

**INSTITUTIONAL RESEARCH**

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**EToys Inc. (NASDAQ: ETYS)**

**Update: Concern on future, competition, poor net sales and growth**

**Rating: Strong Sell**

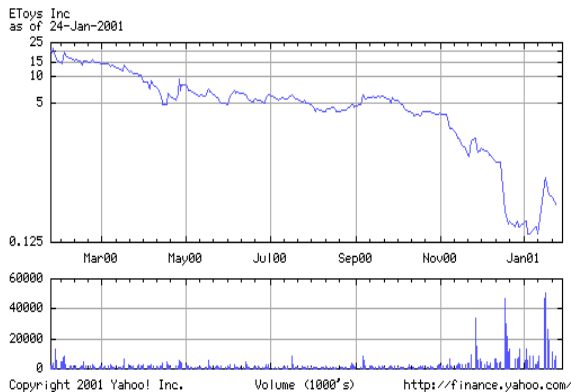
February 15, 2001

**Key Considerations**

- In recent quarters, eToys has suffered greatly due to slow sales and revenue shortfall.
- Financial troubles that arose because of slow sales during the holiday season, eToys stops paying some creditors and suppliers.
- The continued failure in profits is forcing the company to explore new options.
- Massive layoffs of employees and the closing of some warehouses.

Recent Price	11/32
52 week low	1/32
52 week high	19 15/16
P/E	NA
P/Book	.35
P/Sales	.30
Market Capitalization	57.9M
Shares Outstanding	154,972
Float	71.5M
Daily Volume	8M
<b>EPS</b>	
1999A	(\$0.27)
2000A	(\$1.65)
2001E	(\$1.40)
2002E	(\$1.06)

**One-Year Price and Volume Graph**



**Company Profile**

A product of Idealab Internet company incubator, eToys was founded in 1996 in Santa Monica, California and employs a staff of 620 people. This company is a purely e-commerce toy retailer focused on the sales of children's products. The company's aim is to provide a unique and fun shopping experience with the convenience of staying at home or shopping from the workplace to the consumers.

This report was prepared by John Yoon and David Riva, Ph.D.

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## **The Company**

Etoys was founded in 1996 and used to employ around 500 people, which grew to about 1000 people in 2000. It is a Web-based retailer focused on Toys and children's products, but now is a company struggling to stay afloat. The company's aim was to use their expertise in children's products to provide consumers with a unique and fun shopping experience.

An addition to the long line of services provided by eToys was introduced on October 2, 2000. BabyCenter Inc., a wholly owned subsidiary of eToys Inc., launched a new site called ParentCenter.com. This site was created to serve as a personalized information resource for parents of children ages 2 to 12. The web-site offers parents advice, tips from other parents, and more than a thousand articles on children's health, fun activities, learning, and parenting.

During the quarter, before the holiday season, eToys announced that it would not meet expectations. They had announced that its sales may be half of what the analysts expected. Etoys, the once considered premier online retailer, with good customer service, strong brand names, and a easy to use web-site, is now struggling along with other net companies. During the holiday season, eToys didn't sell as much products as they had hoped to. Because of the lack of profits, this month eToys was unable to pay some of its creditors, laid off 380 employees and are planning to let about 320 more go by March 31<sup>st</sup>, and are in the process of shutting down warehouse operations in California and Greensboro, NC.

## **Products and Services**

The products that are offered by eToys are still the same name brand products offered in the past, with a few additions. Etoys offers a selection of toy products (from Mattel, Hasbro, LEGO, BRIO, PLAYMOBIL, and Learning Curve), video games (for the Sega Dreamcast, Sony Playstation, Nintendo 64, and Game Boy platforms), books (offers more than 80,000 titles at competitive prices), software (such as Broderbund, Disney Interactive, etc.), children's video (ex. Barney, Dr. Seuss, Magic School Bus, Muppets, Peanuts, Rugrats, etc.), children's music (offered a variety of both cassettes and CDs), and baby products (BabyCenter site provides an assortment of products for toddlers).

Etoys provides a number of services to attract consumers and to promote customer retention. The company focus's on providing a high level of customer service. They provide support through a toll-free telephone service during extended business hours as well as through email. The customer service area of the Web-site contains an area which is helpful to first-time users as well as returning consumers.

