DISTRESSED DEBT INVESTOR®

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BIG PICTURE...

Debt Decoupling: What Are the Implications?

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The rise of credit default swaps, other derivatives, and securitization has led to instances where bond ownership and the economic exposure to distress and default are effectively separated. How will this "debt decoupling" play out in workout situations and in bankruptcy court? We dissect a recent academic study and solicit perspective from a practitioner in the field. With distressed credit situations proliferating and expected to increase further, it is an opportune time to analyze the implications of debt decoupling.

The Hu-Black Study

In a recent academic report,[1] Professors Henry T.C. Hu and Bernard Black of the University of Texas Law School explore the phenomenon of decoupling of formal ownership and economic stakes for equity, debt, and hybrid securities. This report focuses on debt decoupling.

Hu and Black note that ownership of debt typically comes with a package of rights – economic rights, contractual control rights, and other legal rights. The legal system assumes these rights are bundled together, and that creditors want to keep solvent companies out of bankruptcy and to maximize the value of insolvent firms. With the advent of derivatives and securitization, these assumptions are no longer reliable.

Debt decoupling is more complex than equity decoupling, which typically involves either holding greater voting power than economic ownership, or greater economic ownership than voting power. Factors explaining this added complexity include:

- Frequent occurrences of multiple classes of debt, with different seniority and voting rights.
- A larger decoupling market for debt, in the sense that credit default swap (CDS) markets are a multiple of the underlying debt market compared with a fraction on the equity side.
- Substantially less disclosure for debt and debt derivatives compared with equity.

[1] Henry T.C. Hu and Bernard Black, *Debt, Equity, and Hybrid Decoupling: Governance and Systemic Risk Implications*, 14 EUR. FIN. MGMT. – (forthcoming 2008), also available at http://ssrn.com/abstract=1084075 (Draft as of Jan. 15, 2008)

Debt decoupling vehicles include credit default swaps,[2] total return swaps,[3] swaptions,[4] and credit spread options.[5] Other decoupling strategies include being long one class of a company's debt while short another, as well as repackaging of debt, for instance when a bank sells some or all of a loan on the secondary market.

Disclosure of CDS hedging positions is negligible

Credit default swaps can muddle the traditional relationship between creditor and debtor. A creditor who hedges a bond position with a credit default swap retains full contractual rights under the bond indenture, and full voting rights in bankruptcy. The CDS position may be greater than the cash bond position, in which case the creditor has negative economic ownership and incentive to act against the interests of the company or the interests of other same-class creditors. Disclosure of firms' CDS hedging positions is virtually nonexistent, so by extension, the prevalence of positive formal ownership with zero or negative economic ownership is unknown.

The authors note that partial hedging is said to be common in the realm of distressed debt, where specialized "vulture" investors often accumulate substantial stakes in a debt class likely to be pivotal in a restructuring. Distressed debt investors often hedge some of this risk, enabling them to limit their economic exposure while maintaining a large voting block.

Reform Indicated

Large-scale fallout from debt decoupling will create pressure for reform in both law and contracting practice. In Hu and Black's view, creditors in bankruptcy proceedings should disclose any significant "empty" voting positions, so that the court, other creditors, and shareholders know where a creditor's economic interest lies. Beyond disclosure, voting rights in a bankruptcy may need to be limited to creditors with a positive economic interest in a debt class, or based on net economic ownership of debt rather than gross ownership. Difficulties in creating workable voting rules lend support for proposals to have bankruptcy proceedings rely more on auctions than on negotiation, or where auctions are not feasible, more on judicial discretion and less on creditor voting.

Future covenants may address debt decoupling issues

Debt contracts and workout procedures will also need to adjust to debt decoupling. For instance, a creditor with negative economic ownership will profit from a loan-covenant violation that causes a technical default, so the creditor may not care about the company's success. As a response, Hu and Black foresee the possible emergence of covenants that limit contractual control rights for creditors who hold zero or negative economic interest.

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[2] A credit default swap is a derivative valued on the credit risk of a company or other underlying entity. Creditors can hedge their positions in a company's debt by purchasing credit default swaps, which pay off in the event of a default.
[3] Total return swaps, also known as loan swaps, are transfers of the entire return associated with a debt obligation.
[4] Swaptions are options to buy credit default or total return swaps.
[5] Credit spread options are swaps in which payoffs are linked to the spread between the yield on a particular bond and a reference yield.

Collateralized debt obligations (CDOs) are another source of decoupling investors' formal debt ownership with economic stakes in the investment. CDO trustees are "empty creditors" in that they have a reputational interest in seeing a favorable resolution to a workout, but no direct financial interest. CDO holders are often large in number and dispersed around the world, and some will be fully or partly hedged or have other interests in the underlying company's equity or debt. This suggests many investors will have little interest in participating in complex workout negotiations, or "rational apathy."

Debt decoupling holds potential to cause broad market dislocations

Beyond causing dislocations in debtor-specific negotiations, externalities from debt decoupling hold the potential to create broader, systemic financial risk, Hu and Black argue. For instance, if a loan is securitized, the dispersion of economic rights complicates renegotiation and increases the chance of default, and increased losses from loan defaults can contract lending overall. Also, debt decoupling tends to reduce the incentives for the initial lender to assess and monitor risks correctly.

Liquidity shocks can be heightened with debt decoupling. This is because with derivatives and securitization, the holder of risk associated with a distressed company may be unidentified, and market participants typically want to deal only with counterparties whose solvency is established. Also, the risk is often held by hedge funds and other investors less sensitive to publicity, regulatory risk, and maintaining relationships than are the big banks who traditionally were the large holders of a company's debt. Further, decoupling promotes refinancing rather than renegotiation, and the refinancing option may not exist when it is needed most.

In the authors' view, debt decoupling is comparatively new and as such the full benefits and costs remain unknown. The hedging and risk-spreading benefits may well exceed the costs imposed by debt decoupling. To ameliorate the risks of debt decoupling, Hu and Black suggest requiring disclosure of holdings such that investors can assess what risks a particular institution faces. Note that the Hu-Black study addresses both pre-default and post-default situations.

Practitioner View

Jon Kibbe of New York-based Richards Kibbe & Orbe LLP points out that conflicts between risk-spreading and decoupling of certain ownership interests are not new, and contends that the resolution of the concerns raised by decoupling through credit derivatives will likely be evolutionary. There have always been silent participations in the bank loan market. Lenders of record sell participations and borrowers know that merely looking at the owner of record does not necessarily determine who has an economic interest. What is new is that as the credit derivative market has grown and become more liquid, it has become increasingly common to see debt decoupling in other forms.

Prompt cash settlement may be best option, one practitioner argues

Some practitioners have argued that increased disclosure and transparency will help resolve decoupling issues. Kibbe, focusing on the post-default period, argues that a more practical mitigant in the case of credit derivatives is the prompt cash settlement following a credit event, rather than protracted physical settlement and exchange of bonds and loans. Loan credit default swaps (LCDS) – have cash settlement hard-wired into the standardized confirm for liquid credits, and the International Swaps and Derivatives Association (ISDA) is working hard to impose similar protocols on CDS for unsecured debt. Kibbe expects the trend of cash settlement to gain further momentum.

From a debtor's perspective, efficient communication with creditors, especially secured lenders, is extremely important in the early stages of a bankruptcy – to resolve Debtor-in-Possession (DIP) financing[6] and 363 sale[7] process issues, for example, and to otherwise drive the direction of the bankruptcy process. If a lender has purchased full credit default protection through LCDS and is completely hedged, it has little economic incentive to respond to, or cooperate with the debtor in efficiently restructuring and maximizing return, Kibbe noted. However, if there is cash settlement of the derivative through a trusted auction process, the lender will receive a prompt protection payment of par minus current value of the loan from its protection seller, the derivative will terminate, and the lender will still hold the loan. The lender then will have an ongoing incentive to cooperate with the debtor to maximize return on the loan, Kibbe explained.

Movie Gallery 2007 CDS auction provided framework for future cases

In Kibbe's opinion, the auction process can change behavior at least as effectively as increased disclosure. **Movie Gallery**, which was widely traded in the derivatives market and a component of the Liquid Credit Derivatives Index (LCDX), is an example of the LCDS market efficiently cash-settling derivative contracts through an auction.[8] Held just one month after a "failure to pay" credit event, and one week after the **Movie Gallery** bankruptcy filing, the auction returned a final price of 91.5% and protection buyers mostly kept their loans if they were long, and received an 8.5% protection payment.

The auction process does not resolve all decoupling issues, Kibbe said. The Bankruptcy Code voting and distribution rules make the assumption that creditors care in proportion to their holdings of record, and the derivatives market challenges this assumption.

There appears to be no clear legal recourse in the Bankruptcy Code for a creditor who wants a company to restructure outside bankruptcy versus another creditor who is fully hedged and does not have the same economic interests. People can argue about disclosure, but generally creditors who are not on ad hoc committees have no duty to disclose holdings to each other.

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[6] DIP financing is arranged by a company while in the Chapter 11 bankruptcy process. DIP financing typically has priority over existing debt, equity, and other claims.
[7] A 363 sale, named after Section 363 in the Bankruptcy Code, is an asset sale that often happens in the first few weeks or months of a bankruptcy case, rather than as part of a reorganization plan.
[8] "Auction Sets Price For Movie Gallery Loans," *Reuters* (October 23, 2007).

Default Rates and the Distress Ratio

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Research assistance provided by Kevin P. Covey

Sharp escalation in the percentage of high yield issuers quoted at distressed levels implies a significant upturn in the default rate over the coming 12 months. Our analysis incorporates new findings on default rates on non-distressed issuers. We examine several potential challenges to our historically based conclusions.

Background

After a longer-than-expected wait, distressed debt investors are currently enjoying a pickup in supply. In January 2008, **Buffets**, **Propex**, **Quebecor World**, and **TOUSA** all went bankrupt, followed by **Plastech** in early February. Furthermore, recent escalation in the distress ratio points to a substantial rise in the speculative grade default rate.

The distress ratio jumped from 1% in July to 17% in January

On June 30, 2007, just 1.2% of the issues in the Merrill Lynch High Yield Master II Index (Ticker: H0A0) had an option-adjusted spread (OAS)[1] greater than 1,000 basis points. That ratio rose sharply in 2007's second half, finishing the year at 10.42%. In January 2008, the distress ratio spiked to 17.1%.

