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The Study of Toys R Us' LBO Failure

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ABSTRACT
Toys "R" Us used to be one of the biggest international juvenile production firms. However, it continually lost its dominant role in the juvenile market and finally declared bankruptcy in 2018. Through studying Toys "R" Us' financial statement and navigating the strategies it used for improving selling in recent years, the research analyzes several possible reasons for Toys ``R" Us' failure of bankruptcy and also states how the $6.6 billion LBO operated in 2005 should be one of the important decisions among these factors. By concluding previous improper strategy usage, the research also gives some advice for strategies to improve product selling for the firm's following return next year 2022. For KKR, Bain, and Vornado, it is good to make sure that managers of the firm have a good new development plan based on the reliable prediction for the toy market's future. In this new plan, the firm may improve in-store experience and open shops in department stores. But in this research, the brand's future is not clear yet, and can not surely be successful by the suggestions given in this research, due to the unwise decision of LBO made before.

Keywords: *Toy, Toys "R" Us, LBO, Declared Bankruptcy*

1. INTRODUCTION

Various leveraged buyout (LBO) cases might be informed to the public through different kinds of media, in which a large number of cases are succeeded in the market by making correct decisions in each stage. (Leverage buyout is one of the ways that a company acquires another company. A company may borrow money then it would be used to cover the cost of acquisition.) However, it is still worth learning some failed cases as it is difficult for each company to go through the LBO process successfully. For this reason, the company has to prepare numerous solutions before the LBO happens to decrease the loss in the future. Hence, a few questions are valuable to be given a thought. Is there enough cash flow in the company? Are the company being able to take the risk of cash flow in the future? What actions can the company take when they are facing the loss of market share? As part of people believe, Toys R Us must have prepared well to process the LBO. But it still failed for some reason.

The research made by Tully concerned the financing process of the buyout of Toys R Us Inc. by Bain Capital Inc. and Tornado Realty Trust. The strategy of refinancing is more dependent on customized real estate (rather than combined bank) and asset-backed loans and bonds. The deal became more complicated because companies not just want Toys R Us' business but want their whole companies. The sponsors tried to use more creative methods to buy bigger companies at higher valuations [1]. The retail Showrooms LLC cooperates with Tru Kids Brands and software-powered experiential retailer to operate the Toys R Us stores in the United States shows the Toys R Us stores bring back to the U.S. Unitdenhowen will be the president and he spends 18 years in different positions of Toys R Us. The Tru Kids CEO (also CEO of the Toy Retail Showrooms) Richard Barry shows his trust in Unitdenhowen's ability and the good expectation of the future of Toys R Us [2]. Seifzadeh stated the things people can learn from Toys R Us. Collapse. Including knowing that the resources and assets don't last forever also consumer behavior changes quickly as the technology continues to advance, debt can play a more significant role in failure than past, do not rely too much on your network of suppliers and it may need to re-examine your value creation more often than you normally thank [3].

Bloomberg studied the report provided by researcher Reis Inc about the amount of occupied retail real estate in 77 major U.S. metropolitan areas decreasing by 3.8 million in the second quarter. Since the majority of newly added jobs in the retail industry are in physical stores in the past 12 months, the Toys R Us stores closing in cities impacted the second-quarter statistics more than any other retailer [4]. Morgan and Nasir focus on larger financial firms. A particular case is examined: the LBO of Toys R Us, where the company's capital structure is restructured, debts replacing considerable equity. A false assumption of a consistent market environment led to this case [5]. Stowell and Raino evaluate the PE's perspective on the LBO of toys r us. (1) determine the risks and merits of an investment in Toys "R" Us, (2) evaluate the spectrum of returns using multiple operating model scenarios, and (3) identify strategic actions that might be undertaken to improve the risk/return profile of the investment [6].

