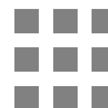

The Toys "R" Us LBO

"I don't want to grow up, I'm a Toys 'R' Us kid" was the famous marketing slogan of Toys "R" Us (the "Company"), the world's leading specialty toy retailer for much of the 1980s and 1990s. Private equity industry veterans may have had a similar attitude regarding the maturation of their industry. In its infancy, the industry had consisted of relatively few firms and lucrative investing opportunities that far exceeded capital in the industry. By 2005, however, a record amount of capital had been committed to the industry and aggregate transaction values had reached a new high. The industry had become intensely competitive and the best investing opportunities were being chased by too much capital, making it difficult for investors to match historically lofty returns. While private equity executives would have preferred that the industry not grow up, they continued to find investment opportunities that provided compelling value to themselves and their limited partners.

In 2006 $252 billion of capital was committed to the private equity industry, compared to $90 billion in 2000—an absolute increase of 181 percent (Exhibit 1). As the amount of committed capital increased, so did the need for more investment opportunities. In 2006 there was more than $233 billion of aggregate transaction value in private equity deals, compared to $41 billion in 2000—an absolute increase of 475 percent (Exhibit 2). An increasing supply/demand imbalance led to an increase in the average purchase price multiple in leveraged buyouts (LBOs), which reached a record high of 8.6× EBITDA in 2006 (Exhibit 3).

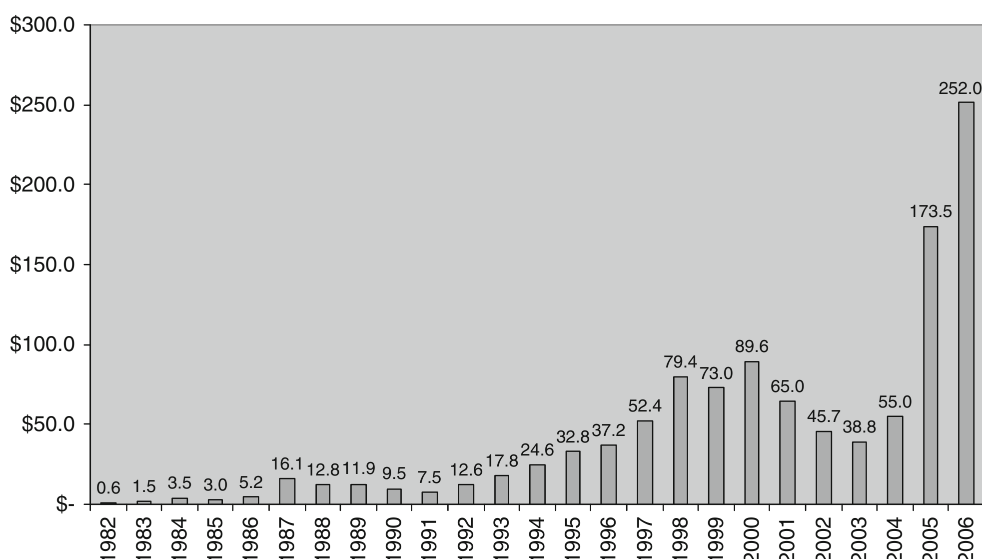

EXHIBIT 1 U.S. Private Equity Committed Capital ($ in billions). *Source*: Standard & Poor's.

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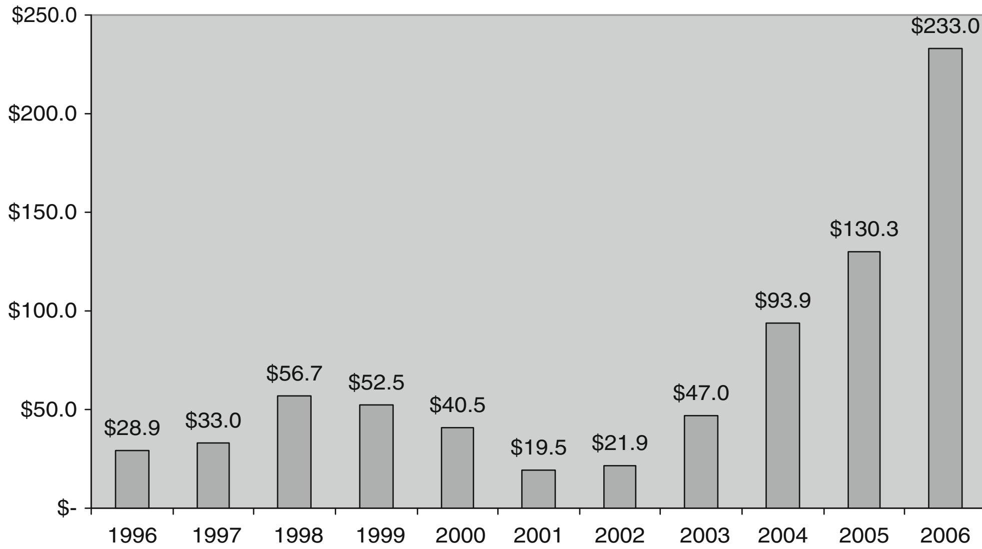

EXHIBIT 2 Value of LBO Transactions ($ in billions). *Source*: Standard & Poor's.