Research soon to be published in the *Journal of Portfolio Management*[2] enables us to link this series to Moody's Investors Service's global speculative grade default rate, which measured 0.91% in the 12 months ending December 2007. Data limitations compel us to mix U.S. and global data, but this should not present a material problem, given the similarity of the two series and the inherent imprecision of all forecasting methods. Over the period 1997-2006, Moody's global and U.S. annual, issuer-based default rates were 4.65% and 4.85%, respectively.

Using an econometric model, the rating agency projects an escalation in the default rate to 4.81% in the 12 months ending January 2009. Furthermore, Moody's projects a 10% rate in calendar 2008 in the event of a U.S. recession during the year. The forecast's sensitivity to economic conditions underscores the point that Moody's default rate model, while eminently sound from a methodological standpoint,[3] can be only as accurate as the economic assumptions fed into it. In this context, the distress ratio's implied forecast provides a useful second opinion.

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[1] Option-adjusted spread (OAS) is a measure of a security's extra yield over the yield of a comparable Treasury security after accounting for any options (calls, puts, sinking funds).
[2] Martin Fridson, Kevin P. Covey, and Karen Sterling, "Performance of Distressed Bonds," *Journal of Portfolio Management* (Spring 2008), FORTHCOMING.
[3] See Albert Metz , *Introducing Moody's Credit Transition Model*, Moody's Investors Service, (August 2007).

We conducted the first-ever analysis of distressed default rates

Distressed issuers are 20 times as likely to default within one year as non-distressed speculative grade issuers

Analysis

We used issuers as our unit of account and the Master II Index as our speculative grade universe. Using the Master II's distressed subindex (inception date: December 31, 1996), we generated distressed counts for the beginning of alternating years from the earliest available observation date, 1997, through 2005. This interval constituted one complete high yield cycle; adding 2007, for example, would have meant including the minimum-default-rate segments of two cycles and could have biased the results downward. Selecting alternating years avoided a potential problem of overemphasizing the impact of issuers that remained distressed from one year to the next. (An issuer nevertheless could have appeared in the distressed sample in two different selected years.) If an issuer had one bond quoted at a distressed level and another at a non-distressed level, we classified it as distressed.

Exhibit 1 shows a mean one-year default rate on distressed issuers of 21.58%. For non-distressed, speculative grade issuers the comparable figure is 1.05%. (See **Exhibit 2**.) The mean default rate for all speculative grade issuers, distressed and non-distressed, is 5.48%. (See **Exhibit 3**.)

Exhibit 1: One-Year Default Rate for Distressed Issuers

Year	Number	Defaults	Default Rate
1997	26	6	23.08%
1999	91	30	32.97%
2001	298	78	26.17%
2003	317	43	13.56%
2005	51	12	23.53%
Total	**783**	**169**	**21.58*%**

* Mean of the five annual rates.

Sources: Edward I. Altman, Merrill Lynch & Co.

Exhibit 2: One-Year Default Rate for Non-Distressed Issuers

Year	Number	Defaults	Default Rate
1997	473	3	0.63%
1999	532	7	1.32%
2001	417	6	1.44%
2003	535	3	0.56%
2005	894	11	1.23%
Total	**2,851**	**30**	**1.05%***

* Mean of the five annual rates.

Sources: Edward I. Altman, Merrill Lynch & Co.

Differences between the Merrill Lynch and Moody's populations have minimal impact on the calculations

Exhibit 3: One-Year Default Rate – All U.S. High Yield Issuers

Year	Number	Defaults	Default Rate	Moody's Reported Rate
1997	499	9	1.80%	2.16%
1999	623	37	5.94%	5.81%
2001	715	84	11.75%	11.11%
2003	852	46	5.40%	5.41%
2005	945	23	2.43%	2.10%
Total	**3,634**	**199**	**5.48%***	**5.32%***

* Mean of the five annual rates.

Sources: Edward I. Altman, Merrill Lynch & Co., Moody's Investors Service.

Our universe, the Master II Index, differs from Moody's U.S. speculative grade universe by excluding loan-only issuers, convertible-only issuers, and issuers with only small amounts or bonds of less than one year to maturity outstanding. Nevertheless, our calculated mean default rate of 5.48% is close to the simple average of 5.32% for the Moody's series in the corresponding years. Furthermore, both rates are only fractionally different from Moody's 4.76% mean rate for the period 1983-2007. Based on these comparisons, we believe the distressed and non-distressed default rates of Exhibits 1 and 2 fairly represent long-run, historical experience.

Exhibit 4 provides two estimates of the expected default rate for the next 12 months. Applying the historical mean default rates to the present distressed/non-distressed mix produces a 4.55% projection. The median default rates generate a 5.02% predicted rate. Moody's non-recession predicted global rate of 4.81% falls almost exactly in-between these two figures. In short, our analysis indicates that the market currently expects a year-ahead default rate in line with Moody's non-recession projection.

A well-supported default rate estimate implies $33.5 billion of newly defaulted bonds in 2008

Based on the Master II index's present par value of $700.1 billion, a 4.81% default rate implies a dollar default volume of $33.7 billion over the next 12 months. This assumes the average defaulting company's par value outstanding is equivalent to the average of all companies in the index. The actual outcome is a matter of conjecture, though, as the dollar-amount default rate has been higher than the issuer rate in some years and lower in others. Note that the $33.7 billion estimate applies only to bonds and does not take into account defaulting loans and other claims of bankrupt companies, and nondefaulted distressed debt, all of which constitute supply for distressed investors.

Caveats

Our findings come with several caveats. A key one is that results for the next 12 months may not be in line with either the mean or median default rates shown in Exhibits 1 and 2. The distressed and non-distressed series are subject to variation, some portion of which appears to be random. Applying the lowest observed distressed default rate and the lowest observed non-distressed default rate to the present mix produces an estimated rate of only 2.78%. On the other hand, the highest observed rates produce a 6.83% estimate.

Exhibit 4: Expected Default Rate
12 Months Ending January 2009

	Distribution of High Yield Universe January 31, 2008 (%)		Annual Default Rate* (%)		Weighted Average (%)
			Mean		
Distressed	17.1	x	21.58	=	3.69
Non-Distressed	82.9	x	1.05	=	0.87
	100.0				4.56
			Median		
Distressed	17.1		23.53		4.02
Non-Distressed	82.9		1.23		1.02
	100.0				5.02

* Based on sample years 1997, 1999, 2001, 2003, 2005.

Sources: Merrill Lynch & Co.

It is conceivable that the permabulls are right in rejecting the historical analysis on the grounds that financial engineering (e.g., covenant-lite loans, toggle PIK[4] bonds) have made defaults less likely, all things being equal, than in the past. In this case, the true default rates implied by the distress ratio are lower than our analysis suggests. Note, however, that similar bullish theses were advanced in all previous cycles and for the most part were discredited by events.

Optimists offer a variety of hypotheses to reject the conclusion that the default rate will rise

Optimists may also argue that the combination of already instituted monetary easing and contemplated fiscal measures will not only avert a recession, but boost the U.S. economy and therefore depress default rates. Observe, however, that the year-to-year variance around the mean default rates in Exhibits 1 and 2 show no ironclad connection with economic conditions. For example, in the only recessionary year, 2001, the distressed default rate was almost 7 percentage points below 1999's peak rate. It is therefore possible to have, for example, average economic performance and an above-average default rate.

Finally, it is likely that some distressed issues would be below the 1,000-basis-point OAS threshold based on their probabilities of default and historically average recoveries, but are currently above the threshold because the market expects historically low recoveries in the present cycle. By implication, the number of defaults (along with the default rate) implied by the distress ratio is lower than our analysis suggests. As with the other conjectures about the future, only time will tell about this one. Investors should be cautious, however, about relying on a prediction that recoveries will be materially lower than in past cycles. Average recovery rates for the cycle (ignoring year-to-year changes) have been strikingly stable through many cycles, despite seemingly important changes along the way in financing practices and bankruptcy procedures.

[4] Payment-in-kind (PIK) bonds give the issuer the option to pay interest with newly issued bonds in lieu of cash. A toggle feature enables the issuer to elect either the cash of the PIK option on each scheduled coupon date.

A rise in the default rate looks inevitable

Conclusion

Moody's current 12-months-forward default rate projection, based on econometric modeling, is supported by a separate analysis tied to the distress ratio. While no forecasting methodology consistently achieves precision, we place a very high probability on a substantial increase in defaulted debt over the next 12 months. We do not believe the market is overreacting sharply enough, or that structural changes have been so profound, to justify dismissing out of hand the evidence of the escalating distress ratio.

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RECOMMENDATION…

BUY: Toys "R" Us 7.625% Notes Due 2011

By Gordian Group
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Exhibit 1: Toys "R" Us, Inc.

(Dollars in Millions)	As of 11/03/2007	Market Value Price	Market Value Value	YTW	Bond Rating S&P	Bond Rating Moody's	Recommendation
Structurally Senior Secured Debt							
Domestic Revolving Credit Facility	$489.0	100.00	$489.0				
Multicurrency Revolving Credit Facility	28.0	100.00	28.0				
Term Loan	797.0	100.00	797.0				
Toys Japan [1]	404.0	100.00	404.0				
Foreign Real Estate Facilities	1,159.0	100.00	1,159.0				
Domestic Real Estate Facility	800.0	100.00	800.0				
Capital Leases and Other [2]	60.0	100.00	60.0				
Total Structurally Senior Secured Debt	$3,737.0		$3,737.0				
Less Unrestricted Cash and Cash Equivalents	240.0		240.0				
Net Structurally Senior Secured Debt	$3,497.0		$3,497.0				
Structurally Senior Unsecured Debt							
Credit Agreement due 2008	$1,300.0	100.00	$1,300.0				
Credit Facility due 2012	180.0	100.00	180.0				
8.750% Debentures due 2021 [3]	22.0	78.00	17.2	12.1%	CCC+	B3	NR
Total Structurally Senior Unsecured Debt	$1,502.0		$1,497.2				
Toys Unsecured Debt							
7.625% Notes due 2011	$500.0	77.50	$387.5	16.4%	CCC+	Caa1	Buy
7.875% Notes due 2013	400.0	73.00	292.0	15.7%	CCC+	Caa1	NR
7.375% Notes due 2018	400.0	68.00	272.0	13.0%	CCC+	Caa1	NR
Total Toys Unsecured Debt	$1,300.0		$951.5				
Net Debt	$6,299.0		$5,945.7				

[1] Reflects consolidation of the Company's 48% interest in Toys "R" Us Japan, Ltd. ("Toys Japan"), and also includes $161 million in aggregate principal amount of unspecified obligations assumed to be secured.
[2] Includes $19 million in aggregate principal amount of Notes due through February 20, 2008, which is assumed to be secured.
[3] Issued by the Company and its subsidiary, Toys "R" Us-Delaware, Inc.

