

REIT Private Equity (LBO)

Objective: The objective of this assignment is to introduce students to the role that REITs can play in the private equity process especially in situations where the real estate of the acquired company represents a pivotal component of the deal.

Assignment: Please download the spreadsheet REIT_PrivateEquity07.xls from my website and answer the following questions. Please highlight your answers in **yellow** and turn in a hard copy of your results. Do **NOT** email me your spreadsheets! **This is an individual assignment.** Please prepare this project in a professional manner since you can use this for job interviewing purposes.

Private Equity Firms: The primary objective of private-equity firms is to purchase companies for their portfolio, fix them, grow them and sell them in three to five years. The eventual buyer could be another company in the portfolio company's industry, another private-equity firm or the public, through an IPO. The holding period is occasionally less than a year or as long as ten years. However, the goal from day one is always to sell the company at a profit. In terms of executive compensation, private-equity firms tie a far larger share of executive pay to the performance of an executive's business. Top managers are also typically required to put a major portion of their own money into the deal. In the ToysRUs deal, Storch purchased a small portion of the company for \$2 million and now has the largest individual investment. His base salary is \$1 million a year, and he can collect a bonus of up to twice that.

Private equity firms generally take out large amounts of debt in order to finance a buyout, and managers must relentlessly service that debt. Consequently, private equity firms are drawn to real estate in particular, because they can use it as collateral against the loans they secure to buy a business. Private-equity firms prefer to buy a company with strong management in place and liberate them. If private equity owners decide that they need to bring in an outsider, they hold a valuable advantage over public companies, namely, no one will know how much they've paid. As a result, they can raid companies using large pay packages.

Operating privately frees companies to make tough decisions, take bigger risks and think longer term e.g., managers can take write-offs as well as make investments that aren't accretive in a year or two without having to answer to analysts, public shareholders or comply with Securities and Exchange Commission (SEC) regulations. The release of managerial time from trying to placate the public markets is thus a huge advantage; the CEO is free to spend close to 100% of his time focused on the business. Privately held companies expedite decision-making. If something changes in the



market, they can quickly decide what they need to do. They can also keep competitors from learning about their margins and market share.

Although private equity owned companies, like public companies, must legally have a board of directors, not only is the board typically smaller but they also consist only of representatives of the PE owners plus industry experts whose explicit job is to help management create and execute strategy.

PE-owned firms are managed for cash flow rather than measures that public companies often use such as earnings per share, return on equity, Ebitda, and return on net assets among others. They tend to be especially disciplined about how to reach their cash goals using key performance indicators (KPIs) with respect to all the critical areas - finances, growth, productivity, quality, safety, market position that are monitored continually.

ToysRUs (Ticker: TOY): Toys “R” Us began in 1948 when founder Charles Lazarus opened a baby furniture store, Children’s Bargain Town, in Washington, D.C. The Toys “R” Us name made its debut in 1957. Toys “R” Us was among the first so-called big-box specialty retailers also known as "category killers". Although Toys “R” Us is still one of the world's largest toy retailers, their toy division is in a time-out. Ironically, Toys "R" Us has fallen victim to a strategy it first employed -- slashing prices to squeeze



out competitors. Now Wal-Mart (NYSE: WMT) is functioning as the so-called "category killer," having overtaken ToysRUs in 1998 as the world's biggest toy seller¹. Wal-Mart's discounting also contributed to the bankruptcies of FAO Inc., owner of the FAO Schwarz² and Zany Brainy chains, and KB Toys Inc., the largest U.S. mall-based toy chain. The discounter and its largest rival Target Corp. have cut toy prices, sometimes selling below cost, to lure shoppers during the holiday season, which can generate more than two-fifths of toy retailers' sales. Additionally, toy sales have been negatively impacted by changing consumer habits, including “age compression,” which is the acceleration of children abandoning traditional toy categories at increasingly younger ages for cell phones, DVD players, CD players, MP3 and other electronic devices.

On November 17, 2003, the company announced plans to close all 146 of the remaining free-standing Kids “R” Us stores and all 36 of the free-standing Imaginarium stores, as well as three distribution centers that supported these stores³. These free-standing stores had incurred significant performance declines in the few years preceding the announcement. This accelerated deterioration in financial performance led to their decision to cease operations in these free-standing stores. On March 2, 2004, Toys “R” Us entered into an agreement under which Office Depot agreed to acquire 124 of the former Kids “R” Us stores for \$197 million in cash or \$75 per square foot GLA, before commissions and fees, plus the assumption of lease payments and

¹ToysRUs is currently the 3rd largest toy seller behind Wal-Mart and Target.

²Although a a far cry from the many retail stores it once operated, FAO Schwarz will reopen its flagship Manhattan store on Thanksgiving 2004, and it plans to reopen its store in Las Vegas.

³All of the Kids “R” Us facilities as well as all of the Imaginarium stores were closed by January 29, 2005.

other obligations. Twenty-four properties were subsequently excluded from the agreement with Office Depot and are being separately marketed for disposition or have been disposed of⁴.

In a conference call in January 2004, Toys' management mentioned that it was considering "strategic alternatives," and chose Credit Suisse First Boston (CSFB) to help it put together a game plan. By June 2004, the board decided to follow two tracks: selling its global toys division – which included the entire international and domestic toys business – and possibly spinning off its fast growing Babies "R" Us division⁵. The spin-off strategy was tabled in November 2004. CSFB contacted 29 private equity firms, and by December 2004, the field had narrowed to four: KKR (Kohlberg Kravis Roberts & Co), Cerberus with partner Kimco Realty, Apollo and a team of Bain and Vornado. In early January 2005 the final bidding process began with a twist to the auction process. Each bidding group was required to submit a markup of a merger agreement but with no price bid attached given the deal's complexity. The global toys division had an intricate set of licensing arrangements and inventory and warehouse deals with its own affiliated companies and outside vendors, so the rationale was that it was best to clarify the terms of the deal before price entered the picture. After receiving the initial terms, bidders were sent a new agreement containing the best terms from each bidder, as assessed by Toys "R" Us. All the sponsor groups submitted bids in the low \$3-billion range by Feb. 17, 2005. However, Cerberus expressed an interest to CSFB in bidding for the entire company. The board's four-person executive committee then gave all the sponsors just two weeks to put together a bid for the whole company. KKR joined with Bain and Vornado to submit a bid of \$6.6 billion (Cerberus came in \$350 million lower). Apollo did not submit a bid, saying it needed more time to perform due diligence.



