:

- Fleeer/Skybox – a trading card company that Marvel had acquired in 1995, which had since become unprofitable due to a contraction in the trading card market plus unfavorable licensing arrangements entered into with sports and entertainment entities while the market for cards was still strong.
- Panini – an Italian subsidiary that produced stickers that had been losing money the last two years, and also which suffered from a fire that cost another \$10M for which the company has not received insurance proceeds. Marvel continued to run this business in the hopes that it would turn around when it should have sold this business.
- Marvel Restaurant Venture Corp – the joint venture with Planet Hollywood that created the Marvel Mania restaurant in Los Angeles, which lost \$5.5M in 1997. Marvel not only decided to keep this business, but it decided to open more – \$25.7 of available cash was spent on this venture, which eventually dried up after draining more money out of the company’s coffers.
- Toy Biz – the toy production arm of the company which was losing money, and had an unfocused array of both Marvel branded and un-branded products (NASCAR, WCW, Resident Evil, kites, girls’ products, etc). But Marvel’s management did not shed enough of the unprofitable products until 1998 when it decided to focus only on Marvel related toys.

Marvel's financial performance over this time period shows some of these trends¹⁸:

Marvel Status - Bankruptcy Period

	Marvel	
	1997	1998
Cash	21.7	43.7
Cash Ratio	4.7%	13.1%
Quick Ratio	31.6%	42.0%
Current Ratio	41.1%	51.8%
Net Income	(254.3)	(32.6)
Revenues	471.7	232.1
Expenses	712.5	261.0
A/R	86.8	50.3
Receivables turnover	5.4	4.6
Days' sales in receivables	67.2	79.1
Inventory	43.9	32.6
Inventory turnover	10.7	7.1
Days' sales in inventory	34.0	51.3
A/P	78.3	7.3
Payable turnover	8.3	3.9
Days' COGS in payables	43.7	93.0
Working Capital	52.4	75.6
Debt	261.1	227.0
Equity	(512.0)	183.6
Interest/Net Income		
Debt/Equity	(0.51)	1.24
Debt/Total Capital	-104%	55%
Z Score	(2.4)	0.1
Share Percentage (\$)	\$ 0.50	\$ 6.19
Shares Outstandings	101.8	33.5
Market Capital	50.9	207.0

Nevertheless, it is clear that Marvel made strides towards righting its ship in one year. By more than doubling cash on hand, Marvel gave itself some freedom to maneuver over the short term. More importantly, however, was Marvel reductions on a number of key variables. For instance, total expenses were reduced by 63% through, amongst other things, layoffs, scale back of operations and reduced SG&A. Accounts payable were also dramatically reduced in bankruptcy

¹⁸ From Marvel Enterprises, Inc. annual reports on Form 10-K for years 1997-1998, Consolidated Financial Statements

from 78.3 to 7.3: a 90% decline, largely due to write-offs. The Z-score was still horrendous at the end of 1998, yet it improved dramatically over the period. While still in a very precarious position, it is clear that Marvel's management was at least moving in the right direction financially.

All told, the picture was still quite gloomy. Amid all of the things that Marvel's management did, what was most lacking was a coherent strategic vision for the company. Management did an admirable job in the face of a tough situation to fix broken parts of the company, but there was no clear direction upon which the company was making its decisions. Marvel appeared to be a disparate collection of business entities loosely affiliated with each other by virtue of the fact that they all marketed Marvel superheroes. Each business entity was run as a separate division with little evidence to suggest that they were being coordinated in their efforts from the CEO.

One could surmise from the data in Marvel's 10-K reports from the time that the Board of Directors was struggling to find the right management team to lead the company out of this situation. In 1997, Joseph Ahearn, who had served as CEO and director of Marvel since 1993, along with his management team, was replaced by Eric Ellenbogen, former president of Golden Books Family Entertainment. He was in turn replaced in 1999 by F. Peter Cuneo, managing director of a private equity fund and turnaround specialist.

Overall, during this period, Marvel's management put forth great effort to help stop the bleeding. But it failed on two fronts: (1) it did not completely fix the major problems such as the Fleer/Skybox, Panini and Marvel Restaurants business, and (2) it did little in the way of trying to deal with the causes of the ailments that were inflicting the company – sustainable revenue sources, declining demand for its products, coordination across divisions – all products of a necessary strategic vision.