Sources: Bloomberg, Public Filings.

Investment Summary: Buy the 7.625% Notes due 2011
Current Price: 77.50

Same-store sales gains and improved profitability underpin our long recommendation on the 7.625% Notes

We recommend that investors buy the 7.625% Notes due 2011 issued by Toys "R" Us, Inc. ("Toys" or the "Company"). Through its subsidiaries, Toys is the largest domestic specialty retailer of toys and the only national specialty retailer of baby-juvenile products in the United States. Since the Company was acquired by private equity firms in July 2005 (the "Acquisition"), Toys has executed an impressive turnaround in sales and profitability. Same stores sales for domestic Toys "R" Us stores ("Domestic Toys") have turned positive after five years of decline, while international Toys "R" Us stores ("International Toys") and the Babies "R" Us chain ("Babies") have generally experienced favorable comparable store trends. Store count has increased and mix improved; gross margin has also expanded. As a result, there has been positive progress in Toys profitability since the Acquisition, supporting the Company's improving credit profile.

Risks in this situation include potential weakness in domestic consumer spending and structural subordination of the public bonds. In our view, however, such risks are outweighed by the Company's operating momentum and market position.

Important disclosures and certifications are located on the last page of this document.

BUY: Toys "R" Us 7.625% Notes Due 2011

Value Cover Conclusions

We developed two forms of income capitalization analysis, to reflect different treatments of the Company's 48% interest in Toys Japan. One form mirrors the Company's financial statements, which consolidates Toys Japan. The other approach deconsolidates Toys Japan and adds back the implied public trading value of this investment (without adjustment for a control premium). Using the consolidated form of the analysis, we estimate value cover for the public bonds at 85% to 178%, while the deconsolidated analysis (which arguably allocates too much operating value to Toys Japan) estimates value cover at 70% to 152%.

Our analysis indicates that the Toys public bonds are "money good" if recent performance trends continue

Based on the foregoing analyses, the Toys public bonds are projected to come out whole in any scenario which contemplates a perpetual growth rate of 2% or greater. We believe a "floor" perpetual growth rate of 2% is reasonable given recent trends in same-store sales, store count and mix, gross margin, and EBITDA, as well as Toys's impressive showing in the holiday shopping season. Furthermore, the implied enterprise values for Toys reflect a 6.4x to 7.7x multiple of LTM EBITDA. Although there are no particularly great pure-play comparables, Wal-Mart Stores, Inc. and Target Corporation trade around 8.5x LTM EBITDA – a meaningful premium to the high end of our valuation range.

Return Analysis

We assumed (i) a twelve-month holding period, (ii) a purchase price of 78, and (iii) a range of selling prices that assume a 200 basis point to 400 basis point tightening of credit spreads for this instrument. Levered returns for the proposed position range from 34.1% to 44.3%. Unlevered returns range from 20.0% to 25.2% under these exit price and holding period assumptions.

Highlights

Domestic Toys posted same store-sales growth of 3.1% for the holiday shopping season

- *Same-Store Sales Gains:* Toys has posted relatively strong same-store sales since the Acquisition. After five years of same-store sales declines, Domestic Toys generated same-store sales growth of 0.6% in 2006, 1.2% through the first nine months of 2007, and 3.1% in the recent nine-week holiday selling season. International Toys reported same-store sales growth between 2.6% and 3.8% since the Acquisition, before posting a more modest 0.9% gain in the recent holiday season. After strong same-store sales gains in 2005 and 2006, Babies reported a 2.1% gain increase in the first nine months of 2007 and a 0.9% gain in the holiday season.
- *Turnaround Story:* Sales have grown at a compound annual growth rate of 7.6% since 2004, due to same-store sales gains, increased store count, improved store mix, and the consolidation of Toys Japan. Gross margin has expanded from 32.48% in fiscal 2005 to 34.27% in the most recent LTM period, due to increased initial markups and reduced promotional activity. EBITDA has increased from $648 million in 2004 to $971 million in the November 2007 LTM period. We estimate the consolidation of Toys Japan accounts for roughly two-thirds of revenue gains but less than one-third of the increase in EBITDA.

BUY: Toys “R” Us 7.625% Notes Due 2011

Toys has relatively strong credit metrics and significant financial flexibility

- *Favorable Credit Profile:* Coverage and cash generation metrics are relatively strong, allowing Toys to reduce net debt significantly from 2006 to 2007. The Company also possesses substantial financial flexibility in terms of liquidity reserves and contractual advantages. We note that Toys entered the fourth quarter with $2,000 million in cash and unused availability under its two major revolving credit facilities. In addition, the Company’s significant credit agreements contain relatively benign covenant packages. Furthermore, Toys has the contractual right to extend approximately $2,100 million in obligations scheduled to mature through 2008 for up to two years.
- *Potential for Deleveraging Event:* Toys’ relatively strong same-store sales performance, particularly in the Domestic Toys segment, underscores the magnitude of the Company’s turnaround since the Acquisition. With that backdrop, we expect Toys to explore a stock offering by the end of 2008, if financial market conditions allow.

Risks

- *Somewhat Disappointing Third Quarter:* The Company reported reduced operating profits despite increased sales and gross margin, due to higher selling, general, and administrative costs. Consolidated sales grew by 10%, due in large part to a calendar shift which accounted from approximately one-third of the year-over-year revenue increase. Although International Toys and Babies posted same-store sales gains, Domestic Toys experienced a 2.2% decline in same-store sales. Gross profit increased by 13%, but a 15% increase in selling, general, and administrative expenses led to a $6 million, or 10%, decline in quarterly EBITDA.
- *Difficult Retail Market:* The 2007 holiday shopping season in the United States was arguably the worst since 2002. Although Toys was one of the retail sector’s “winners” given its same-store sales performance, weakening consumer spending could become a drag on performance in upcoming quarters, and also limit the Company’s ability to pursue a stock issuance.

Company Description

The Company is the largest specialty retailer of toys in the United States and Puerto Rico

The Company, through its subsidiaries, is the largest specialty retailer of toys in the United States and Puerto Rico, and the only national specialty retailer of baby-juvenile products in the United States. Toys offers branded products from “Mattel, Inc.,” “Fisher Price,” “Lego,” and “Cranium” among other well-known brands. Toys also sells products under private label brands such as “Animal Alley,” “Fast Lane,” “Imaginarium,” “Dream Dazzlers,” and “You & Me.” As of November 3, 2007, the Company operated 1,553 branded retail stores across the world.

BUY: Toys "R" Us 7.625% Notes Due 2011

Toys operates in three segments: Domestic Toys (44% of LTM revenue), International Toys (38%), and Babies (18%)

The Company's operations are classified into three segments, reflecting the domestic Toys "R" Us stores ("Domestic Toys"), international Toys "R" Us stores ("International Toys"), and Babies "R" Us chain ("Babies"). The Domestic Toys segment, which represents approximately 44% of LTM revenue, operates 587 stores across 49 states and Puerto Rico. This segment sells toys, plush items, games, bicycles, sporting goods, movies, video games, software and electronics, outdoor play equipment, books, educational and development products, clothing, infant and juvenile furniture and gear, and educational and entertainment computer software for children. These stores typically range in size from 30,000 to 45,000 square feet and carry between 8,000 to 10,000 items year-round.

International Toys (38% of LTM revenue) operates, licenses, and franchises 709 toy stores in 35 countries outside the United States. Stores are located in Australia, Austria, Canada, France, Germany, Japan, Portugal, Spain, Switzerland, and the United Kingdom, among other countries. These stores typically range in size from 30,000 to 45,000 square feet of space and carry approximately 7,500 to 9,500 products year-round.

The Babies segment (18% of LTM revenue) consists of 257 specialty stores in 41 states. Babies stores offer products for newborns and children up to four years of age, including furniture (such as cribs, dressers, changing tables, bedding, and accessories), baby gear (such as play yards, booster seats, high chairs, strollers, and car seats), toddler and infant toys, gifts, apparel, and consumables (such as diapers, formula, and feeding products). Stores typically average 37,000 square feet and offer over 24,000 items.

The Company was acquired in a leveraged transaction for $6.6 billion in July 2005

The Company was formed in 1948 by Charles Lazarus and began operations as a baby furniture store, "Children's Bargain Town." Ten years later, the Company adopted "Toys "R" Us" as its name. Toys operated as a public company from 1978 until July 2005, when the Company was acquired by an investment group consisting of affiliates of Bain Capital Partners LLC, Kohlberg Kravis, Roberts & Co., and Vornado Realty Trust for $6.6 billion (the "Acquisition").

Description of Publicly Traded Bonds

The Company issued $1.3 billion in aggregate principal amount of pari passu notes across three series. These three issues are each unsecured obligations of the Company, without subsidiary guaranties. As a result, these bond issues are structurally subordinated to more than $5.2 billion in secured and unsecured subsidiary debt.

7.625% Notes due 2011: In July 2001, the Company issued $500 million in aggregate principal amount of 7.625% Notes due August 1, 2011. Interest is paid semi-annually on February 1 and August 1 of each year until maturity in August 2011. The 7.625% Notes are currently trading at 77.5, representing a yield-to-worst of 16.4%.

