Toys "R" Us Battles Back

by Jeffrey Rothfeder
The giant toy retailer missed the Wal-Mart incursion and the Web discontinuity. But with its bricks-and-mortar advantages, it can still fight the e-tail war.
Consider what Toysrus.com CEO John Barbour is up against: people like 10-year-old Luke Armour. In February, the fourth-grader, who lives in Montclair, N.J., was sent via e-mail a $50 birthday gift certificate to Toysrus.com by his grandparents. Luke loves computers — he spends hours on the Internet each day — so his grandparents figured this would be an exciting shopping experience for the boy, one that would keep him engaged and provide a few lessons about how to spend money independently.

Unfortunately, that isn’t quite the way it turned out. With his gift certificate number facing him on his computer screen, Luke went online and searched for toys for 10-year-olds and above. Toysrus.com offered two short screens: A few Nintendo games (“I’m not allowed to play Nintendo,” Luke says), a couple of football jerseys (“I wasn’t interested”), and a bike or two (“I already have one,” he says). Finally, an hour after beginning the shopping spree, he quit. His grandparents took back the gift certificate and gave him money instead.

“I didn’t get it; I’ve been to Toys ‘R’ Us stores and they have such a big selection, so I couldn’t figure out why they had almost nothing on the Internet,” Luke says. “I expected a lot more.”

This is an all-too-familiar story for Mr. Barbour. After an initially promising Christmas selling season, Toysrus.com ended up placating unhappy customers with $100 apiece when it failed to deliver products by December 25. And after nearly a year as CEO of Toysrus.com (the independently managed Internet subsidiary of Toys “R” Us Inc.), Mr. Barbour is still wrestling to create a plan that would give the bricks-and-mortar giant prominence on the Web.

So far, Toysrus.com is clearly behind in the online race against rivals like eToys Inc., currently the No. 1 Internet toy seller. Hampered by strategic stumbles and mixed messages from the parent company, Toysrus.com has been embarrassed and stunted by management turmoil and has struggled to find its legs on the Internet. It hasn’t helped that Toys “R” Us, the parent, has had a difficult decade, during which its stock price barely budged and its earnings were erratic — so much so that Toys “R” Us actually slipped into the red in fiscal 1999.

Comparing the Toysrus.com site with the eToys.com site, it’s easy to see why the upstart is the more popular one. At the time of a visit to the site in late February, Toysrus.com’s opening page, which trumpeted the operation as “a new site,” was a hard-edged series of blocks and strident colors with confusing stacked search fields and two prominent “Coming Soon” links that went nowhere. There was a grim warning that the selection of items online varied from those featured in stores; supplies of online items were limited and inventory changed often; and rain checks were available at retail locations only. If the unfriendly atmosphere didn’t scare away customers, that set of caveats likely did.

By contrast, eToys is soft and inviting — all muted blues and whites with graphics of children playing contentedly and dozens of easy-to-use links to categories and toy recommendations. Numerous details focus on customer needs — such as creative hints for getting the most out of specific toys; reviews by adults and children; handy alerts when a toy needs batteries (as a result, some days batteries are eToys’ top-selling item); and a gift-wrapping service that packs items from an order separately with appropriate “To/From” tags attached.
Additionally, eToys is remarkably well stocked. For example, it has more than 200 different train sets — 10 times as many as Toysrus.com has — including 15 from high-end Brio Corp. of Germantown, Wis., which refuses to sell its painstakingly crafted products at Toys “R” Us or Toysrus.com to avoid having them shown next to less expensive and lower-quality trains.

Considering all of this, it’s not surprising that eToys booked $107 million in revenue during its fiscal quarter that ended December 31, well ahead of the $39 million in sales posted by Toysrus.com during the holiday season.

No joy in Toyville, at least in Toysrus.com’s corner of it? In fact, quite the opposite. The 1999 holiday numbers are probably a poor indicator of who will be on top next Christmas. Indeed, virtually everybody watching this story play out — people close to Toys “R” Us and eToys, industry analysts, and e-commerce experts — is convinced that Toysrus.com will beat out eToys, and soon. What’s more, the drubbing could be ugly. The survival of eToys as an independent company or even as a thriving business is a huge uncertainty.