The “Repositioning Years” from 1999-2000

1999 was a milestone year in which Marvel was freed from Chapter 11. Management continued to streamline its capital structure, sell non-core assets, and improve operations of the core business. But more importantly, 1999 was the first time that the company began slowly shifting its focus away from addressing bankruptcy issues to building the company for the future.

Good Decisions

First, when this third management team in as many years took control in 1999, it already seemed to behave in a way that was different from its predecessors. When we looked at the management trends across the 10-Ks, we noticed that the 1999 team under F. Peter Cuneo, a private equity managing director and former CEO of Remington Products, had no separate COO. By 2000, there was no separate CFO listed. Cuneo had apparently consolidated the powers of CEO, CFO and COO under himself. The “old guard” from before the bankruptcy were all eventually put either in directors positions or management positions within the Toy Biz subsidiary. By 2002, when the company was very stable, Cuneo had apparently stepped down into a director role and a new CEO, CFO and CMO were installed. From what we have learned in class, it appears that Cuneo may have consolidated power in order to control the direction of the company, and that once he succeeded in making the company profitable, he stepped down and allowed successors to manage the company. If this was the case, Cuneo’s management decision to consolidate power was a good one indeed as he ushered in a period of stability at the company.

Second, after years of poor performance, Marvel’s management finally divested Fler/Skybox in February 1999 and Panini in October 1999, which had lost \$400M since acquisition¹⁹. This was long overdue.

¹⁹ Raviv, Dan. Comic Wars. Broadway Books, NY p.256

Third, to offset the lost revenue from these divestitures, they signed big licensing deals for motion pictures, most notably:

- With Sony to produce Spiderman, which was the first licensing deal in which Marvel received a percentage of gross receipts at the box office plus a percentage of home video/DVD sales. In addition, Marvel received a large cash advance and agreed to jointly develop and market Spiderman toys and other products with Sony.
- With 20th Century Fox to produce X-Men I and II, Fantastic Four and Silver Surfer.

Whereas these deals did not have the most optimal licensing terms, they represented evidence that the company was truly moving in a new direction toward being a licensor of intellectual property versus a product (comics, toys, cards, candy) company (more on this below). Monetizing the character library through increasingly lucrative licensing deals enabled the company to nurse its balance sheet back to health and generate significant levels of free cash flow.

Fourth, they reorganized the company around 5 operating units. By re-organizing their businesses around 5 business units to replace the myriad number of units that they operated under prior to bankruptcy, Marvel positioned the company to focus their efforts on the most value added activities. The 5 units were licensing, publishing, film/TV/DVD, internet/new media and toys.

Fifth, management further reduced operating costs by making large scale labor cuts. They reduced their in-house workforce from 1,650 persons and 550 freelance staff in 1998 to 800 in-house and 530 freelance staff as they divested large business units and streamlined their operations.

Most important though in this period was management's clear articulation of a vision for the company for the first time since the company began its decline. Marvel set out to be a leading entertainment company (as opposed to a comic book company or a toy company) by focusing on selling rights to its most valuable strategic assets – its library of comic book characters. They applied a brand management approach to their characters by looking at each character as a brand

that could be built up and marketed across different product categories and media formats.

According to Kenneth West, Executive Vice President and CFO, "We consider ourselves the talent agent for our characters, and we foster relationships with other major commercial players."²⁰ In addition to its focus, this approach was also good in that it was a non-capital intensive model for revenue. Marvel was to become primarily an intellectual property company, with ancillary products such as films, toys and DVDs, and an in-house comic book arm that served not only as a cash cow for revenues but more importantly as an "R&D" facility where new character brands could be developed, tested, marketed and used to create more revenue opportunities for the company.