RECOMMENDATION…

BUY: Toys "R" Us 7.625% Notes Due 2011

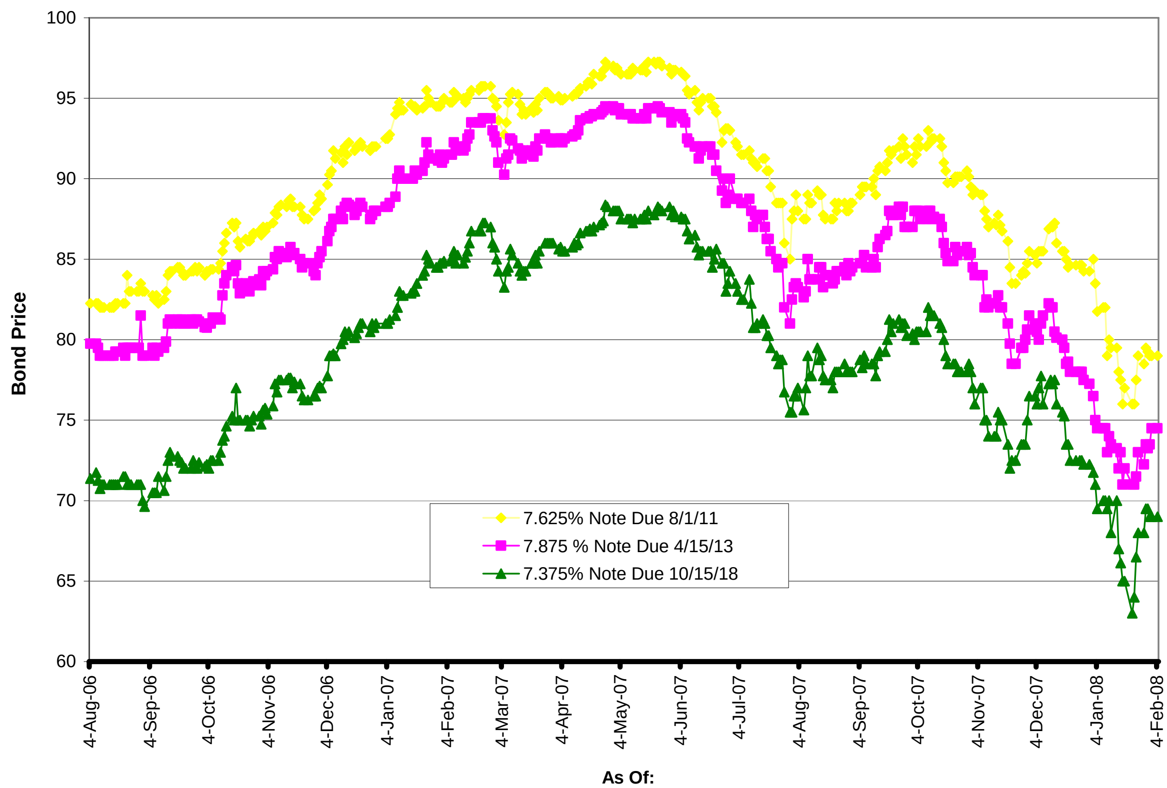
Toys has $1.3 billion in notes trading at distressed and near-distressed yields

7.875% Notes due 2013: In April 2003, the Company issued $400 million in aggregate principal amount of 7.875% Notes due April 15, 2013. Interest is paid semi-annually on April 15 and October 15 of each year until maturity in April 2013. The 7.875% Subordinated Notes are currently trading at 73, representing a yield-to-worst of 15.7%.

7.375% Notes due 2018: In September 2003, the Company issued $400 million in aggregate principal amount of 7.375% Notes due October 15, 2018. Interest is paid semi-annually on April 15 and October 15 of each year until maturity in October 2018. The 7.375% Subordinated Notes are currently trading at 68, representing a yield-to-worst of 13.0%.

Please see, **Exhibit 2**, below for price history of Company's public debt instruments.

Exhibit 2: Price History for Public Bonds



Source: Factset Data Systems.

Toys bonds have recovered somewhat in the two weeks since the emergency rate cut and fiscal stimulus plan were announced

Despite relatively favorable operating performance, credit spreads have widened significantly for the Company's publicly traded bonds. Toys bonds rebounded after the high yield market downturns that occurred in late February/early March, late July/early August, and again in late October/early November. The public debt then went into freefall from mid-December through the third week of January, despite the release of relatively strong performance in the holiday shopping season. Only the combination of the 75 basis point rate cut and the proposed $150 billion fiscal stimulus plan ended that selloff; Toys public debt has rallied sharply since then.

BUY: Toys "R" Us 7.625% Notes Due 2011

Industry Overview: Toys a Winner in Difficult Holiday Season

Domestic Toys was one of the retail sector "winners" in a difficult holiday shopping season

Industry Dynamics: Retail toy sales have generally stagnated in recent years, due in part to price competition from mass merchandisers and changes in product mix. Mass merchandisers and discounters (such as Wal-Mart, Target, and Kmart) account for more than 50% of domestic toy sales, versus approximately 20% for Toys. In addition, "traditional" toys represent just two-thirds of domestic toy sales, as video games account for roughly one-third of total sales. As a result, consumer electronics firms such as Best Buy, Circuit City, and GameStop now compete with the Company. Other competitors include national and regional chains like KB Toys and local retailers.

In contrast, the retail baby-juvenile market in the United States is large and growing. Recent increases in domestic fertility rates should also support continued market expansion. In this segment, the Company competes with mass merchandisers, national and regional chains, department stores, discount stores, supermarkets, warehouse clubs, drug stores, and local retailers.

Economic Factors: Sales of toys and baby-juvenile products depend upon discretionary consumer spending, although the degree of sensitivity is open to debate. For example, we believe that toy purchases are more insulated from business cycle effects than luxury goods or adult fashion, on the assumption that parents constrain their own purchases rather than "deprive" their children. Regardless, weak economic conditions should reduce toy spending budgets.

Toy retailing is highly seasonal with sales and earnings highest in the fourth quarter. As has been well reported, the 2007 holiday shopping season in the United States was arguably the worst since 2002. Although Toys was one of the retail sector's "winners" given its same-store sales performance, weakening consumer spending could become a drag on performance in upcoming quarters, and also limit the Company's ability to pursue a stock issuance.

Operating Performance: Looking Like a Shiny New Toy

Summary: Operating performance has generally improved since the Acquisition. Aggregate revenue has increased by 7.6% per annum due to improved comparable store sales and net store openings, as well as the consolidation of Toys Japan in 2006. Gross margin has also improved significantly. As a result, EBITDA has increased at a 15.8% compound annual rate since fiscal 2004.

Comparable Store Sales: Toys has posted relatively strong same-store sales since the Acquisition. After five years of same-store sales declines, Domestic Toys generated same-store sales growth of 0.6% in 2006, 1.2% through the first nine months of 2007, and 3.1% in the recent nine-week holiday selling season. International Toys reported same-store sales growth between 2.6% and 3.8% since the Acquisition, before posting a more modest 0.9% gain in the recent holiday season. After strong same-store sales gains in 2005 and 2006, Babies reported a 2.1% gain in the first nine months of 2007 and a 0.9% gain in the holiday season. See **Exhibit 3**, below.

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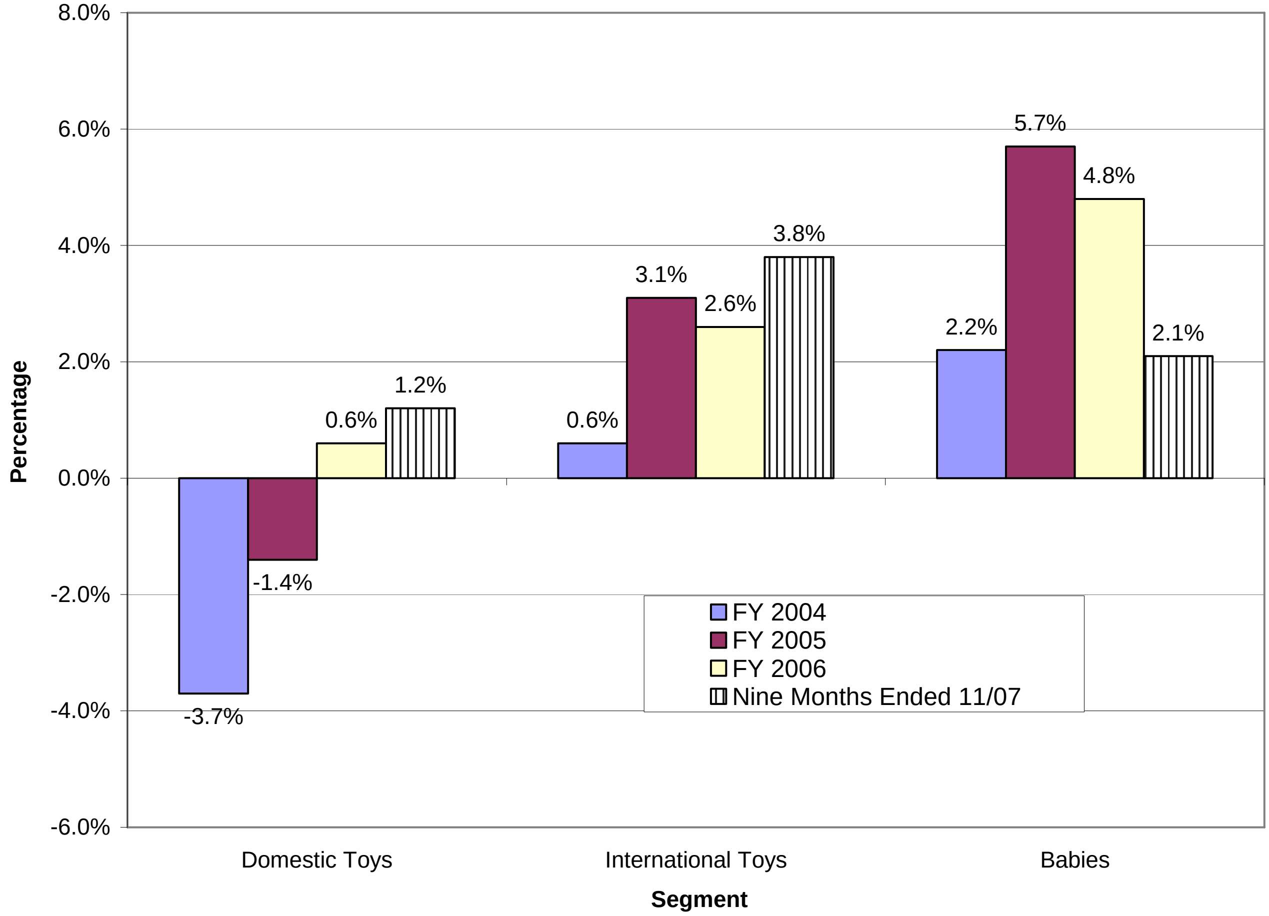
Exhibit 3: Comparable Store Sales by Segment