“Toysrus.com has finally moved beyond window dressing when it comes to facing the challenges of the Internet; they know they screwed up and are absolutely focused on fixing it,” says Seema Williams, a senior analyst at Forrester Research Inc. “They’ve got a great opportunity to take out eToys.”

This position echoes what’s becoming a more and more widely held view: that the top retailing space on the Internet is going to increasingly resemble a real-world shopping strip, with names like Wal-Mart, Nordstrom’s, Macy’s, Best Buy, and Toys “R” Us anchoring cyber-commerce, and a few Amazons and eBays thrown in. This view also takes on the myth of the first-mover advantage. As e-commerce evolves, the idea that the pioneers on the Web are the certain winners, while it may hold true in a few cases, is being shaken by the broader view that their lack of a real-world presence will increasingly put the dot-coms at a disadvantage.

The reason: Despite the fumbling early Internet efforts of many of the established retailers, they’ve amassed significant benefits from their decades of storefront existence that are critical to success on the Web. Among these benefits are well-tuned just-in-time distribution systems and other logistics expertise; long-held relationships with suppliers; widely known brands; huge amounts of cash for marketing, inventory, and technology development; a thorough knowledge of their business lines and what customers want; and Web and real-world cross-selling opportunities.

“Established retailers have significant advantages that are crucial for Web success: just-in-time distribution systems; logistics expertise; relationships with suppliers; a well-known brand; cash flow for marketing and inventory; and cross-selling opportunities,” says Steve Weinstein, a retail analyst at Pacific Crest Securities in Portland, Ore. “People say they hate Wal-Mart and Toys ‘R’ Us, but that’s to the tune of $132 billion and $11 billion of annual hatred respectively. Any online company would love to have this kind of a customer base.”

What established retailers have lacked is a sense of urgency about the Web, which has allowed online startups to nab the lion’s share of the initial e-business and publicity. And that’s been deadly: The Internet is speeding up the need to constantly reinvent the business model and also exposing successful companies that have lost their edge because they rested on their laurels too long. “There’s no bigger reason for failure than success,” says Clayton M.
Christensen, associate professor at the Harvard Business School and author of The Innovator’s Dilemma.

In most cases, e-commerce resistance on the part of traditional retailers comes from a paralyzing but unfounded fear that a Web presence — with its impulse buying and constant price wars — would cannibalize real-world business, cutting into sales and commissions and upsetting the old-line retailing talent running its stores.

The painful outcome of that argument has become all too clear. Take the case of Barnes & Noble Inc. Ceding the Internet to Amazon.com for nearly four years hasn’t hurt Barnes & Noble’s store sales at all; they’re still rising a healthy 9 percent a year. But it has put its latecomer Web venture, barnesandnoble.com LLC, in a position where it can’t catch up to Amazon.com Inc., no matter how hard it tries. During the last quarter, barnesandnoble.com’s market share of online book sales dropped about a percentage point to 16.7 percent, while Amazon.com’s rose to about 62 percent, a more than 5 percent increase, according to Harris Interactive Inc.

In short, the notion of cannibalization is a flawed excuse for shying away from the unknown, and missing the chance to capitalize on a potentially lucrative business transformation. As the Barnes & Noble example shows, a Web business doesn’t have to hurt real-world sales, especially if a retailer’s stores offer good prices on a large selection in a pleasant atmosphere. Furthermore, it’s likely that much of the business Web retailers are attracting, especially in a thriving economy, is actually made up of new customers — people who prefer the Web to a store or who unexpectedly find something to purchase while browsing the Net. In the end, they add to overall retail sales.

For many established retailers, the fear of repeating Barnes & Noble’s mistake — specifically, forfeiting opportunities because they were too hesitant — is beginning to eliminate fear of the Internet. “The inevitability of the Internet as a place to be is setting in among retailers,” says retail industry watcher Kurt Barnard, publisher of Barnard’s Retail Trend Report. “They once thought they had a choice or could somehow escape e-commerce, but that idea is obsolete.”

Toys “R” Us had to hit rock bottom before its management understood this, though. Last April, after a dismal 1998 in which it handed off its position as the No. 1 toy seller to Wal-Mart and then posted a net loss of $132 million in January 1999 (see Exhibit 1), then-Toys “R” Us-CEO Robert C. Nakasone signed an agreement with Benchmark Capital, a Menlo Park, Calif.-based venture capital firm, to team up in creating the Toys “R” Us Web site. Benchmark, which funded eBay Inc. and more recently the Michael Jordan, John Elway, and Wayne Gretzky startup MVP.com, and which was investing $10 million in Toysrus.com, thought it was supposed to recruit a management team with e-commerce experience that would set the business up as an independent operation in Northern California.