On Thursday, March 17, 2005, Toys "R" Us announced that it had agreed to sell the entire company to the investor consortium led by KKR Group, Bain Capital and Vornado Realty Trust for \$6.6 billion, plus the assumption of \$2.29 billion in long-term debt. This price was roughly half its 2006 sales. No sooner was the auction over when a group of shareholders sued Toys "R" Us and its board in Delaware Chancery Court to stop the sale. They argued that the board did not get the best possible deal for the

⁴All closings were completed by January 29, 2005 and net cash proceeds of approximately \$150 million were received. A \$55 million gain associated with the closing of our Kids "R" Us stores was recorded during 2004, of which \$53 million was related to our transaction with Office Depot.

⁵The reason for this separation was that Toys "R" Us expected to sell the Toys "R" Us division to focus on the more profitable and faster-growing segment of baby stores. Babies "R" Us accounts for 75% of the company's operating income, despite having just 15% of the company's total sales. In the past year, Toys "R" Us has also closed its money-losing Kids "R" Us and Imaginarium chains. A key difference between the two businesses - and a reason why the baby business is less vulnerable to competition from discounters than the toy industry - is that Babies R Us is not dependent on having a "hot toy" during any given season. The baby-supplies business is a niche that has so far been relatively shielded from significant competition from discounters such as Wal-Mart and Target. That is changing, however, as discounters start carrying a wide range of baby merchandise and displaying it in special sections.

company and that it should have conducted a longer bidding process. In June, the court ruled against the plaintiffs and praised the board for maximizing shareholder value throughout the sale thus validating the auction process. The sale brought an end to seven months of speculation about the toy seller's future. Under the terms of the agreement, the investor group acquired all the outstanding shares of the Wayne, N.J.-based Toys "R" Us for \$26.75 a share, an 8 percent premium relative to the company's closing price Wednesday of \$24.77 a share. The acquisition was finally completed on July 21, 2005 with each of the 3 investors owning an equal stake in the company. The division of labor among the partners will likely have KKR and Bain focused on operations (Bain owns KB Toys), with Vornado seeking to maximize the value of the real estate, both in absolute terms and relative to the overall enterprise. Advisers for the buyer included Bank of America, Deutsche Bank, JPMorgan and Morgan Stanley while Credit Suisse First Boston and Duff & Phelps advised the seller.

The \$6.6 billion in required capital after backing out assumed debt was financed with each of the partners investing \$450 million in cash for total equity of \$1.35 billion. The partnership arranged \$2.0 billion in bridge financing; and the remaining \$ 3.25 billion balance to come from a combination of balance-sheet cash, property-level financing on a number of U.S. and international real estate assets, and securitizing Toys 'R' Us's inventory. More specifically, to finance the \$3.25 billion portion of the deal, Deutsche Bank together with Bank of America used a combination of asset-backed, real estate backed and CMBS markets in several countries to achieve lower overall financing costs for its sponsors than a traditional bank and bond deal could have provided. To structure the financing, real estate finance executives at Deutsche Bank and BofA divided the 900 stores into three categories. The first group of stores, valued at \$1 billion, contained stores that would be used by Toys "R" Us, one of its affiliates (such as Babies "R" Us) or another unit yet to be created to provide the collateral for an \$800 million CMBS loan. Although the CMBS market allows the most leverage, it is more restrictive relative to the term loan market. Assets designed for one purpose (for example, to be used as a Babies "R" Us store) cannot be sold or leased out to another retailer if they are used as collateral for CMBS. Covenants also restricted the amount of CMBS debt that could be added to the company's balance sheet. The second group of stores could be retained, leased to another retailer or sold. The third group would be sold or leased. These final two groups provided the collateral for a \$1.2 billion term loan used to take out a portion of a \$1.9 billion bridge loan and the \$700 million remaining on the bridge. The remainder of the bridge loan can be taken out with either a high-yield deal, a term loan or through asset sales. This resulted in more flexibility for the buyers and financing that was more tailored than a typical bank LBO financing package which was important since downgrades to Ford Motor and General Motors had roiled the junk market, making it a less attractive financing option.



The Real Estate Play: Steven Roth, CEO of Vornado Realty Trust (one of the three buyers), at a real estate conference at New York University noted⁶ that "We became interested in Toys 'R' Us principally because it has lots and lots of terrific real estate, in the U.S. and abroad." Vornado is expected to take an active part in determining which of Toys 'R' Us stores to unload first. While some of Toys 'R' Us real estate is expected to come to market following this deal, a full real estate play is not expected before management tries to turn the toy retailer's fortunes around.



The trick to unlocking the "hidden" value of the underlying real estate is that the rates on the sale and/or leaseback of properties which translate into earnings multiples must exceed that for the operating business. For example, if properties can be sold at earnings multiples of over 10 times, and as long as you are paying less than that for the operating business, you can benefit from the resulting arbitrage on the multiple you paid for the company and the multiple for which you can sell the real estate⁷. Stated differently, in the current market, rental income streams are valued significantly higher than operating income. Operating income is valued at 5x - 8x EBITDA and real estate rents at 13x - 15x, a 50% to 100% premium. As such, real estate can be used to finance the buy-out. To capture the real estate value, a real estate subsidiary, REIT, or a sale leaseback mechanism is utilized.

Toys R Us' 681 U.S. stores occupy 30 million square feet of space. The company owns the land and buildings on 314 locations, while it owns the buildings on leased land at another 152 sites. Often older leases are laced with benefits such as locked-in rent renewal rates that are significantly lower than today's average of \$100 a square foot and as much as \$150 in some suburban areas. Financial analysts have valued the company's real estate alone at \$11 a share, or about \$2.3 billion⁸. Abroad, the company owns 83 stores outright, and 20 are on leased land. Retail analysts and brokers predict that the new owners will dump more than 100 poorly performing Toys R Us stores in the U.S.⁹. Possible new tenants for Toys 'R' US big-box space may include Old Navy and Best Buy. The toy chain can realize large profits through selling shuttered sites on the properties it owns. And because many of its leases are below market rates, it can profit by selling those leases, or carving up and subleasing each locale to two or three retailers.

