Fun While It Lasted

How Toys "R" Us, once a mighty category killer, became an object lesson in financial mismanagement

The early tale of Toys "R" Us brims with ambition, energy, and no small amount of ruthlessness, as creation stories often do. Charles Lazarus had gone from high school straight to the U.S. Army, where he served as a cryptographer during World War II, and as he cast about for a business venture upon his return, he identified a market that was largely unexploited: kids. "Everyone I talked to said they were going to go home, get married, have children, and live the American dream," he often recounted of those days.

Lazarus may not have anticipated the full impact of the Baby Boom or the accompanying sprawl, malls, television, and advertising, but he took advantage of Americans' desire to accumulate and the cultural imperative to conform. He opened the first big-box toy store, outside Washington, D.C., in 1957, then another and another, until by the mid-1980s there were more than 200 across the country. Toys "R" Us Inc. offered abundance on a scale that smaller competitors could never equal, much of it at prices they could never match. As its mascot, Geoffrey the Giraffe, became as recognizable as Tony the Tiger and its "I don't want to grow up" jingle lodged itself in the brains of a generation of kids, Toys "R" Us became the first category killer. In 1985, Goldman Sachs called it "one of the outstanding companies in all of retailing," and for much of the decade, Lazarus was among the highest-paid chief executive officers in the U.S.

His final opportune move was to step down just as Toys "R" Us peaked. That was in 1994. Four years and two CEOs later, Toys "R" Us was overtaken by Walmart as the biggest toy seller in the U.S. Two years after that, Toys "R" Us struck a disastrous deal to give up its troubled website and exclusively sell its wares online with Amazon.com Inc. By 2004 the company, which now relied on its Babies "R" Us stores for much of its profit, was looking to sell itself. Executives suggested it might have to get out of the toy business altogether.

By Susan Berfield, Eliza Ronalds-Hannon, Matt Townsend, and Lauren Coleman-Lochner
Photograph by Sarah Anne Ward

Instead, the private equity firms Bain Capital LP and KKR & Co., along with Vornado Realty Trust, took over the company in a $7.5 billion leveraged buyout in 2005. For the next 13 years the owners would watch a succession of executives try to halt the steady slide of Toys "R" Us amid a recession and retail upheaval. As the last big toy store chain, Toys "R" Us had a captive audience. Kids could reasonably be counted on to badger, drag, or otherwise persuade adults to bring them to toy stores, especially if they were fun and hands-on. Those adults would more readily acquiesce if the stores were well-organized and the toys competitively priced. There could have been an alternate ending for Toys "R" Us.

Complicating the executives' efforts, though, was the central fact of the company's existence: It was living on borrowed money. When Toys "R" Us filed for bankruptcy in September, one figure was particularly clarifying. The company had been paying interest of $400 million on about $5 billion of debt every year for a decade. In the good years, that was almost half its operating profit. Toys "R" Us had U.S. revenue of $7 billion and, even toward the end, a 14 percent share of the toy market, but there was no math that made $400 million look sustainable.

When it all came crashing down in March, Toys "R" Us had just about run out of cash, and it could find no one willing to replenish its accounts. It was a category killer killed by bigger and more powerful rivals, with the inevitable ending hastened by the cold logic of its private equity owners and bankers. But it goes deeper than that. As the company's advisers liquidate its 735 U.S. stores, make deals for the operations around the world, and determine the value of its intellectual property, it's become clear that Toys "R" Us didn't only have an improvident amount of debt—it also had a debt structure as complex and precarious as a Jenga tower, which obscured the company's tenuous finances. But gravity always wins in the end.