In theory, that was Toys “R” Us’s view as well, but neither Mr. Nakasone nor Chairman Michael Goldstein was willing to follow through. Typical of the stop-and-go effort was a meeting in May between the top brass at Toys “R” Us and A. Robert Moog, a Silicon Valley toy executive and a Benchmark associate who had taken the job as CEO of Toysrus.com. Mr. Moog laid out a plan to cut toy prices on the Web site below even Toys “R” Us store prices, as well as those offered by eToys and other competitors. Perhaps, Mr. Moog thought, this would put online rivals in a difficult financial position that would undermine their ability to ramp up inventory and marketing for Christmas. That, in turn, would give Toysrus.com the edge with online holiday shoppers.

But Toys “R” Us executives shut Mr. Moog down, refusing to do anything that might undercut their stores and anger retail managers. “They kept talking about what they’ve done in the past and how only that will make them successful in the future. And that meant, in other words, focusing only on the stores, even though they weren’t doing very well anymore,” says Mr. Moog, who today heads two puzzle companies he founded,
University Games Inc. and areyougame.com. “They definitely were not willing to look at new paradigms for doing business.”

Toys “R” Us also, as it turns out, wasn’t interested in looking for new California office space for Toysrus.com, and flinched at giving Benchmark too big a stake or too much decision-making power. “If they want the magic of a Silicon Valley startup, traditional companies have to let the teenagers go to college; they have to let an independent operation be free to move away, use the name and brand, and create something out of it. But Toys ‘R’ Us was clearly not ready for this,” says Robert C. Kagle, a general partner at Benchmark, which is no longer involved with Toysrus.com.

In fact, soon after this meeting, Mr. Moog quit; by August, the Benchmark deal unraveled. That left Mr. Nakasone, who had boasted that Toys “R” Us would become “the clear leader in the online retail market for toys and children’s products by fourth quarter,” with egg on his face and a lot of explaining to do to investors and the press.

A
tually, the initial inability of Toys “R” Us to puzzle out the Web and to grasp how influential e-commerce would be should not have come as a surprise. After all, it was the second business transformation Toys “R” Us failed to respond to quickly enough. And the same root causes were responsible for both missteps.

At the heart of a retail dislocation when it first opened its doors in the late 1970s, Toys “R” Us was once a retailing revolutionary. But in later years, it forgot what had made it so noteworthy, as management quit taking chances and got so drunk on early success that it lost the focus to revisit and rewrite its basic business model to reflect changes in the retailing environment. In other words, Toys “R” Us stopped evolving its brand.

That’s a sad reflection on a company that pioneered the category-killer concept when Charles Lazarus founded the chain in 1978. The idea at that time was to adapt the broad discounter model of Wal-Mart and the Kmart Corporation to a focused product line. These category killers, which eventually included Best Buy, Circuit City, Barnes & Noble, and Tower Records, among many others, relied on just-in-time logistics systems and vast amounts of customer data and buying power to offer a huge number of items at the lowest prices. Although margins were low, profitability was assured by turning over the inventory as many as five times a year.

Mr. Lazarus was able to keep Toys “R” Us a step ahead of imitators like Child World, but when he left the CEO slot in 1994 at the age of 69, the company began a slow downhill slide. His successor, longtime associate Mr. Goldstein, “just didn’t have the instincts that Lazarus did and that every visionary does,” a retailing analyst close to Toys “R” Us says. “Missing was that ability to anticipate what’s changing around you and to immediately know the right reaction.”

By that time, Toys “R” Us was facing two threats. One was that discounters like Wal-Mart, Kmart, and Target had added toys to their product mix. Today, more than 40 percent of toys are sold through discount stores, and only 23 percent at toy chains. And while their selections aren’t expansive, these discount stores generally charge less and offer a more comfortable customer experience than Toys “R” Us, whose stores have aged badly, are poorly designed, and aren’t known for knowledgeable salespeople. The second threat that emerged was a new breed of toy stores stressing educational and creative products — retailers like Imaginarium, Store of Knowledge, and Zany Brainy. Their price tags are higher, but they have excellent customer service and items that Toys “R” Us usually doesn’t carry.

