



**Toys-R-Us (A) in the Online Toy Business*
&
Toys-R-Us (B) Forms an Online Alliance**

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ABSTRACT

Objectives and Use

This case conveys a situation that is complex, yet easy for students to relate to in a practical real-world setting. Toys-R-Us is in an industry that every student can understand and to which all students can easily relate. The company in the case is responding to industry changes occurring as a result of the E-commerce revolution; again, a technological change that students can understand and to which they can relate. Students can find issues within this case that has implications for the broad range of topics covered in a strategy class including: the general environment, the industry environment (Porter, 1980), internal environment resources and capabilities (Barney, 1991; Peteraf, 1993), value chain analysis (Porter, 1985), business level strategy analysis, and corporate level strategy.

The teaching note was written for an undergraduate Strategic Management course and suggests ways to use these cases at two different points during the course. The case could be used as the initial case to set the stage for an undergraduate business policy and strategy course. In this setting, the primary learning objective for students is to begin to understand through case discussion some of the central topics and decision points that are part of a business policy and strategy course. Alternatively, the cases can be more specifically targeted use with the corporate strategy topic; helping students to understand the many issues associated with the decision to horizontally diversify. The learning objective in this application is more targeted to corporate strategy and specifically diversification issues including why firms diversify, how they can do it and how to analyze it in terms of relatedness (Rumelt, 1974) and potential synergies (Sirower, 1999).



Synopsis

* This case is solely based upon library research. Special thanks to Margaret Ann de Souza-Lawrence for research assistance on this project. Previous versions of this case were presented at the 2001 NACRA meeting and 2001 EAM / CASE meeting.

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In June 1998, Toys-R-Us established a Website, www.toysrus.com, and began selling its products through the Internet. The Internet toy business was \$650 million dollars in 1999 and was expected to grow to \$1.8 billion by 2003. In addition, management also recognized the threat posed by new online competition that included companies like Etoys.com, Amazon.com, Smarterkids.com, Target.com and Toysmart.com.

At the same time that Toys-R-Us was creating its online business unit, it was also facing competitive pressures in its traditional brick and mortar business. Its market share had dropped from 25% in 1990 to 15.6% in 1999. Wal-Mart had dethroned Toys-R-Us as the number one toy seller after more than a decade on top and Etoys.com was ahead online. CEO John Eyler had been at Toys-R-Us less than a year and he faced strategic dilemmas related to both traditional and online arenas.

Toys-R-Us (A) in the Online Toy Business

“How do I explain to my son that Santa is giving him a gift a week late?” said Michele Read on December 24, 1999 as she worried how to explain to her 4-year old son Tyler that the Leap Frog Learning toy she had ordered from Toysrus.com was not going to be under the Christmas tree the next day.[\[1\]](#)

“This does nothing to appease a child on Christmas morning when he doesn't find his present,” said Kevin Davitt, a customer who was still waiting for an order from Toysrus.com on December 23, 1999. “A 6-year- old doesn't want a gift certificate, he wants his Nintendo or his Pokemon,” said Davitt, a publicist from Glen Rock, N.J., had ordered two video games for his 6-year-old son on December 13, 1999 and agreed to pay \$19.90 for express shipping so that the gift would arrive within five days.

Michael Kinney, a customer from South Pasadena, California who is the manager of a local taxi service ordered a ‘Chickaboom’ game for his son and was promised delivery within two weeks. After seven weeks, Kinney declared, “I’ll never shop Toysrus.com again.”

During Christmas 1999 Toysrus.com employees faced a real siege. The company’s “Black Sunday” came on Sunday, November 6, 1999 as 62 million advertising circulars were placed in local newspapers around the U.S. offering free shipping on Christmas toy orders placed over the Internet. When Toysrus.com was unable to fulfill orders in time for Christmas, the firm received numerous consumer complaints and negative publicity from newspaper and magazine articles and TV news reports about the firm’s problems. Toys-R-Us had the toys available in its warehouses, but was unable to pick, pack, and ship customer orders in a timely manner. Many



employees worked for 49 straight days to fill orders, with some employees reported to pull sleeping bags out from under their desks to rest during the round-the-clock operation². Despite the heroic efforts, customers were still displeased. "I have never been exposed to fouler language," explained Joel Anderson, a Toysrus.com vice president, as he described the angry e-mails from unhappy customers.^[2]

In January 2000 John Eyer became the fourth CEO of the 53-year-old Toys-R-Us toy chain and parent of Toysrus.com. He came from being president of much smaller FAO Schwarz toy chain and entered on the heels of the 18-month tenure of the previous CEO. He was immediately faced with the aftermath of the Christmas 1999 crisis and less than twelve months to fix things for Christmas 2000.

