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EToys Inc. (NASDAQ: ETYS)

Revenue growth, infrastructure improvement and renewed concerns about competition

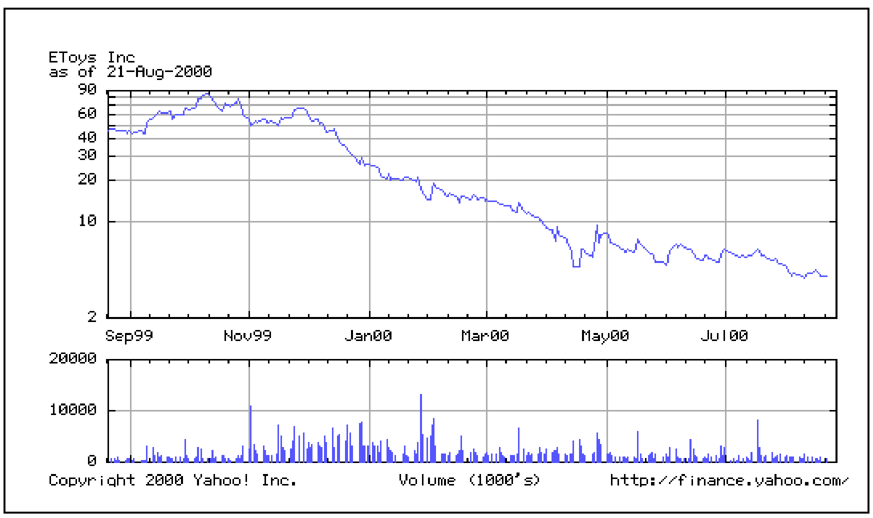
Rating: Accumulate August 25, 2000

KEY CONSIDERATIONS

- Etoys has established itself as a leading" pure-play", toy e-tailer, but is facing competition from traditionally strong, brick-and-mortar toy retailers like ToysRus, Wal-Mart and K-Mart.
- Investor emphasis on profitability has exerted downward pressure on the stock prices of many Internet companies, especially e-commerce companies. EToys hasn't been immune to this trend.
- In recent quarters eToys has seen strong growth in revenue. But, the growth in revenue has been exceeded by significant expenditures to strengthen the company's infrastructure and brand.
- Strong and focused management team has executed their business plan well.
- Continual increases in the number of Internet users and online shoppers provide considerable room for growth both domestically and internationally.

Recent Price	$4.06
52WK Low	$3.88
52WK High	$86.00
P/E	N/A
P/Book	2.4
P/Sales	3.1
Market Capitalization	$495 M
Shares Outstanding	122 M
Float	42.7 M
Daily Volume (3-month Average)	N/A
EPS	
1999A	($0.27)
2000E	($1.46)
2001E	($1.20)
Current Ratio	4.71
Total Debt to Equity	0.65
LT Debt to Equity	0 .62
Total Cash	$134.8 M

ONE-YEAR PRICE AND VOLUME GRAPH



COMPANY PROFILE

A product of the Idealab Internet company incubator, eToys was founded in 1996 in Santa Monica, California and employs a staff of 940 people. The company is one of the most prominent Web-based retailers and is exclusively focused on toys and children's products. The company aims to combine their expertise in children's products and a commitment to excellent customer service with the benefits of Internet retailing in order to provide a unique and fun shopping experience to consumers.

This report was prepared by Richard Jackson and David R. Rivas, Ph.D.

THE COMPANY

EToys' recently concluded first quarter for fiscal year 2001 reflected both the company's continuing growth and the effects of competing in the highly competitive online toy industry. Net sales for the quarter were $24.9 million, a 212% increase over the same period a year ago. Gross margins grew to a record 21.9% and the company added 219,000 customers, bringing total customer accounts to 2.1 million. Fierce competition and the seasonal nature of the toy industry are manifested in customer acquisition cost of $72, up from $24 the previous quarter.

During the quarter, eToys announced it had obtained $100 million in new funding through the sale of convertible preferred stock and warrants to a group of institutional investors led by Promethean Asset Management. The investment was on terms less favorable than eToys initial public offering in May 1999 and a subsequent financing in December 1999, but is expected to fund eToys' business plans well into calendar year 2001. Also in June, eToys took possession of its new 763,000 square foot West Coast shipping hub and began to receive inventory in preparation for the holiday season. The company also, conducted the final stages of integration testing in its new automated fulfillment center on the East Coast and began the final stages of construction of reserve inventory space adjacent to the automated center. The new facilities will increase gross margins by lowering fulfillment costs.