Mr. Goldstein, and his successor, Mr. Nakasone, who became CEO in 1998, reacted to these develop-
ments in all the wrong ways. To fight off the education-minded upstarts, in 1996, Toys “R” Us launched Concept 2000, an expensive plan to revamp its stores with a more open, less maze-like design and to add some higher-end products as well as features like photography studios, hair salons, and snack centers. After overhauling about 10 percent of its more than 1,500 stores, Toys “R” Us scrapped Concept 2000; it didn’t attract enough additional customers to make up for the cost.

Meanwhile, Wal-Mart and its ilk tapped a vein with customers, mainly because just as these stores entered the toy market, Toys “R” Us was completely losing touch with kids’ changing tastes. “The problem was they took their advertising slogan, ‘I want to be a Toys “R” Us kid,’ too seriously; fewer and fewer kids actually felt that way,” says Forrester’s Ms. Williams.

While the discounters stocked up on videos, computer games, interactive toys, and anything electronic early on, Toys “R” Us mostly ignored this trend until the late 1990s. At the same time, the retailer made mistakes like ordering an additional 150,000 Holiday Barbies in mid-December 1997. When January rolled around, Toys “R” Us still had about 153,000 Barbies left.

“There was an institutional hubris, a whistling-past-the-graveyard mentality,” says one Toys “R” Us insider, who recalls a meeting of top executives led by then-CEO Mr. Goldstein around the time of the Holiday Barbie fiasco. When questioned about the expensive inventory and Concept 2000 mistakes and how the company was going to get back on track, Mr. Goldstein refused to admit to the recent failures; instead, he said abruptly: “If we build it, they’ll come; if we offer it, they’ll buy it.”

It’s unlikely that Toys “R” Us could have done much about Wal-Mart’s incursion into its business, retail analyst Kurt Barnard says, but the company could at least have prevented some of the erosion had it simply kept doing what it did under Mr. Lazarus: adapting and improving the brand to respond to new conditions while retaining the positive values that customers identified with the retailer. That would have meant incrementally updating the stores, improving customer service, adding to the product mix with items that could be sold at its traditional low prices, anticipating the next hot toys, and promoting those toys heavily with special offers.

The toll of lagging behind in this pre-Internet business transformation was significant. By the end of the decade, the company’s market share had slipped from 25 percent in 1990 to 15.6 percent in 1999, 1.8 percentage points behind Wal-Mart, which had barely had any toys on its shelves 10 years earlier. Just as badly, Toys “R” Us’s annual inventory turnover had dropped to 2.6 in 1999, compared to 3.8 for the toy and hobby retailing industry and Wal-Mart’s 5.5. And to make matters worse, toy sales have been sluggish since the mid-1990s, rising an average of only about 5 percent per year. (See Exhibit 2.)

With these problems already hanging over Toys “R” Us last year, the Web meltdown was the last thing the retailer needed. It was a sure sign that something was woefully wrong at the company. Nothing it was doing was working. Investors got this message all too clearly. Soon after Mr. Moog quit as head of Toyrusrus.com last June, the stock tumbled from about $25 per share to below $15 in August, when the Benchmark deal broke down. The board of Toys “R” Us had seen enough; Mr. Nakasone was fired as CEO. Former CEO Mr. Goldstein

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**Exhibit 2: U.S. Sales of Traditional Toys (Excluding Video Games)**

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<th>Years</th>
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<td>1999</td>
<td>22.9</td>
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Source: The NPD Group
was reinstated, but not for long. In January 2000, FAO Schwarz CEO John Eyler got the post.

The executive revolving door shook up Toys “R” Us — and, as most retail analysts see it, created a turning point. Gone was any notion of invincibility or the arrogant view that the company’s destiny was nothing but rose-colored. In short, Toys “R” Us finally came to recognize that its world had changed, and it had to change, too.

The company’s suddenly altered state was what convinced John Barbour to take the job to run Toysrus.com last summer, people who know him say. “I don’t think he would have gone there had they not told him they were committed to e-commerce as an independent operation and one that was crucial for Toys ‘R’ Us’s future,” says a toy industry expert who spoke with Mr. Barbour at the time of his hiring. “He’s got an entrepreneurial streak that fits perfectly with the new attitude at the company.”