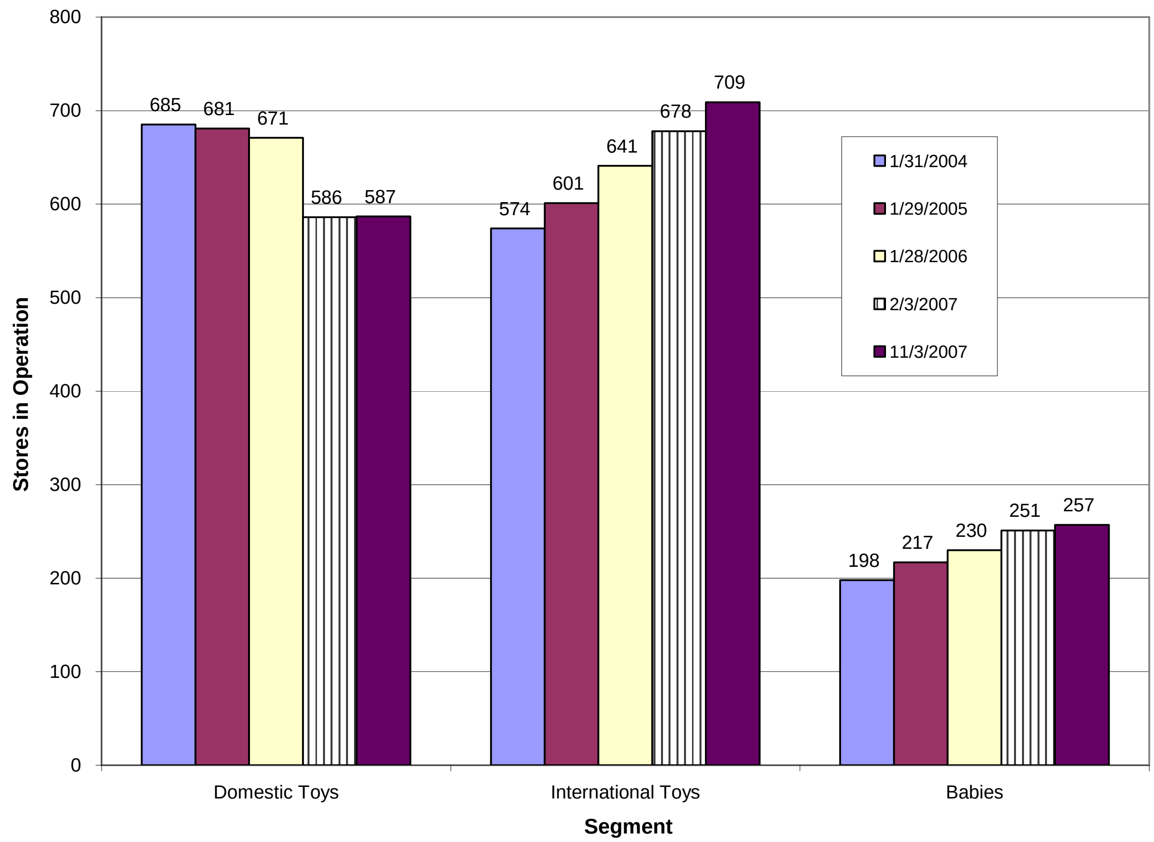


Source: Public Filings.

Same stores sales trends have turned around for Domestic Toys and remained strong for International Toys, while Babies has come back to earth

The Company has added 96 net new stores since the beginning of 2004, although the mix of stores between segments has changed significantly. As noted above, Domestic Toys store operations have contracted by 98 stores since the beginning of 2004. In contrast, International Toys added 135 net new stores during this time frame, including 169 store additions due to the consolidation of Toys Japan. The Babies store network increased by 59 stores, representing a relatively robust 30% gain in store count from the beginning of 2004. See **Exhibit 4**, below.

Exhibit 4: Stores in Operation by Segment



Source: Public Filings.

EBITDA has increased from $648 million in 2004 to $971 million in the November 2007 LTM period

Revenue and Profitability: As a result of same-store sales gains, increased store count, improved store mix, and the consolidation of Toys Japan, Toys has posted substantial gains in revenue and operating profitability. Sales have grown from $11,155 million in fiscal 2004 to $13,646 million the last-twelve-months ("LTM") period ended November 2007, representing a compound annual growth rate of 7.6%. We attribute approximately two-thirds of these gains to the consolidation of Toys Japan. Gross margin has expanded from 32.48% in fiscal 2005 to 34.27% in the most recent LTM period, due to increased initial markups and reduced promotional activity. EBITDA has increased from $648 million in 2004 to $971 million in the November 2007 LTM period, reflecting a compound annual growth rate of 15.8%. We estimate the consolidation of Toys Japan accounts for roughly two-thirds of revenue gains but less than one-third of the increase in EBITDA (and this assumption in respect of EBITDA may be overly generous to Toys Japan). See **Exhibit 5**.

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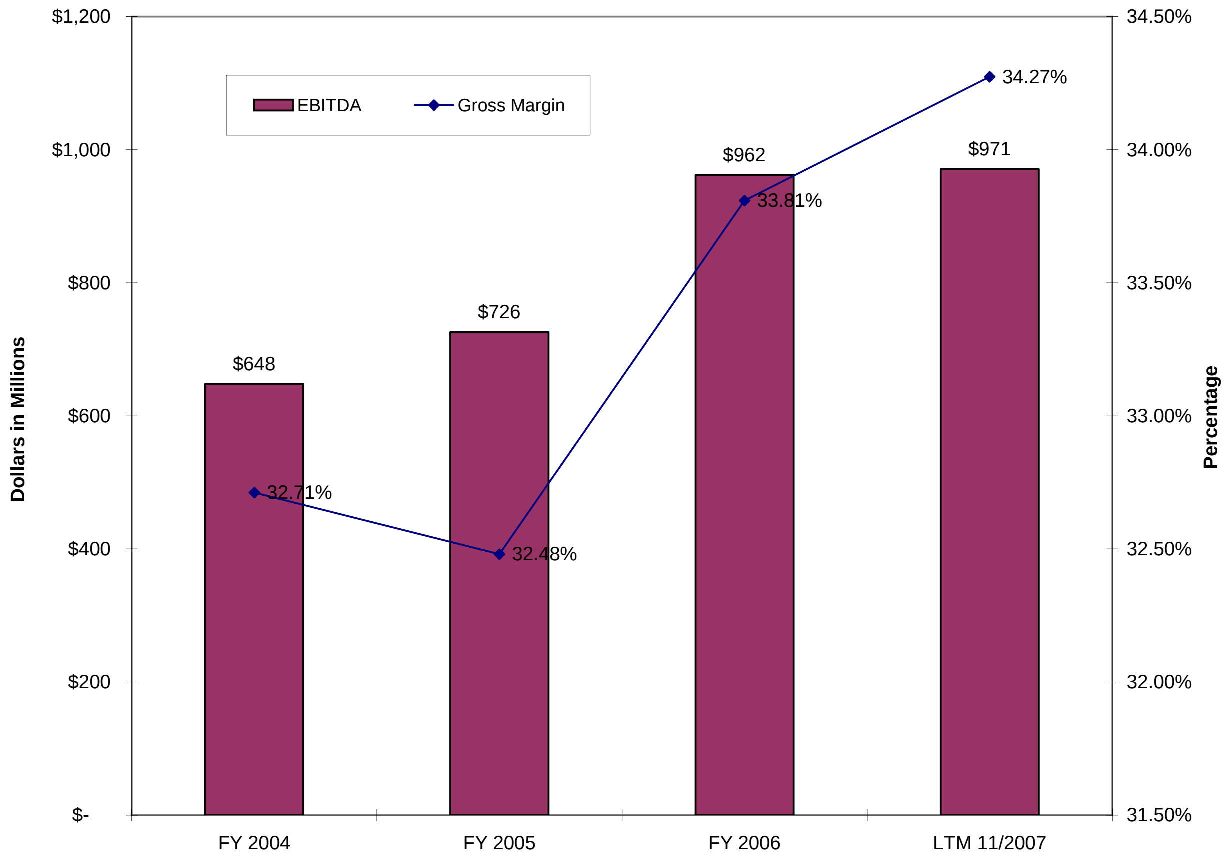
Exhibit 5: Gross Margin and EBITDA



Source: Public Filings.

Third-Quarter Performance: A Little Disappointing

Toys reported a 10% decline in third quarter EBITDA, as increased sales and gross margin were offset by higher SGA expense

Summary: The Company reported reduced operating profits despite increased sales and gross margin, due to higher selling, general, and administrative costs. Consolidated sales grew by 10%, due in large part to a calendar shift which accounted from approximately one-third of the year-over-year revenue increase. Although International Toys and Babies posted same-store sales gains, Domestic Toys experienced a 2.2% decline in same-store sales. Gross profit increased by 13%, but a 15% increase in selling, general, and administrative expenses led to a $6 million, or 10%, decline in quarterly EBITDA, from $59 million to $53 million. See **Exhibit 6**.