⁶<http://www.cfo.com/article.cfm/3909639?f=related>

⁷This assumes that there is a disconnect between capital markets and underlying real estate markets in terms of valuing a cash flow stream e.g., the cap rates in the "real" asset market differ from the equity and firm multiples in the capital market.

⁸Lehman Brothers real estate analyst David Harris estimated the toy retailer's properties to be worth \$2.6 billion (May 2005)

⁹Howard Davidowitz, chairman of retail consulting and investment banking firm Davidowitz & Associates for example expects about 200 money-losing stores to be closed nationwide.

Turning ToysRUS Around: Epilogue

Operations: To turn the company around, the investor consortium hired Gerald L. Storch, ex vice Chairman of Target, as its new chief executive and chairman in February 2006. Storch's vision of a new Toys R Us features cleaner stores, fewer products on store shelves, orderly aisles, and helpful better-trained employees with a focus on younger children. Since taking the helm, Storch has secured more than 70 exclusive products. He has launched a store revamp program and begun testing a wide range of new concept stores. To boost store traffic, he has re-emphasized seasonal products and combined some Toys R Us and Babies R Us stores. He has also replaced half of the ToysRUs management team with executives from successful category retailers. In particular, it hired Ron Boire, Best Buy's former global merchandising manager, to bring the chain's offerings more in line with the digital age. ToysRUs has also severed ties with Amazon.com¹⁰. Storch's strategy is not to compete head on with Wal-Mart, but rather to be the authority on toys.

Financing: Toy's "R" Us' has substantial debt as the result of a \$6.6 billion leveraged buyout in March 2005 by KKR, Bain Capital Partners and Vornado Realty Trust. Fitch Ratings, has maintained a B-minus credit rating with a negative outlook since the buyout. On October 31, 2005, Deutsche Bank launched a \$1.5 billion deal for Toys "R" Us to partially take out the \$1.9 billion bridge loan put in place for the leveraged buyout by Bain Capital, Kohlberg Kravis Roberts & Co. and Vornado Realty Trust. The loan has a three year maturity.

Real estate: At the time of the buyout announcement, there was much speculation over the number of stores and type of stores that would be closed since the buyout group initially remained silent on this issue. Some of the company's 700 U.S. toy stores are seen as more valuable for their real estate than as sales outlets. CNN¹¹ reported that according to Faith Consolo¹², "A third is a reasonable number to expect, especially since one of the buyers in this sale is a well-known real estate trust company." Older stores that need renovation, stores in less visible, off-mall locations, and most importantly, stores with poor sales have the greatest risk of closing. In contrast, larger stores (over 100,000 square feet) in prominently locations known as flagship stores are relatively safe from closure. In addition to store closings, analysts speculated that other possibilities for real estate include converting a few Toys "R" Us stores into Babies "R" Us stores.

On January 9, 2006, Toys "R" Us announced that 87 stores in the United States would close that year, most closing within the spring 2006. Twelve of these stores will be converted into Babies "R" Us stores, resulting in the permanent closure of 75 stores. Vornado was responsible for handling the leasing and disposition of the real estate for the stores. Following the completion of the store closings, the Company will, directly or

¹⁰Ties were severed following a ruling in March 2006 from a New Jersey superior court judge who found that Amazon.com breached a deal to give Toys R Us exclusive rights to supply some toy products as a third-party vendor on Amazon.com.

¹¹http://money.cnn.com/2005/03/17/news/fortune500/toysrus_closings/index.htm

¹²chairman of the retail leasing and sales division of Prudential Douglas and Elliman

indirectly, own, operate or lease 587 Toys “R” Us stores and 230 Babies “R” Us stores in the United States.

On Wednesday, February 15, 2006, Toys R Us did a sale leaseback of 60 stores in Europe \$868 Million according to an SEC filing. More specifically, Toys Limited and Toys "R" Us Properties Limited, an indirect subsidiary of Toys "R" Us, Inc., will sell to Toys Properties by way of an inter-company transfer 29 stores and one distribution center having an aggregate market value of £493.2 million (U.S.\$868.0 million) and lease those properties back pursuant to operating leases. The acquisition is being financed through commercial mortgage backed floating rate notes of £355.8 million (U.S.\$626.2 million.) The company will also sell and leaseback 22 properties located in Spain and nine in France under similar arrangements. The proceeds from the transaction, together with other available funds, were used to repay all of the outstanding indebtedness under the bridge facility component of the acquisition facilities with, among others, Deutsche Bank AG, London Branch, Barclays Bank PLC and The Royal Bank of Scotland plc, and to pay part of the transaction costs related to the various transactions. Following the closing of the U.K. transaction, there remained no outstanding balance under the bridge facility.

In September 2006, Vornado Realty Trust, one of the three partners agreed to purchase up to 44 previously closed stores of which 26 are leased or subleased to other retailers and 18 are currently vacant for up to \$190 million (\$105.55 per square foot). These properties comprise 1.8 million square feet and are primarily located in eight east coast states, Texas and California. Of the 44 properties, 21 are owned, eight are ground-leased and 15 are space leased. Although Vornado didn't announce plans for the sites, it is spinning the properties into a new subsidiary called Vornado Surplus 2006 Realty LLC. The 44 stores are located in dense markets with few opportunities for greenfield development.

Since the merger, Toys has decreased its overall store count by about 100, to 1,400. It now operates 587 U.S. stores, down from 681 stores when the merger was announced. Meanwhile its international store count has risen from 601 to 651 and the Babies R Us chain has added 26 locations to grow to 244 units.