Etoys has a variety of different contents on its web-site to attract customers to the site and to encourage them to stay. The Company's advanced search technology, utilized in the web-sites, allow the consumers to locate products efficiently and effectively based on the selected criteria depending on the department. By using the keyword search or a product search in the Company's department, a customer can search by the any combination of age, category, keyword, or price. The simplistic construction of the web-site helps to ease the navigation through the product packed web-site.

## **Industry and Competition**

### **The Electronic Commerce**

The online commerce market is new, rapidly evolving and intensely competitive. Increased competition is likely to result in price reductions, reduced gross margins and loss of market share, any of which could seriously harm its net sales and results of operations. The Company expects competition to intensify in the future because current and new competitors can enter its market with little difficulty and can launch new Web sites at a relatively low cost. In addition, the children and baby products industries, including toy, video game, software, video, books and music are intensely competitive.

In the United States, over half of the American households own a computer, and around 65 million Americans shopped through the Internet in 2000. Online e-tailers include a wide range of online stores. Almost any product can be bought via the Internet from big name store such as Staples, Office Depot, etc. to small unknown online stores.

Even though the popularity of online shopping on the Internet has increased, the e-commerce industry has some problems. The strong brand name have the most chance of success but the expenditures for e-commerce will hurt profitability in the short run because of investment costs are high.

E-commerce, at the end of the holiday shopping season, traffic to the e-tail sites increased about 30.3 percent from the previous year according to Internet measurement firm Media Metrix. But out of the e-tail site online, the toy category did not place among the most visited sites.

### **Online Toy Market**

A year ago, the wide open online toy market had a broad range of e-tailors competing for dominance. As the holiday season at the end of the year approached, only two candidates remained competing for the number one spot on the online toy space, eToys and Amazon.com. At the end of summer, ToysRus.com had agreed to move to Amazon.com and now share the operating responsibilities for the online store that would battle eToys. These two were the only two online toy market players left, the other dot-com companies had dropped out of competition.

The online market had proven fatal even before the holiday season, to e-tailors such as Toysmart.com, backed my Walt Disney. Co. which fell out in May, and Toytime.com, which gave up after nine months of trying. The online toy market wasn't an easy place to do business, even to those that had a vast amount of money and big-name investors.

After the holiday rush of 2000, eToys had placed below Amazon/ToysRus.com in the race. Etoys had faltered in the third quarter missing its revenue estimates. It had also announced plans to cut its workforce in an effort to conserve its cash supply. While eToys was faltering during the holiday season, Amazon/ToysRus.com had seen more than five times the number of visitors than eToys. EToys saw 21.12 million shopping visits during the season while Amazon and Toys 'R' Us had seen around 123 million visitors.

## Competition

	eToys.com	Amazon/ToysRus.com	Garden.co m	Egghead.c om	Barnes and Noble
Brand	known	Highly Recognized	known	known	Highly Recognized
Prices	Lowest	average	average	average	Average
Variety of Products	A variety of toys and baby products	Books and Toys of all kind	Garden related products	Computer related products	Book on all subjects
Operating History	Short	Long	Short	Long	Long
Customer or user bases	good amount	high amount	small amount	good amount	Good amount

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 the Company does. Many of these competitors can devote substantially more resources to Web site development than the Company can. In addition, larger, well-established and well-financed entities may join with online competitors or suppliers of children and baby products, including toys, video games, software, videos, books and music as the use of the Internet and other online services increases.

The Company's competitors may be able to secure products from vendors on more favorable terms, fulfill customer orders more efficiently and adopt more aggressive pricing or inventory availability policies than the Company can. Traditional store-based retailers also enable customers to see and feel products in a manner that is not possible over the Internet.

## Strategy For the Future

Etoys' goal to be the world's leading online retailer of children's product seems very gloom at their present state. Their goal currently isn't to grow but to find a way out of their ditch. Starting from the beginning of the third quarter, the weaker than expected sales forced eToys to announce that it expected lower than estimates provided on October 30.

The company expected net sales to be between \$120 million and \$130 million, instead of the \$210 million to \$240 million previously estimated. Even gross margin is expected to be between 21% and 23%, instead of the 22% to 24% previously estimated.