Poor Decisions

Much of what Cuneo and his team did was good for the company. However, two glaring issues still remained:

- The toy business was still a laggard. The management team eliminated more product categories and lines (e.g. Kindergarden Babies, Miss Party Surprise) to focus its business on marketing and distributing toys based on Marvel characters, which provide the company with higher margins because no license fees are required to third parties and because of media exposure require less promotion and advertising support than the non-Marvel toy categories. Despite these measures, we still believe that the toy business was not optimally designed. We believe that the company should only focus on a handful of well-known Marvel and non-Marvel cartoon, comic or sci-fi/fantasy characters. All other product lines should be dropped. Further, we believe that the products should only be designed and marketed by a small team within Marvel while the production and distribution should be

²⁰ "Superheroes to the Rescue" by Ellen Heffes. <http://www.smartpros.com/x37370.xml>

outsourced to the lowest bidder to reduce operating expenses and to allow for flexibility during seasonal toy cycles. However, the company did not go this far.

- The company in 2000 was still making overall *net* losses. The small positive *operating* income that the company saw in 1999 all but disappeared in 2000 because the small positive operating profit in 1999 was due in large part to the one-time cash advance from Sony to Marvel for the Spiderman license. When there was no similar chunk of cash received, operating profits went negative again. This indicated to us that the company, though operating at a much better financial condition than before, was still not positioned right for long term value. The year 2000 was in a way a wake-up call to this fact.

From the table below, it is clear that Marvel still looked ugly. Cash decreased considerably from 1999 to 2000- and given the terrible Z-scores and net income numbers, one could easily argue that Marvel should have retained some of its focus on improving the company's financial position instead of funding growth projects.

Marvel Status - Repositioning Period

	Marvel	
	1999	2000
Cash	64.8	22.8
Cash Ratio	80.0%	32.4%
Quick Ratio	164.9%	100.4%
Current Ratio	213.5%	161.2%
Net Income	(33.8)	(89.9)
Revenues	319.6	231.7
Expenses	351.5	322.5
A/R	55.8	39.2
Receivables turnover	5.7	5.9
Days' sales in receivables	63.8	61.8
Inventory	39.4	42.8
Inventory turnover	8.1	5.4
Days' sales in inventory	45.0	67.4
A/P	9.6	18.6
Payable turnover	3.8	3.0
Days' COGS in payables	95.3	121.5
Working Capital	85.6	63.4
Debt	250.0	250.0
Equity	135.8	31.4
Interest/Net Income		
Debt/Equity	1.84	7.96
Debt/Total Capital	65%	89%
Z Score	0.5	(0.2)
Share Percentage (\$)	\$ 5.50	\$ 1.44
Shares Outstandings	33.6	33.7
Market Capital	184.6	48.4

Overall, Cuneo's team did what previous management teams could not – it not only focused the company around its core business, but it articulated a vision for the company and moved it in that direction. But this vision of Marvel being an entertainment company using its comic book assets to generate media-based licensing fees is wrought with its own risks and disadvantages, which the company will face from 2001 to the present.

The “Stable but Uncertain” Years from 2001-Present

In our estimation, 2001 began a period in Marvel’s history in which is it financially stable but strategically uncertain. From 2001-2003, the company successfully transforms itself into a free cash flow generating machine – low capital expenditures, low debt, low overhead and large licensing revenues based on motion pictures based on popular characters. Indeed, excited Wall Street analysts seem to think that Marvel is a sure thing. We, however, believe that Marvel’s long-term value is still uncertain for the reasons that we describe below.

Good Decisions

First, management made a big push to reduce long term debt and interest expense because it was hindering company growth. It bought back \$99M of its 12% senior notes to reduce annual interest expense by \$10M/yr.

Second, it restructured its perennially loss-making toy division. Instead of creating toys in-house, it embarked on a royalty-based production relationship with a Hong Kong based company called Toy Biz Worldwide (not affiliated with Marvel’s Toy Biz subsidiary) for the sale and manufacture of toy action figures and accessories that feature Marvel characters other than those based upon the upcoming Spider-Man movie. TBW is using the Toy Biz name for marketing purposes but Marvel has neither ownership interest in TBW nor any other financial obligations or guarantees related to TBW. The agreement represents a strategic decision by the Company to eliminate much of the risk and investment previously associated with these lines of toys while enabling Marvel to participate in their success through ongoing licensing fees. Toy Biz does product design, marketing and sales for TBW and is reimbursed for these expenses. This was an excellent and long-overdue move that we advocated from the get-go.