Toys-R-Us Today

Toys-R-Us stores carried everything from Crazy Bones at \$1.99 to Sony PlayStation at \$129.99. Toys-R-Us Inc., headquartered in Paramus NJ, is one of the largest toy store chains in the USA with sales of \$11.3 billion reported in the fiscal year 2000. The merchandise mix included both children's and adult's toys and games, bicycles, sporting goods, small pools, infant and juvenile furniture, infant and toddler apparel and children's books. An electronics section, which featured video games, electronic hand-held toys, videotapes, audio CDs, computer software, along with a smattering of small TVs, shelf-stereos and radios, generated about \$2 billion in sales in 1998.^[3] Most Toys-R-Us stores conformed to a traditional big-box format, with stores averaging about 46,000 square feet. Stores in smaller markets ranged between 20,000 and 30,000 square feet. In 1999, the company began converting stores to a new layout named the "C-3"^[4] format store intended to make the Toys-R-Us stores easier to shop with wider aisles, more feature opportunities and end-caps, more shops, and logical category layouts.

In addition to the traditional brick-and-mortar locations, Toys-R-Us Direct was organized in 1999 and consolidated both selling via the Internet (www.toysrus.com) and through mail-order catalogs. In July 1999, Toys-R-Us, with an interest in the educational and learning toy segment, announced the purchase of Imaginarium, the number 37 player ranked by sales. Existing stand-alone Imaginarium stores continued, and Toys-R-Us incorporated in-store Imaginarium World sections in 10 to 20 of its C-3 format stores in time for Christmas 1999.

By February of 2001 the company had a total of 1581 stores worldwide. Toys-R-Us strived to be the "Worldwide Authority on Kids, Families and Fun" with 6 divisions: Toys-R-Us USA, Toys-R-Us International, Kids-r-us, Babies-r-us, Toysrus.com, and the newest division, Imaginarium. See exhibit 1 for store types and see exhibit 2 for company vision.



Exhibit 1
Breakdown of Stores by Divisions by Year

	2001	2000	1999	1998	1997	1996	1995	1994	1993	1992
Number of Stores										
Toys"R"Us - U.S.	710	710	704	700	682	653	618	581	540	497
Toys"R"Us - International	491	462	452	441	396	337	293	234	167	126
Kids"R"Us - U.S.	198	205	212	215	212	213	204	217	211	189
Babies"R"Us - U.S.	145	131	113	98	82	-	-	-	-	-
Imaginarium	37	40	-	-	-	-	-	-	-	-
Total Stores	1,581	1,548	1,481	1,454	1,372	1,203	1,115	1,032	918	812

Source: Toys-R-Us, Inc., 10-K report

Exhibit 2
Vision, Mission, and Goals

Vision: Put joy in kids' hearts and a smile on parents' faces.

Mission: A commitment to making each and every customer happy.

Goal: To be the "Worldwide Authority on Kids, Families and Fun."

Source: Toys-R-Us, Inc. 2000 Annual Report

Background

Charles Lazarus started Toys-R-Us in 1948 in Washington D.C. Lazarus started out in business with a baby furniture store. However, as customers requested toys too, he gradually moved into the toy business. In 1957, Lazarus opened the first toy supermarket. Specialty retailing and off-price positioning were revolutionary concepts in those pre-mall, pre-discount store days. With the success of these stores, Toys-R-Us became a public company in the late 1970s. Lazarus pioneered the toy supermarket concept and led Toys-R-Us to dominate the industry. The company has evolved into an \$11 billion dollar business with over 1,581 stores worldwide. See exhibit 3 contains company performance data.