PRODUCTS AND SERVICES

In order to expand its product offering and launch a new content channel, eToys acquired selected assets of eParties American, an online, party planning and supplies site, for $1.6 million in eToys common stock. The acquisition of eParties expands a product base that already included 100,000 products in departments such as toys, video games, books, software, videos, music and baby oriented products. The acquisition allows eToys to sell party supplies under its private label and continues eToys' move toward a product mix emphasizing specialty toy and private label products. While eToys provides a comprehensive selection of well-known brands such as Mattel, Hasbro 5 and LEGO, the margins for such mass-market products are significantly lower than the margins for specialty toys and private label merchandise. EToys currently offers specialty toy brands such as BRIO, Discovery Toys and Learning Curve that are not available at other toy superstores. We believe the shift in emphasis to specialty and private label products is a good strategy that will increase total margins and insulate eToys from price wars on mass-market products sold by competitors.

In addition to a wide variety of products, the eToys' Web site also offers customers a number of appealing services. A report by Resource Marketing, that was published in Fortune Magazine in August 2000, rated eToys as the top performing retail web site for overall customer satisfaction. EToys provides services such as detailed product information, helpful and useful shopping services, and innovative merchandising through easy-to-use Web pages. Customers can enjoy easy gift giving by creating a Gift Registry, Wish Lists, Birthday Reminders, and more. In addition, eToys offers special sections such as Rosie's Readers, Shop by Age, the Idea Center, and other helpful features.

INDUSTRY OUTLOOK AND COMPETITION

Internet Sector

The North American Internet retailing segment is on pace to surpass $29.3 billion in 2004, a 75 percent increase over 1999 revenue according to the Gartner Group. In 1999, North American online retail totaled $16.8 billion, up 157 percent from 1998 revenue. Despite market growth, many e-tailers have seen significant decreases in the price of their shares since the first quarter of the calendar year. Some analysts have even questioned the validity of the "pure-play" model. A report released during Summer 2000 by McKinsey & Company and Salomon Smith Barney said that retailers who sold to their customers across multiple channels (stores, catalogs and online) would emerge victorious against "pure play" e-tailers. Joanna Barsh, a director at McKinsey & Company said, "The notion of 'pure play' is turning out to be the wrong play." Such sentiment, though not unanimous, conveys some of the perceptions plaguing the E-Commerce sector.

Toy Industry

According to the Toy Manufacturers of America ("TMA") the North American toy industry generated over $31 billion in revenue from sales of toys and video games in 1999, however online toy sales accounted for only one percent of total revenue. EToys generated $148.5 million in revenue in North America during fiscal year 1999, which accounts for nearly half the $310 million TMA said was transacted online in North America during the year. The total revenue from toy sales worldwide was over $71 billion, with less than a percent of sales revenue coming from online sales. Both the toy market and the percentage of toys purchased online are expected to grow in coming years. The international toy market has traditionally grown at a rate slightly under 5% per year and the North American toy market grew 17% from 1997 to 1999 based on TMA statistics. Jupiter Communications predicts that by 2003, 5.6% of toy sales revenue in the United States will be transacted online, considerable growth compared to current percentages.

Since the online toy market is relatively small and barriers to entry are quite low there is fierce competition for market share. Etoys' most formidable competition comes from the new Amazon.com/ToysRus partnership, Wal-Mart and K-Mart. Wal-Mart and K-Mart (Bluelight.com) have sold a high quantity of toys offline and are planning to improve their capability and commitment to selling online for the 2000 Holiday Season. The partnership between Amazon.com and ToysRus will enable each company to specialize in their area of expertise, resulting in increased efficiency and earnings over the course of the ten-year agreement. Amazon offers outstanding order fulfillment but is not experienced in the toy industry. ToysRus has years of experience in selecting and maintaining inventory but has had problems with online order fulfillment. While the Amazon.com/ToysRus partnership creates a potentially powerful competitor, eToys may benefit from continuing consolidation in the toy market.

STRATEGIES FOR GROWTH

EToys' goal is to be the world's leading online retailer of children's products. Key elements of eToys' strategy include the following:

Focus on Online Retailing of Children's Products - eToys is planning to enhance its current product offerings, expand into additional categories, and create new and distinct content areas focused on topics of interest to parents and children. We believe the addition of new content areas is a good strategy because eToys indicated during a May analyst meeting that content based products outsold non-content based products at a rate of ten to one.