Vornado: Epilogue

In the year since the deal closed, Vornado's 32.9% stake in the retailer has been a drag on earnings. More specifically, in three of the last four quarters Toys has posted net losses, restricting Vornado's FFO gains. For Vornado's third quarter (ending Sept. 30, 2006) its results include a Toys operating loss of \$36.4 million, which drags Vornado's FFO down \$0.18 per diluted share. This follows Toys losses of \$7.8 million in the second quarter and \$39.6 million in the fourth quarter of 2005. Only in the first quarter of 2006 was Toys' impact positive providing Vornado a net income of \$52.8 million.

Competitors: Competitors of ToysRUs according to Hoover's and various analyst reports include Wal Mart (WMT), Target (TGT), Best Buy (BBY) for the Toys division and Gymboree (GYMB), The Childrens Place (PLCE), and Tween Brands (TWB) for the Babies division.

Valuation Assumptions:

Category	Description																								
Date of Analysis	March 17, 2005 (Date of the Leveraged Buyout (LBO))																								
NA	Treat "NA" as if it were a zero (0).																								
Bond Rating	Moody's Ba2 S&P BB																								
Equity Market Value (Market Cap)	Equity Market Value = Price per Share * Number of Shares Outstanding. Price per share is given in the "Stock Prices" worksheet. Shares outstanding is reported in the financial statement (line 80) for each company.																								
Enterprise Value (Value of the Firm; Firm Value)	Enterprise Value = Equity Market Value + Total Debt																								
Price per Square Foot for Real Estate	<table border="1"> <thead> <tr> <th></th> <th>Owned</th> <th>Ground Leased¹³</th> <th>Leased</th> </tr> </thead> <tbody> <tr> <td>Price per Square Foot</td> <td></td> <td></td> <td></td> </tr> <tr> <td>Toys 'R' Us (U.S.)</td> <td>\$100</td> <td>\$75</td> <td>\$25</td> </tr> <tr> <td>Toys 'R' Us (International)</td> <td>\$100</td> <td>\$75</td> <td>\$25</td> </tr> <tr> <td>Babies 'R' Us</td> <td>\$100</td> <td>\$75</td> <td>\$25</td> </tr> <tr> <td>Distribution centers</td> <td>\$40</td> <td></td> <td>\$3</td> </tr> </tbody> </table>		Owned	Ground Leased ¹³	Leased	Price per Square Foot				Toys 'R' Us (U.S.)	\$100	\$75	\$25	Toys 'R' Us (International)	\$100	\$75	\$25	Babies 'R' Us	\$100	\$75	\$25	Distribution centers	\$40		\$3
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Holding Period (Years)	KKR, Bain Capital, and Vornado are expected to hold Toys "R" US for a period of 5 years. Also assume a 5 year holding period for the real estate.																								
Occupancy Cost/Sales ¹⁵	10%; Average occupancy costs includes rent, common area maintenance expense, real estate taxes, merchant association dues and other charges. In retail total occupancy costs shouldn't exceed 15% of gross sales and should be below 10% if possible. A typical rule of thumb is that in order to remain profitable, an average retailer's total occupancy costs should not exceed 10 percent of its gross sales. Most smaller (larger) retail stores follow the "14% (10%) rule of thumb" meaning that total occupancy costs should be no more than 14% (10%) of their sales.																								

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Cap Rate	8%; Please refer to the "BigBox Retailers R.E. Stats" worksheet																				
Percent to Firm	25% of the economics (sales) accrue to the venture (store/firm) on the leased and ground-leased stores.																				
Number of Stores Closed	Assume that Toys "R" Us will close 100 of its stores – 50 owned stores and 50 leased/ground leased stores. The value of real estate is only realized or "unlocked" through the sale proceeds of closed stores since real estate is still required for the operations of the toy and babies divisions.																				
Debt to Equity Ratio	80%/20% = 4.0 for an LBO deal																				
Debt to Total Capital Ratio	Debt to Equity Ratio/(1 + Debt to Equity Ratio)																				
Interest Coverage Ratio	Interest Coverage = EBIT/Interest Expense. As a rule of thumb, LBO firms such as KKR like to use a 1.4 coverage ratio which we assume for our current case. To obtain the debt rating associated with this coverage ratio, please refer to the "Implied Ratings" worksheet.																				
EBITDA Multiple	13; The LBO firm used a 13x EBITDA multiple to price the Toys "R" Us deal. Use this multiple in the "11. Real Estate as an Option" worksheet.																				
Acquisition Value	\$6.6 billion																				

¹⁵Landlords know retailers will value rent at a factor of approximately 10% or so of gross sales (Source: http://retailtrafficmag.com/mag/retail_hot_topic_long/index.html)

¹⁶Owned buildings on leased land.

Assignment: Please download the REIT_PrivateEqty07.xls spreadsheet to answer the following questions. *This is an individual assignment.*

1. Margin Analysis¹⁷ (5 points): Using the financial information (10K) on competitors for the two main divisions of Toys “R” US contained in the “ToysRUs Segments“, “ToysRUS (TOYS)“, “Target (TGT)“, “WalMart (WMT)“, “BestBuy (BBY)“, “Gymboree (GYMB)“, “Childrens Place (PLCE)“, “Tween Brands (TWB)“ worksheets, complete the “1. Margin Analysis” worksheet. What does the margin analysis of the Toy Division and Babies R US Division relative to their respective Peer Groups indicate about the viability of each division? Please discuss.

Note on Financial Statements: Cost of Goods Sold (COGs) in our worksheet **excludes** Depreciation and Amortization. To determine if COGs excludes Depreciation, look at the Depreciation and Amortization line item in the Income Statement (line or row 69). If you see an NA for it then this means that COGs includes Depreciation and Amortization. In these situations, to subtract Depreciation and Amortization out of COGs, go to the Statement of Cash Flows and use the Depreciation and Amortization reported. An NA in the Depreciation and Amortization line item in the Income Statement will also mean that the **INC BEF DEP & AMORT** row (see for example, the “WalMart (WMT)” worksheet, row 68 and row 69) is not equal to EBITDA but rather it is equal to operating income a.k.a. EBIT because the COGs figure includes depreciation and amortization. In these situations, you must add back depreciation and amortization to INC BEF DEP & AMORT to obtain EBITDA. For example, the actual EBITDA for WalMart in 1/31/2005 is 14,181,000 + 4,405,000 = 18,586,000. In contrast, the INC BEF DEP & AMORT for Target is the actual EBITDA since Depreciation & Amortization is reported in line 69.

