How To Improve Your Survival Odds

The demise of Toys R Us is being described as the failure of a brick-and-mortar retailer to adapt to the internet age. Its chain of big box stores was supposedly no match for Amazon and a host of other aggressive online merchants. While there's an element of truth to this assessment, we would argue that Toys R Us was more the victim of an over-leveraged balance sheet than a changing retail environment. And that the sad Toys R Us saga, culminating in the closure of 800 stores and the firing of 30,000 employees, is a cautionary tale for everyone in the music industry.

Online competition has unquestionably intensified, yet Toys R Us was a potent force in the toy business right up until the moment creditors pulled the plug. The company's $11.1 billion in revenue for the trailing 12 months represented an estimated 22% share of market and dwarfed all other competitors. Its liquidation will also leave a promotional void that is projected to trim the size of the U.S. toy market by 5% this year according to *The Toy Book*, a leading industry journal. Why couldn't this market clout be transformed into a viable business? Look to the balance sheet for the answer. Toys R Us just couldn't service its $5.0 billion in debt, and the accompanying $400 million in annual interest payments.

The debt burden was the result of a leveraged buyout that saw Bain Capital and the Vornado Real Estate Trust take control in 2005. Based on cash flow estimates and projections of a growing market, they were confident that Toys R Us could comfortably support the $5.0 billion in debt. Unfortunately, they failed to anticipate the wrenching 2008 financial meltdown, the impact of online competition, and several billion dollars worth of game revenue shifting from retail sales to a subscription basis. It's conceivable that a less leveraged Toys R Us could have successfully navigated these market shifts. However, we now know that cash flow diverted to bond holders instead of operations put the company at a fatal disadvantage.

The Toys R Us story—bright forecasts, aggressive borrowing, unforeseen adversity, leading to calamity—has played out countless times in the music products industry, although on a smaller scale and far from the front pages. Of the 100 largest retailers we ranked in 1993, fewer than fifty are still in business today. Some were brought down by changing markets, like the drastic contraction of the home organ market. Others closed because owners retired. But a fair number were victims of too much leverage, either in the form of heavily financed inventory or excessive leasehold obligations. Initially, the debt may have led to higher revenues, but when a new competitor opened and siphoned off sales, or a municipal construction project blocked traffic to a location, or the largest employer in the area closed down, or any number of other strokes of "bad luck" arose, they faced a harsh binary choice: pay creditors or enter bankruptcy.

Million dollar lottery winners and the bold entrepreneurs who cash in on high-risk bets are the object of envy and copious media attention. But hoping to beat extreme odds doesn't make for a workable business model. Just ask the far more numerous lottery losers or the business owners who bet the proverbial ranch and then lost it. There is a thriving industry churning out books and seminars on the topic of the accelerating pace of change and how to successfully adapt to it. Yet for all the advice about how to direct, profit from, embrace, or learn to love disruptive change, insufficient attention is given to the importance of a solid balance sheet. As the Toys R Us saga illustrates, it's a lot easier to adapt when there is some equity in the business: Responding to a changing market while simultaneously keeping creditors at bay is next to impossible.

Just about every business we've chronicled over the years has faced the occasional brush with disaster due to an unforeseen event—an invalidated patent, a competitor with a superior product, a costly lawsuit, or even a natural disaster. Those that survived and went on to prosper were invariably those with a more restrained approach to leverage. A financial cushion provided the time needed to work through the problems.

Retail is currently undergoing seismic changes, technology is altering the way music is made and shared, and if headlines are to be believed, the world remains an uncertain place. How exactly these forces will play out is anyone's guess, and dealing with these unknowns is no easy task. But, a decent balance sheet definitely improves the ability to address them and adapt. Building this kind of financial resilience is a long-term undertaking that requires discipline, deferred gratification, and a healthy dose of self-sacrifice. Saving for the inevitable rainy day may not be as exciting as planning for growth, projecting profits, or crafting a great marketing strategy, but it dramatically improves your odds of surviving (and prospering) in an uncertain world.

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