For all of its life after Lazarus, through six CEOs, Toys "R" Us tried both growing and shrinking to become more profitable. John Eyler, who became CEO No. 4 in 2000, had the luxury of trying Option A. Under his guidance the company invested hundreds of millions of dollars to make the U.S. stores look less like impersonal warehouses, to retrain an often indifferent sales staff, and to expand a private-label line of toys. It purchased a 192-acre corporate campus in Wayne, N.J., for $36 million and named it the Global Resource Center, the sort of move that often looks like corporate hubris in hindsight. In late 2001, Eyler oversaw the opening of a flagship store in New York's Times Square, with a 60-foot Ferris wheel, a life-size Tyrannosaurus rex, and a Barbie dollhouse bigger than many Manhattan apartments. Eyler promised that 20 million people a year would visit, and maybe they did, but the store never made money.

It might have been considered a grand marketing expense, but sales and profits at the more utilitarian stores continued to falter, and the company's stock price continued to drop. In 2004, Eyler and the directors took drastic action. It was a good time for retail companies, with their steady cash flows, to be on the market. Capital was plentiful, and private equity firms were competing for deals. The most attractive thing about ▶

Toys “R” Us was its real estate portfolio: It operated 1,500 stores globally, including 900 in the U.S., of which it owned almost half. Vornado and its partners figured they could use the real estate, which the company valued at $2.3 billion, for the higher financial purpose of raising more debt. Eyler left Toys “R” Us when the private equity deal closed. He was only 58 but could afford to retire: He received $65 million on his way out.

The new owners helped finance Toys “R” Us by putting about 500 of its U.S. stores into two corporate entities that became the retailer’s landlords. This arrangement allowed the company to eventually sell an additional $2 billion of debt, all backed by its own rent payments. “That’s the beauty of it: Anybody who owns real estate can do this,” Todd Sammann, then a managing director in commercial real estate at Deutsche Bank Securities, told Bloomberg News in 2006.

When the next CEO, Gerald Storch, arrived from Target Corp. in 2006, he described Toys “R” Us as dispirited. “Victim thinking” pervaded the company, he told *Businessweek*. Boss No. 5 purged upper management; then, as might be expected when private equity is involved and a recession is taking hold, he cut jobs and closed stores. But the company also acquired the struggling FAO Schwarz, the oldest toy store in the country, and, as the threat from Amazon grew, three rival websites, BabyUniverse.com, ePregnancy.com, and EToys.com. Storch remodeled stores to combine the toy and baby businesses and introduced exclusive products that could be sold at full price.

Yet for all of Storch’s efforts, when a significant amount of debt, $725 million, came due in 2009, Toys “R” Us had to take out additional loans—backed by mortgages on more than a hundred properties—to repay it.

Analysts praised the company’s operating discipline in difficult economic circumstances, which was enough to convince Bain and its partners that they could follow through on their plan to reduce their stakes in the company and pay down some of its debt through a stock offering in 2010. Toys “R” Us intended to raise as much as $800 million. But the market wasn’t interested. The IPO was delayed that year and the next, and when prospects didn’t look any more promising in 2012, the company had to ask lenders to add $225 million to one loan so it could pay off bonds coming due.

Former employees have started a Facebook page, Dead Giraffe Society

Then came more trouble. Holiday sales, which usually brought in 40 percent of the company’s annual revenue, were dismal in 2012, and in early 2013 Storch resigned. When Toys “R” Us reported that profit for 2012 had fallen by 75 percent (to a trifling $38 million), it also confirmed what most suspected: There would be no stock sale. The board set a three-year deadline to improve prospects with an undetermined strategy that would be implemented by an unnamed CEO.

That executive turned out to be Antonio Urcelay, head of the company’s European division. His strategy was to do everything better—and that, he said, would only slow the company’s descent. Wall Street appreciated the honesty. But without the cash from the public offering, the strain on the owners’ patience and lenders’ confidence was severe. Toys “R” Us was left to continually defer its moment of reckoning, each time with fewer resources to draw on.