Exhibit 3
Consolidated Statements of Earnings

Consolidated Statements of Earnings: Toys-R-Us Inc. and subsidiaries				
(In millions except per share data)	Feb 2001	Jan 2000	Jan 99	Jan 98
Net sales	11,332	11,862	11,170	11,038
Cost of Sales	7,815	8,321	8,191	7,710
Gross Profit	3,517	3,541	2,979	3,328
Selling general & administrative expense	2,832	2,743	2,443	2,231



Depreciation, amortization & asset write-	290	278	255	253
Restructuring				294
Equity in net earnings Japan	(31)			
Total operating Expenses	3,091	3,021	2,992	2,484
Operating Income/Loss	426	520	(13)	844
Gain from IPO Japan	315			
Interest expense	(127)	91	102	85
Interest and other income	23	(11)	(9)	(13)
Interest Expense Net	80	93	72	
Earnings/loss before Income taxes	637	440	(106)	772
Income Taxes	233	161	26	282
Net earnings/Loss	404	279	(132)	490
Basic earnings/loss per share	1.92	1.14	(0.50)	1.72
Diluted earnings/loss per share	1.88	1.14	(0.50)	1.70

The Toy Industry

Brick and mortar

The \$29.4 billion traditional toy industry had undergone significant changes during the 1990s (see exhibit 4 for industry growth). General mass merchandise retailers had grown, as had their toy departments. Mall retailers like KB Toys managed to channel a great deal of money into shopping malls with the introduction of their small mall-based toyshops. Exhibit 5 shows the changing market share among retailer types. The Toys-R-Us chain suffered and saw its market share drop from 25% in 1990 to 18% in 1997 and 16.5% in 1998^[5]. Toys-R-Us had been the leader for over a decade, however, in 1998 the scenario changed as Wal-Mart ousted Toys-R-Us and became the top toy retailer in the USA as indicated in exhibit 6.

Exhibit 4 US Toy Industry Sales

Industry Segments	1993	1994	1995	1996	1997	1998	1999	2000
Total Industry (with Video Games)	\$18.7	\$20.1	\$20.8	\$22.7	\$25.6	\$27.2	\$29.9	\$29.4
Traditional Toys	\$14.8	\$17.0	\$17.7	\$19.1	\$20.6	\$21.0	\$23.0	\$23.0
Video Games	\$3.9	\$3.1	\$3.1	\$3.6	\$5.0	\$6.2	\$6.9	\$6.4

Note: Stated in billions of dollars

Sources: Toy Manufacturers of America, Inc., New York and NPD Group, New York.



Exhibit 5
Distribution of Sales by Retailer Type

Type	Dollar Share (%)					
	1995	1996	1997	1998	1999	2000
Discount Stores	41.2	40.7	41.6	41.5	40.0	41.8
National Toy Stores	23.6	23.6	23.2	21.7	20.8	21.0
All Other Outlets	13.8	13.4	12.9	12.8	13.8	11.9
Mail Order	4.4	4.8	4.6	5.3	5.0	5.1
Card / Gift / Stationary	0.9	1.2	1.9	3.1	4.2	2.2
All Other Toy Stores	3.6	4.3	3.9	3.7	3.9	3.4
Food / Drug Stores	3.4	3.4	3.5	3.6	3.4	2.9
Department Stores	4.1	3.8	3.4	4.1	3.3	4.0
E-Tailers *	-	-	-	-	1.2	2.1
Hobby / Craft Stores	2.9	3.1	3.2	2.7	2.8	3.5
Variety Store	2.1	1.7	1.8	1.5	1.7	2.1

* New category

Sources: Toy Manufacturers of America, Inc., New York and NPD Group, New York.

Exhibit 6
Percent of Annual Industry Sales, Top Toy Sellers

Retailer	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Wal-Mart	10.2	10.4	13.4	14.1	14.6	15.3	16.3	17.4	17.4	19.0
Toys R Us	19.1	20.6	19.7	21.0	19.2	18.9	18.3	16.8	15.6	16.5
Kmart	6.9	6.9	7.6	7.4	8.5	8.3	8.2	8.0	7.2	7.4
Target	4.9	5.6	5.2	5.6	6.1	6.4	7.1	6.9	6.8	7.2
KB Toys / Toy Works	5.0	4.6	3.9	4.3	4.3	4.3	4.9	4.9	5.1	4.7
Ames			-	1.0	1.2	1.2	1.1	1.3	1.6	1.9
J.C. Penney	1.3	1.4	2.1	2.2	1.5	1.7	1.5	1.6	1.2	1.4
Hallmark								1.0	1.1	0.9



Meijer						1.0	1.1	1.2	1.0	0.9
Shopko								0.9	0.8	0.8
Lionel Leisure	1.7	1.4*								
Child World	3.1	1.4*								
Service Merchandise	1.8	2.1	1.8	1.9	1.8	1.6	1.1			
Sears	2.4	2.0*								
Hills			1.2	1.4	1.6	1.3	1.2	1.1		

Sources: NPD Group, New York and Toy Manufacturers of America, Inc., New York.