Build Strong Brand Recognition - eToys focuses their online and offline marketing efforts primarily towards mothers, who eToys believes, are the principal decision-makers for purchases of children's products. This is a good strategy because according to International Data Corp. mothers are the most likely demographic to make repeat toy purchases.

Promote Repeat Purchases - eToys intends to maximize the number of repeat purchases by their customers by targeting existing customers through direct marketing techniques, building features unique to each individual customer and enhancing customer service.

Expand into Additional International Markets - eToys currently offers children's products in the United States and Canada through the eToys.com online store and in the United Kingdom through the eToys.co.uk and BabyCentre.co.uk online stores. EToys is exploring opportunities to expand in Europe through an existing subsidiary located in the Netherlands. North America makes up only 43% of the International toy market so there is considerable opportunity to increase revenues in other markets.

Maintain Technology Focus and Expertise - eToys intends to enhance their service offerings to take advantage of the unique characteristics of online retailing. EToys plans to increase the efficiency of their relationships with product vendors and manufacturers and their distribution operations.

Build Strong Strategic Marketing Alliances - eToys has effectively promoted its brand through marketing alliances with Gap Kids and BabyGap, McDonalds, LEGO, Rosie's Readers and the children's television show "Between the Lions". Additionally, eToys has spent $18 million on an anchor spot on AOL for the next three years. These alliances have promoted the eToys brand to million of consumers.

KEY RISK FACTORS

Competition - Many traditional store-based and online competitors have longer operating histories, larger customer or user bases, greater brand recognition and significantly greater financial, marketing and other resources than eToys does. Increased competition is likely to result in price reductions, and loss of market share, any of which could seriously harm net sales and results of operations.

Difficulty in obtaining additional capital - Since its inception, eToys has experienced negative cash flow from operations and expects to experience significant negative cash flow from operations for the foreseeable future. Significant volatility in the stock markets, particularly with respect to Internet stocks, may increase the difficulty of raising additional capital.

Inventory Risk - The rapidly changing trends in consumer tastes subject eToys to significant inventory risks.

Fulfillment - Failure to deliver products to customers in a timely and accurate manner would damage eToys' reputation and brand.

FINANCIALS

Revenue - We expect eToys should continue to experience strong top line revenue growth as a greater percentage of total toy purchases are made online. Also, we expect current eToys customers to increase the size and frequency of their orders because of eToys' dependable customer service record.

Gross Profit – We expect gross margins to improve because of emphasis on specialty and private label merchandise that has higher product margins. Also, the new fulfillment and shipping centers are expected to decrease the cost of sales. These factors should help offset the effects of market competition.

Research and Development – We expect research and development costs to increase in absolute dollars, but decrease as a percentage of net sales. EToys believes investment in its Web site and technology is critical in attaining its strategic objectives. Investment will also be made to develop new products, services and international expansion.

Sales and Marketing – We expect sales to increase in absolute dollars, but decrease as a percentage of net sales. The effects of eToys trying to strengthen its own brand while competing against strong retail brand names could be very evident in this area.

Net Income – We expect net income to remain negative throughout the current fiscal year and into the following fiscal year. We also expect net losses for the current fiscal year ending in March 2001 to exceed net losses from the previous year. EToys hopes to be profitable sometime during the 2002 calendar year.

VALUATION

Based upon the table comparing eToys' results with the results of other online, retail specialty companies, we believe that eToys' valuation is currently fair. Etoys' current price and P/S ratio are within the corresponding averages of the other specialty retail companies. EToys' relatively high gross margin also justifies the current valuation.

Value Comparison 8/21/00					
	$ Price	***Market Cap. In millions***	***Trailing 12 Month Sales in millions***	***P/S***	***Gross Margin %(TTM)***
EToys	**4.06**	**495**	**168**	**2.9**	**19.6%**
Amazon	**39.00**	**13,878**	**2,184**	**6.1**	**19.4%**
Garden.com	**2.13**	**37**	**16**	**2.3**	**15.4%**
Egghead.com	**2.16**	**91**	**514**	**.15**	**5.31%**
Drugstore.com	**6.22**	**324**	**78**	**4.2**	**8.1%**

Investment Opinion

In the last twelve months eToys' price per share declined from a high of $86 to a current price of $4.06. The decline in eToys' stock price was instigated by insider selling, competitive pressures and unsubstantiated worries over Holiday 1999 order fulfillment. EToys' stock has under-performed relative to the TheStreet.com's Internet Index by a significant margin in the last twelve months. EToys has also under-performed relative to TheStreet.com's E-Commerce Index during the same period. However, since the Internet sector market correction in April 2000, eToys' performance has been comparable to both TheStreet.com's Internet and E-Commerce Indices and we expect this trend to continue.