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Exhibit 6: Historical Operating Performance

Dollars in Millions	For the Year Ended: 01/28/06	02/03/07	Growth	For the Quarter Ended: 04/29/06	05/05/07	Growth	07/29/06	08/04/07	Growth	10/28/06	11/03/07	Growth	LTM 11/03/07
Net Sales	$11,333	$13,050	15%	$2,405	$2,581	7%	$2,432	$2,605	7%	$2,534	$2,781	10%	$13,646
Total Cost of Sales	7,652	8,638	13%	1,556	1,671	7%	1,584	1,669	5%	1,673	1,804	8%	8,969
Gross Profit	$3,681	$4,412	20%	$849	$910	7%	$848	$936	10%	$861	$977	13%	$4,677
Selling, General and Administrative Expenses	$2,955	$3,450	17%	$740	$792	7%	$738	$820	11%	$802	$924	15%	$3,706
Depreciation and Amortization	400	409	2%	114	96	-16%	99	101	2%	92	94	2%	395
Net (Gains) Losses on Sales of Properties	3	(110)	NM%	0	(3)	NM%	0	(12)	NM%	(109)	(18)	-83%	(34)
Restructuring and Other Charges	33	14	-58%	5	2	-60%	0	(1)	NM%	(1)	3	NM%	14
Contract Settlement Fees and Other	22	0	-100%	0	0	0%	0	0	0%	0	0	0%	0
Transaction and Related Costs	410	0	-100%	0	0	0%	0	0	0%	0	0	0%	0
Total Expenses	$3,823	$3,763	-2%	$859	$887	3%	$837	$908	8%	$784	$1,003	28%	4081
Operating Profit (Loss)	($142)	$649	NM%	($10)	$23	NM%	$11	$28	155%	$77	($26)	NM%	$596
Adjustments to Operating Profit													
Add: Net (Gains) Losses on Sales of Properties	$3	($110)	NM%	$0	($3)	NM%	$0	($12)	NM%	($109)	($18)	-83%	($34)
Add: Restructuring and Other Charges	33	14	-58%	5	2	-60%	0	(1)	NM%	(1)	3	NM%	14
Add: Contract Settlement Fees and Other	22	0	-100%	0	0	0%	0	0	0%	0	0	0%	0
Add: Transaction and Related Costs	410	0	-100%	0	0	0%	0	0	0%	0	0	0%	0
EBIT	$326	$553	70%	($5)	$22	NM%	$11	$15	36%	($33)	($41)	24%	$576
Plus Depreciation and Amortization	400	409	2%	114	96	-16%	99	101	2%	92	94	2%	395
EBITDA	$726	$962	33%	$109	$118	8%	$110	$116	5%	$59	$53	-10%	$971
Less Capital Spending	285	285	0%	31	31	0%	59	69	17%	80	118	48%	333
EBITDA less Capital Spending	$441	$677	54%	$78	$87	12%	$51	$47	-8%	($21)	($65)	NM%	$638
Number of Stores													
Toys "R" Us - U.S.	671	586	-13%	587	586	0%	587	585	0%	587	587	0%	587
Toys "R" Us - International	641	678	6%	647	685	6%	649	693	7%	662	709	7%	709
Babies "R" Us	230	251	9%	232	254	9%	234	255	9%	245	257	5%	257
Total Store Count	1,542	1,515	-2%	1,466	1,525	4%	1,470	1,533	4%	1,494	1,553	4%	1,553
Comparable Store Sales			**Difference in Basis Points**			**Difference in Basis Points**			**Difference in Basis Points**			**Difference in Basis Points**	
Toys "R" Us - U.S.	-1.4%	0.6%	200	-6.9%	5.1%	1200	-0.2%	1.1%	130	0.4%	-2.2%	(260)	NA
Toys "R" Us - International	3.1%	2.6%	(50)	3.9%	3.9%	0	-0.4%	5.9%	630	5.3%	2.0%	(330)	NA
Babies "R" Us	5.7%	4.8%	(90)	4.7%	2.8%	(190)	5.8%	2.2%	(360)	6.2%	1.2%	(500)	NA
Margins													
Gross Margin	32.48%	33.81%	133	35.30%	35.26%	(4)	34.87%	35.93%	106	33.98%	35.13%	115	34.27%
SGA / Sales	26.07%	26.44%	36	30.77%	30.69%	(8)	30.35%	31.48%	113	31.65%	33.23%	158	27.16%
EBIT Margin	2.88%	4.24%	136	-0.21%	0.85%	106	0.45%	0.58%	12	-1.30%	-1.47%	(17)	4.22%
EBITDA Margin	6.41%	7.37%	97	4.53%	4.57%	4	4.52%	4.45%	(7)	2.33%	1.91%	(42)	7.12%
EBITDA less Capital Spending Margin	3.89%	5.19%	130	3.24%	3.37%	13	2.10%	1.80%	(29)	-0.83%	-2.34%	(151)	4.68%

Source: Public Filings.

Toys reported a 9.7% gain in revenue, due to same-store sales gains in two divisions, store openings, and a favorable calendar shift

Third-Quarter Review: The Company reported total third-quarter revenues of $2,781 million, representing an increase of $247 million, or 9.7%, from the prior-year period. Sales gains were largely driven by the International Toys and Babies segments, which posted same-store sales gains of 2.0% and 1.2%, respectively. In addition, store count increased by 59 sites, consisting of 47 net new stores in International Toys and 12 net new stores in Babies. A one week shift in the Company’s calendar accounted for roughly $80 million, or one-third, of the revenue gain.

Please see **Exhibit 7**, below, for summary segment performance information. Domestic Toys revenues increased by $54 million, or 5.5%, to $1,040 million, versus $986 million reported in the prior-year period. The Company largely attributes this gain to the calendar shift, which accounted for $53 million in sales, and greater internet sales. Such gains offset a comparable-store sales decline of 2.2%, due to weak performance in the learning, core toys, juvenile, and seasonal categories.

BUY: Toys "R" Us 7.625% Notes Due 2011

International Toys reported third-quarter revenues of $1,107 million, representing an increase of $159 million, or 16.8%. The calendar shift accounted for $25 million, or roughly 16%, of the year-over-year revenue gain. Translation effects accounted for approximately $71 million, or 45% of the revenue gain, with sales from new stores and same-store sales gains contributing approximately $63 million of the year-over-year increase in revenue. Comparable-store sales increased by 2.0%, due to strong demand for Nintendo Wii and Sony Playstation 3, increased sales of consumables, bedding, and furniture in the infant category, and higher sales of licensed action figures.

Revenue for the Babies segment increased by $34 million, or 5.7%, to $634 million, versus $600 million in the third quarter of 2006. Newly opened stores and a 1.2% gain in same-store sales accounted for the lion's share of the revenue gain, as the calendar shift contributed just $2 million of the change in sales. Comparable store sales increased due to strong demand for diapers and wipes, featured space for baby food and new products in the commodities category.

Gross margin increased by 115 basis points to 35.13%, with gains in all three segments

Cost of sales increased by $131 million, or 7.8%, from $1,673 million in the third quarter of 2006 to $1,804 million in the corresponding period in 2007. As a result, gross profit improved by $116 million, or 13.5%, to $977 million, versus $861 million in the prior-year period. The increase in gross profit can be attributed to improvements in initial markup across all divisions, partially offset by increased markdowns at Domestic Toys and Babies. Consolidated gross margin increased by 115 basis points to 35.13%. Segment gross margin increased by 196 basis points for International Toys, 88 basis points for Babies, and 37 basis points for Domestic Toys.

Selling, general, and administrative ("SGA") expenses increased by $122 million, or 15.2%, to $924 million. Higher overhead costs were driven by increased store-occupancy and payroll-related expenses, as well as greater corporate-related and advertising expense. SGA expenses as a percentage of total revenues were 33.23%, representing a 158 basis point increase from the prior-year period.

The Company posted an operating loss of $26 million, versus operating income of $77 million in the prior-year period, representing a decrease of $103 million. Increased segment operating income for International Toys and Babies was nearly offset by an increased operating loss for Domestic Toys. The operating income (loss), as usual, contains various non-recurring costs such as restructuring charges as well as a substantial gain on sale in the third quarter of 2006. Adjusting for these charges, third-quarter EBIT was $(41) million, compared with $(33) million in the prior-year period, representing a decrease of $8.0 million. EBIT margin decreased 17 basis points to (1.47)%, from (1.30)% in the prior-year period.

Third-quarter EBITDA was $53 million, versus $59 million in the prior year period, representing a $6 million decline. EBITDA margin fell 42 basis points to 1.91% versus 2.33% in the third quarter of 2006.

EBITDA less capital spending was $(65) million, compared with $(21) million in the corresponding period in 2006, representing a decrease of $44 million, largely as a result of significant increases in capital spending. EBITDA less capital spending margin was (2.34)% for the third quarter of 2007 versus (0.83)% in the prior-year period, representing a 151-basis-point decline.

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BUY: Toys “R” Us 7.625% Notes Due 2011

Exhibit 7: Segment Operating Performance

	For the Year Ended:			For the Quarter Ended:									LTM
Dollars in Millions	**01/28/06**	**02/03/07**	**Growth**	**04/29/06**	**05/05/07**	**Growth**	**07/29/06**	**08/04/07**	**Growth**	**10/28/06**	**11/03/07**	**Growth**	**11/03/07**
Sales													
Toys "R" Us - U.S.	$6,431	$5,894	-8%	$1,015	$1,024	1%	$980	$994	1%	$986	$1,040	5%	$5,971
Toys "R" Us - International	2,815	4,780	70%	793	908	15%	890	998	12%	948	1,107	17%	5,162
Babies "R" Us	2,087	2,376	14%	597	649	9%	562	613	9%	600	634	6%	2,513
Total	$11,333	$13,050	15%	$2,405	$2,581	7%	$2,432	$2,605	7%	$2,534	$2,781	10%	$13,646
Segment Gross Profit													
Toys "R" Us - U.S.	$1,833	$1,829	0%	$343	$340	-1%	$320	$335	5%	$294	$314	7%	$1,861
Toys "R" Us - International	1,048	1,645	57%	276	314	14%	318	365	15%	330	407	23%	1,807
Babies "R" Us	800	938	17%	230	256	11%	210	236	12%	237	256	8%	1,009
Total	$3,681	$4,412	20%	$849	$910	7%	$848	$936	10%	$861	$977	13%	$4,677
Segment Operating Earnings (Loss)													
Toys "R" Us - U.S.	($4)	$254	NM%	($13)	$9	NM%	$3	($4)	NM%	($54)	($95)	76%	$228
Toys "R" Us - International	193	233	21%	(23)	(23)	0%	11	17	55%	(6)	37	NM%	282
Babies "R" Us	226	340	50%	91	104	14%	65	78	20%	87	93	7%	372
Corporate [1]	(557)	(178)	-68%	(65)	(67)	3%	(68)	(63)	-7%	50	(61)	NM%	(286)
Total	($142)	$649	NM%	($10)	$23	NM%	$11	$28	155%	$77	($26)	NM%	$596
Margins			**Difference in Basis Points**			**Difference in Basis Points**			**Difference in Basis Points**			**Difference in Basis Points**	
Segment Gross Profit Margin													
Toys "R" Us - U.S.	28.50%	31.03%	253	33.79%	33.20%	(59)	32.65%	33.70%	105	29.82%	30.19%	37	31.17%
Toys "R" Us - International	37.23%	34.41%	(281)	34.80%	34.58%	(22)	35.73%	36.57%	84	34.81%	36.77%	196	35.01%
Babies "R" Us	38.33%	39.48%	115	38.53%	39.45%	92	37.37%	38.50%	113	39.50%	40.38%	88	40.15%
Total	32.48%	33.81%	133	35.30%	35.26%	(4)	34.87%	35.93%	106	33.98%	35.13%	115	34.27%
Segment Operating Profit Margin													
Toys "R" Us - U.S.	-0.06%	4.31%	437	-1.28%	0.88%	216	0.31%	-0.40%	(71)	-5.48%	-9.13%	(366)	3.82%
Toys "R" Us - International	6.86%	4.87%	(198)	-2.90%	-2.53%	37	1.24%	1.70%	47	-0.63%	3.34%	398	5.46%
Babies "R" Us	10.83%	14.31%	348	15.24%	16.02%	78	11.57%	12.72%	116	14.50%	14.67%	17	14.80%
Corporate [1]	NM%	NM%	NM	NM%	NM%	NM	NM%	NM%	NM	NM%	NM%	NM	NM%
	-1.25%	4.97%	623	-0.42%	0.89%	131	0.45%	1.07%	62	3.04%	-0.93%	(397)	4.37%