* Exit the toy business

Online

Between 1999 and 2002 the share of the toy market held by Internet retailers was expected to grow ten times according to Deutsche Bank's Alex Brown[6], which would amount to 2.2% of the market. However, even that small percentage of the market was likely to influence the industry profoundly. One major way

Internet retailers competed in the toy market was based upon price since profit margins were quite slim. Participants in the toy war on the web besides Toys-R-Us included Etoys, Amazon.com, Smarterkids.com, Target.com, and Toysmart.com. The year 2000 brought approximately 28+ million shoppers online and \$793 million in total online toys sales, compared to \$650 million in online sales in 1999[7]. In 1998 Etoys.com was the number one online toy merchant, stunning industry watchers-and complacent offline retailers-by selling \$23 million in toys and related products during the holiday season. In 1999 Etoys.com topped the market again with \$151 million in sales. Analysts attributed Etoys.com win to the company's superior web store user-interface that enabled shoppers find items easily and quickly.[8] Exhibit 7 shows the selected sales and percentages of toy revenues derived from online sales by the top players in 1999.

Exhibit 7 1999 Online Toy Sales

Company	Online Toy Sales	Percentage of Total Toy Revenue
Etoys	\$151million	100%
Amazon.com	\$95 million	100%
Toys-R-Us	\$50 million	0.4%
KB Toys	\$26 million	1.5%

Source: USA TODAY research



Selected Online Competitor Profiles

EToys.com

Launched in October of 1997, Etoys.com was a leading online retailer exclusively focused on children's products. This online only store offered an extensive selection of product from well-known and specialty toy brands. In addition to toys, the company offered over 100,000 carefully chosen items included children's video games, software, videos, books, and music. Etoys.com corporate vision was to create the premier family-oriented destination on the Internet. In fact, in July 2000, Etoys.com was named the best Internet toy store by Gómez Advisors, with the highest overall score for the 4th consecutive quarter. Net sales for the fiscal year ended March 31, 2000 reached \$151 million, up fivefold compared with \$30 million in the prior year. Cumulative customer accounts over that same period also grew fivefold from 365,000 to about 2 million. By June 2000 the scenario had changed drastically, a venture into the European market was a disaster and the company took heavy losses. Etoys.com stock traded at \$86 in October 1999 and was down to \$6 in June 2000 as investors were disillusioned and wary. Further the company faced stiff competition and was quickly burning away cash reserves to keep up. In June 2000 they were forced to raise \$100 mil through the sale of preferred stock to a group of private investors. The stock carries a 7% dividend yield payable in cash or Etoys.com common stock.

The Website

The user-friendly Web site combined detailed product information, helpful shopping services, and innovative merchandising strategies, along with the convenience and flexibility of shopping 24 hours a day, 7 days a week. The site's advanced search technology made it easy for customers to locate products by any combination of age, toy category, keyword, or price. In addition, Etoys.com provided regularly updated product recommendations through the site's favorites by age, bestsellers, birthday gifts, and under \$20 sections of the online store. Etoys.com also highlighted award-winning products from prominent parenting and family publications.

By enhancing the current product offerings and expanding into additional categories, Etoys.com aim was to be the primary resource for consumers of children's products. Many of the store's brand name and specialty products were carefully selected and personally tested to provide customers with the highest quality. This level of product evaluation enabled Etoys.com to deliver valuable, personalized product information to shoppers. Etoys.com gift services supplied gift recommendations by age, relationship, and price specification, child-appropriate gift-wrapping, personalized message cards to accompany the gifts, and electronic gift certificates. The gift services also provided a birthday reminder service, through which shoppers could be notified of a child's birthday three weeks in advance via e-mail with age-appropriate gift ideas. Through a wish list service, parents and children could e-mail family and friends a list of gifts wanted.