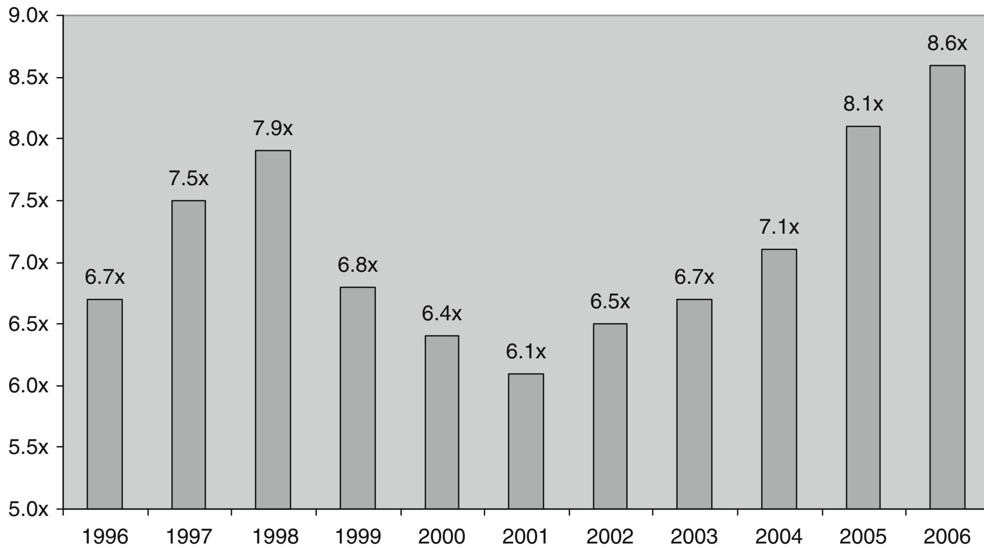

EXHIBIT 3 Buyout Acquisition Multiple. *Source*: Standard & Poor's.

Case Focus

This case simulates the experience of a private equity investor evaluating a potential investment. It requires the reader to: (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. The case discusses the participants in the Toys "R" Us LBO and emerging trends in the private equity industry.

Emergence of Club Deals in a Maturing Industry

In the past, the largest private equity funds were able to minimize competition with smaller funds because of the distinct advantage their fund size provided. As of November 2004, the largest single private equity fund, raised for JP Morgan's Global 2001 Fund, was approximately $6.5 billion.[1] That amount would be greatly overshadowed by the capital raised by private equity firms just a few years later, however. As of January 2007, for example, both KKR and Blackstone had raised single private equity funds with approximately $16.0 billion of committed capital.[2] JP Morgan's Global 2001 Fund would not rank in the top ten largest funds raised as of January 2007.[3]

Historically, private equity firms preferred to complete acquisitions without other financial partners to ensure complete control over acquired companies. In an industry that required a precise strategy to create value, partnering issues (e.g., agreeing on strategic decisions, capital structure, and investment exits) could prove problematic. However, as the asset class grew and competition for traditional private equity transactions increased, private equity firms turned to club deals.

A club deal was an acquisition completed by two or more private equity firms that allowed them to acquire companies that were too large for one private equity firm to acquire. Many funds set concentration limits on the percentage of committed capital that could be invested in a single asset. Club deals expanded the universe of potential acquisitions by bringing together the capital of multiple firms, enabling very large acquisitions. By allowing large private equity firms to target companies beyond the reach of smaller private equity firms, club deals reduced competition and increased potential returns.

Although there was competition between consortia—for example, more than one club chasing an asset—this competition was below the level observed in the traditional small/middle private equity market. Chasing bigger assets through club deals allowed the largest funds to more efficiently allocate their time (the industry's most precious resource) as they put money to work.

Club deals offered the following advantages:

- Limited competition
- Allowed for greater deployment of capital
- Leveraged multiple sources of expertise while conducting due diligence and evaluating an investment
- Spread expenses incurred while evaluating the investment and reduced "busted" deal costs

Disadvantages included the following:

- Limited ability to control an investment—potential for strategic disagreements
- Interfered with limited partners' desire for risk diversification because they became owners of the same asset through participation in multiple funds
- Created potential regulatory issues regarding anticompetitive behavior

Specific charges included submitting separate bids to gauge a competitive price with an agreement to "club up" in the future and "clubbing up" at the beginning of a process to reduce the field of potential buyers. In October 2006 the Department of Justice began an inquiry into

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[1] "The New Kings of Capitalism," *The Economist*, November 25, 2004.

[2] "The Uneasy Crown," *The Economist*, February 8, 2007.

[3] Ibid.

potential anticompetitive behavior by private equity firms. Justice Department officials sent letters requesting information on deals and auctions to Kohlberg, Kravis & Roberts, Silver Lake Partners, and other firms.[4]

According to *Buyouts* magazine, of the 845 private equity deals completed in 2005, 125 were club deals, meaning that private equity shops were teaming up nearly 15 percent of the time.[5] Recent high-profile club deals included SunGard Data Systems, Hertz Corporation, and HCA. Barring a major change in the regulatory environment or problems in existing club deals, club deal activity was likely to continue to increase.

Dividends and Fees Paid to Private Equity Firms

Another trend that was gaining popularity in the private equity industry involved rapidly accessing the capital markets after closing a deal to raise cash to pay a large dividend to the private equity owners. Firms typically used the debt markets to finance these dividends, creating more highly levered, riskier companies. In some cases, dividends paid to private equity firms within one year of their original investment equaled the original equity commitment. In the Hertz LBO transaction, Clayton, Dubilier & Rice, Carlyle Group, and Merrill Lynch collected $1 billion in bank-funded dividends six months after buying rental car company Hertz for $15 billion.[6] About four months later, Hertz issued an IPO to pay off the debt and to fund an additional dividend, resulting in total dividends paid to the owners that equaled 54 percent of their original investment of $2.3 billion (still leaving them with 71 percent ownership).

Private equity funds also took cash out of their portfolio companies to pay large "advisory" fees to themselves. These fees exceeded $50 million on large transactions during the buyout phase and annual fees often continued throughout their ownership.

U.S. Retail Toy Industry in 2005

In 2005 sales in the U.S. retail toy industry totaled $21.3 billion, down 4 percent from $22.1 billion in 2004.[7] While some categories—such as plush, vehicles, and games and puzzles—had large declines in sales in 2005, there was growth in certain subcategories. It is difficult to track consistent data across multiple sources as category and subcategory definitions varied. However, it is important to note that, in aggregate, dollar sales in the industry declined for a third consecutive year. See Exhibit 4 for growth by category.

Video game sales continued to outperform traditional toy sales in 2005 as younger children increasingly chose video games over traditional toys. In addition, the video game market benefited from the increased acceptance of video gaming among adults. In 2004 the average video game player was 29 years old.[8] Video game sales were expected to continue to outperform the traditional toy market.