In recent quarters eToys has shown growth in revenues and gross margins and has received excellent customer service ratings. However, the costs associated with building company infrastructure and brand recognition have resulted in sizeable net losses. The fact that eToys has executed their plan well is overshadowed by the prospect of negative earnings in the foreseeable future. There are also renewed concerns about competitive pressures coming from the Amazon.com/ToysRus partnership and strong offline brands like Wal-Mart. We expect eToys to continue the process of building infrastructure, while also increasing revenue and combating competitive pressures. We give eToys an ACCUMULATE rating; believing the stock should be purchased during times of weakness.

Financial Model

Income Statement

Etoys financial information			Q1		
In thousands, except per share amounts	**1999A**	**2000A**	2001A	**2001E**	**2002E**
Net sales	**29,959**	**151,036**	24,862	**362,486**	**688,723**
Cost of sales	**24,246**	**121,973**	19,415	**280,927**	**523,430**
Gross profit	**5,713**	**29,063**	5,447	**81,559**	**165,293**
Operating expenses:					
Marketing and sales	**20,719**	**120,460**	29,603	**156,494**	**194,367**
Product Development	**3,608**	**43,429**	12,526	**72,960**	**86,904**
General Admin	**4,352**	**16,665**	7,500	**32,163**	**39,525**
Goodwill Amortization	**319**	**27,835**	8,490	**32,313**	**34,200**
Deferred compensation amortization	**5,814**	**13,701**	3,109	**12,811**	**13,558**
Total operating expenses	**34,812**	**222,090**	61,228	**306,741**	**368,554**
Operating Loss	**(29,099)**	**(193,027)**	(55,781)	**(225,182)**	**(203,261)**
Net Interest	**542**	**3,401**	1,176	**(5,012)**	**(4,425)**
Provision for taxes	**1**	**0**	0	**0**	**0**
Net loss	**(28,558)**	**(189,627)**	(56,957)	**(230,194)**	**(207,686)**
Basic and diluted net loss per share	**($0.85)**	**($1.65)**	($0.47)	**($1.86)**	**($1.60)**
Net loss, excluding deferred comp and goodwill amort.	**(22,425)**	**(148,091)**	(45,358)	**(180,058)**	**(155,503)**
Basic and diluted loss per share, excluding deferred comp and goodwill amortization costs and accretion of discount and dividends on preferred stock	**($0.27)**	**($1.29)**	($0.37)	**($1.46)**	**($1.20)**
Shares used to compute basic and diluted net loss	**81,923**	**114,601**	121,534	**123,500**	**129,500**
Margin Analysis					
Gross Margins	**19.0%**	**19.2%**	21.9%	**22.5%**	**24.0%**
Marketing and Sales	**69.2%**	**79.8%**	119.1%	**43.2%**	**28.2%**
Product Development	**12.0%**	**28.8%**	50.4%	**20.1%**	**12.6%**
General Administration	**14.5%**	**11.0%**	30.2%	**8.9%**	**5.7%**
Amortization of Goodwill	**1.1%**	**18.4%**	34.1%	**8.9%**	**5.0%**
Deferred Compensation Amortization	**19.4%**	**9.1%**	12.5%	**15.7%**	**2.0%**
Operating Margin	**-97.1%**	**-127.8%**	-224.4%	**-62.1%**	**-29.5%**
Net Margin	**-95.3%**	**-125.6%**	-229.1%	**-63.5%**	**-30.2%**
Growth					
Revenue	**n/a**	**404.1%**	211.7%	**140.0%**	**90.0%**
Gross Profit	**n/a**	**408.7%**	258.8%	**180.6%**	**102.7%**
Marketing and Sales	**n/a**	**481.4%**	155.8%	**29.9%**	**19.5%**
Product Development	**n/a**	**1103.7%**	159.0%	**68.0%**	**19.1%**
General Administration	**n/a**	**282.9%**	153.7%	**93.0%**	**22.9%**