Smarterkids.com

SmarterKids.com sold toys, but the company wanted to supply parents with many tools not just toys--to help their children learn. "We consider ourselves an educational destination a whole lot more than a store," said Al Noyes, the company's executive vice president of sales and marketing. "We're a combination Sylvan Learning Center and Etoys."^[9]

This online company made \$4.3 million in revenue during the last quarter of 1999, far outpacing the \$22,000 recorded for the same period in 1998. The fourth-quarter total also accounted for the biggest chunk of \$5.4 million in yearly revenue, but even that respectable increase was overshadowed by Etoys.com, which had sales of nearly \$107 million during the quarter, up 366% from 1998. On a typical day, 35,000 unique visitors stopped by SmarterKids, adding up to about 1 million a month, although those figures inflate during the holiday season--2 million visitors came to the site in December 1999. Of those visitors, anywhere from 2 to 10% were converted from browsers to buyers, according to CEO Al Noyes.⁹ Although SmarterKids had a clear niche and offered more content and customization than competitors, Pain Stubing, a retail analyst with Ernst & Young, was skeptical it could survive the cutthroat online toy market.

"The site is charming, but I don't think it's absolutely essential. Big players such as Wal-Mart, Etoys and Toys-R-Us could easily roll over SmarterKids if they branch into educational toys."⁹

Stubing suggested that SmarterKids could partner with a big bricks-and-mortar toy seller or else tie in with all the mom-and-pop toy retailers out there and set up a purchasing co-op, transforming itself from a retailer to a wholesaler.⁹

The Website

At first glance, the Website did not differ much from Etoys.com or Toysrus.com. Shoppers could search for merchandise based on age and grade, by keyword, by themes like construction and pretend play, by brand, or by character, such as Barney.^[10] Non-parents stumped over finding an age-appropriate gift, could head for the gift center or the online registry for help. But a closer look showed that the site's huge selection of learning toys was also searchable by skill and subject, such as alphabet, counting and writing. SmarterKids was packed with educational content. The "parents' center" was a hub for news, activities, links to other sites, articles and columns to help moms and dads inspire their children to turn learning into a fun, ongoing pastime, not a classroom-only event. In fact, Gomez Advisors chose SmarterKids as the top educational toy site on its Internet Toy Scorecard. The site's free specialty centers, housed within the parents' section, gave information on talented and gifted children as well as those with special needs. For kids in the latter category, the offerings included fact sheets on autism, visual impairment, learning disabilities and attention-deficit disorder, along with recommendations for toys that nurture children with those needs. A step-by-step guide helped parents determine whether their child fits into one of the special needs categories. Similarly, the gifted and talented center features resources, toy recommendations and tools for building aptitude in math, science, written and oral communication, and the arts. Both sections included "ask our teacher," a feature that allowed parents to query a resident educator. The preschool



category broke out children's skills into social, emotional, language, motor and cognitive. Clicking on any of those categories took you to a list of skills for that subset, and a button that brought up a roster of suitable products.

A particularly useful feature was "MySmarterKids" and its patent-pending "SmartPicks" system, which allowed parents to customize their shopping and content browsing. After parents set up learning profiles for each child, the site matched learning needs, goals and styles with merchandise tested and approved by teachers on staff. This feature was unique, but wasn't showcased as well as it could be, since the site didn't use technology to identify those who had previously setup a custom page. Instead, visitors who had used the feature saw the same home page as everyone else, rather than a tailored one that took them directly to their profile and product picks. Also, the home page was busy looking, and the design didn't telegraph the relative importance of each section.

Kbkid.com

Formed in June 1999, the KB Toys, KBkid.com site, was owned 80% by Consolidated Stores Corporation. A leading value retailer, Consolidated operated approximately 1309 toy stores nationwide. KBkid.com, as a part of it, was one of the fastest growing online retailers with an exclusive focus on children's products. During 1999, this toy seller was ranked number one for online customer confidence and overall cost by Gomez Advisors, among the top e-commerce transaction gainers by Next Card, and was named one of the "Ten Best Online Software Stores" of 1999. KBkid.com hoped to do for the toy industry what Amazon.com did for the staid world of selling books.