Third, management improved licensing all around by:

- Signing more deals for more motion pictures – Daredevil, X2, Hulk.

- Signing better deals – more gross participation and equity participation deals versus profit participation deals or notorious “Hollywood Accounting” deals involving a simple, front-loaded, one-time royalty fee.
- Signing many ancillary deals with companies such as Burger King, Activision, Universal.

Fourth, it improved the comic book publishing arm by:

- Reducing even further the cost structure and architecture for comic book publishing.
- Expanded distribution of comics in mass market bookstores such as Borders and Barnes and Noble.

Finally, in 2001, it reduced its operating costs even more by reducing its in-house employment to approximately 500 persons (including operations in Hong Kong and Mexico) and in 2002, reduced it down to 200 persons. The Company also contracted for creative work on an as-needed basis with approximately 500 active freelance writers and artists.

Marvel Status - Stable But Uncertain Period

	Stable but Uncertain	
	2001	2002
Cash	21.6	53.7
Cash Ratio	30.7%	59.6%
Quick Ratio	112.9%	118.4%
Current Ratio	142.7%	136.2%
Net Income	5.3	22.6
Revenues	181.2	299.0
Expenses	209.3	275.7
A/R	35.6	43.4
Receivables turnover	5.1	6.9
Days' sales in receivables	71.8	53.0
Inventory	20.9	16.0
Inventory turnover	8.7	18.6
Days' sales in inventory	42.1	19.6
A/P	13.1	11.6
Payable turnover	4.2	8.9
Days' COGS in payables	86.1	41.2
Working Capital	43.5	47.8
Debt	188.0	151.0
Equity	42.0	242.9
Interest/Net Income		
Debt/Equity	4.48	0.62
Debt/Total Capital	82%	38%
Z Score	(0.1)	0.8
Share Percentage (\$)	\$ 3.80	\$ 8.98
Shares Outstandings	34.8	61.1
Market Capital	132.1	549.0

The 2001 to 2002 period brought some true improvements to Marvel's financial statements. Cash more than doubled, reaching levels not seen in close to a decade. Net income grew 300% in year 2002, inventories fell considerably, and accounts payable continued to decline. Debt also continued to drop; and while the Z-score remained on precarious footing, it clearly continued its streak of improvement from the trough of -2.4 in 1997. Clearly, Marvel's finances were improving; but it was not yet in a comfortable position.

How Successful was This Turnaround²¹?

From a purely financial standpoint, the turnaround was a runaway success. Here is some evidence.

1. Minimal capital spending – just \$4M Capex with no real fixed assets.
2. Low debt - Only \$151M in 12% senior notes that will be called June 2004, and will most likely be paid off.
3. No more preferred stock – a combination of a tender offer and a forced conversion of preferred into common shares at \$1.39/share have eliminated all preferred stock interest obligations.
4. Estimated free cash flow yield of 7.2%.
5. Predicted share price increase in 26% to \$25 over the next 1-3 years.
6. High return on invested capital – 28%
7. Market valuation of equity – \$1.377B

From an operational standpoint, the turnaround was also strong. Here is the current evidence.

1. Licensing: The licensing model, upon which the new and improved company was based, has generated extremely high margins (gross profit margins of 70-80%) with little to no capital investment. Marvel succeeded not only in picking the right strategy (the strategy that leverages Marvel's biggest strategic assets – its characters) but also executing on it. The licensing group signed more licenses with improved licensing terms than had been previously signed. For instance, they signed equity participation deals with the smaller movie studios and profit participation deals with the larger studios (e.g. X-Men 2). Next, they used their momentum from their films to diversify their licensing revenues from DVD, video game, television, theme parks like Universal Studios, apparel, and other consumer

²¹ From Bear Stearns and Nateris Analyst reports, 2001-2002.

products like apparel, stationary, back-to-school, seasonal gifts, footwear, and collectibles.

Finally, they increased their potential future licensing deals by increasing the film pipeline.