[1] Corporate line item also includes certain non-recurring charges identified in consolidated analysis.

Source: Public Filings.

Prospects: No Coal in this Stocking

Toys should post year-over-year gains in sales and EBITDA in the fourth quarter.

Available data suggests that Toys had a strong holiday shopping season. Domestic Toys generated same-store sales growth of 3.1% in the recent nine-week holiday selling season, while International Toys and Babies both posted 0.9% gains. While such gains may have been driven by increased promotional activity, we believe that the Company will post year-over-year gains profitability as well as sales. We project that Toys will report a 5% increase in fourth-quarter revenues to $6,435 million (versus $6,127 million in the prior-year period) and a 2% increase in fourth-quarter EBITDA to $710 million (versus $692 million in the prior-year period).

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BUY: Toys "R" Us 7.625% Notes Due 2011

Credit Analysis: Positive Cash Flow is Gift That Keeps on Giving

Summary: We believe that Toys has "grown into" its capital structure. Coverage and cash generation metrics are relatively strong, allowing Toys to reduce net debt significantly from 2006 to 2007. The Company also possesses substantial financial flexibility in terms of liquidity reserves and contractual advantages. We note that Toys entered the fourth quarter with $2,000 million in cash and unused availability under its two major revolving credit facilities. In addition, the Company's significant credit agreements contain relatively benign covenant packages. Furthermore, Toys has the contractual right to extend approximately $2,100 million in obligations scheduled to mature through 2008 for up to two years. Given the magnitude of the Company's turnaround since the Acquisition, we expect Toys to explore a stock offering by the end of 2008, if financial market conditions allow.

Toys possesses relatively favorable credit metrics given yields for the public bonds

Credit Statistics: Toys possesses relatively favorable credit metrics given yields for the public bonds. Coverage metrics are more than adequate, with EBITDA interest coverage consistently between 1.8x and 1.9x and EBITDA less capital spending coverage between 1.1x to 1.3x. Net cash generated by operating activities has also increased substantially from $411 million in the February 2007 LTM period to $703 million (representing 5.2% of revenue) in the most recent LTM period. Relative leverage has worsened on a sequential basis due to seasonal inventory buildup and corresponding cash requirements, although we note that net debt at quarter-end dates in 2007 have consistently been $350 million to $500 million less than levels reported in 2006. On a year-over-year basis, we expect leverage to decline; we project net debt / EBITDA of 5.0x for the LTM ended February 2008, compared with 5.4x in the prior year period. Liquidity metrics have remained robust, as Toys had aggregate liquidity of $2,000 million (or 3.9x LTM interest expense) going into the holiday selling season. See **Exhibit 8**, below:

Exhibit 8: Certain Credit Metrics

	For the LTM Period Ended:				
	01/28/2006	**02/03/2007**	**05/05/2007**	**08/04/2007**	**11/03/2007**
EBITDA / Interest Expense	1.8x	1.8x	1.8x	1.9x	1.9x
EBITDA less Capital Spending / Interest Expense	1.1x	1.3x	1.3x	1.3x	1.2x
CFO	671.0	411.0	650.0	652.0	703.0
CFO / Revenue	5.9%	3.1%	4.9%	4.9%	5.2%
Net Debt / EBITDA	6.8x	5.4x	5.8x	6.1x	6.5x
Net Debt / EBITDA less Capital Spending	11.3x	7.6x	8.2x	8.7x	9.9x
Total Liquidity	$3,324.0	$1,994.0	$1,737.0	$1,563.0	$2,000.0
Unrestricted Cash and Cash equivalents / Interest Expense	2.5x	1.4x	0.7x	0.4x	0.5x
Liquidity / Interest Expense	8.4x	3.7x	3.3x	3.0x	3.9x

Source: Public Filings.

BUY: Toys "R" Us 7.625% Notes Due 2011

There is $5.2 billion in structurally senior debt ahead of the public bonds, including $3.7 billion in secured debt

Capital Structure: There are three distinct levels to Toys' capital structure. The Company has approximately $3,737 million in structurally senior secured debt, consisting of (ii) $517 million in outstanding domestic and international revolver borrowings, (ii) $797 million in term loan obligations, (iii) $1,959 million in domestic and international real estate facilities, (iv) $404 million in Toys Japan obligations, and (v) $60 million in miscellaneous obligations. These obligations are typically located at the operating subsidiary level (domestic or international, as the case may be) and/or Toys-Delaware, although Toys is a borrower under the domestic revolving credit facility.

The Company also has approximately $1,502 million in structurally senior unsecured borrowings, including (i) $1,480 million in credit facility debt and (ii) $22 million in aggregate principal amount of 8.75% debentures, which were jointly issued by Toys-Delaware and Toys. The three series of public bonds issued by Toys (and not carrying any subsidiary guarantees) are effectively at the bottom of the pile.

Structurally Senior Secured Facilities: In general, the Company's revolving credit facility agreements are relatively affordable and covenant-light. The domestic secured revolving credit facility provides for a $2,000 million Revolving Credit Facility (consisting of $1,800 million of domestic revolving commitments and $200 million of Canadian revolving commitments), subject to a borrowing base calculation based upon percentages of eligible credit card receivables, eligible inventory, with a reduction for applicable reserves. This facility includes a minimum availability covenant (set at $125 million), as well as a sliding scale for applicable margin based upon availability.

The multi-currency revolving credit facility provides for up to £95 million and €145 million in borrowings, scheduled to mature on July 21, 2010. The facility also contained a bridge loan of an initial amount of $1,000 million, which was repaid on February 9, 2006. This facility includes a minimum cash interest coverage ratio and a maximum leverage ratio covenant (both calculated for Toys "R" Us Europe, LLC), as well as a sliding scale for applicable margin based upon facility utilization.

The secured term loan facility originally provided for an $804 million term loan (with $797 million currently outstanding) maturing in July 2012 and a $200 million asset sale facility, which has subsequently been repaid. Outstanding term loan balances bear interest at LIBOR plus 4.25% or base rate plus 3.25%.

The Company's $800 million domestic real estate facility was originally scheduled to mature in August 2007, although Toys elected to exercise the first of three one-year maturity extension options in advance of the scheduled maturity. The Company intends to exercise the remaining two extension options at the appropriate times, resulting in an effective maturity of August 2010.

Structurally Senior Unsecured Facilities: This group of obligations is dominated by the $1,300 million unsecured credit facility established in December 2005 by an indirect, wholly owned subsidiary of the Company. The proceeds from this facility were used to repay approximately $927 million of indebtedness under a $1.0 billion bridge facility. The $1,300 million facility is scheduled to mature on December 9, 2008, but the Company has the contractual right to extend this maturity for two one-year periods, which would effectively extend maturity of this obligation to December 9, 2010.

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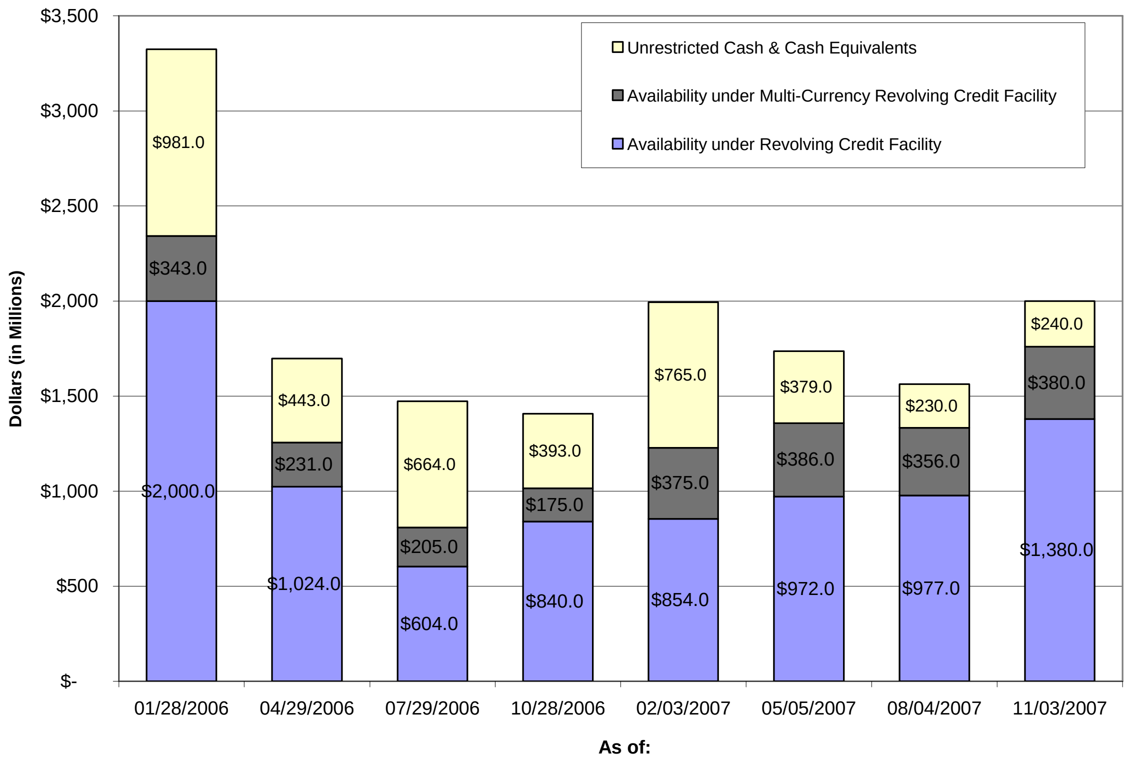
Toys had $2,000 million in available liquidity at the end of the third quarter, versus $1,408 million twelve months earlier

