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Toys "R" Us Japan

I do not believe the Japanese have chosen freely to have these limitations. All we would have to do is open a large retail store where prices were 40% less and choices were very broad. If the Japanese consumer didn't like products offered in that fashion, then the store would not be a success. . . .

—Carla Hills, United States Trade Representative, February 1990

In early 1991, Toys "R" Us seemed poised on the brink of a high profile entry into the world's second largest toy market. A "category killer" that enjoyed phenomenal success in the United States and Europe, Toys "R" Us had tried for several years to crack the lucrative but forbidding Japanese market. At every step, the U.S. company had faced difficulty and opposition. Japanese retailers had tried repeatedly to block the chain's entrance, as had small shopkeepers from the area around Niigata, site of the first Toys "R" Us store. The Japanese media had loudly denounced Toys "R" Us as the "black ship of Kawasaki," and a host of Japanese toy manufacturers, including Nintendo, had refused to deal directly with the U.S. retailer.[1] The very structure of Japan's multilayered distribution system also seemed to conspire against Toys "R" Us, thwarting the company's attempts and perpetuating Japan's infamously high consumer prices.

Despite this litany of problems, though, success seemed finally within reach. Toys "R" Us had found an influential local partner, Den Fujita, and won approval from Japan's powerful Ministry of International Trade and Industry (MITI). Management also felt confident that some of the more restrictive aspects of Japanese retail regulation were about to change. But still some basic questions remained: Would Japanese customers, accustomed to small shops and personal service, ever accept a self-service discount warehouse? Would Japanese manufacturers risk damaging long-standing relationships with wholesalers and retailers by dealing directly with Toys "R" Us? And how quickly and efficiently could the chain hope to expand in the face of protracted local opposition?

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[1]The epithet referred to Commodore Matthew C. Perry's four black warships that sailed into the harbor at Edo (now Tokyo) in 1854, forcing the Shogun's government to end three centuries of self-imposed Japanese isolation. "Black ships" thus became symbolic of the opening of Japanese culture to Western influence. *Reuters*, December 19, 1991, and *The Toronto Star*, December 23, 1991.

Professor Debora Spar prepared this case with the assistance of Jacqueline MacKenzie, MBA '95, and Research Associate Laura Bures as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

The Toys “R” Us Company

Toys “R” Us was the brainchild of Charles Lazarus, a shop owner who founded the chain in 1957. Born in Washington, D.C., in 1923, Lazarus had learned about the retail business from his father, who rebuilt bicycles and sold them at the family store. When Lazarus asked why the store did not sell new bicycles, his father explained that the big chain stores could sell them much cheaper—a comment Lazarus would clearly recall later in his career.[2]

After a wartime career as a cryptographer, Lazarus inherited the family shop and turned to selling children’s furniture in a market boosted by the post-war baby boom. Over time, he began to realize that because baby furniture did not wear out, repeat purchases of items such as cribs were rare.[3] Toys, by contrast, were frequently requested. Toys, he therefore decided, created a far superior business opportunity. After studying the U.S. discounter Korvettes, Lazarus decided to experiment with a self-service, supermarket-style format. In his new Children’s Supermarket, he vowed to undercut competition and have a bigger, better selection than any single toy store. Discounting had arrived in the toy business.

Children’s Supermarket quickly grew into a thriving chain of four stores, renamed Toys “R” Us after Lazarus decided he needed better signs with “shorter words, bigger letters.”[4] He sold the chain to Interstate Stores in 1966 for $7.5 million, retaining a seat on the company’s Board. When Interstate folded in 1978, Lazarus rescued his company, determined to build it into a nationwide chain. Over the next decade, Toys “R” Us sales compounded by 26% per year, with sales productivity per square foot double that of the retailer’s nearest competitor.[5] By 1988, Toys “R” Us had captured 20% of the U.S. toy market, with sales surpassing the $4 billion mark.[6] Sourcing directly from manufacturers, the chain used its huge buying clout to offer goods at 10-20% discounts compared to smaller toy retailers. Year-round advertising campaigns encouraged consumers to buy toys at any time, instead of just at Christmas.

A typical Toys “R” Us store brought together 8-15,000 SKUs (stockkeeping units) of toys and children’s products in a warehouse-sized (54,000 sq. ft.) self-service outlet. The presentation was simple and colorful, based on a “cookie cutter conformity” where stores resembled each other down to the layout of each aisle. Central control was a key feature of the organization, and extensive computer networks ensured almost automatic replacement of every toy sold once inventories dropped below pre-determined levels. The key to the sales and inventory formula, according to Lazarus, was that “No decisions are made in the field.”[7]

In 1984, the company took its retailing concept global, opening its first international outlet in Canada and then moving quickly into Europe, Hong Kong, and Singapore. As it had in the United States, the discount formula quickly proved popular with customers who flocked to the new Toys “R” Us outlets. Whenever the chain expanded abroad, however, it drew the ire of local retailers, who feared (correctly in many cases) that the giant discount stores would drive them out of business. German manufacturers, for example, refused to sell to Toys “R” Us in 1987 for fear of damaging their relationships with the thousands of small retailers and wholesalers who dominated toy distribution.