Stowell reports the case of Toys R us in terms of the financialized private equity finance and the debt gamble which has specified three components of private equity and states that people's realization of that is increasing, which means more people begin to do debt servicing. Also, Stowell has mentioned and pointed out the opinion of whether toys r us is a worst-case scenario of financialized [7]. Stowell also analyses the experience of a private equity investor finding a potential investment. By showing some data, to state the emergence of Club Deals in a Maturing Industry. It also contains information on how dividends could be set and fees paid to private equity firms as a new trend in the market. The toy retailers in the US have also shown their revenue and market conditions [8]. Lee and Raziff examine the effects of technological adaptation on the case of Hasbro and Toys R Us. It is found that the firm that adapted to the change of technology continues to grow while the firm that fails may struggle to stay in the market [9]. Beck states the decision-making and strategies that retailers could have for expansion overseas. For toys r us, it contains a local adaptation process that it could have, in Japan. There's also a table showing clearly the way that toys R us could do within a different process. And standardized-adaptation problem to work out what a company could do to make businesses go abroad [10].

In this article, the main purpose is to analyze the case of Toys R Us. Due to the reason that it had experienced an LBO failure decades ago. Therefore, it is a case that might be useful in the future if readers are intending to have a successful LBO to take over other companies. To figure out some confusion in this case and as a warning in the latter days for other companies that plan to go through LBO, essays or the news from other media would be used in the reading to prove what has been the state. Based on the knowledge that people may have already had, it is a try to evacuate more information that is valuable and worthy.

Around the mid-2000s, with the help of developments in data transferring and internet technology, the first generation of "video streaming" has entered the traditional television media market. After nearly twenty years of further development and iteration, the video streaming market in the 2020s has generally changed its market focus from quality-based competition to a more content-oriented condition. Under this background, how the current main players in the video streaming market, Netflix and Amazon Prime Video, act to the new trend and their further business strategies can roughly represent the market trend and have much significance in studying the future development of the video streaming market.

2. WHAT WENT WRONG

Toys' R US was one of the world's biggest juvenile products retailers and leading dedicated toy. Till January 29, 2005, it had operated 1499 retail stores in global-wide. In 2005, PE firms KKR, Bain Capital, and Vornado purchased Toys "R" Us in a $6.6 billion leveraged buyout. More than $5.3 billion of the purchase price was paid using debt. Meanwhile, the main competitors are Wal-Mart and Target. The company has suffered a lot due to these two competitors because of their increased competition from the channel discounts and the decrease in demand. In May 2010, Toys "R" Us registered for an IPO but soon withdrew its IPO registration due to declining sales. In 2018, Toys "R" Us filed for Bankruptcy disclosing plans to close 182 stores.

Under the revenue decline and challenge from the supermarkets and the change of the performance of the purchase behavior, Toys R Us decided to re-promote its national business and seek an opportunity to sell the whole company. Finally on March, 17th, 2005, Toys R Us sold its whole global business to the investment alliance founded by KKR, Bain Capital, and Tornado Realty Trust for 6.7 billion dollars. The price for single equity is 26.75 dollars, which is over 122.5 percent over the price in the previous day evaluation and 62.9 percent over the price for Toys R Us toys in the toy retail market [1].

The objective for LBO is to pay down debt during the holding period and increase its equity value (realize IRR). They first make sure how much cash flow that can pay for the debt, which can be shown from cash flow from operations - capital expenditures, that can determine the debt capacity to avoid risks from industry, company, and structural aspects. They also use historical data to predict their revenue, expenditure, tax to estimate when the debt should be paid off. Furthermore, KKR sold part of its business and the debt was paid on LBO day and the EBITDA ratio improved gradually. The leverage ratio was an important index for credit and it can further influence the calculation for IRR.

There are advantages of the deal itself for Toys R Us at the time of the deal, not considering its following events. The sudden inflow of cash gave the new company a chance, under new owners, to go through changes allowing greater efficiency and operating margin. The deal gave potential for significant changes to the business operations of Toys R Us, to potentially change its competitive situation, by either focusing on in-store experience or perfecting the system for online shopping.