However, as Consolidated's losses widened during 2000 management sought a buyer for their toy division, which included the KBkid.com online. In March 2000 Consolidated changed its name to Big Lots, Inc to emphasize the firm's focus on the closeout retail business. By the end of the second quarter of 2000 Consolidated reported a net loss of \$62.7 million, or 68 cents a share compared with a net loss of \$ 4.4 million, or 7 cents a share, in the same period of 1999. In December 2000 Big Lots sold the KB toy division to Bain Capital, a private investment firm.

The Website

The KBkid.com was a sleek, innovative Website with customer-friendly features, functionality, and an emphasis on great prices and strong merchandising. Toys could be found via a search engine or customers could shop by category: Toys, Videos, Games, Software, DVD & Video, Collectibles and Specialty Toys. Categories were broken down on the left frame and items were displayed in the right frame, making it easy for customers to find what they wanted. The site's search capabilities were also impressive; customers could easily comb through some 10,000 products. The product lists from customer searches were displayed with the product title, a thumbnail photo of the item, recommended age bracket, toy category, price, a short description, and a link to more details. Design experts and reviewers attributed the site's success to a clean interface, smooth search function, good use of graphics, and easy-to-use shopping-cart and checkout functions.



The KBkids.com was good enough to beat click-and-mortar rivals like Toys-R-Us but could not match the pure Internet plays for website style and function. Shortcomings included a lack of order tracking or real-time inventory information. Unlucky customers were notified via e-mail if their shipment would be late.

Amazon.com

Amazon.com opened its virtual doors on the World Wide Web in July 1995. Amazon's mission was to use Internet to transform book buying into the fastest, easiest, and most enjoyable shopping experience possible. Amazon.com sought to be the world's most customer centric company, where customers could find and discover anything they wanted to buy online.

The Amazon.com net sales for the second quarter of 2000 were \$578 million; an increase of 84% over the net sales of \$314 million for the same period in 1999 (net sales for the entire year were only \$511,000 in 1995). The company also reported significant increases in sales outside USA. Amazon.co.uk (United Kingdom) and Amazon.de (Germany) sales were \$73 million, up 134% from \$31 million for the second quarter of 1999. The two sites added 500,000 new customer accounts in the second quarter of 2000, bringing their total customer accounts to more than 3 million, up from about 800,000 as of June 1999.

The bad news for Amazon started coming in the beginning of 2000, Wall Street showed disenchantment with its former Internet darling. Top tech-fund managers began to reduce or even eliminate Amazon.com from their portfolios. Ravi Suria, Lehman Brother Inc. analyst, argued: "The only triple-digit that mattered is Amazon's cash-flow loses."¹ 2000 marked the end of Amazon's fairytale honeymoon of unlimited prospects with Wall Street. Amazon's stock adjusted closing price from \$76.13 per share at the end of 1999 to \$15.56 per share at the end of 2000.

The Website

The site offered millions of distinct items separated in different categories. The site was proud to have Earth's Biggest Selection™, along with online auction and free electronic greeting cards. Amazon.com listed more than 18 million items that could be found under books, CDs, toys, electronics, videos, DVDs, tools and hardware, lawn and patio items, kitchen products, software, and video games. Through Amazon's zShop, any business or individual could virtually sell anything to Amazon's more than 23 million customers. The site offered the customers superior shopping experience by product value through selection, low prices, product information and intense focus on customer service. Proven as a technology leader, Amazon.com had developed electronic commerce innovations such as 1-click technology, personalized shopping services, easy-to-use search and browse features, secure payment protections and wireless access to the stores.

The New Toys-R-Us Strategy for 1999

Customers complained that the stores were ugly and untidy, shopping was difficult, and that there were not enough sales personnel. To help regain its number one place from Wal-Mart,



Toys-R-Us developed a new corporate strategy and marketing plan. Toys-R-Us hired a new Marketing VP, Warren Kornblum, who immediately overhauled their whole marketing operation. In the past Toys-R-Us had joined in small vendor promotions and managed scattered marketing efforts. Kornblum changed that around, deciding to do fewer but bigger promotions. The company teamed with Major League Baseball as a sponsor for the Diamond Skills Program, a youth skill competition. Then the firm helped a champion women's soccer team travel to 12 US cities with a tie-in from SFX Entertainment to create the Toys-R-Us Victory Tour. Toys-R-Us also did a promotional deal with Fox Kids Network and Walt Disney for the feature film "Toy Story 2." As a result of these marketing efforts, sales increased from \$11.2 billion in 1998 to \$11.9 billion in 1999.^[11] For 2000-01, the company restructured its budget to allocate more money towards marketing. Toys-R-Us planned to continue with sports and movie entertainment themes for promotions.