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[2] David Owen, *The Man Who Invented Saturday Morning*, Villard, 1988.

[3] Ibid.

[4] *Newsmakers*, October 1992.

[5] *Business Quarterly*, June 22, 1989, and *Newsmakers*, October 1992.

[6] *Tokyo Business Today*, February 1990.

[7] *Newsweek*, November 11, 1991.

And in the United Kingdom, retailers also protested, noting that the number of British toy stores had declined from 3,500 to 2,000 in the five years after Toys “R” Us first arrived.[8]

But Toys “R” Us regularly overcame the protests and its foreign outlets flourished. By 1991, the chain operated 97 stores abroad, with international operations accounting for 14% of the chain’s total sales. Commenting on this spectacular growth, Larry Bouts, president of the chain’s international division since 1991, suggested that the expansion of Toys “R” Us actually benefited foreign retailers as well as consumers. “Initially I think there was a fair amount of consternation from competitors,” he acknowledged, “but now the industry has grown so much, there’s really a lot warmer feeling. From the consumer’s point of view, they’re very happy . . . coming to us in droves.... People said it wouldn’t work, but consumers want value today.”[9] Confident that this formula applied broadly, Toys “R” Us management began to contemplate an entry into one of the world’s toughest retail markets: Japan.

The Japanese Market for Toys

By any measure, Japan was an extremely attractive market for toys. Throughout the 1980s, the entire retail market in Japan had expanded dramatically, propelled by the economy’s continued strength and a long-awaited increase in consumer spending. According to the Bank of Japan, annual retail sales grew 94% during the 1980s, while Japan’s GDP grew at an average annual rate of 7%.[10] Japan’s children were particularly strong beneficiaries of this boom. Despite a rigorous education system that left children with little time for play, children’s products accounted for a significant proportion of consumer spending in Japan. Perhaps to compensate for the constant pressure to excel in school, parents lavished expensive toys and clothes on their offspring.[11] Japan’s falling birthrate also allowed parents and grandparents to focus their spending on fewer children; and fewer mouths to feed enabled families to spend less money on food and more on toys.[12]

Thus Japan’s toy market had become the second largest in the world, lagging only behind the United States’. In 1991, the Japanese toy market was worth Y932 billion ($7.1 billion), up Y26 billion from the previous year. Responding to this boom, large retailers designed special formats to appeal to children. In October of 1990, Isetan opened a special section called “Dr. Kids Town” within one of its Tokyo department stores, while Seibu’s flagship store opened a “Kids Farm,” complete with a hollow miniature mountain amidst clothing racks and toy shelves.[13] A Sesame Street theme park was opened outside of Tokyo in 1990.

On the surface, these developments suggested that the Japanese toy market was ripe for Toys “R” Us. But as the chain’s management quickly discovered, the structure of Japan’s retail industry made it very difficult for new retailers—particularly foreign discount retailers—to establish a market position. Despite the rapid growth it had experienced, Japan’s toy industry remained highly fragmented and locally-focused. Though some estimates claimed that the number of toy stores had fallen from 8,000 in 1980, at least 6,000 remained in 1990.[14] A typical toy store was less than 3,200

[8]*Wall Street Journal*, September 10, 1990.

[9]*Europe*, September 1992.

[10]*Business Tokyo*, May 1992, and *International Marketing Data and Statistics 1995*, p. 183.

[11]*The Washington Post*, February 11, 1991.

[12]The average number of children per family had fallen from four in the early post-war years to just two by the early 1990s. *Washington Post*, February 11, 1991.

[13]Ibid.