The disadvantage is apparent, the cash drain from the debts was a factor that can't be ignored in snuffing out opportunities for an overhaul to the brands' operations. In the 6.6 billion dollar buyout, more than $5.3 billion of the purchase price was paid using debt. The enormous debt interest amounted to $425 million to $517 million every year. This amount is around 4% to 5% of the company's sales for each year.

At the current point, the brand under new owners is experimenting with new strategies, which fulfills the brand's need to change. The New York-based brand management company WHP Global bought Toys "R" Us in March with plans to build a "global network and digital platform" for the brand. Back in 2018 when the company declared bankruptcy, Tru Kids Inc purchased the brand in the liquidation sale. Tru kids initially had plans to revitalize the brand but failed with the interference of Covid-19-led poor mall traffic. And now WHP Global, through acquiring a controlling interest in Tru Kids, controls Toys R Us [5].

The brand is opening shop-in-shops at 400 department stores next year, specifically in Macy's, through a partnership. This time the strategy is to use Macy's brand image and advantages to compete against the previous competitors' Toys ``R" Us lost to Target and Walmart. It can see concrete plans for competing in physical stores, as for the statement: to build a "global network and digital platform", the specific strategy is not yet revealed. In our team's opinion, with covid receding people may be more compelled for offline physical experiences at physical stores. Currently, all purchases on the brands' website are redirected to Amazon, from WHP's statement, this situation may change, however in this team's opinion, competing in online shopping against Amazon may be difficult. It is too early to say if WHP's plans will be successful, from the current time point, it looks promising. Shortly, it seems unlikely any significant financial events will happen to this brand.

3. THE CAUSE FOR FAILURE

3.1 Insufficient cash flow

Toys R Us has simplified the brand's services and businesses and developed online service to avoid too much spending and hope to improve the company's financial statement step by step. However, they underestimate the influence caused by changing the structure of the toy market and overall economic condition inside and outside the U.S. The entertainment developed for children has become more and more variable, for example, video games are becoming popular among most kids. This made Toys R Us hard to be competitive among neither global nor the U.S. Therefore the company can not get much cash flow from its revenue from selling toys. "In 2012, the fourth season's selling revenue declined 2.6% than the revenue in the same period last year, and the net profit declined 30% to 23.9 million" [11].

Furthermore, in 2013, Toys R Us withdraw the application for IPO they provided three years ago because the "marketing environment is not good and CEO Gerald Storch has resigned." The information indicates the company's condition is not well and they cannot get enough cash flow to keep their wish to apply for IPO one day. Besides decreasing in cash flow indicates their ability to operate further toys production and distribution channel development may be deferred so cash flow will continue to be hard to generate [11].

3.2 Extra expenditures

People may learn from the news or any media that the acquisition of Toys R Us did not achieve what had been expected at last. According to this, a few reasons Could be analyzed clearly in this article.

Table 1. U.S Retail Toy industry (billions) [5]

Category	2004	2005	Growth
Total traditional toys	22.12	21.29	-3.8
Total video games	9.19	10.50	6.0

As shown in Table 1, it is easy to recognize that the differences between 2004 and 2005 in the U.S retail toy industry, in many aspects, traditional toys own a negative percentage, which indicates that fewer people have consumed or are attracted by practical toys. In contrast, video games have become more prevalent and have a positive growth rate.

Table 2. Consolidated Statement of Cash Flow ($ in millions) [5]

Net cash used in investing activities (millions)	2003	2004	2005
Short-term borrowings, net	$ 0	$ 0	$ 0
Long-term borrowings	548	792	0
Long-term debt repayment	-141	-370	-503

Toys R Us was losing its market share, the acquisition at the same time had caused more expenditure. For instance, in Table 2, long-term debt repayment can be found and it increased to $503 million in 2005 while the value in the year 2003 was $141 million. The inclination of this value may cause toys r us to have less cash flow to operate. Plus, its competitors are always increasing such as Walmart or so, which may lead Toys R Us to spend more on advertising or other unnecessary parts. So Toys R Us at that stage was under great pressure.