2. Valuation of the Operating Lease (Off-Balance Sheet Debt) (5 points): Calculate the present value of Toys R US operating leases using the “2. Valuation of OpLease” worksheet together with the information contained in the “TreasRates” and “BondSpreads” worksheets. The PV of operating leases represents the amount of off-balance sheet debt. From your basic finance course, recall that operating leases are regarded as cash flows to the debt holder and therefore needs to be discounted at the pre-tax cost of debt which is calculated as follows:

$$\text{Pre-tax Cost of Debt } (k_{\text{Debt}}) = \text{risk free rate } (r_F) + \text{Default spread}$$

where risk-free rate is the yield on a 10 year Treasury bond

Default spread is the spread over the 10-year treasury yield for a given bond rating

¹⁷It is called margin analysis since it looks at various levels of profit relative to sales (sales is in the denominator). This technique is also known as the percentage of sales method since In other words, the margin is defined as the percent of sales that result in profits. The various profit levels include gross profit (revenues – cost of goods sold), EBITDA, and EBIT (EBITDA – depreciation and amortization; also known as operating income) which are all measures of firm profit and Net Income before Extraordinary Items which is a measure of shareholder profit.

To find out how many years remain after Year 2010 e.g., “Thereafter”, we will use the convention of taking the aggregated net minimum rental amount reported for Year 2010 and beyond (2010+) of \$1351 million and divided it by the net minimum rental in the previous year (2009). Assume that TOYS R US will continue to pay Year 2009 rental in year 2010 and beyond with a lower amount paid in the last year such that the sum of the net minimum rentals equals the aggregated net minimum rental amount of \$1351 million.

3. Valuation of Toys Division (10 points): Calculate the value for the Toys Division of Toys “R” US which includes U.S., International, and the .com business segments using the “3. RelVal (Toys Division)” worksheet. Comparable companies (peer group) include WalMart, Target, and Best Buy. Revenue, EBIT, and information to calculate EBITDA for the toys division of Toys “R” US is located in the “ToysRUs Segments” worksheet. We will focus primarily on the EBITDA (earnings before interest, depreciation, and amortization) multiple to value the division. Corporate acquirers, particularly leveraged buyout (LBO) firms, rely heavily on cash flow which they define as EBITDA to repay acquisition debt.
4. Valuation of Babies R US Division (10 points): Calculate the value for the Babies Division of Toys “R” US using the “4. RelVal (Babies Division)” worksheet. Comparable companies (peer group) include Gymboree, The Childrens Place, and Tween Brands. Revenue, EBIT, and information to calculate EBITDA for Babies “R” US is located in the “ToysRUs Segments” worksheet.
5. Valuation of Real Estate (20 points): Value the real estate of Toys “R” US using each of the following methods.
 - a. Price per Square Foot Method (Method 1): Using the valuation assumptions starting on page 8 together with the “5a. RE Value (Method 1)” worksheet, calculate the current real estate value and the future real estate value (5 years hence) of Toys “R” US. This method is what some Wall Street investment banks such as Bear Stearns used when the deal was announced to value the real estate.
 - b. Cap Rate Method (Method 1): Using the valuation assumptions starting on page 8 together with the “5b. RE Value (Method 2)” worksheet, calculate the current real estate value of Toys “R” US. This method is what other Wall Street investment banks such as Salomon Brothers used when the deal was announced to value the real estate.
6. Sum of the Parts Valuation (20 points): Perform a sum of the parts valuation using your answers in question 3 through question 5 above in conjunction with the “6. Sum of Parts Valuation” worksheet. In this method of valuing a company, each business unit / operation is valued based on either discounted free cash flows (DCF) or peer multiples (comparative companies’ analysis, CCA). The sum of these parts makes up the total enterprise value (EV) of the company (value of operations). If the component

values substantially exceed the stock price, the shares are a buy. The sum of its parts technique is also known as **breakup analysis**. The intuition is that the analyst doesn't appraise the company as one large going concern but rather as a collection of separate units, each of which can be spun-off division by division to realize unlock value not recognized by the market. This technique is typically used for conglomerates with unrelated business divisions or companies with complementary divisions that don't fit well together.

7. Valuation of Toys Division Revisited (5 points): Four basic tenets underlie a leveraged buyout. One of these tenets is to improve operating performance through shifting management's orientation to acting as owners instead of employees. More specifically, after acquisition, LBO firms seek above-average efficiencies from their management teams. Many respond through reducing expenses in Cost of Goods Sold (COGs) and Selling, General and Administrative Expenses (SGA) thereby increasing the EBITDA and EBIT margins. As such, redo the valuation of the Toys Division assuming that the EBITDA and EBIT for the toys division is equal to imputed EBITDA and EBIT using the Year 2004 Peer Group EBITDA and Operating Margins applied to Sales of the toys division. Please refer to the "1. Margin Analysis" worksheet. You can either make a copy of your filled in "3. RelVal (Toys Division)" worksheet or use the "7. RelVal (Turnaround Toys Div)" worksheet provided. You will notice that the only difference in the answers between the two worksheets is the area highlighted in gold.
8. Sum of the Parts Valuation Revisited (5 points): Redo the sum of the parts valuation using the "8. Sum of Parts (Peer Margins)" worksheet. Notice that the only change in this sum of parts worksheet is the value of Toy Division where the value is based on the 2004 EBITDA Margin for the peer group. Discuss whether KKR, Bain Capital and Vornado overpaid for Toys "R" US (\$26.75 per share) given the breakup value per share assuming that the partners can achieve the operating efficiencies from their new Toys "R" Us management team.
9. LBO Analysis & Debt Capacity (10 Points): The mechanics of implementing an LBO pivot around finding a target firm that can support the debt required to finance about 80 percent of its purchase price since using as much leverage as possible can magnify the prospective equity returns¹⁸. To justify taking on this degree of leverage, LBO lenders prefer borrowers with lots of tangible assets such as real estate, plant and equipment, inventory, and receivables. Calculate how much the LBO firm can pay for Toys "R" US using the "9. LBO Analysis & Debt Capacity" worksheet. Is your answer consistent with the \$6.6 billion (plus the assumption of \$2.29 billion in long-term debt) that KKR, Bain Capital and Vornado paid for Toys "R" Us? What about the proportion of debt and equity used? Recall from the case that the \$6.6 billion in required capital after backing out assumed debt was financed with each of the partners investing \$450 million in cash for total equity of \$1.35 billion. The partnership arranged \$2.0 billion in bridge financing; and the remaining \$ 3.25 billion balance to come from a combination of balance-sheet cash, property-level financing on a