By the spring of 2015, Toys “R” Us had announced it was closing the Times Square store as well as the Fifth Avenue flagship of FAO Schwarz. The Ferris wheel was recycled, the T. rex dismantled. David Brandon, CEO No. 7, joined that summer. He announced that his plan would involve taking some calculated risks. “Not bet the farm,” he told Bloomberg News. “Not be reckless. But what do we need to do that really breaks through? We are going to be testing a lot of stuff that has that potential.” Yet the company had $1.2 billion of debt due in 2017 and an additional $668 million the following year, and Brandon felt compelled to state that he “didn’t take this job to lead a bankruptcy effort.”

As the company edged closer to that first deadline, its surprisingly decent 2015 holiday results—sales increased by 2 percent in established stores, the first gain in four years—were, nonetheless, not nearly enough to matter. Brandon eventually had to negotiate another swap, offering cash dividends and equity in the company’s international business. This desperate deal gave the company only a brief reprieve.

Toys “R” Us was caught: It didn’t have the money for Brandon to test “a lot of stuff” to make its stores modern, fun, distinctive, convenient—or even two of the four. The baby business was faltering. And though the company had wrested back its website, when it finally upgraded its technology to allow customers to check out in fewer than five steps, it was already a half-decade behind. By then, Best Buy Co. was holding off Amazon with its Geek Squad; Target had distinguished itself by creating a billion-dollar kids’ clothing line; and Warby Parker had proved that people will try out and buy products in stores if the stores are appealing and the staff knowledgeable.

During the summer of 2017, Brandon bargained with lenders, hoping to put off $400 million due the next spring. For the first time in a decade, though, Toys “R” Us and its financiers couldn’t come to an agreement. Wariness had finally, unavoidably, set in. The company prepared to file for Chapter 11 bankruptcy, a last-ditch attempt to get out from under its debt and rebuild on firmer ground. In early September, CNBC reported on the plans, which “started a dangerous game of dominoes,” as Brandon said in a court filing. Almost 40 percent of the company’s vendors refused to ship their products without cash in advance, cash on delivery, or payment of all their outstanding obligations—if Toys “R” Us did fail, their claims would have low priority. It was two months before the busiest season.

The company promised all of its cash as collateral to secure a $3.1 billion operating loan from JPMorgan Chase & Co., Goldman Sachs Group, and Barclays Plc, so it could comply with its suppliers’ demands and stay in business through the holidays. This particular kind of loan, debtor-in-possession financing, comes with a special guarantee in case the company closes down. The banks get first dibs on what’s left.

In late September, with this financing in place, Brandon held a press conference at one of the company’s pop-up stores, notably close to its former Times Square spectacle, and said: “It’s the dawn of a new day for the company. It’s the opportunity to do things we’ve wanted to do for a long time but haven’t been able to.”

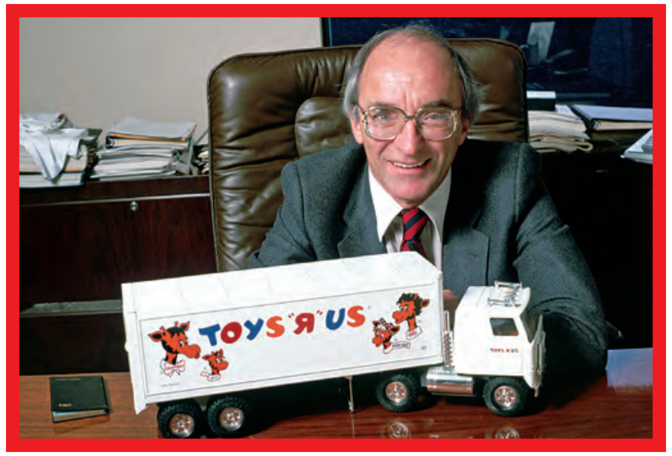
That was Brandon’s last burst of optimism. After a devastating holiday season—sales were 15 percent lower than the year before—Toys “R” Us calculated that it was about $250 million short of what it needed to stay in business until the next holiday season. Brandon could only offer to close 180 stores and shut down the troubled baby business altogether. That idea found no takers. Eight potential investors looked at the company, and several retailers considered buying it outright, but none made an offer. Sycamore Partners produced a plan that could have kept open half the U.S. stores, but the retailer’s senior creditors calculated they would see a better return if the company were liquidated and its assets sold off. By February some of the lenders were insisting on that approach.