Mr. Barbour showed that trait as the founder of OddzOn Products Inc., the maker of Koosh balls, among other novelty items. Hasbro Inc. eventually bought OddzOn, and Mr. Barbour continued to run the unit as a separate part of the overall business, even with its own Web site.

Publicly, Mr. Barbour has been vague about his plans for Toysrus.com, and he declined to be interviewed for this article. But his discussions with analysts and e-commerce experts, as well as some of the initiatives announced so far, reveal a lot about his strategy. Perhaps most importantly, they’ve made former critics actually bullish about Toysrus.com’s prospects. “Toysrus.com has strong enough assets that now that it’s finally found religion, it should be one of a small number of long-term winners in Internet toy retailing,” says Benchmark’s Mr. Kagle.

Two moves since last summer set the tone for how much Toys “R” Us has changed its attitude toward e-commerce. In November 1999, Toysrus.com announced a two-year agreement with America Online to become the anchor store of AOL’s “Kids, Toys, and Babies” mall. As part of the agreement, which analysts estimate will cost Toysrus.com upward of $5 million, the retailer says it will offer sales promotions with prices below those of real-world stores — one of the very strategies rejected at the May 1999 meeting in Silicon Valley.

Just as big a turnaround is Toysrus.com’s new relationship with the Japanese venture capitalist Softbank Corp., a large stakeholder in Yahoo and E-Trade, among others. Although Toys “R” Us resisted Benchmark’s request for about 10 percent of the online unit last year because it didn’t want to cede that much control, Toysrus.com signed an agreement in February that gave Softbank 20 percent of the operation for $57 million, as well as a prominent place on the board and consulting responsibilities. The premium attached to Toysrus.com’s brand and experience is reflected in that deal; by contrast, in 1996, Silicon Valley venture capitalist Idealab took a 15 percent stake in eToys, and became its biggest backer for just $91,600.

Mr. Barbour has told associates that this is a prelude to taking Toysrus.com public, perhaps as soon as this summer. Based on the valuation of the Softbank investment, this offering could generate anywhere from $100 million to $200 million, possibly more, depending on how large a stake the parent company keeps. After the IPO, it’s likely that Toysrus.com will move to Silicon Valley
Valley. When all of this happens, to placate the company’s traditional retailers on the East Coast, options and shares in the new venture are expected to be given to executives overseeing the real-world stores.

The most visionary part of Mr. Barbour’s plan — and the one that excites analysts the most — is the way he wants to use the retailer’s huge bricks-and-mortar advantages to trump its online competition. Chiefly, Mr. Barbour intends to merge the enormous warehouse and logistics systems that Toys “R” Us already has with new overnight distribution sites to be built around the country. In this way, Toysrus.com, with its infinite “shelf” space, will have a much larger inventory than the physical stores, which, as even 10-year-old Luke Armour figured out, is what people expect on the Web. Additionally, this setup will ensure that Toysrus.com has vastly more items than anyone else online, and it can use its already existing volume-buying relationships with suppliers to get the best prices and on-time inventory replenishment.

On top of this, Mr. Barbour intends to use the busy in-store traffic to move more business to the Internet. Kiosks throughout the stores will let people access Toysrus.com and order items that are out of stock or unavailable in the retail locations. This is a model that has worked well for any number of retailers in other industries. There will also be Web promotions such as coupons at the cash register that offer discounts on Internet purchases.

But perhaps the biggest advantage of an established company that Mr. Barbour hopes to tap into is the parent company’s deep pockets. Even with its troubles, Toys “R” Us had nearly $1 billion in cash flow in fiscal 1999. By dipping into this money, as well as using proceeds from the impending IPO, Toysrus.com could put on an advertising blitz and a marketing campaign aimed at the gargantuan Toys “R” Us mailing list that would dwarf anything the online competition could muster.

“They have brand, money, customers, and systems; it’s a shame it took them this long to realize that the same business advantages that work in the real world — that they took so much pride in — are just as important, if not more important, on the Web,” says Mr. Moog. (See “Playing the E Game” on page 77.)