¹⁸However, leverage is a double edged sword and can also magnify losses in case the deal implodes.

number of U.S. and international real estate assets, and securitizing Toys 'R' Us's inventory. Finally, how does the LBO per share value compare to the \$26.75 per share price paid for Toys "R" Us? Was it in the "ballpark"? Please discuss.

10. Sale-Leaseback Option (5 Points): One of the options that Wall Street analysts have talked about in turning Toys "R" Us around is to monetize the real estate either through outright sale or through a sale and leaseback of the stores. Using the "10. Sale Leaseback Option" worksheet, does it make sense to do a sales-leaseback option in general using a per store analysis? In your discussion, please refer to other facets of the case to support your answer rather than merely looking at the numbers.
11. Valuing Real Estate as an Option (5 points): Using the "11. Real Estate as an Option" worksheet, discuss to what extent real estate can be used turn around the toys division of Toys "R" Us.

Appendix A: Toys R Us Debt

Securitized Debt

Toys R Us Inc. 8 3/4% debentures, due 2021:

AUTHORIZED -- \$200,000,000.

OUTSTANDING -- Feb. 1, 2003, \$198,000,000.

DATED -- Aug. 29, 1991.

DUE -- Sept. 1, 2021.

INTEREST -- 8 3/4% per annum payable semi-annually on M&S 1.

TRUSTEE -- United Jersey Bank.

DENOMINATION -- Fully registered, \$1,000 and any integral multiple thereof. Global debts will be deposited with, or on behalf of, The Depository Trust Company and registered in the name of Cede & Co., as The Depository Trust Company's nominee.

CALLABLE -- Not callable prior to maturity.

SECURITY -- Not secured. Ranks pari passu with all other unsecured unsubordinated indebtedness of Co. Co. or any domestic subsidiary will not issue, assume or guarantee any debt if such debt is secured by any mortgage upon any principal property of Co. or of any domestic subsidiary or any shares of stock or indebtedness of any domestic subsidiary, whether owned at the date of the indenture or thereafter acquired, without effectively securing the debt securities equally and ratably with such debt.

SALE AND LEASEBACK -- Co. or any domestic subsidiary of any principal property are prohibited unless the net proceeds of such sale and leaseback transaction are at least equal to the sum of all costs incurred by Co. or any domestic subsidiary in connection with the acquisition of, and construction of any improvement on, the principal property to be leased and either (a) Co. or such domestic subsidiary would be entitled to incur debt secured by a mortgage on the property to be leased without equally and ratably securing the debt securities, mortgages on any property acquired, constructed or improved by Co. or any domestic subsidiary after Feb. 2, 1991, which are created or assumed within three years after such acquisition, or completion of such construction or improvement to secure or provide for the payment of the purchase price or cost thereof, or mortgages existing on any property at the time of its acquisition or (b) does not exceed the greater of 10% of consolidated net tangible assets or 15% of consolidated capitalization or (c) Co. or such domestic subsidiary applies an amount equal to the sum of all costs incurred by Co. or such domestic subsidiary in connection with the acquisition of, and the construction of any improvements on, such property (i) to the payment or other retirement of debt incurred or assumed by Co. that ranks senior to or

pari passu with the debt securities or of debt incurred by any subsidiary; (ii) to the purchase of other principal property.

INDENTURE MODIFICATION -- Indenture may be modified, except as provided, with consent of majority of debts outstanding.

RIGHTS ON DEFAULT -- Trustee, or 25% of debts outstanding, may declare principal due and payable (30 days' grace for payment of interest).

PURPOSE -- Proceeds added to Co.'s general funds and will be available for general corporate purposes.

OFFERED -- (\$200,000,000) at 100 plus accrued interest (proceeds to Co., 99.125) on Aug. 22, 1991 thru Goldman, Sachs & Co., Salomon Brothers Inc., Wertheim Schroder & Co., Inc. and associates.

Toys R Us Inc. 6.875% notes, due 2006:

AUTHORIZED -- \$250,000,000.

OUTSTANDING -- Feb. 1, 2003, \$267,000,000.

DATED -- Dec. 18, 2001.

DUE -- Aug. 1, 2006.

INTEREST -- F&A 1 to holders of record on J&J 15 at 6.875% per annum.

TRUSTEE -- Bank of New York.

DENOMINATION -- Fully registered, \$1,000 and integral multiples thereof.

CALLABLE -- As a whole or in part at any time at the option of Co., upon at least 30 but not more than 60 days notice, at the greater of (i) 100% or (ii) the sum of the present values of the remaining scheduled payments of principal and interest, discounted to the date of redemption on a semi annual basis at the treasury rate plus 25 basis points, plus in each case accrued interest to the date of redemption..

SINKING FUND -- None.

SECURITY -- Unsecured. Rank equally with all other senior unsecured indebtedness of Co.

INDENTURE MODIFICATION -- Indenture may be modified, except as provided, with the consent of a majority of notes outstanding.

RIGHTS ON DEFAULT -- Trustee or 25% of notes outstanding may declare principal due and payable (30 days grace for the payment of interest).

PURPOSE -- Co will receive no proceeds from the exchange offer.

OFFERED -- (\$250,000,000) on Dec. 18, 2001 in exchange for 6.875% notes, due 2006 originally issued on July 19, 2001 in a private placement.

Toys R Us Inc. 7.625% notes, due 2011:

AUTHORIZED -- \$500,000,000.

OUTSTANDING -- Feb. 1, 2003, \$554,000,000.

