

7th May 2008

**ASX Code: BRT**  
**Speculative Buy**

**Capital Structure**

Sector	Consumer durables & Apparel
Share Price	A\$0.099
Fully Paid Ordinary Shares	109.2m
Options (ex 20c ,Mar 31, 2013)	74.86m
Market Capitalisation (undiluted)	\$13.6m
Share Price Year High-Low	\$0.21-\$0.07

**Management**

Charles MacKinnon	Executive Chairman
Alex Aguero	Managing Director
Bob Finn	CEO, Director
Graham Nicol	Director
Lawrence H.Bernstein	Director
Keith Bales	Non-Executive Director

**Major Shareholders**

Marshmallow Fun Company LLC	17.5%
Noble Investments PL	10.8%
Alex Aguero	5.2%
Lothbury Pty Ltd	4.5%

**Analyst**

Industrial Analyst  
Dennis Trlin  
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**Share Price Performance**



Source: E-trade.com

# Brainytoys Limited

## Acquisitions completed, maiden profits around the corner.

### New acquisitions completed, marshmallow shooter to enter U.S markets

Brainytoys Limited ( "Brainytoys", "BRT", the "Company") has completed its acquisition of the Marshmallow Fun Company ("MFC"), a US based supplier of marshmallow shooters. The Marshmallow Shooter, the flagship product in the range, won the Creative Child Magazine's Top Toy of the Year for 2006/2007 and the Seal of Excellence award in 2004. More recently, the Marshmallow Shooter and the recent introduction to the range; the Marshmallow Bow and Mallow have been ranked Top Ten Toys by two major independent industry observers in the United States - BMO Capital Market's "Toys" New York Toy Fair Report and Toys and Family Entertainment Magazine (USA).

The Purchase consideration for the MFC acquisition totalled US\$4m which includes the issue of 19.048m shares in Brainytoys at an issue price of 15 cents. Purchase agreements also included a media purchase and inventory financing agreement for US\$1.3m.

In addition to the MFC Acquisition the company has completed its acquisition of UK Business, Toyway Ltd ("Toyway"). The Toyway acquisition gives Brainytoys access to an established toy and hobby business in the UK with a strong sales network, logistical infrastructure and existing customer base. Toyway will serve as a distribution point for over 250 Brainytoys group products into the European market.

We expect revenue for CY2008 to reach \$20m as a direct result of recent acquisitions and we anticipate half of this turnover to fall in the fourth quarter of the year due to the seasonal nature of the toy business.

### Exceptional product offering, business model evolving

Brainytoys has evolved into a global toy distribution company with a complementary Perth based toy development arm. New acquisitions give Brainytoys pre-qualified vendor numbers, which enables access to the majority of the key mass market retailers around the world.

Brainytoys currently holds exclusive licensing rights to several major brands which include rights to the Hummer Brand worldwide and is seeking to develop a range of new remote controlled and action vehicles for Hummer. The Hummer brand is a highly popular brand in the US with iconic appeal.

Brainytoys has also acquired exclusive Master Toy licensing rights for the Golden Books brand. The Golden Books brand is universally recognized and has more than two billion copies in print. Brainytoys will introduce a variety of characters which include The Poky Little Puppy, The Shy Little Kitten, The Saggy Baggy Elephant and Tootle. The new line of Golden Book products is likely to hit stores in the United States, Australia, UK and New Zealand in the fourth quarter of CY2008.

Distribution capacity has been bolstered through Enertec Enterprises Ltd ("Enertec"), Modern Brands Pty Ltd ("Modern Brands"), Toyway Ltd ("Toyway") and Reveal Entertainment Inc ("Reveal") having capacity to service in excess of 20,000 independent and mass market retail stores in the US, Europe, Canada, Australia and Latin America.

Catalysts for the stock in coming months include: positive new flow from the Marshmallow Fun Company, sales news for Hummer and Golden Book brands and the potential for strong quarterly performance from newly acquired subsidiaries. We continue to recommend **Brainytoys Limited** as a **Speculative Buy**.

## Company Background

Brainytoys Limited, headquartered in Perth Western Australia, is a toy and games development company with a portfolio of over fifty largely market ready electronic toys and games. In addition to these newly developed toys the company has in excess of 2000 toys in its product line following completion of recently acquired companies such as Enertec, Reveal, Marshmallow Fun Company and Toyway. The toys and games are developed and prototyped using computer graphics, 3D modelling and animation to produce “virtual” models based on digital imagery. BRT then uses 3D colour and plastic printing machines for creating 3D physical prototypes.

This printing technology supports rapid prototyping and frequent concept adjustments, effective product customisation, including private label options, resulting in greater flexibility, increased efficiency, improved speed to market and significant economies of scale. The Company then outsources the production of toys to contract manufacturers in China.