After a period of robust growth in the 1990s, analysts and industry experts in 2005 were expecting 0 to 2 percent growth in the traditional toys and games market over the next three

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[4] "Justice Department Probing Buyout Funds," *MSNBC.com*, October 10, 2006.

[5] Mark L. Mandel, "Wielding a Club," *New York Law Journal*, June 29, 2006.

[6] "Gluttons at the Gate," *BusinessWeek*, October 30, 2006.

[7] NPD Group Press Release, February 13, 2006.

[8] Citigroup Equity Research, "Toy Industry Outlook," September 22, 2004.

EXHIBIT 4 U.S. Retail Toy Industry ($ in billions)

Category	2004 ($)	2005 ($)	Growth (%)
Action figures and accessories	1.25	1.30	4.0
Arts and crafts	2.50	2.40	–4.0
Building sets	0.60	0.70	16.0
Dolls	2.76	2.70	–2.0
Games/puzzles	2.64	2.40	–9.0
Infant/preschool	3.13	3.10	–1.0
Learning and exploration	0.37	0.39	5.0
Outdoor and sports toys	2.78	2.70	–3.0
Plush	1.53	1.30	–15.0
Vehicles	1.96	1.80	–8.0
Other	2.60	2.50	–4.0
Total traditional toys	22.12	21.29	–3.8
Total video games	9.91	10.50	6.0

Source: NPD Group Press Release, February 2006

EXHIBIT 5 Projected Population Growth (in millions)

Age Cohort	2005	2010E	Total Growth (%)	Implied CAGR (%)
Ages 5 and under	20,311	21,426	5.5	1.1
Ages 6–8	11,782	12,228	3.8	0.7
Ages 9–12	15,744	15,986	1.5	0.3

Source: NPD Group, October 2006

to five years. This stabilization was based in part on a view that the worst of the price competition was behind the industry and continued consolidation should improve the competitive dynamic. In addition, favorable demographic trends were expected to help the industry. See Exhibit 5 for growth estimates by age cohort.

According to the NPD Group, the mass/discount channel continued to gain share from other toy retailers in 2005, accounting for 54 percent of total toy sales, while toy stores represented 20 percent (the vast majority of this was Toys "R" Us). Clearly the mass/discount channel—specifically Wal-Mart and Target—were growing at the expense of the specialty toy retailers (see Exhibit 6).[9] Toys "R" Us was the largest specialty toy retailer in the industry, and while it struggled in a difficult operating environment, it was better equipped to compete with the mass/discount channel than its peers. For example, two other leading specialty toy retailers, KB Toys and FAO Schwarz, filed for Chapter 11 protection in 2004. Online toy sales continued to increase as well, generating more than $1.3 billion in 2005, a 2.6 percent increase over the prior year, and accounting for approximately 6 percent of sales for the year.[10]

The retail toy industry was highly competitive. Competitors included discount and mass merchandisers, electronics retailers, national and regional chains, and local retailers. Competition

[9] JP Morgan Equity Research, "Toy Retailing: The Shakeout Goes On," May 5, 2003.

[10] NPD Group Press Release, February 13, 2006.

EXHIBIT 6 U.S. Toy Retail Market Share (%)

	2003	2005
Mass market share	48.6	54.0
Toy stores	25.1	20.0

Source: NPD Group Press Release, February 2006, and Doug Desjardins, "Toy Market Still Full of Surprises," *DSN RetailingToday*, September 6, 2004

was principally based on price, store location, advertising and promotion, product selection, quality, and service. Advantages in financial resources, lower merchandise acquisition costs, and/or lower operating expenses were usually passed along to customers in an attempt to preserve or gain market share. Discount and mass merchandisers increasingly used aggressive pricing policies and enlarged toy-selling areas during the holiday season to build traffic for other store departments (e.g., toys were used as a loss leader).

Success in the retail toy industry depended on a company's ability to identify, originate, and define product trends, as well as anticipate, gauge, and react to changing consumer demands in a timely manner. If a retailer misjudged the market for products, it might have significant excess inventories for some products and missed opportunities for others. Sales of toys and other products depended upon discretionary consumer spending, which was affected by general economic conditions, consumer confidence, and other macroeconomic factors. A decline in consumer spending would, among other things, negatively impact sales across the toy industry and result in excess inventories, requiring discounting to move old inventory.

Electronics retailers became more relevant competitors in toy retailing by capitalizing on "age compression," the acceleration of the trend of younger children leaving traditional play categories for more sophisticated products such as cell phones, DVD players, CD players, MP3 devices, and other electronics products. The age compression pattern tended to decrease consumer demand for traditional toys or at least increase competition for purchases within the segment of 5- to 12-year-olds.

An article in *DSN Retailing Today*[11] examined the competitive environment in the industry during 2003–2004:

> *Retailers can't afford a repeat of the 2003 holiday season when a slow economy and price wars between Wal-Mart and Target produced a nightmare scenario. Toys "R" Us reported a 5% decline in fourth quarter same-store sales, and KB Toys reported a 10% decline in sales in 2003.*
>
> *In the aftermath, Toys "R" Us closed its Kids "R" Us and Imaginarium divisions, and KB filed for Chapter 11 bankruptcy and closed nearly 500 stores. FAO Schwarz fared worst of all and liquidated its 89-store Zany Brainy chain and sold its flagship stores in New York City and Las Vegas.*
>
> * * *
>
> *Toy industry analyst Chris Byrne doesn't expect the specialists to fare any better during the upcoming [2004] holiday season. "The business model for toy retail is really changing, and we could be seeing the end of the specialty toy store," said Byrne.*

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[11] Doug Desjardins, "Toy Market Still Full of Surprises," *DSN Retailing Today*, September 6, 2004.