3.3 Stagnant growth in profit

Two major things dented the profits of Toys R Us, which the investors failed to predict or take into consideration. "On August 9th, 2000, Toys R Us entered a 10-year deal with Amazon to create a co-branded online store, where amazon would handle the order fulfillment and customer service while Toys R Us manages the merchandising and buying inventory. The deal meant less urgency for Toys R Us to become independent in "order fulfillment and customer service", having relied on Amazon's expertise. Toys R Us was losing in terms of trying to catch up, ever since the partnership with amazon collapsed in lawsuits" [12].

Therefore, Toys r us they were struggling to catch up with selling over the internet, losing that share of the market to Amazon. Secondly, Target and Walmart both decided that toys are an attractive market. Toys are only a section in these supermarkets, meaning every time parents shop here, that gives their kids justification to do their shopping in the toys section. While in Toys ``R" Us, it's only toys, families come here with the sole purpose of buying toys. If they were not up to this they wouldn't even come.

"During last year's December holiday season, Wal-Mart, Target, and other discounters captured a large share of the $27 billion United States toy business by expanding their selections and slashing prices. Wal-Mart now has about 20 percent of the market, said Chris Byrne, a toy consultant based in Manhattan, and Target has about 18 percent, while Toys "R" Us has dipped to 17.

Ten years ago, Toys "R" Us held 20 percent, followed by Kmart, Sears, and Ames, Mr. Byrne said. Wal-Mart and Target were insignificant players" [13]. Toys "R" Us' response was with price cuts and promotions, which cut into their profit margins.

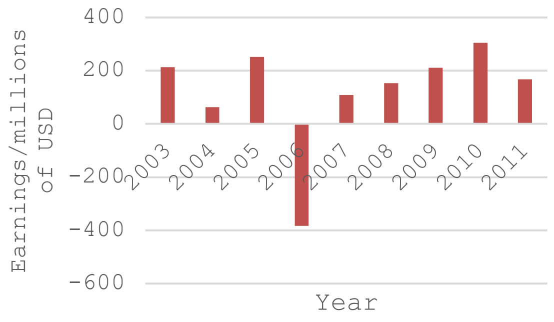

Figure 1 Net (loss) earnings of Toys "R" Us

As shown in Figure 1, it is apparent that no significant growth in terms of earnings was achieved since the LBO.

4. DISCUSSION

4.1 The cause for failure

Toys "R" Us was not capable of growing with its current competitive strategy. Toys "R" Us needed help in guiding the company to change. The company needed new ideas, new strategies for competing against its rivals. On top of a viable strategy, the company needed cash to finance any such activities.

The buyers provided little of either. Toys "R" Us tried ramping up in-store events, but the changes weren't enough. The enormous cash drain caused by the combination of factors fore mentioned made it impossible for the company to invest or innovate even if its trio of buyers had been up to the challenge.

There is another similar example for strategy error caused failure in the market is the Blue Moon, one of the most famous Chinese liquid laundry detergent brands. It used to be the earliest home-used laundry detergent brand in China. Its liquid detergent and its hand sanitizer (another product of the company) used to be No. 1 in market share over 11 years and 8 years. However, according to its financial report in the first half-year of 2021, its sales revenue declined quickly; its gross margin dropped 19.2% compared to the same period last year and stock price decreased 60% compared to the highest point in January 2021. After choosing to not continue to cooperate with typical supermarkets including Carrefour and RT-market, since 2015, Blue Moon built many "Moon House" offline stores and joined the e-commerce platform. However, the company soon found that people still prefer to buy liquid detergent in supermarkets and are not willing to go to its "Blue House". The Blue Moon then returned to the supermarkets in 2017 but its competitors had already taken its place in the supermarket. The Blue Moon company then decided to put its major selling online (nearly 70%) on several online platforms. After a period, the company found it is hard to control their detergent's price because each platform has different prices by different sales methods used. Under the company's reliance on the online platform, the brand's revenue finally declined rapidly [14].