Optimism about Toysrus.com is particularly strong because eToys, its chief online rival, is remarkably weak competition. Unlike the significant head start in books that Amazon.com had when Barnes & Noble belatedly launched its e-commerce venture, the two-and-a-half-year-old eToys has barely made a dent in the toy market: Its sales last year represented about 0.5 percent of the $23 billion U.S. toy market, compared to the roughly 4 percent share that Amazon.com enjoys in the $13 billion book market.

Although eToys has put a lot of money into building a big inventory, it’s woefully underfunded and under-staffed for a sustained battle of the shelves against Toysrus.com — a vulnerability that could hurt eToys badly, because as a retail sector, toys depend for survival on fully stocked inventories of the most popular products anticipated.

As of the beginning of this year — and after selling $150 million of convertible bonds in December — eToys had about $220 million on hand. That may not cover expenses much past the next 12 months. As it is, eToys had $144 million in operating losses in the nine months ended December 31, 1999, and in a recent filing with the Securities and Exchange Commission, it warned, “We anticipate our losses will increase significantly from current levels because we expect to incur additional costs...
and expenses.” Highlighted expenses include brand development, marketing, inventory management systems, the expansion of warehouses and distribution operations, more product offerings, and the development of relationships with suppliers. Many of these, of course, are areas where Toysrus.com’s parent already has a distinct lead.

Furthermore, eToys won’t be able to rely on using its stock as currency for expansion or as a means of raising more money. It has had a disappointing Internet stock history. After going public last May at $20 per share, it traded as high as $86 in October before tumbling to about $15 by February, even as the Nasdaq continued to soar. The shares could drop even lower; the stock is being diluted by, among other things, an increasing number of options being granted to employees as compensation for the falling stock price. Making matters worse, insiders, obviously frightened by the falling value of their investment, have filed to pour 13 million of their shares onto the market. Among them is Idealab, which filed last November to sell more than 13 percent of its 15 million shares.

Some industry observers don’t even expect eToys to remain a direct rival of Toysrus.com for much longer. The more likely scenario, they say, is for eToys to become an “e-kids” portal — a one-stop-shopping source with parenting information, toy ideas, pediatric health and pregnancy advice, and wholesome children’s content. With this approach, some believe eToys could develop multiple revenue streams, including advertising and subscriptions as well as transactions.

Whether it remains a separate e-commerce site or morphs into a portal, eToys may not stay independent. With its stock price so weak, its market capitalization is only $1.8 billion, a low figure considering that it’s the top toy seller on the Web. That could make it a takeover candidate for giant retailers with much bigger market caps, like Kmart, Wal-Mart, or Target, which already sell toys in their real-world stores and are expanding those operations onto the Web.

Consolidated Stores, which owns KB Toys, already hinted at this approach for established real-world retailers when it paid $80 billion for Internet toy site BrainPlay.com last year and relaunched it as KBkids.com. “It’s likely that the aggressive bricks-and-mortar companies will do more of this — especially picking off low-hanging fruit,” says Forrester’s Ms. Williams.

What can we learn from the tale of Toysrus.com? If it closes with the happy ending (happy for Toys “R” Us, anyway) that most e-commerce and industry observers expect, we learn above all how difficult it is for companies born on the Web to maintain their lead in the way Amazon.com has. In retailing, so much of the customer relationship and customer satisfaction depends on giving people a place to return items, a person to talk to about products, and individual attention. It’s possible to recreate this on the Net, by making an e-commerce site into a personalized, virtual community, but as the balance sheets of Amazon.com, Yahoo, and E-Trade show, it’s an expensive way to lure customers.

That, combined with the incredibly complex logistics involved in keeping inventory stocked and shipments flowing to customers quickly and efficiently, makes cutting costs associated with customer acquisition and attraction even more important. For that reason, retail experts increasingly feel that the hybrid approach — stores that promote Web sites and Web sites that drive people to stores — is the one that will be the most lucrative and the model used by the eventual Internet retailing top guns.

Toys “R” Us finally seems ready to take the Web plunge after learning that even in the world of toys, where so much is left to the imagination, the shopping experience can’t be.

Resources

The NPD Group Inc., Port Washington, N.Y.: www.npd.com
www.toysrus.com
www.etoys.com

For more discussion on Toys “R” Us, visit the Strategy+Business Idea Exchange at www.strategy-business.com/idealexchange/