[14]*Nihon Keizai Shimbun*, February 10, 1990.

square feet in area and sold 1-2,000 SKUs. Display areas were customarily cramped, inventories turned slowly, and most stores stocked very similar merchandise. Nearly all retail shops were domestically owned and bought their toys from local wholesalers, usually for 75-80% of the manufacturer's "suggested price."[15] Retailers then sold the toys for the "suggested price," deviating from it only rarely.[16] In exchange for maintaining prices, retailers were able to return their unsold goods to the wholesaler or manufacturer for full credit. In this tightly-knit system, only two national players existed: Chiyoda, which sold through the Hello Mac and Ace formats; and Marutomi, which operated a traditional toy chain, Banban, as well as a discount format, Toy Ryutsu Center. With a combined 700-800 stores, the two chains accounted for over Y100 billion in annual sales.[17]

At the wholesale level, the Japanese toy industry was again marked by its characteristic pattern of fragmentation and long-standing relationships. Even such giants as Nintendo, the Kyoto-based maker of Gameboy and other popular electronic games, distributed its products through a sprawling network of 70 affiliated distributors.[18] These distributors served as the key link between manufacturers and retailers, cementing long-term relationships based on personal commitments rather than competitive terms. They also served as a barrier to foreign firms, making it difficult for foreigners to achieve sufficient scale in either manufacturing or retailing to cover the costs of their investment. As a result, foreign firms were almost entirely absent from the Japanese domestic toy industry, and even imports accounted for only 9.2% of sales.[19]

Potentially, Toys "R" Us had the ability to change the Japanese toy industry and profit handsomely in the process. Merely by undercutting the "suggested price" it could capture the entire discount market. All it needed to do was to mimic precisely what it had done elsewhere: establish large-scale stores and use the buying power created by these stores to negotiate lower prices from toy manufacturers. Since 1987, the chain's management had been trying to implement this strategy. But in Japan, they came to realize, the very structure of the retail sector made their customary strategy almost inconceivable.

The Structure of Japanese Retail

A "Nation of Shops"

For years, Japan had been aptly described as a nation of small shopkeepers. Though the population of the four islands was approximately half that of the United States, the number of retail outlets in Japan was almost the same, resulting in twice as many outlets per capita.[20] Many of these outlets were the country's famous "mom and pop" stores. In 1988, over half of all retail outlets in Japan employed just one or two people; less than 15% of outlets employed more than five people.[21]

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[15] *Nikkei Weekly*, February 22, 1993.

[16] In 1989, 70% of toy retailers priced at the manufacturer's "suggested price," according to figures from Japan's Fair Trade Commission.

[17] *Nikkei Weekly*, February 22, 1993.

[18] *Nikkei Weekly*, June 29, 1991.

[19] *Nikkei Weekly*, June 20, 1992.

[20] Jack G. Kaikati, "Don't crack the Japanese distribution system - just circumvent it," *Columbia Journal of Business*, Summer 1993.

[21] MITI survey.

In the early 1980s, such small stores accounted for a full 75% of retail spending. Nearly half of these outlets sold food, compared with 20% in the United States.[22]

The fragmentation of the retailers was matched by the fragmentation of the wholesalers who served them. Of the 436,421 wholesalers operating in 1988, less than half employed more than five people, and nearly all sold their products through a complex distribution system that typically involved between three and five layers of intermediaries. The primary wholesaler was often a subsidiary, or close affiliate, of the manufacturer. The secondary wholesaler was a regional distributor, while the tertiary wholesaler operated on the local level. As in the toy industry, prices of goods were effectively controlled by the manufacturers, who sold to wholesalers at a pre-arranged discount of the "manufacturers' suggested price." With the added inducements of credit and generous payment terms, manufacturers throughout the Japanese system gained guaranteed distribution of their products, while wholesalers and retailers gained some measure of protection against economic swings and fluctuations in demand.

While Western observers tended to mock the Japanese retail system as cumbersome and archaic, most Japanese consumers genuinely seemed to enjoy and appreciate its benefits. As an article in *The Economist* explained, "The Japanese are as sentimental about their tiny shops as the French are about their peasants and the British about their old industries. Small Japanese shops are the centers of village neighborhoods in big cities. Small stores flourished before the rest of Japan modernized because merchants were restricted by law to their local patch, and retailers were encouraged to mop up labor from the land."[23]

In addition to its commercial function, small store retailing thus served a valuable social purpose. Described directly by some as a "social service," the retail sector was "filled with under-employed workers who in other societies might well be unemployed."[24] All together, the Japanese distribution system accounted for 18% of the nation's employees and 13% of its GNP.[25] In a 1980s survey, 26% of shopkeepers reported "security in old age" as a reason for opening a shop, and 10% said they opened a shop because their husbands would soon retire.[26] One quarter of owner-operators of stores were over 60. In a country with few pension provisions, small scale retailing offered a safety net for retirement.

Supporters of the Japanese system further argued that small stores were a natural reflection of the Japanese way of life, that Japanese consumers preferred to shop every day for small quantities of fresh goods.[27] Small homes and kitchens allowed no space for storing large amounts of goods, and use of automobiles was impractical in Japan's congested streets.[28] High quality and personalized service, many claimed, were expected by Japanese consumers, who were willing to pay for the privilege.