The same lesson for the Blue Moon and the Toys "R" Us is to try not to make an unmatched strategy with their products' character. Or otherwise, the brands like daily used chemicals and toys will soon lose their competitiveness in its market. There are many replaceable brands where people can more easily access them. The following change will be harder to make and easy to make mistakes because people want to get back to their previous status and improve their condition soon by innovating and that causes more expenditure. after the LBO, Toys ``R" Us found it is hard to get a chance to stop its downward spiral by continuing investing in its future production.

4.2 In hindsight: possible strategies

Toys "R" Us is making a comeback in 2022, the New York-based brand management company WHP Global bought Toys "R" Us in March with plans to build a "global network and digital platform" for the brand. The brand is opening shop-in-shops at 400 department stores next year. These plans have not yet come to fruition, but are different from the company's previous strategies, and may have proven impactful enough should the company make such attempts after the LBO. Competing against amazon with online digital platforms may still prove challenging, but the idea of integrating stores in larger department stores would have been a step in the right direction. As fore-mentioned, Toys are only a section in supermarkets such as Walmart and Target, meaning every time parents shop here, that gives their kids justification to do their shopping in the toys section. Opening shop-in-shops in department stores would give Toys "R" Us the same edge.

Another possible move was to put more work into in-store entertainment and experience. This kind of improvement is sure to give Toys ``R" Us an edge, since such an advantage is unattainable for the companies' major competitors. Amazon can't provide any real-life in-store experience being a purely online platform. Target and Walmart are supermarkets, whose main business isn't toys. A highly competitive strategy would be to combine both ideas. Open shop-in-shops in department stores, with a focus on the in-store experience. This would complete a weekend family experience, being in a department store with possibly a movie theater, dining, shopping, and at the end of the night, activities in the Toys ``R" Us store for the children. This strategy would remove most of Toys ``R" Us' competition in the respective scenario.

4.3 Should the LBO have happened at all

About whether the LBO was advisable: for the brand Toys R Us, from hindsight, the LBO was a bad move. Without the LBO, the brand may still be stagnant in growth and perform poorly but may continue to survive without having to declare bankruptcy and liquidate assets. If the LBO never happened, the brand will certainly gradually control a smaller market share. In this scenario, Toys' may still eventually seek to sell, but to different buyers. In this case, these new buyers may be more prudent and choose a different approach, they might give better inputs for the brand to change. A second possibility for the scenario is that Toys' simply doesn't sell and survives as a public company up until 2021. In this case, Tru Kids and WHP might not come into the story, and any potential that we currently see for the future resulting from the changes and new strategy from WHP Global might be lost.

For the previous stockholders of Toys R Us, the LBO may have been a good decision. They've avoided any further loss from a devaluation of stocks. For the buyers, KKR, Bain, and Vornado, it was a big failure. The companies didn't have the solution for Toys' problems, and they were reckless in bringing so much debt into the company. Toys R Us had unstable cash flows due to challenges in competition.

5. CONCLUSION

Toys "R" Us was being outcompeted, which is the initial reason for this LBO. It needed funds and ideas for changes to grow, and yet such resources were not attained through the LBO. KKR, Bain, and Vornado were not able to predict the effects of the internet and the increasing competition. They were not able to foresee how the operations of Toys R Us would be affected, neither were the three firms able to contribute enough to help the company adapt.

Toys R Us continued to stagnate in its market even after the LBO, due to incapability to adjust and increasing competition. The company did not have the resources to invest or innovate, by a combination of factors. On top of shrinking profits; debt interest, advisory, and management fees were also eating chunks away. It was a downward spiral, which ultimately led to the company's fall. The LBO was an overall loss for the brand and the buyers, though it may have been the right idea for the previous owners.

In order for a better outcome for KKR, Bain and Vornado, as well as the brand it-self, the management of these companies needed better foresight into how the market would develop and the effects of these development would have on the brands operations. Management needed better plans, such as opening shops in department stores, as well as providing more in store experiences. However due to the nature of a LBO activity, in which Toys “R” Us is bound to be bound by debt, there is no saying if any of the above would have been able to save the brand. The best option at that time point for KKR, Bain and Vornado, was to not make the purchase at all.

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