To combat the problems that has arisen, eToys announced in mid December, the company anticipates that it will be required to take some steps in reducing operating costs, which is being seen currently with the 380 layoffs and 320 more to come in March. In order to continue its reduction in costs, the company has also ceased warehouse operations in the City of Commerce, California and Greensboro, North Carolina. It will consolidate those operations within eToys' existing distribution centers in Ontario, California and Blairs, Virginia. EToys also said that it would close its United Kingdom web-site on Jan. 19<sup>th</sup>. The company has even stopped paying off its creditors due to a lack of funds.

On eToys' 8-K form filed on January 4, 2001, it states "eToys Inc. (NASDAQ: ETYS) today provided details of the cost reduction plan it announced on December 15 while it continues to explore a range of strategic options for the future." eToys also said it was in the process of reviewing its financial projections for the fiscal year ending March 31, 2001 and periods thereafter. In light of the lower-than-expected revenue growth experienced during the quarter

ended December 31, any information previously provided by the company with respect to such periods should not be relied upon. Specifically, the company no longer estimates that it will achieve profitability by its fiscal year ending March 31, 2003, or that its quarterly loss will narrow year-over-year beginning in the quarter ending December 31, 2000 and for all subsequent quarters, as previously stated.

By what is coming up on past and recent news, the company isn't looking at a strategy for growth, it is more like a strategy to make it out alive. The question should be how long can eToys survive? By the estimates, the company has only enough cash to last until March.

### **Key Risk Factors**

View on Internet Retailing- During the third quarter, the general public had a negative view of buying products on the Internet. This had a substantial result on the company in general, which strived to get a greater amount of the general public interested in e-commerce.

The concern over the economy- The harsh conditions in the retail industry attributed to the revenue loss this quarter.

Competition- EToys Inc. had to go up against Amazon/Toys "R" Us in the Internet toy sector. Because eToys is a "pure play" e-tailer, the pressure was greater than Amazon/Toys "R" Us, which isn't a "pure play" e-tailer also have store outside the web. The public's view on e-commerce was the deciding factor, being solely in a risky sector.

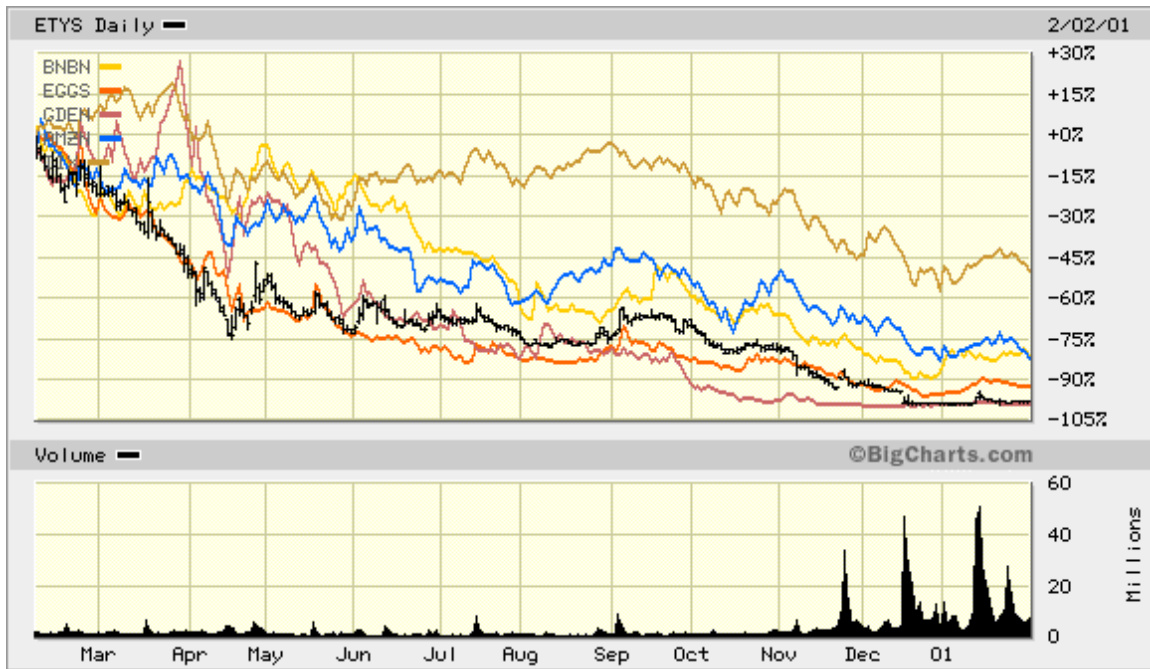
### **Financials**

**Revenue** for the company did not meet the expectations by a great amount. EToys should continue having problems with revenue growth in the months to come.