EXHIBIT 7 European Traditional Toy Sale Market Share by Country (%)

Country	2004	2005
UK	22.8	24.0
France	19.6	19.6
Germany	18.1	17.0
Italy	8.0	7.9
Spain	6.3	6.5
Poland	2.0	2.0
Hungary	0.6	0.6
Czech Republic	0.5	0.5
Others	22.1	21.9
Total	100.0	100.0

Source: Toy Industries of Europe, Facts & Figures, July 2006

He said the specialists are not being hurt just by mass merchants, noting that other chains are stealing away business in core categories, such as video games and action figures. "What we're seeing is more and more category specialists," said Byrne. "Places like Best Buy and GameStop have become great places to buy toys."

European Retail Toy Industry

In 2005 traditional toy sales in Europe (excluding video games) grew 3 percent to €13.3 billion from €12.9 billion.[12] The market had been stable over the previous few years, and in most European countries there was increased demand for infant/preschool toys, building sets, and action figures.[13] Analysts and industry experts expected European traditional toy sales to outpace sales in the United States. Including video games, growth was expected to be in the 3 to 6 percent range. Exhibit 7 shows market share by country in Europe.

While the industry drivers and demand trends in Europe were similar to those in the United States, the competitive landscape was different. On average, the specialty toy retailers had better market share across Europe than in the United States. Exhibit 8 shows distribution channel market share across Europe.

Infant, Toddler, and Preschool Market

The U.S. market for infant, toddler, and preschool products was approximately $34 billion in 2005 and consisted primarily of the following segments: home furnishings and accessories ($8 billion), clothing ($17 billion), baby care supplies ($6 billion), and traditional toys ($3 billion).[14] Traditional toys in this market segment overlapped with sales in the broader traditional U.S. toy market. The mass/discount retailers and Babies "R" Us (the Company's specialty baby/juvenile stores) were the clear market share leaders in this segment, with the remaining market share

[12]Toy Industries of Europe, Facts & Figures, July 2006.

[13]Ibid.

[14]Data compiled from various packaged facts industry reports.

EXHIBIT 8 Distribution Channel by Country (%)

	France	Germany	Spain	Italy	UK	Europe
Toy specialist	44.3	40.8	46.0	34.0	26.9	36.2
Mass merchant/discount stores	42.9	14.2	30.8	39.0	10.6	24.0
General merchandise	3.3	5.5	5.8	13.2	27.0	13.2
Department stores	1.9	15.7	11.8	7.6	3.3	6.5
Mail order	3.5	6.7	0.0		3.5	3.9
Other	4.1	17.1	5.6	6.2	28.7	16.2
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: Toy Industries of Europe, Facts & Figures, July 2006

distributed across a highly fragmented, specialty retailer base and department/grocery stores. This market had shown steady growth over the previous few years and analysts and industry experts estimated it would continue to grow at a 3 to 6 percent rate. Growth was expected to come from an anticipated increase in the infant population and increased spending per child.

This market segment had become more attractive to retailers as competition in the traditional toy market intensified, and it was insulated from age compression as it focused on very young children. In addition, it did not have the same price competition as the traditional toy market because retailers were better able to differentiate based on perceived product quality and shopping experience.

Overview of Toys “R” Us

Toys “R” Us was a worldwide specialty retailer of toys, baby products, and children’s apparel. As of January 29, 2005, it operated 1,499 retail stores worldwide.[15] These consisted of 898 locations in the United States, including 681 toy stores and 217 Babies “R” Us stores. Internationally, the Company operated, licensed, or franchised 601 stores (299 operated stores, two of which were Babies “R” Us, and 302 licensed or franchised stores, seven of which were Babies “R” Us). See Exhibit 9 for a breakdown of owned and leased stores. The Company also sold merchandise through its Internet sites.

The retail business began in 1948 when founder Charles Lazarus opened a baby furniture store, Children’s Bargain Town, in Washington, D.C. The Company changed its name to Toys “R” Us in 1957. The first Babies “R” Us stores opened in 1996, expanding the Company’s presence in the specialty baby/juvenile market. The Company was among the market share leaders in most of the largest markets in which its retail stores operated, including the United States, the United Kingdom, and Japan. See Exhibit 10 through Exhibit 13 for consolidated and segment financial results.

The Company’s worldwide toy business was highly seasonal, with net sales and earnings highest in the fourth quarter, which included the all-important holiday sales of November and December. More than 40 percent of net sales from the Company’s worldwide toy business and a substantial portion of its operating earnings and cash flows from operations were generated in the fourth quarter. See Exhibit 14 for quarterly results from the fiscal year ending January 29, 2005.

[15]Toys “R” Us FYE 2005 10-K Filing. Note all financial data related to the Company is from the 2005 10-K Filing.

EXHIBIT 9 Toys "R" Us Property Summary

	Owned	*% of Total*	Ground Lease	*% of Total*	Leased	*% of Total*	Total
Stores							
Toys "R" Us	315	*46.3*	155	*22.8*	211	*31.0*	681
International[a]	80	*26.8*	23	*7.7*	196	*65.6*	299
Babies "R" Us	31	*14.3*	76	*35.0*	110	*50.7*	217
Total	426	*35.6*	254	*21.2*	517	*43.2*	1,197
Distribution centers							
U.S.	9	*75.0*	0	*0.0*	3	*25.0*	12
International	5	*62.5*	0	*0.0*	3	*37.5*	8
Total	14	*70.0*	0	*0.0*	6	*30.0*	20
Operating stores and distribution centers	440	*36.2*	254	*20.9*	523	*43.0*	1,217

[a]Excludes 302 licensed or franchised stores in international markets.
Source: Toys "R" Us FYE 2005 10-K Filing

Toys "R" Us—United States

The Company sold toys, plush, games, bicycles, sporting goods, VHS and DVD movies, electronic and video games, small pools, books, educational and development products, clothing, infant and juvenile furniture, and electronics, as well as educational and entertainment computer software for children. Its toy stores offered approximately 8,000–10,000 distinct items year round, more than twice the number found in other discount or specialty stores selling toys. The Company sought to differentiate itself from competitors in several key areas, including product selection, product presentation, service, in-store experience, and marketing. This became increasingly important as discount retailers and other specialty retailers increased competition.