Liquidity: We calculate liquidity as the sum of (i) unused borrowing availability under both the domestic revolving credit facility and the multi-currency revolving credit facility and (ii) unrestricted cash and cash equivalents. As demonstrated above, the Company has been able to maintain ample aggregate liquidity since the Acquisition. As of November 3, 2007, the Company had approximately $2,000 million in available liquidity as compared to $1,408 million in the prior year period and $1,994 million at the end of Fiscal 2006. See **Exhibit 9** for recent trends in liquidity.

Exhibit 9: Liquidity Trends



Source: Public Filings.

Value Cover Analysis:

We estimate value cover of 70% to 178% for the Toys public bonds

Summary: We employed two forms of income capitalization analyses (reflecting different treatments of the Company's investment in Toys Japan) to estimate prospective value cover for the $1.3 billion in parent company bonds. These analyses indicates a value cover range of 70% to 178% for these instruments, compared with recent prices of 77.5 for the 7.625% Notes, 73 for the 7.875% Notes, and 68 for the 7.375% Notes.

Income Capitalization Analysis: We employed two forms of income capitalization analyses, to reflect different methods of incorporating the Company's investment in Toys Japan. The first form is consistent with Toys' financial statements, which consolidate Toys Japan. Using this construct, we developed an estimate for unlevered net income by assuming (i) consolidated LTM EBITDA of $971 million, (ii) LTM capital spending of $333 million, (iii) a tax rate of 40%, and (iv) depreciation equal to capital spending. In this consolidated analysis, estimated enterprise value is reduced by minority interest of $130 million.

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We also created an income capitalization analysis that "deconsolidates" Toys Japan, by assuming that Toys Japan accounts for roughly 13% of EBITDA, capital spending, and cash and cash equivalents (which may be a little generous for Toys Japan). This model provides a range of enterprise value estimates for Toys excluding Toys Japan; the trading value of Toys Japan is then added to enterprise value to capture value available to stakeholders. The value "waterfall" associated with this analysis excludes the debt of Toys Japan incorporated on the Company's financial statements.

The Toys public bonds come out "whole" assuming a perpetual growth rate of 2% or more.

The Company's unlevered cost of capital was estimated at approximately 7.6%, using (i) prevailing 10-year bond yields, (ii) an estimated risk premium of 5%, and (iii) an estimated unlevered beta of 0.8. We assumed a range of perpetual growth rates, from 1.5% to 2.5%, which are consistent with recent comparable store sale growth metrics. See **Exhibit 10**, below.

Exhibit 10: Value Cover for Public Bonds under Various Assumptions

	Toys Japan Consolidated At Various Perpetual Growth Rates			Toys Japan "Deconsolidated" At Various Perpetual Growth Rates [1]		
Dollars in Millions	**1.5%**	**2.0%**	**2.5%**	**1.5%**	**2.0%**	**2.5%**
EBITDA	$971	$971	$971	$845	$845	$845
CAPEX	333	333	333	290	290	290
EBIT	638	638	638	555	555	555
Taxes at 40%	255	255	255	222	222	222
Unlevered Net Income	$383	$383	$383	$333	$333	$333
Ten Year Treasury	3.6%	3.6%	3.6%	3.6%	3.6%	3.6%
Beta	0.8	0.8	0.8	0.8	0.8	0.8
Risk premium	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
Unlevered cost of equity	7.64%	7.64%	7.64%	7.64%	7.64%	7.64%
Implied Multiple	16.3	17.7	19.5	16.3	17.7	19.5
Implied Enterprise Value	$6,235	$6,787	$7,447	$5,424	$5,905	$6,479
Adjustment for Toys Japan [1]	130	130	130	(118)	(118)	(118)
Net Structurally Senior Secured Debt	3,497	3,497	3,497	3,124	3,124	3,124
Available for Unsecured Debt	2,608	3,160	3,820	2,418	2,899	3,473
Structurally Senior Unsecured Debt	1,502	1,502	1,502	1,502	1,502	1,502
Available for Public Bonds	$1,106	$1,658	$2,318	$916	$1,397	$1,971
Aggregate Principal Amount of Public Bonds	$1,300	$1,300	$1,300	$1,300	$1,300	$1,300
Implied Value Cover	85%	128%	178%	70%	107%	152%
Implied EV / EBITDA Multiple	6.4x	7.0x	7.7x	6.4x	7.0x	7.7x

[1] This analysis reduces EBITDA, capital spending, and cash and cash equivalents by 13% to reflect "deconsolidation" of Toys Japan. This analysis also excludes Toys Japan debt from value cover waterfall calculations.

[2] In consolidated analysis, minority interest in Toys Japan reduces enterprise value. In deconsolidated analysis, market value in Toys Japan is added to enterprise value.

Using the consolidated form of the analysis, we estimate value cover for the public bonds at 85% to 178%, while the deconsolidated analysis (which arguably allocates too much operating value to Toys Japan) estimates value cover at 70% to 152%.

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The 2% growth assumption seems reasonable in the context of recent trends in same-store sales, sale count, gross margin, and EBITDA

Based on the foregoing analyses, the Toys public bonds are projected to come out whole in any scenario which contemplates a perpetual growth rate of 2% or greater. We believe a "floor" perpetual growth rate of 2% is reasonable given recent trends in same-store sales, store count and mix count, gross margin, and EBITDA, as well as Toys' impressive showing in the holiday shopping season.

In addition, the implied enterprise values for Toys reflect a 6.4x to 7.7x multiple of LTM EBITDA. Although there are no particularly great pure-play comparables, Wal-Mart Stores, Inc. and Target Corporation trade around 8.5x LTM EBITDA – a meaningful premium to the high end of our valuation range.

Return Analysis

Based on the foregoing, we are favorably disposed to the Company's publicly-traded bonds. In particular, we recommend a long position in the 7.625% Notes due 2011, which has the shortest tenor of the three pari passu series. Please see **Exhibit 11**, below, for a summary of prospective returns for a long position in the 7.625% Notes.

Exhibit 11: Prospective Returns on Proposed Position

	At Various Selling Prices		
	86	**88**	**90**
Purchase Price	78.00	78.00	78.00
Bond Coupon	7.63%	7.63%	7.63%
Bond Collateral Pct	50.00%	50.00%	50.00%
Borrowing Rate	6.00%	6.00%	6.00%
Collateral Required	39.0	39.0	39.0
One-Year Coupon	7.6	7.6	7.6
Years	1.0	1.0	1.0
Leveraged Cash Flows			
Year Zero	(39.0)	(39.0)	(39.0)
Year One	52.3	54.3	56.3
IRR (Leveraged Return)	34.1%	39.2%	44.3%
Unleveraged Annual Return	20.0%	22.6%	25.2%

Unlevered returns could range from 20% to 25%

In our return analysis, we assumed (i) a twelve-month holding period, (ii) a purchase price of 78, and (iii) a range of selling prices that assume a 200 basis point to 400 basis point tightening of credit spreads for this instrument. Levered returns for the proposed position range from 34.1% to 44.3%. Unlevered returns range from 20.0% to 25.2% under these exit price and holding period assumptions.

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UPDATE…

Correction

In the “LBOs Are Disproportionately Distressed” report in the January 24, 2008 *Distressed Debt Investor*, the opening sentence of Page 5’s third paragraph should read “Below-average propensity for a private equity firm’s deals to become distressed may reflect such factors as rigorous due diligence, disciplined avoidance of overbidding in competitive situations, and effective corporate governance following the transaction.”

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Gordian Group

Gordian Group is a leading national investment bank specializing in resolving distressed situations and multi-faceted challenges for clients across a wide range of industries. Gordian Group is consistently cited by *Turnarounds & Workouts* and *The Deal* as one of the nation's top restructuring firms.

Founded in 1988 and with a nationwide practice spanning across all industry lines, Gordian Group's analytical and tactical expertise is second to none. Its professionals are experienced negotiators, particularly in pressure situations, with an arsenal of skills and tactics honed under the most difficult of circumstances. Services include:

- advising companies in connection with financial restructurings;
- providing M&A services in connection with distressed and/or complex situations;
- providing companies and boards of directors with advice on enhancing equity value;
- raising equity and debt capital;
- rendering fairness, solvency, and valuation opinions; and
- litigation support/expert witness services.

Representative Engagements:

- Ben & Jerry's - Gordian Group advised Ben & Jerry's in its award-winning sale to Unilever.
- Enron - Gordian Group currently advises a major financial institution with significant exposure to Enron.
- Farmland Industries - Gordian Group advised Smithfield Foods, the successful buyer of significant assets in Farmland's Chapter 11.
- LTV Steel - Gordian Group recouped a bank's $225 million securitization exposure after the court declined to recognize the "bankruptcy remote" receivables vehicle.
- Mississippi Chemical - Gordian Group financially reorganized the company in Chapter 11.

Other Publications:

- Gordian professionals Peter Kaufman and Henry Owsley published the definitive work in the field *Distressed Investment Banking: To the Abyss and Back* in May 2005.

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