2. Publishing: Marvel made this core business profitable once again. On the cost side, they cut back on expensive exclusive agreements with certain writers and artists, and replaced expensive hand coloring processes with less expensive computer coloring. On the revenue side, they mended relationships with the industry's top talent, many of whom had left Marvel during the bankruptcy or before because of artistic reasons, to improve the quality of their product so that sales would increase again. On the distribution side, they contracted with Diamond Comics, an independent unaffiliated entity, which processes all orders from the independent comic shops. This allowed Marvel to print to order to eliminate excess inventory.
3. Toys: Marvel also made this business profitable by shedding all but the most profitable toy lines, which usually amounted to those toys that were derivatives of their most popular licensed characters like Spiderman, X-Men and the Hulk, and only housing the design function in-house. All production was contracted out to a Hong Kong- based company called Toy Biz Worldwide (no affiliation with Marvel's Toy Biz).
4. Management: Marvel finally got rid of the checkered personalities that drove the company bankrupt and into chaos and replaced them with business folks who had the company's best interests in mind. Marvel also restructured/simplified the management organization structure by reducing the number of directors on the board, centralizing the CEO and COO functions under one person, and eliminating management positions that did not fall directly into the 3 new business units.

PART IV: PROSPECTS FOR THE FUTURE

What Could They Have Done Better/Differently?

The company clearly did a skillful job of turning itself into a cash cow. What is less certain however is the long-term viability of this licensing model, upon which the entire business of Marvel depends.

The Risk: Marvel's current success is largely driven by a handful of blockbuster films that have licensed their characters – Spiderman, the X-Men franchise and Daredevil to a certain extent. This means that Marvel's fortunes are intimately tied with Hollywood's fortunes. Hollywood is a hit driven industry – one big hit offsets a string of break-even or loss-making ventures. For Marvel, a movie's box office revenue drives not only its movie licensing revenues but also all of its downstream revenues except for the core comics business. Thus if movies based on Marvel characters produce less than stellar box office returns, all of Marvel's revenue streams will be adversely affected.

The question then becomes – will Marvel characters continue to produce hits? The answer is still up in the air. The Hulk, which was supposed to bring in blockbuster revenues flopped at the box office. As Marvel works its way down its list of marketable characters, it will increasingly be left with lesser known ones that will reduce the likelihood of a blockbuster. Further, the box office success of earlier movies like Spiderman will determine how interested the studios will be in the future, which will determine the amount of negotiating leverage that Marvel will bring to the table for licensing contracts. The pipeline for movies, DVDs and video games looks good for 2004-2005, but what if there are no more hits? And if Marvel decides to flood the market with as many of their superhero movies as they can, will audiences tire of them in the same way that comics readers grew tired of the oversaturation of comics books under Perelman? Given this huge

outstanding risk to the long-term viability of the company, we recommend the following courses of action to improve Marvel's position:

First, Marvel should focus on a few of the best comic titles and grow them. Marvel's Comic Book brain trust (not necessarily the business people) should strive to build demand around a few selected titles over the next couple of years to increase the likelihood that there will be a market with pent up demand for a movie version of this comic book. Care should be taken to:

1. Not oversaturate the market, or over-gimmick the offerings lest Marvel alienate their core reader base again.
2. Eliminate overprints to re-vitalize the collector market.
3. Refrain from distributing these growth titles in retail bookstores to increase their "exclusive" image. Instead, use the retail bookstore channels to distribute already established mainstream "character brands" only.
4. Segment the market into children readers and adult readers and cater unique titles to each segment.
5. Use television shows/cartoons as demand generators once a strong niche market has been established around a particular character brand. Revenues are small from this but their primary value is the added exposure and viewer impressions that create interest and buzz.