**Gross Profit** also has not met the expectations and is expected that it will not achieve profitability by its fiscal year ending on March 31,2003. It forecasted that its quarterly gross profit will continue to be insufficient.

**Net Income** has been negative since the company first began and it is expected to remain negative in the near future due current news and trend.

## Valuation



Stock	Price	Market Cap.	P/S	Sales (ttm)	Gross Margin% (ttm)
ETYS	0.31	55.7M	.20	205M	23.34%
AMZN	14.75	5.134B	1.83	2.76B	23.74%
GDEH	0.13	2.03M	.14	16.7M	25.89%
EGGS	1.03	43.8M	.08	519.4M	6.57%
BNBN	2.16	310.9M	1.04	297.6M	17.76%

Performing significantly under the Internet index since Nov 1999, eToys will likely follow its downward trend. The highly anticipated holiday season being a loss, eToys has moved closer to the end of the line. When comparing the results with the results of other online retail specialty companies, is one of the farthest under the index. Even though the gross margin is relatively high, EToys' P/S is lower than the corresponding averages of the other specialty companies, which helps justify the current valuation of sell.

**Investment Opinion**

EToys, with its current direction, has lost its appeal. In the last twelve months, the price per share dropped from \$20 to a current price of \$.35. The drop in the price during the third quarter was due to the poor performance during the holiday season. It has shown that the public is still hesitant in e-commerce, even though the number of people shopping in online stores has increased. EToys is also pressured from the Amazon.com/ToysRus and other the offline industry. Online, which maybe the future, isn't the way for the general people of today.

Even though eToys has executed their plans in growth of revenue and gross margins and has received excellent customer service ratings, the cost involved and net loss in the current quarters have severely hurt the company. As news of the company states that the company is not looking to expand and grow, but instead to looking for ways to get out of its slump, not being able to pay creditors, the shutting down of two warehouse operations, falling short by a wide margin in profits, etc, has given the company in a negative view. Because of the struggles with the company, we expect eToys to continue on its trend.

**Rating**

For the short term rating, a target price of \$0.19 is given for a two month period. We give eToys a STRONG SELL rating for short term rating D. For the long term rating 1, we expect the stock to be traded at \$0.03 giving the stock also a STRONG SELL.

INCOME STATEMENT

Etoys financial information				
In thousands, except per share amount	1999A	2000A	2001E	2002E
Net Sales	29959	151036	205000	225500
Cost of sales	24246	121973	157850	166091
Gross Profit	5713	29063	47150	59409
Marketing and Sales	20719	120460	160150	174563
Product Development	3608	43429	72060	75663
General Admin	4662	16665	36550	53363
Amort of Good will and Def Comp	5814	41536	40140	40590
Operating Income/(Loss)	-29099	-222090	-261750	-284770
Net Interest	542	3401	4650	5125
Pretax Income/(Loss)	-28557	-218689	-257100	-279645
Tax Expense	1	0	0	0
Net Income/(Loss)	-28558	-218689	-257100	-279645
Net Loss, excluding deferred comp and good will	-22743	-148091	-216960	-239055
Fully Diluted EPS	-0.27	-1.65	-1.4	-1.06
Shares Outstanding	81923	114601	154972	225524
<b>Marginal Analysis</b>				
Gross Margin	19%	19%	23%	26%
Market and sales	69%	80%	78%	77%
Product Development	12%	29%	35%	34%
General Admin	15%	11%	18%	24%
Amort of Good will and Def Comp	19%	28%	20%	18%
Operating Margin	-97%	-147%	-127%	-126%
Net Margin	-95%	-144%	-125%	-124%
<b>Growth</b>				
Revenue	n/a	404%	29%	10%
Gross Profit	n/a	408%	62%	26%
Marketing and Sales	n/a	481%	33%	9%
Product Development	n/a	1104%	66%	5%
General Admin	n/a	283%	119%	46%