Warren Kornblum's strategy seemed to work. He setup a "Scan and Win" promotion where shoppers held up UPC game pieces to scanners to see if they had won a prize. More than a million consumers were scanned in with this promotion, making this one of the company's most successful store traffic improvement programs. The mountains of sweepstakes entries and packed venues however began causing inventory shortages in the all-important holiday period of 1999. Inventory mishaps were the main reason why fourth-quarter 1999 sales stayed at a flat \$5 billion.

When John Eyler came in as the new CEO of Toys-R-Us in January 2000, he slashed expenses across the board, started efforts to provide better customer service, increased the number of employees in stores, and expanded store operating hours. All of the marketing activities were aimed at bringing customers into the chain's new store design and layout concept, C3: customer driven, cost effective concept. This easier to shop C3 format allowed for 18% more selling space, wider aisles and were to be installed in 75% of the stores by the end of 2000. Toys-R-Us hoped this new strategy would take market share back from Wal-Mart, K-Mart, Target and KB Toys.

To make the stores more shopper-friendly and better able to compete with the more intimate specialty retailers, Toys-R-Us also introduced the merchandise "world" in 1999. See exhibit 9 for a list of the "worlds" developed.

Exhibit 9 Toys-R-Us Merchandise Worlds

World	Description
R Zone	Video, electronics, computer software, and related products
Action and Adventure	Action figures, die-cast cars, etc.
Girls	Dolls, collectibles, accessories, lifestyle products
Outdoor Fun	Bikes, sports, play sets
Preschool	Toys, accessories
Seasonal	Christmas, Halloween, Summer, etc.
Juvenile	Baby products and apparel



Learning Center	Educational and developmental products
Family Fun	Games and puzzles

Source: Toys-R-Us, Inc. 1999 Annual Report

Toys-R-Us.com

Toys-R-Us arrived late to the E-business world with Toysrus.com in 1998 losing critical early battles to eToys.com and ceding some of the market to Amazon.com and KBkids.com. The development, launch, and operation of toysrus.com turned out to be both a corporate and public relations headache for almost a year. Things fell apart just as quickly as they came together. The investment deal they made with Benchmark Capital to fund their venture crumbled a few months after it was made as neither party could agree to the shares they would have. Bob Moog, who was hired to run of Toysrus.com, backed out of his employment deal in July 1999 three months after agreeing to come onboard. This reportedly prompted the resignation of Toys-R-Us CEO, Robert Nakasone. With Christmas 1999 approaching, Toys-R-Us scrambled to put its Internet venture together. Hasbro executive John Barbour was hired as the new president for Toysrus.com in August 1999. Barbour quickly developed a new plan, redesigned the site, and prepared for a holiday traffic onslaught. The company began promoting online offers in its off-line marketing efforts, the most ambitious of which dangled a \$10 discount for online purchases in the nationally distributed Toys-R-Us “holiday big book” coupon circulars. Toysrus.com also offered free shipping for the holiday season.

The free shipping and “big book” coupon strategy worked, but a little too well for the logistics department of the company. Traffic exploded, and the site drowned in an avalanche of orders "beyond our most optimistic forecasts," said John Barbour president of Toysrus.com. The site quadrupled its servers, but even the hardware improvements were no match for a ten-fold increase in consumer traffic. The company was finally forced to announce that five percent of all online orders would not be fulfilled in time for Christmas. Embarrassed, Toys R Us issued a formal apology and issued \$100 gift certificates to Web customers whose orders didn't make it under the tree.

Toysrus.com declared revenues of \$49 million in 1999, \$39 million of which came during the holiday season. The Web operation remained relatively quiet in the first quarter of 2000, as executives focused on upgrades. New marketing efforts were to break in the second half of 2000 in readiness for the holiday season that would be “seamlessly” integrated with bricks-and-mortar promotions. In February 2000, Toysrus.com got a \$57 million investment from Softbank Venture Capital to help improve the firm’s operational readiness for the Christmas 2000 season.