Toys “R” Us made their last wish come true, and on March 9, Bloomberg News reported that the company would close its U.S. operations. Five days later, Brandon gathered the administrative and executive staff at the Global Resource Center to tell them that the U.S. business was in default, other loan covenants were about to be breached, and its lenders had been “arguing, negotiating, at times it seemed like fighting with one another.” Toys “R” Us would have to close all 735 remaining U.S. stores; sell $2 billion worth of merchandise at a discount; take bids for its brand name, mascot, and intellectual property, as well as its leases, office equipment, and more; and lay off all 30,000 employees. “Many of those involved in the bankruptcy process live by and make decisions by spreadsheets and economics,” Brandon told them. “I get that. It’s how the world works. It’s not how I work.” He sounded exhausted and embittered. Toys “R” Us came to its end in a snarl of recrimination.

A week after Brandon’s announcement, with liquidation sales under way, Lazarus, who’d been ill for months, died. He was apparently unaware of the company’s ruin.

Brandon left unspoken the other shortcomings revealed by the bankruptcy: a lattice of guarantees, liens, security pledges, and collateral. The final confounding account is on the last page of the filing; read it if you dare. Almost every company asset—cash flows, property, inventory, equity in the international operations—was pledged to a lender, sometimes twice. Toys “R” Us had nothing left to promise.

The retailer’s overseas divisions weren’t part of the bankruptcy, but stores in the U.K. ended up in liquidation, too, after discussions about selling the business fell apart. Smyths Toys, an Irish company, bought operations in Austria, Germany, and Switzerland for about $94 million; Fairfax Financial Holdings Ltd., a Toronto-based investment firm, was the only bidder for the Canadian division and acquired it for $237 million. The Asian business, the company’s most profitable, has drawn enough interest to require a second round of bidding.



Lazarus during the chain’s heyday

An auction for the company’s name, customer data, and baby-shower registry will be held on June 18 in bankruptcy court in Richmond, Va. Target had earlier expressed interest in the registry and the Babies “R” Us website. Hundreds of internet domain names, bought over the years to make sure no one else could use them, are also for sale, sex-toys-r-us.com and toysrussucks.com among them.

The money gathered from the company’s remains will likely pay off loans of at least $710 million. The company still owes billions more to lower-ranked creditors, including vendors that may be out hundreds of millions. “Every single step of the way, their business judgment has been wrong,” Jeff Schwartz, a lawyer for Learning Resources, an educational toy company, said when he made his client’s $2.3 million claim in the liquidation hearings. Bain, KKR, and Vornado, which together collected $470 million in fees and interest payments over the years, will end up losing well over a billion dollars combined. KKR and Vornado have written off their investments; all three companies declined to comment on one of their most public failures.

All stores will be empty by July, but until then customers can stand in front of a “selfie banner featuring Geoffrey,” the retailer said in May. Soon after, Brandon and four other senior executives, now deemed nonessential, left the company. Brandon received almost $7 million in compensation in 2017, including a $2.8 million retention bonus paid just before the bankruptcy filing. He’s already started a consulting company. Former employees have started a Facebook page, Dead Giraffe Society. Some rallied outside the offices of Bain, KKR, and Vornado to protest losing their jobs without severance and occupied a soon-to-be-closed Toys “R” Us store in Union, N.J. Twenty miles away, the company began to liquidate its headquarters. Photos of what’s for sale, including a giant Sully from *Monsters, Inc.* posed next to a pool table, are available online.

For their part in one of the biggest unravelings in U.S. retail history, lawyers and advisers have received more than $100 million; they expect to get about a quarter of a billion dollars more before it’s all over. Even the demise of Toys “R” Us is expensive. Ⓑ —*With Steven Church*

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