Market penetration occurs through two main avenues which include worldwide distribution through its group sales network and high-visibility brand licensing agreements for well recognised brand such as Golden Book, The Wiggles and Hummer. A core strength of the Brainytoys business model is the creative and development team based in Perth which regularly produces new concepts which are highly sought after by major toy retailers and brand licensors.

## Distributor partnerships

Through the newly acquired distribution network; Brainytoys now has access to over 20,000 independent and mass market retail stores globally.

### Enertec (100% owned)

Enertec is a Hong Kong based toy manufacturing and marketing company whose customers include some of the largest mass retailers, global and regional chains, and specialty outlets in the US, Canada, UK, France, Australia, New Zealand, and South America.

### Reveal (100% owned)

Reveal is a North American supplier of games, gifts, books and educational toys, and is Brainytoys exclusive marketer and distributor in the US and Canada. Reveal, based in Texas, has a distribution network comprising 2,700 retail outlets that includes national, regional and independent stores, mail-order catalogues and online channels.

### Toyway (100% owned)

Recently acquired UK business specialising in educational toys, diecast models and plastic and wooden construction kits. Toyway's online catalogue features in excess of 1000 toys.

### Marshmallow Fun Company (100% owned)

MFC is the world's leading producer of Marshmallow related toy products. To date the product has been sold through catalogue sale businesses such as Hammacher Schlemmer, Drug Store.com and other specialty stores. Prior to the acquisition the business suffered from supply constraints and was not able to satisfy market demand. Brainytoys will attempt to boost revenues by addressing the mass retail market which accounts for 70% of all toy sales. Management considers the product to exhibit blockbuster potential and has commenced an aggressive mass retail market strategy for the product in 2008.

### Modern Brands (Australian distribution partner)

Modern Brands (rated Australia's fastest growing toy distributor in 2005 by GFK Australia, a worldwide market research organisation) is BRT's exclusive marketer and distributor in Australia and New Zealand. Modern Brands is one of the largest toy marketing and distribution companies in Oceania having 2,000 independent retail accounts, servicing 14,000 schools in Australia and New Zealand and publishing over a million catalogues annually.

“In excess of 2000 toys in product offering ”

“Marshmallow Shooter to be distributed through Target and Toys R Us”

## Licenses Portfolio

Products recognised by children through stories, TV, movies and peer influences dominate the global toys and games market. BRT has secured the licenses to well known kid's characters such as The Wiggles® and Thomas the Tank Engine® (via a partnership with Modern Brands), Jay Jay the Jet Plane, Little Golden Books, and DreamWorks' "Bee Movie" characters. The Company can use the same characters and create multiple toys on the same technology platform. BRT acquires licenses from brand owners of characters such as the Wiggles for a period of two to four years in a particular market / geographical segment. License owners provide a strong competitive advantage by preventing cross licensing amongst competing toy companies. This assists companies such as BRT with exclusivity in a defined market for a fixed period of time. BRT pays an upfront license fee and up to 15% of the total sales revenue to the licensor. High value brands such as The Wiggles who offer new licensing agreements allow Brainytoys to enter mass markets at a low cost with plenty of blue sky upside if product marketing is a success.

## Management

### Charles MacKinnon

### Chairman

Mr MacKinnon has over three decades of experience in the finance industry, including senior positions in investment banking in the UK, Australia and South East Asia. In 1993, Mr MacKinnon served as one of four McCarrey Commissioners conducting a comprehensive efficiency/financial review of State Finances and Public Service Agencies for the Government of Western Australia. Currently, he is the Managing Director of investment bank Lothbury Advisory Pty Ltd.

### Alex Aguero

### Managing Director

Mr Aguero has over 25 years of experience in software and hardware development projects such as national data broadcasting networks with ABC TV and Telstra Corp Ltd. His experience also extends to interactive information booths, voice activated robotics, bio-feedback devices and visual stimulation systems for SciTech Discovery Centre. In 1981, Mr Aguero invented a labelling device now marketed worldwide under Casio®, Brother® and Dymo® brand names with several million units sold. Mr Aguero has also spearheaded the development, manufacture, and marketing of numerous computer and hand-held electronic games.

### Larry Bernstein

### Non-Executive Director

Mr Bernstein was the former president of US based Hasbro Toys, the world's second largest toy company and brings the very highest level of US toys management experience to BRT. Mr Bernstein worked with Hasbro toys from 1978-1994, taking the company from revenue of US\$77m to US\$600m. Hasbro has now grown to be the world's second largest toy company with revenues of approximately US\$3 billion.

### Bob Finn

### CEO, Executive Director

Mr Finn was formally the Hasbro Toys Executive Vice President of International Operations and has in excess of 30 years very high level experience in the toy industry.

### Keith Bales

### Non-Executive Director

Former Walt Disney Company VP of Europe. Extensive knowledge and experience in toy and games industry. Knowledge and experience in merchandising, licensing, home videos and DVD markets.