Distribution Center Operations and Order Fulfillment

Learning from the fiasco of Christmas 1999 where Toysrus.com failed to deliver goods in time, the company decided to improve its distribution system. In April 2000, Toysrus.com announced plans to triple its fulfillment capacity, to 1.9 million square feet, by opening distribution centers in Mira Loma, California and Chambersburg, Pennsylvania in addition to



upgrading the existing Memphis, Tennessee facility. Toysrus.com's Memphis based distribution center was designed to fill direct-to consumer orders quickly and with great accuracy. The Distribution center was able to hold very deep inventory in the most popular toy lines. It was also engineered to handle high-volume, small quantity orders, which are the staple of the e-commerce world. The facility was driven by piece movement and designed for enormous flexibility. The company could go from hockey sticks, to golf bags to shirts to Barbie dolls very easily. Not many pick and pack operations systems had this high a level of product variability. The highlight of the system was a two-tiered cross-belt sorter (the only one of its kind in the nation.[12] The unit could perform 16,000 sorts per hour. The center's Memphis location also gave direct access to Federal Express' home hub for fast overnight shipping. Orders received by 9:00pm central could be processed and in the customer's home by the next morning. Many customer specific services, such as personalization and gift-wrapping were also performed at the facility. Toys-R-Us was banking on all these centers to add up to a successful online shopping experience.

Winter 2000 Approaches

John Eyler and his direct report John Barbour (president of the Toysrus.com division) still faced uncertain times ahead. The firm had placed orders earlier in the year 2000 with suppliers and was more confident about sales forecasts and demand levels than they had been in 1999. Toys-R-Us had placed 78% of its Christmas orders by April 2000, up 40% from 1999.[13] However, purchasing was not the major area of concern, it had been online customer order processing, distribution, and logistics that had caused the problems in 1999. Eyler had also announced plans to beef up warehousing and logistics for both retail and online sales. However, there were questions as to whether the distribution system could be ready for Christmas 2000. Eyler had aggressively continued efforts to refit the brick and mortar retail stores to the C-3 layout. What else could Eyler and Barbour do for the online business? Could they avoid repeating Christmas past?

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Toys-R-Us (B) Forms an Online Alliance

In August 2000, Toys-R-Us signed a ten-year contract with Amazon.com agreeing on a 10-year partnership to develop a co-branded toy and video game store Web site in the fall and baby products Web site the following year-2001. Toysrus.com was to buy and manage inventory and Amazon would oversee site development, order fulfillment, and customer service.

Amazon was widely recognized as having one of the better CRM (customer relationship management) systems among online companies. "This showcases [Amazon.com's] ability to turn online transactions into reality," said Vernon Keenan [14], senior analyst at Keenan Vision, in San Francisco, noting that Toysrus.com failed in this arena at Christmas 1999. Amazon had on the other hand been criticized for its expensive real-world warehousing infrastructure. However this deal would allow Amazon to rationalize the cost of that warehousing infrastructure, according to David Cooperstein, research director at Forrester Research, in Cambridge, Mass.



While Toys-R-Us brought the toy business expertise to the table, this deal solved the problem that many brick-and-mortar companies were having at the time. Toys-R-Us, among others, had not figured out how to go from receiving an online order to getting products to the doorstep as well as Amazon. At the same, the deal showed that Amazon no longer believed it could single-handedly be a global online shopping center. The Toysrus.com and Amazon.com deal was structured as follows. Toysrus.com would identify, buy, and manage inventory.

Amazon.com would create a co-branded site for toys and video games and a site for baby products. Amazon would do order fulfillment and customer service and house inventory. Toysrus.com will make fixed periodic payments to Amazon, per-unit payments, and a single-digit percentage of revenue¹. This would allow Toys-R-Us to keep most of the profits. Yet, Amazon expected to make a profit on each sale from the venture. In addition, Amazon would receive warrants to acquire 5% of Toysrus.com. Both firms expected the site to be profitable by the fourth quarter of 2001. For the venture to get to profitability, sales would have to triple or quadruple by 2002 according to John Eyler, CEO of Toys-R-Us^[15]. The hope by Amazon.com and Toys-R-Us was to create a joint toy sales website that was likely make them much more formidable.

However, in return for securing a stable online sales and warehousing platform, what had Toys-R-Us given up?

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