Toys "R" Us—International

Toys "R" Us—International operated, licensed, and franchised toy stores in thirty foreign countries. These stores generally conformed to prototypical designs similar to those used by Toys "R" Us in the United States. As noted above, as of January 29, 2005, the Company operated 299 international stores, two of which were Babies "R" Us, and licensed or franchised 302 international stores, seven of which were Babies "R" Us. International added thirty-three new toy stores in calendar year 2004, including twenty-six licensed or franchised stores, and closed ten stores, including five licensed or franchised stores. The division intended to add forty-one new toy stores in 2005, including thirty-one licensed or franchised stores. As of January 29, 2005, Toys "R" Us—Japan, Ltd., a licensee of the Company, operated 153 stores, which were included in the 302 licensed or franchised international stores. The Company had a 48 percent ownership in the common stock of Toys "R" Us—Japan.

Babies "R" Us

In 1996 the Company opened its first Babies "R" Us stores. The acquisition of Baby Superstore, Inc. in 1997 added seventy-six locations, and the continued expansion of this brand helped Babies "R" Us become the leader in the specialty baby/juvenile market. Babies "R" Us stores targeted

EXHIBIT 10 Consolidated Financial Results ($ in millions, except per share data)

	For the Year Ended		
	2/1/2003	**1/31/2004**	**1/29/2005**
Net sales	$11,305	$11,320	$11,100
Growth		0.1%	–1.9%
Cost of sales	(7,799)	(7,646)	(7,506)
Gross margin	$3,506	$3,674	$3,594
Growth		4.8%	–2.2%
Margin	31.0%	32.5%	32.4%
SG&A	($2,724)	($3,026)	($2,932)
Growth		11.1%	–3.1%
Margin	–24.1%	–26.7%	–26.4%
Reported EBITDA (pre-restructuring charges)	$782	$648	$662
Growth		–17.1%	2.2%
Margin	6.9%	5.7%	6.0%
D&A	($339)	($368)	($354)
Restructuring and other charges	0	(63)	(4)
EBIT	$443	$217	$304
Growth		–51.0%	40.1%
Margin	3.9%	1.9%	2.7%
Interest expense	($119)	($142)	($130)
Interest and other income	9	18	19
Pretax income	$333	$93	$193
Growth		–72.1%	107.5%
Margin	2.9%	0.8%	1.7%
Income tax (expense)/benefit	(120)	(30)	59
Net income	$213	$63	$252
Growth		–70.4%	300.0%
Margin	1.9%	0.6%	2.3%
Diluted EPS	$1.02	$0.29	$1.16
Growth		–71.6%	300.0%
Adjusted consolidated EBITDA			
Reported EBITDA (pre-restructuring charges)	$782	$648	$662
Add-back of one-time items in Toys "R" Us—U.S.[a]	0	0	118
Adjusted consolidated EBITDA	$782	$648	$780
Growth		–17.1%	20.4%
Margin	6.9%	5.7%	7.0%

[a]EBITDA for FY 2005 adjusted by adding back $132 million in inventory markdowns and excluding $14 million related to a lawsuit settlement—$118 million net add-back in FY 2005.
Source: Toys "R" Us FYE 2005 10-K Filing

the prenatal and infant markets by offering juvenile furniture such as cribs, dressers, changing tables, and bedding. In addition, the Company provided baby gear such as play yards, booster seats, high chairs, strollers, car seats, toddler and infant plush toys, and nursing equipment. As of January 29, 2005, Babies "R" Us operated 217 specialty baby/juvenile retail locations, all in the United States. Based on demographic data used to determine which markets to enter, the

EXHIBIT 11 Consolidated Balance Sheet ($ in millions)

	For the Year Ended	
	1/31/2004	**1/29/2005**
ASSETS		
Cash and cash equivalents	$1,432	$1,250
Short-term investments	571	953
Accounts and other receivables	146	153
Merchandise inventories	2,094	1,884
Net property assets held for sale	163	7
Current portion of derivative assets	162	1
Prepaid expenses and other current assets	161	159
Total current assets	$4,729	$4,407
Property, plant, and equipment		
Real estate, net	$2,165	$2,393
Other, net	2,274	1,946
Total PP&E	$4,439	$4,339
Goodwill, net	348	353
Derivative assets	77	43
Deferred tax asset	399	426
Other assets	273	200
Total assets	$10,265	$9,768
LIABILITIES AND STOCKHOLDERS’ EQUITY		
Short-term borrowings	$0	$0
Accounts payable	1,022	1,023
Accrued expenses and other current liabilities	866	881
Income taxes payable	319	245
Current portion of long-term debt	657	452
Total current liabilities	$2,864	$2,601
Long-term debt	2,349	1,860
Deferred income taxes	538	485
Derivative liabilities	26	16
Deferred rent liability	280	269
Other liabilities	225	212
Minority interest in Toysrus.com	9	0
Total liabilities	$6,291	$5,443
Stockholders’ equity		
Common stock	$30	$30
Additional paid-in capital	407	405
Retained earnings	5,308	5,560
Accumulated other comprehensive loss	(64)	(7)
Restricted stock	0	(5)
Treasury shares, at cost	(1,707)	(1,658)
Total stockholders’ equity	$3,974	$4,325
Total liabilities and stockholders’ equity	$10,265	$9,768

Source: Toys “R” Us FYE 2005 10-K Filing

EXHIBIT 12 Consolidated Statement of Cash Flow ($ in millions)