DATED -- Dec. 18, 2001.

DUE -- Aug. 1, 2011.

INTEREST -- F&A 1 to holders of record on J&J 15 at 7.625% per annum.

TRUSTEE -- Bank of New York.

DENOMINATION -- Fully registered, \$1,000 and integral multiples thereof.

CALLABLE -- As a whole or in part at any time at the option of Co., upon at least 30 but not ore than 60 days notice, at the greater of (i) 100% or (ii) the sum of the present values of the remaining scheduled payments of principal and interest , discounted to the date of redemption on a semi annual basis at the treasury rate plus 30 basis points, plus in each case accrued interest to the date of redemption..

SINKING FUND -- None.

SECURITY -- Unsecured. Rank equally with all other senior unsecured indebtedness of Co.

INDENTURE MODIFICATION -- Indenture may be modified, except as provided, with the consent of a majority of notes outstg.

RIGHTS ON DEFAULT -- Trustee or 25% of notes outstg may declares principal due and payable (30 days grace for the payment of interest).

PURPOSE -- Co will receive no proceeds from the exchange offer.

OFFERED -- (\$250,000,000) on Dec. 18, 2001 in exchange for 7.625% notes, due 2011 originally issued on July 19, 2001 in a private placement.

Toys R Us Inc. 7.875% notes, due 2013:

AUTHORIZED -- \$400,000,000.

OUTSTANDING -- Apr. 2, 2003 \$400,000,000.

DATED -- Apr. 2, 2003.

DUE -- Apr. 15, 2013

INTEREST -- A&O 1 to holders of record on M&S 15 at 7.875% per annum accruing from Apr. 8, 2003.

TRUSTEE -- Bank of New York.

DENOMINATION -- Fully registered, \$1,000 and integral multiples thereof.

CALLABLE -- As a whole or in part at any time at the option of Co., upon at least 30 but not ore than 60 days notice, at the greater of (i) 100% or (ii) the sum of the present values of the remaining scheduled payments of principal and interest , discounted to the date of redemption on a semi annual basis at the treasury rate plus 50 basis points, plus in each case accrued interest to the date of redemption..

SINKING FUND -- None.

SECURITY -- Unsecured. Rank equally with all other senior unsecured indebtedness of Co.

INDENTURE MODIFICATION -- Indenture may be modified, except as provided, with the consent of a majority of notes outstg.

RIGHTS ON DEFAULT -- Trustee or 25% of notes outstg may declares principal due and payable (30 days grace for the payment of interest).

PURPOSE -- Proceeds will be used to repay a portion of indebtedness maturing in 2003, for working capital needs and other general corporate purposes.

OFFERED -- (\$400,000,000) at 98.305 plus accrued interest (proceeds to Co. 97.55) on apr. 2, 2003 thru Barclays Capital; Credit Suisse First Boston; JPMorgan; BNY Capital Markets, Inc. Banc One Capital Markets, Inc.; The Royal Bank of Scotland; Salomon Smith Barney; SG Cowen; and Wachovia Securities.

Toys R Us Inc. 7.375% notes, due 2018:

AUTHORIZED -- \$400,000,000

OUTSTANDING -- Sept. 17, 2003, \$400,000,000

DATED -- Sept. 17, 2003

DUE -- Oct. 15, 2018

INTEREST -- A&O 15 to holders of record on A&O 1 at 7.375% per annum accruing from Sept. 22, 2003

TRUSTEE -- Bank of New York

DENOMINATION -- Fully registered, \$1,000, and integral multiples thereof.

CALLABLE -- As a whole or in part at any time at the option of Co., upon at least 30 but not more than 60 days notice, at the greater of (i) 100% or (ii) the sum of the present values of the remaining scheduled payments of principal and interest discounted to the date of redemption on a semi annual basis at the treasury rate plus 50 basis points, plus accrued and unpaid interest on the principal amount being redeemed to the date of redemption.

SINKING FUND -- None

SECURITY -- Unsecured. Rank equal in right of payment with all existing and future unsecured and unsubordinated indebtedness of Co.

INDENTURE MODIFICATION -- Indenture may be modified, except as provided, with the consent of a majority of notes outstg.

RIGHTS ON DEFAULT -- Trustee or 25% of notes outstg may declare principal due and payable (30 days grace for the payment of interest)

PURPOSE -- Proceeds will be used for the repayment of indebtedness maturing in calendar year 2004 and any balance for other general corporate purposes.

OFFERED -- (\$400,000,000) at 99.551 plus accrued interest (proceeds to Co. 98.701) on Sept 17, 2003 thru Citigroup; Wachovia Securities; BNY Capital Markets, Inc.; Banc One Capital Markets, Inc.; Barclays Capital; Credit Suisse First Boston; Fleet Securities, Inc.; JPMorgan; McDonald Investments Inc.; The Royal Bank of Scotland; and SG Cowen

Ratings Changes - Below are any credit rating changes for this company's active bonds since April 1995.

TOYS R US INCORPORATED NT 7.375% Due 10/15/2018

Current Ratings

Moody's Caa1

S&P CCC

Fitch BB

Changes

Agency	Rating	Date	Reason
Moody's	Caa2	10/17/2005	Downgrade
Moody's	B3	08/03/2005	Downgrade
S&P	B-	06/30/2005	Downgrade
Moody's	Ba2	03/24/2004	Downgrade
S&P	BB	03/10/2004	Downgrade
S&P	BB+	01/08/2004	Downgrade

TOYS R US INCORPORATED DEB 8.75% Due 09/01/2021

Current Ratings

Moody's B3

S&P CCC

Fitch BB

Duff & Phelp's NR

Changes

Agency	Rating	Date	Reason
Moody's	B2	10/17/2005	Upgrade
Moody's	B3	08/03/2005	Downgrade
S&P	B-	06/30/2005	Downgrade
Moody's	Ba2	03/24/2004	Downgrade
S&P	BB	03/10/2004	Downgrade
S&P	BB+	01/08/2004	Downgrade
Fitch	BB+	03/24/2003	Downgrade
S&P	BBB-	03/05/2003	Downgrade
S&P	BBB	05/28/2002	Downgrade
Moody's	Baa3	03/13/2002	Downgrade
Fitch	BBB-	03/07/2002	Downgrade
Moody's	Baa2	10/18/2001	Downgrade
Fitch	BBB	07/17/2001	Downgrade
S&P	BBB+	03/20/2000	Downgrade
Moody's	A3	01/20/2000	Downgrade
Duff & Phelp's	A	05/27/1999	Downgrade
S&P	A-	05/10/1999	Downgrade
Moody's	A2	12/17/1998	Downgrade
S&P	A+	05/10/1996	Company Performance