Second, Marvel should try to maximize its current licensing revenues to squeeze as much cash out of their current and pipeline deals as possible so that they have enough cash reserves on hand to weather any future hit droughts. Although Marvel has greatly improved their licensing terms, they are still suboptimal. Marvel needs to obtain equity participation rights (percent of gross revenues including home video, DVD, cable, television syndication and video games after deducting direct costs) because under this situation, a film can perform materially lower in terms

of gross intake but Marvel could still derive substantially better revenues. This will be challenging for Marvel to obtain considering that for movie studios, box office intake is seen as a cost recovery vehicle and DVDs/home video, cable, TV and video games are seen as the primary profit generators. Marvel should focus its negotiating efforts first on movies based on less popular characters because there is precedence for these movies to do well when the sum total of their revenues from all sources is tabulated. For instance, Blade and Men in Black generated over \$1B worldwide across all products, but because of their lower popularity, Marvel sold the deals for a much lower amount of cash upfront. Marvel should look for these smaller movies to increase their participation to the equity level. Artisan Entertainment's upcoming movie called The Punisher (based on the Marvel character and starring John Travolta) is Marvel's first equity participation deal.

Third, Marvel should diversify their core business geographically. Currently less than 10% of the company's licensing revenue is derived internationally. This is huge considering that roughly half of their total worldwide box office grosses have come from outside North America. Thus, there is demand. Specifically, Marvel should explore creating international characters in places like Japan. They should look into partnering with Japanese anime companies to create non-Hollywood, feature-length "un-Disney" animation movies to diversify their motion picture portfolio. Finally, they should mine international markets for new ideas for comics.

Finally, Marvel should be mindful of the actions of their biggest comics competitor DC, which is owned by AOL Time Warner. DC, home of Superman, Batman, Wonder Woman and the rest of the Justice League, could begin introducing more superhero based motion pictures into the market which could either stimulate more interest in superhero movies or tire audiences out and thus negatively impact Marvel's fortunes.

PART V: CONCLUSION

Marvel Today

While critics are still skeptical of the stamina of Marvel's recovery, the success of Marvel today proves that it undertook the right turnaround strategy. The stock market agrees: it sailed through the three-year bear market unscathed, rising more than 250%.²² Marvel seems to have learned that it needs to adapt to changing in consumer preference quickly. Marvel's products are fashion products that depend a lot on the success of movie and popularity of characters- which is difficult to predict. Therefore, ability to adapt to change and continuous innovation is crucial for Marvel.

Marvel's new business model also reduces risk and capital expenditures. Marvel combines its creative content and talent with the capital, expertise, experience and distribution strengths of its industry-leading partners to create Marvel character-based entertainment projects, consumer products and services. Through this model Marvel is able to pursue a much broader array of projects which bear little or no financial risk while creating high-margin licensing income streams and strategically important consumer exposure.

Another benefit from bankruptcy is that Marvel records of an asset on its balance sheet for Federal tax net operating loss (NOL) carry-forwards. Marvel expects to exhaust this NOL asset and begin paying Federal taxes sometime in the second half of 2004.

Marvel continues to focus on its core competency by expanding its licensing business internationally to Europe and Asia. To that end, in November, 2003, Marvel hired Bruno Maglione of Universal Studios to head up Marvel International. Bruno stated, "Marvel possesses one of the greatest character catalogues in the entertainment world and one which is enjoying a resurgence thanks to the box office success of Marvel character movies. The Company has only

²² "Marvel's profit sense is tingling as superhero films prevail." *USA TODAY*, May, 2003.

begun to scratch the surface of opportunities that this combination brings to key markets abroad.”²³ Additionally, Marvel recently partnered with new licensees such as Electronic Arts to produce a new generation of fighting video games pitting Super Heroes from the Marvel Universe.

Nevertheless, Marvel still has problems of the kind mentioned earlier in the paper looming on the horizon, such as industry cyclicalities, future decreasing returns from the licensing model, and potential problems with international expansion. Matt Krantz wrote in *USA Today* last year: “But even superheroes have weaknesses...[There is] a danger of a few superflops, which would cool Hollywood off in a hurry. And there's always a danger of moviegoers getting tired of superheroes.”²⁴ Either way, it is clear that Marvel’s reinvention is what will keep it relevant into the 21st century. What an interesting turn of events for a company founded to produce cartoon books for Depression-era children.

²³ (http://www.marvel.com/about/pr/archive/111803_bruno.htm)

²⁴ “Marvel's profit sense is tingling as superhero films prevail” by Mark Krantz, *USA Today*, May 6, 2003. http://www.usatoday.com/money/media/2003-05-06-marvelous_x.htm