	For the Year Ended		
	2/1/2003	**1/31/2004**	**1/29/2005**
CASH FLOWS FROM OPERATING ACTIVITIES			
Net earnings	$213	$63	$252
Adjustments to reconcile net earnings to net cash from operating activities:			
Depreciation and amortization	$339	$368	$354
Amortization of restricted stock	0	0	7
Deferred income taxes	99	27	(40)
Minority interest in Toysrus.com	(14)	(8)	(6)
Other non-cash items	(9)	1	2
Non-cash portion of restructuring and other charges	0	63	4
Changes in operating assets and liabilities:			
Accounts and other receivables	8	62	(5)
Merchandise inventories	(100)	133	221
Prepaid expenses and other operating assets	(118)	28	76
Accounts payable, accrued expenses, and other liabilities	109	117	(45)
Income taxes payable	48	(53)	(74)
Net cash provided by operating activities	$575	$801	$746
CASH FLOWS FROM INVESTING ACTIVITIES			
Capital expenditures, net	($395)	($262)	($269)
Proceeds from sale of fixed assets	0	0	216
Purchase of SB Toys, Inc.	0	0	(42)
Purchase of short-term investments and other	0	(572)	(382)
Net cash used in investing activities	($395)	($834)	($477)
CASH FLOWS FROM FINANCING ACTIVITIES			
Short-term borrowings, net	$0	$0	$0
Long-term borrowings	548	792	0
Long-term debt repayment	(141)	(370)	(503)
Decrease/(increase) in restricted cash	(60)	60	0
Proceeds from issuance of stock and contracts to purchase stock	266	0	0
Proceeds from exercise of stock options	0	0	27
Net cash (used in)/provided by financing activities	$613	$482	($476)
Effect of exchange rate changes on cash and cash equivalents	($53)	($40)	$25
CASH AND CASH EQUIVALENTS			
(Decrease)/increase during year	$740	$409	($182)
Beginning of year	283	1,023	1,432
End of year	$1,023	$1,432	$1,250

Source: Toys "R" Us FYE 2005 10-K Filing

Company opened nineteen Babies "R" Us stores in calendar year 2004. As part of its long-range growth plan, it planned to continue expanding its Babies "R" Us store base in 2005.

Toysrus.com

Toysrus.com sold merchandise to the public via the Internet at *www.toysrus.com*, *www.babiesrus.com*, *www.imaginarium.com*, *www.sportsrus.com*, and *www.personalizedbyrus.com*. The Company launched its e-commerce Web site in 1998. To improve customer service and order fulfillment, the Company entered into a strategic alliance with Amazon.com and launched a co-branded toy store in 2000.

EXHIBIT 13 Financial Performance by Segment ($ in millions)

	For the Year Ended						For the Year Ended		
	2/1/ 2003	*% of Total*	1/31/ 2004	*% of Total*	1/29/ 2005	*% of Total*	2/1/ 2003	1/31/ 2004	1/29/ 2005
NET SALES BY SEGMENT							GROWTH BY SEGMENT (%)		
Toys "R" Us—U.S.	$6,755	*59.8*	$6,326	*55.9*	$6,104	*55.0*		−6.4	−3.5
Toys "R" Us—International	2,161	*19.1*	2,470	*21.8*	2,739	*24.7*		14.3	10.9
Babies "R" Us	1,595	*14.1*	1,738	*15.4*	1,863	*16.8*		9.0	7.2
Toysrus.com	340	*3.0*	371	*3.3*	366	*3.3*		9.1	−1.3
Kids "R" Us	454	*4.0*	415	*3.7*	28	*0.3*		−8.6	−93.3
Consolidated net sales	$11,305	***100.0***	$11,320	***100.0***	$11,100	***100.0***		0.1	−1.9
OPERATING EARNINGS BY SEGMENT							MARGIN BY SEGMENT (%)		
Toys "R" Us—U.S.	$256	*49.4*	$70	*20.4*	$4	*0.9*	3.8	1.1	0.1
Toys "R" Us—International	158	*30.5*	166	*48.4*	220	*51.9*	7.3	6.7	8.0
Babies "R" Us	169	*32.6*	192	*56.0*	224	*52.8*	10.6	11.0	12.0
Toysrus.com	(37)	*−7.1*	(18)	*−5.2*	1	*0.2*	−10.9	−4.9	0.3
Kids "R" Us[a]	(28)	*−5.4*	(67)	*−19.5*	(25)	*−5.9*	−6.2	−16.1	−89.3
Segment operating earnings	$518	***100.0***	$343	***100.0***	$424	***100.0***	4.6	3.0	3.8
Corporate/other expenses[b]	(75)		(63)		(116)				
Restructuring charges	0		(63)		(4)				
Reported operating earnings	$443		$217		$304		3.9	1.9	2.7
ADJUSTED EBITDA BY SEGMENT							MARGIN BY SEGMENT (%)		
Toys "R" Us—U.S.[c]	$447	*55.1*	$264	*39.3*	$322	*37.4*	6.6	4.2	5.3
Toys "R" Us—International	210	*25.9*	227	*33.8*	295	*34.3*	9.7	9.2	10.8
Babies "R" Us	197	*24.3*	223	*33.2*	262	*30.5*	12.4	12.8	14.1
Toysrus.com	(33)	*−4.1*	(16)	*−2.4*	1	*0.1*	−9.7	−4.3	0.3
Kids "R" Us[a]	(10)	*−1.2*	(27)	*−4.0*	(20)	*−2.3*	−2.2	−6.5	−71.4
Adjusted segment EBITDA	$811	***100.0***	$671	***100.0***	$860	***100.0***	7.2	5.9	7.7
Corporate/other expenses[b]	(75)		(63)		(116)				
Add-back: other D&A	46		40		36				
Consolidated adjusted EBITDA	$782		$648		$780		6.9	5.7	7.0

[a]Includes markdowns of $49 million and accelerated depreciation of $24 million in 2003 related to the closing of all stores.

[b]Includes corporate expenses, the operating results of Toy Box, and the equity in net earnings of Toys "R" Us—Japan. Increase in amount is due to our strategic review expenses and Sarbanes-Oxley Section 404 compliance totaling $29 million. In addition, we incurred charges of $8 million relating to our 2004 restructuring of the Company's corporate headquarters operations, and a $19 million increase in incentive compensation costs.

[c]EBITDA for FY 2005 adjusted by adding back $132 million in inventory markdowns and excluding $14 million related to a lawsuit settlement—$118 million net add-back in FY 2005.