### Rand Brenner

### Licensing & Marketing Consultant

Mr Brenner has over 20 years of marketing experience marked by licensing and promotion agreements with Fortune 1000 companies such as Hasbro, Bandai America, Hewlett Packard, Kellogg's, Quaker Oats, Pepsi, and others. He was responsible for the licensing success of characters such as Mighty Morphin Power Rangers, Batman movies and Looney Tunes at Saban Entertainment and Warner Bros. He also worked with companies such as Mattel (Hot Wheels), Ogilvy & Mather, Yamaha electronics, Toshiba computers and Host International Restaurants.

## Industry Overview

Figure 1: Marshmallow Shooter



Source: Brainytoys Ltd

The global toys and games industry has evolved significantly with advances in electronics, microprocessor technologies and changing consumer demographics. Lower number of births in developed countries and the KGOY phenomenon (apparent maturing of kids at an earlier age) has made product innovation and recognisable names important in the industry. Recognisable names include famous, comic book or movie characters such as Shrek, Aladdin, Thomas the Tank Engine and so on. These characters are usually licensed by their creators to toy manufacturers. Licensed toys currently represent 30% of total industry sales in the US. The total world wide market for toys was estimated to be worth US\$60.2 billion in 2006. The US was the largest market accounting for US\$24.6 billion followed by Asia/Oceania at US\$17.8 billion and Europe at US\$17.2 billion (Source: NPD). The retail toy industry in the US has grown by 15.5% from US\$21.3 billion in 2005 to US\$24.6 billion in 2006.

On the manufacturing and supply side, Hong Kong is the hub of the world toy industry. All toys are manufactured in production facilities located in China. The toy manufacturing process also includes retail chain-specific technical compliance requirements including technical, environmental and safety lab tests. These tests and certifications are mandatory for any product vendor to supply to a large retail chain. There are thousands of toy factories in China that offer varying degrees of quality control and pricing. With rapidly evolving toys, the manufacturing units have to continuously build and re-build the tools or moulds required for toy production.

Brainytoys manufacturing is expected to be based, largely in two factories in Shenzhen and Dongguan. These factories are highly equipped, have 15,000 employees and are required to meet the highest European (RoHS) and USA Environmental, Quality and Safety Standards.

## Financial Analysis

We have revised our earnings guidance as we now consider Brainytoys new acquisitions should enable the Company to deliver revenues and profit before tax of \$20m and \$2.0m respectively in CY08. However, sales could be substantially higher if Brainytoys delivers a blockbuster toy in the medium term.

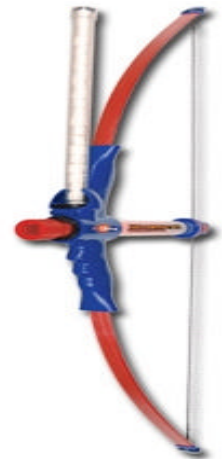
The current Group cash position for the company is approximately 900k following completion of a non-renounceable pro-rata entitlement option issue to shareholders of approximately 74.8m options which raised up to \$748,627 before costs. The funds are to be used for part payment of Marshmallow Fun Company assets and new working capital.

## Conclusion

New acquisitions provide an entry point into US and European markets and give the Company a worldwide marketing, sales, distribution and logistics network to propel its new suite of products. The new product offering is innovative and includes several globally recognised brands which include Golden Books, The Wiggles, Hummer, Jay Jay The Jet and The Bees Movie. Licensing agreements such as Golden Books exhibit low cost entry for Brainytoys combined with significant blue sky if products achieve strong take up in mass markets. Overall, the Company now has in excess of 2000 toys in its product offering.

Acquisitions are generally earnings accretive if you can maintain a high percentage of existing staff and their intellectual property in the company and the industry. Brainytoys has been successful in retaining all key personnel from these acquisitions which is of great benefit to the Company. Brainytoys has also been able to retain the services of highly regarded industry executives, including key former Hasbro (world's second largest toy company) executives Larry Bernstein, Bob Finn and Jim Andrews (Toyway's UK MD).

Figure 2 : Marshmallow Bow



Source: Brainytoys Ltd

**RMWise Research** considers that these new acquisitions together with new product offerings will set the stage for a rapid sales ramp up in 2008. **RMWise Research** recommends **Brainytoys Limited** as a **Speculative Buy**.

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<b>Buy</b>	Companies with 'Buy' recommendations have been cash flow positive for some time and have a moderate to low risk profile. We expect these to outperform the broader market.
<b>Speculative Buy</b>	We forecast strong earnings growth or value creation that may achieve a return well above that of the broader market. These companies also carry a higher than normal level of risk.
<b>Hold</b>	A sound well managed company that may achieve market performance or less, perhaps due to an overvalued share price, broader sector issues, or internal challenges.
<b>Sell</b>	Risk is high and upside low or very difficult to determine. We expect a strong underperformance relative to the market and see better opportunities elsewhere.

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