**TOYS R US INCORPORATED MANDATORY CONV EQUITY SECURITY UNITS
6.25% Due 08/16/2005**

Current	Ratings
Moody's	NR
S&P	BB
Fitch	NR

Changes			
Agency	Rating	Date	Reason
S&P	BB+	01/08/2004	Downgrade
S&P	BBB-	03/05/2003	Downgrade

TOYS R US INCORPORATED NT 7.625% Due 08/01/2011

Current	Ratings
Moody's	Caa1
S&P	CCC
Fitch	BB

Changes			
Agency	Rating	Date	Reason
Moody's	Caa2	10/17/2005	Downgrade
Moody's	B3	08/03/2005	Downgrade
S&P	B-	06/30/2005	Downgrade
Moody's	Ba2	03/24/2004	Downgrade
S&P	BB	03/10/2004	Downgrade
S&P	BB+	01/08/2004	Downgrade
Fitch	BB+	03/24/2003	Downgrade
S&P	BBB-	03/05/2003	Downgrade
S&P	BBB	05/28/2002	Downgrade
Moody's	Baa3	03/13/2002	Downgrade
Fitch	BBB-	03/07/2002	Downgrade

TOYS R US INCORPORATED BD RULE 144A 7.625% Due 08/01/2011

Current	Ratings
S&P	CCC
Moody's	Baa2
Duff & Phelps	NR
Fitch	NR

Changes			
Agency	Rating	Date	Reason
S&P	B-	06/30/2005	Downgrade

TOYS R US INCORPORATED NT 6.875% Due 08/01/2006

Current	Ratings
Fitch	BB

Changes

Agency	Rating	Date	Reason
S&P	CCC	10/21/2005	Downgrade
Moody's	Caa2	10/17/2005	Downgrade
Moody's	B3	08/03/2005	Downgrade
S&P	B-	06/30/2005	Downgrade
Moody's	Ba2	03/24/2004	Downgrade
S&P	BB	03/10/2004	Downgrade
S&P	BB+	01/08/2004	Downgrade
Fitch	BB+	03/24/2003	Downgrade
S&P	BBB-	03/05/2003	Downgrade
S&P	BBB	05/28/2002	Downgrade
Moody's	Baa3	03/13/2002	Downgrade
Fitch	BBB-	03/07/2002	Downgrade

TOYS R US INCORPORATED BD RULE 144A 6.875% Due 08/01/2006

Current	Ratings
Moody's	Baa2
Duff & Phelp	NR
Fitch	NR

Changes

Agency	Rating	Date	Reason
S&P	CCC	10/21/2005	Downgrade
S&P	B-	06/30/2005	Downgrade

TOYS R US INCORPORATED NT 7.875% Due 04/15/2013

Current	Ratings
Moody's	Caa1
S&P	CCC
Fitch	BB

Changes

Agency	Rating	Date	Reason
Moody's	Caa2	10/17/2005	Downgrade
Moody's	B3	08/03/2005	Downgrade
S&P	B-	06/30/2005	Downgrade
Moody's	Ba2	03/24/2004	Downgrade
S&P	BB	03/10/2004	Downgrade
S&P	BB+	01/08/2004	Downgrade

TOYS R US INCORPORATED EUR\$ NT REG S 7.125% Due 02/13/2004

Current	Ratings
S&P	BB+
Fitch	BB+
Moody's	Baa3
Duff & Phelps	NR

Changes

Agency	Rating	Date	Reason
Fitch	BB+	03/24/2003	Downgrade
S&P	BBB-	03/05/2003	Downgrade
S&P	BBB	05/28/2002	Downgrade
Fitch	BBB-	03/07/2002	Downgrade
Moody's	Baa2	10/18/2001	Downgrade
Fitch	BBB	07/17/2001	Downgrade

Appendix B: List of Store Closings (January 2006)

California: Colma, Fairfield (converting to Babies R Us), Redding, Signal Hill, Vallejo, San Diego (1), San Francisco (1), Merced (1), Orange (1); Colorado: Grand Junction, Littleton, Pueblo; DC: Wheaton, Laurel; Florida: Coral Springs, Sarasota, Tampa (Dale Mabry Highway), Vero Beach, Westchester, Georgia: Macon; Illinois: Arlington Heights, Borbonnais, Chicago, Lansing; Indiana: Michigan City, West Side, Indianapolis; Iowa: Dubuque, Sioux City; Kansas: Wichita (converting to Babies R Us); Kentucky: Owensboro, Springdale; Louisiana: New Orleans East; Massachusetts: Medford, Cambridge, Dorchester, Holyoke (converting to Babies R Us); Michigan: Battle Creek, Lansing, Madison (converting to Babies R Us), Midland; Minnesota: Duluth, Woodbury; Mississippi: Biloxi, Jackson; Montana: Bridgeton; New Jersey: Parsippany (Troy Hills Center); New Mexico: Las Cruces; New York: Commack, Freeport, Levittown, Niagra Falls (Williams Road), Wheatfield (Summit Mall); North Carolina: Raleigh; Ohio: Columbus (West Broad St.), Springfield; Oregon: Albany; South Carolina: Columbia (Two Notch), West Ashley; Tennessee: Antioch/Hickory Hollow; Texas: Brownsville, Houston (North Freeway), Sherman, Texarkana; Virginia: Hampton, Harrisonburg, Tysons Corner; Washington: Bellingham, Federal Way; Wisconsin: Fond du Lac

Source: <http://collectdolls.about.com/od/moderndolls1980snow/a/toysrusclosings.htm>