Source: Toys "R" Us FYE 2005 10-K Filing

EXHIBIT 14 Quarterly Financial Results ($ in millions)

	For the Quarter Ended								FYE
	5/1/ 2004	***% of Total***	**7/31/ 2004**	***% of Total***	**10/30/ 2004**	***% of Total***	**1/29/ 2005**	***% of Total***	**1/29/ 2005**
Net sales	$2,058	***18.5***	$2,022	***18.2***	$2,214	***19.9***	$4,806	***43.3***	$11,100
COGS	(1,330)	***17.7***	(1,441)	***19.2***	(1,475)	***19.7***	(3,260)	***43.4***	(7,506)
Gross margin	$728	***20.3***	$581	***16.2***	$739	***20.6***	$1,546	***43.0***	$3,594
SG&A	(643)	***21.9***	(661)	***22.5***	(682)	***23.3***	(946)	***32.3***	(2,932)
D&A	(86)	***24.3***	(86)	***24.3***	(88)	***24.9***	(94)	***26.6***	(354)
Restructuring (charges)/ income	(14)	***NM***	(31)	***NM***	26	***NM***	15	***NM***	(4)
Operating earnings	($15)	***−4.9***	($197)	***−64.8***	($5)	***−1.6***	$521	***171.4***	$304
Reported EBITDA (includes one-time items)	$85	***12.8***	($80)	***−12.1***	$57	***8.6***	$600	***90.6***	$662

Note: EBITDA is defined as operating earnings with an add-back of D&A and restructuring charges (does not exclude one-time items)
Source: Toys "R" Us FYE 2005 10-K Filing

Challenging Times for Toys "R" Us

During 2003–2004, the Company's performance and prospects were hurt by developments in the retail toy industry. Discount and mass merchandisers with greater financial resources and lower operating expenses had reduced pricing and profit margins for other players in the retail toy industry, and the Company's toy sales had decreased because of changing consumer habits, including age compression. On November 17, 2003, the Company announced plans to close all 146 of the freestanding Kids "R" Us stores, with final closings completed by January 29, 2005.

The Company's consolidated net sales decreased 1.9 percent to $11.1 billion in fiscal year end (FYE) January 29, 2005, from $11.3 billion in FYE January 31, 2004, and $11.3 billion in FYE February 1, 2003. The decrease in net sales was primarily the result of declines in comparable store sales at the Toys "R" Us—U.S. division, which posted comparable store sales declines of 3.7 percent for FYE 2005, following comparable store sales decreases of 3.6 percent and 1.3 percent in FYE 2004 and FYE 2003, respectively (see Exhibit 15).

These decreases in net sales were partially offset by net sales increases in the Babies "R" Us division of 7.2 percent to $1.9 billion in FYE 2005, and net sales increases in the international division of 10.9 percent (these figures include the effect of currency translation) to $2.7 billion in FYE 2005, primarily due to the addition of nineteen Babies "R" Us stores in the United States and seven wholly owned international stores in 2004. In addition, comparable store sales at Babies "R" Us and international divisions showed favorable increases.

Toys "R" Us Strategic Review and Sale

Facing both difficult industry trends and weak performance of U.S. toy stores during the 2003 holiday season, Toys "R" Us decided to conduct a strategic evaluation of its worldwide assets

EXHIBIT 15 Comparable Store Sales Performance (%)

	For the Year Ended		
	2/1/2003	**1/31/2004**	**1/29/2005**
Toys "R" Us—U.S.	–1.3	–3.6	–3.7
Toys "R" Us—International	5.9	2.1	0.6
Babies "R" Us	2.7	2.8	2.2

Note: This does not reflect sales from new store openings or store closings, comparable stores year over year.
Source: Toys "R" Us FYE 2005 10-K Filing

and operations. The Company retained Credit Suisse First Boston (CSFB) as its financial advisor. The Company and CSFB considered several alternatives, including:

- Maintaining status quo and refocusing management on reviving domestic performance at Toys "R" Us
- Unlocking value in a faster-growing asset by selling the global Toys "R" Us business or spinning off Babies "R" Us
- Pursuing the sale of consolidated Toys "R" Us

The Company and CSFB initially decided to separate the U.S. toy retailing business and Babies "R" Us by running a thorough sale process for its toy retailing business. However, participants in the auction determined it would be too difficult to uncouple the businesses. One participant said, "It would be like selling your kitchen to one buyer and your dining room to another."[16] With no compelling bids for any of the individual businesses after an extended period of time, pressure increased for Toys "R" Us to sell the portfolio of businesses together.

Ultimately, a consortium that included Cerberus, Goldman Sachs, and Kimco Realty Corp. submitted a bid for the entire business. Subsequently Kohlberg, Kravis & Roberts (KKR) teamed up with Bain Capital Partners and Vornado Realty Trust (Bain and Vornado initially joined to bid on the toy business) and submitted a rival bid. On March 17, 2005, the Company announced that it had reached a definitive agreement to sell the entire worldwide operations to the consortium of KKR, Bain Capital, and Vornado Realty Trust for $26.75 per share in a $6.7 billion transaction.[17] The acquisition price represented a 122.5 percent premium over the stock price on the day before the announcement of the strategic review on January 7, 2004, and a 62.9 percent over the stock price on August 10, 2004, the day before the Company announced it was seeking to divest its toy retailing business.

The $26.75 per share winning bid for Toys "R" Us represented an aggregate value of $6.7 billion, including all transaction fees. It is important to note that as part of the transaction, the consortium assumed the Company's existing debt and cash not used in the transaction. Exhibit 16 summarizes the sources and uses for the transaction. Based on adjusted EBITDA of $780 million during FYE January 29, 2005, Exhibit 17 shows the implied purchase price and leverage multiples (including all assumed debt and cash) for the Toys "R" Us transaction.

As part of this transaction, John H. Eyler, Jr. (chairman, CEO, and president of Toys "R" Us) and Christopher K. Kay (executive vice president and chief operations officer) were to leave

[16] "Toys 'R' Us Narrows Suitors to Four," *Wall Street Journal*, March 1, 2005.
[17] Toys "R" Us Company Press Release, March 17, 2005.

EXHIBIT 16 Sources and Uses ($ in millions)

Sources		**Uses**	
Cash on balance sheet	$956	Purchase of common stock	$5,900
Senior secured credit facility	700	Purchase of stock options and restricted stock	227
Unsecured bridge loan	1,900	Settlement of equity security interests	114
Secured European bridge loan	1,000	Purchase of all warrants	17
Mortgage loan agreements	800	Transaction fees	362
Sponsor equity	1,300	Severance and bonus payments	36
Total	$6,656	***Total***	$6,656

Summary of Fees	
Summary of Fees	
Advisory fees and expenses	$78
Financing fees	135
Sponsor fees	81
Other	68
Total	$362

Note: Senior secured credit facility has $2.0 billion of availability.
Source: Toys "R" Us, Form 10-Q, July 30, 2005

EXHIBIT 17 Enterprise Value and Leverage Summary ($ in millions)

	Amount	**Multiple of FYE 2005 Adj. EBITDA**
Transaction proceeds (excl. fees)	$6,294	
Approximate existing debt assumed by the consortium	2,312	
Remaining cash and short-term investments on balance sheet	(1,247)	
Enterprise value	$7,359	9.4x
Transaction fees	362	
Total transaction value	$7,721	9.9x
FYE 2005 adjusted EBITDA	$780	
LEVERAGE ANALYSIS		Cumul. Multiple
Approximate existing debt	$2,312	3.0x
$2 billion senior secured credit facility	700	3.9x
Unsecured bridge loan	1,900	6.3x
Secured European bridge loan	1,000	7.6x
Mortgage loan agreements	800	8.6x
Total	$6,712	8.6x
Remaining cash and short-term investments on balance sheet assumed by the consortium	(1,247)	
Net leverage	$5,465	7.0x

Note: Assumes transaction closed on January 29, 2005 for simplicity.

the Company. The consortium appointed Richard L. Markee (a Company veteran) as interim CEO, with the expectation of filling out the management team over time. This was somewhat unusual, as financial sponsors typically preferred to back an in-place management team to lead

a company through the initial period after an LBO. This action was particularly noteworthy given the pressures of operating a business in a difficult industry with a significant amount of new leverage.

Markee had served as president of Babies "R" Us since August 2004. Prior to that, he had been vice chairman of Toys "R" Us Inc., president of Toys "R" Us Domestic, president of Specialty Businesses and International Operations, president of Babies "R" Us, and chairman of Kids "R" Us.

The Toys "R" Us Club

The Toys "R" Us Club featured two of the premier private equity firms in the world and a leading real estate investment trust (REIT). The two private equity firms—KKR and Bain Capital—had also partnered in several deals, including a $11.4 billion buyout of SunGard Data Systems, which had closed in August 2005. Including the Toys "R" Us deal, KKR had become the most active participant in club deals, having participated in ten announced club deals valued at $95.3 billion during the previous two years.[18]

The Toys "R" Us Club was particularly interesting because of the diverse core competencies of each member. KKR was known for structuring highly complex transactions with expert use of financial engineering, a skill that was of particular importance given the recent performance issues at Toys "R" Us. Bain Capital, while also skilled at financial engineering, had built a reputation for in-depth industry research capabilities, especially in retail. The consortium leveraged Bain Capital's resources to understand and analyze the nature of the industry downturn and to forecast the future viability of both the Company and the industry. The inclusion of Vornado highlighted the club's focus on understanding the value of the Company's real estate portfolio. While it historically had been rare for an REIT to be involved in a typical private equity deal, as private equity firms began to target companies with large real estate portfolios, there was an increased need for expertise in valuing real estate.

KKR

Established in 1976 and led by co-founding members Henry Kravis and George Roberts, KKR had completed more than 140 transactions valued at approximately $215 billion[19] and created $68 billion of value from $26 billion of invested capital, a multiple of 2.5 times.[20] KKR historically had been involved with the highest-profile, largest transactions in the private equity industry, including those involving RJR Nabisco, SunGard Data Systems, and HCA.

Bain Capital

Established in 1984, Bain Capital was one of the world's leading private investment firms with approximately $40 billion in assets under management. Since its inception, Bain Capital had completed more than 200 equity investments. The aggregate transaction value of these investments exceeded $17 billion.[21] Bain Capital had been founded by three ex-Bain & Company partners, Mitt Romney, T. Coleman Andrews, and Eric Kriss. Less than one year before its acquisition of

[18] "KKR Tops 'Club' Buyout Deals," *CNN Money.com*, October 17, 2006.

[19] KKR, http://www.kkr.com.

[20] Ibid.

[21] Bain Capital, http://www.baincapital.com.

Toys "R" Us, Bain Capital had completed the acquisition of another specialty retailer, the Canadian dollar store chain Dollarama.

Vornado Realty Trust

Vornado Realty Trust was a fully integrated REIT. The firm was one of the largest owners and managers of real estate in the United States, with a portfolio of approximately 60 million square feet in its major platforms, primarily in the New York and Washington, D.C. metro areas.[22]

The Assignment

Your private equity firm has been approached by KKR, Bain, and Vornado to join the consortium. You have been asked by a senior member of your firm to prepare a presentation that summarizes the Toys "R" Us investment opportunity. You should:

- Use the provided operating model template to develop assumptions that drive a base case operating model and analyze the returns for the investment group
  - Use the operating model to generate input for an LBO model, which will calculate relevant returns, financial data, and credit statistics
  - Focus on developing a reasonable set of projections on which to base your investment recommendation

  The presentation should include the following (a template has been included for guidance):

- Risks and merits of the transaction
- Summary of the industry dynamics, including the major issues and potential catalysts for improvements
- A list of key due diligence questions/requests you want to ask the Company
- Summary of the debt in the transaction: indicate whether you feel comfortable with the capital structure proposed by the consortium
- Downside case(s) that stress test the investment under various difficult operating outcomes: quantify the risk/return profile of the transaction and evaluate this profile
- Potential exit alternatives for this investment
- Recommendation whether or not to join the consortium

For the purpose of your evaluation assume that you are not able to change the consortium's proposed capital structure.

[22]Vornado Realty Trust, http://www.vno.com.