Detractors, though, argued that small stores continued to exist simply because they were protected from more efficient competitors by laws restricting the construction of large stores and by

[22]*The Economist*, September 19, 1981.

[23]Ibid.

[24]Ibid, and Hugh T. Patrick and Thomas P. Rohlen, "Small-Scale Family Enterprises," *The Political Economy of Japan: The Domestic Transformation*, Vol. 1, Stanford University Press, 1987, p. 350.

[25]*Business Asia*, January 4, 1993.

[26]Patrick and Rohlen, "Small-Scale Family Enterprises," p. 350.

[27]Takatoshi Ito, *The Japanese Economy*, MIT Press, 1992, p. 392.

[28]Japanese typically had 60% of the living space enjoyed by their U.S. counterparts. *Business Review Weekly* January 12, 1990.

tacit non-competition arrangements. Japanese consumers *would* accept less service in exchange for lower prices, they asserted, but by 1991, they had rarely been offered the choice.

Keiretsu Stores

In fact, choice of retail goods in some sectors was actively restricted by the activities of diversified conglomerates such as Matsushita and Toshiba. Working through their own distribution keiretsu (related groups of companies), these giant firms supported tens of thousands of small affiliate stores that stocked only "their" manufacturer's brand at manufacturer-specified prices. Where these stores prevailed, customers found no benefit in comparison-shopping, since price uniformity was nearly absolute. What they did get however, and what many Japanese reportedly preferred over low prices, was personal attention from the shop-owner and guaranteed repair or replacement service for the life of their purchase.

The operators of the small keiretsu stores also effectively made a trade-off between prices and personal loyalty. Simply by becoming a store owner, one gained a position of some visibility in the community, a position symbolized by the store-front pairing of the proprietor's name with that of a well-known manufacturer. Through the manufacturers' many affiliates, store operators also received financial and marketing advice and even information about their competitors' activities. In exchange for this assistance, they implicitly agreed to tie themselves closely to the keiretsu's lead manufacturer. Storekeepers who dared to meddle with the manufacturer's "suggested price" faced expulsion from the network and blacklisting by other manufacturers. In 1979, Yoshio Terada, a National (Matsushita) retailer in Tokyo, incurred the wrath of his supplier by discounting batteries by 20%. When he refused to remove the discount, a truck arrived instead to remove the National sign from his store and with it, his entire business.[29] Terada subsequently set up a no-service discount electrical appliance business called STEP and, despite Japanese consumers' alleged preferences for full-service stores, built a $100 million business in ten years. Yet, few keiretsu retailers at the time would have dared to defy the might of Matsushita. In 1991, over 20,000 keiretsu stores still existed, and the principle of loyalty to manufacturers remained strong in both retailing and wholesaling.

The Role of Regulation

In addition to customers' habits and personal loyalties, Japan's retail structure was also bolstered by a series of laws restricting the spread of larger retail stores. By sheer force of numbers, the country's 1.4 million store owners wielded considerable voting power. For decades, they had used this power to extract concessions and explicit protection from Japan's reigning political party, the Liberal Democratic Party (LDP). In 1990, the Chairman of the National Shopkeepers Promotion Association described the political situation succinctly: "The big stores stuff the politicians with money, but we have the power of 20 million votes."[30]

The small store owners won their first victory in 1956, just after the LDP came to power. The 1956 Department Store Law required that a permit be obtained for each new department store, effectively allowing department store construction to be blocked by smaller retailers. By 1990, there were still only about 1,600 department stores in Japan—one for every 75,000 people. With the growth of department stores so severely limited, most innovation in Japanese retailing came through the emerging supermarkets—large, non-specialized, low-price stores with large grocery sections. But just as the supermarkets were starting to gain ground, they, too, encountered the shopkeepers' force.

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[29]Kenichi Miyashita and David W. Russell, *Keiretsu,* McGraw-Hill, 1994, pp. 203-4.
[30]*East Asian Executive Reports*, May 15, 1990.

In 1973, Japan's Ministry of International Trade and Industry (MITI) responded to the small retailers' demands by introducing the Large Scale Retail Law, legislation that subjected all would-be large retailers to a rigorous screening process. Before building any stores over 1,500 sq. m. (16,000 sq. ft.), retailers had to submit detailed plans to MITI and then allow these plans to be passed on to a local review board composed of consumers and retailers. In 1982, the law was made even more stringent, requiring large store operators to "explain" their plans to local retailers directly, even before notifying MITI. With this provision in place, small store owners could effectively delay the construction of large stores for years, simply by boycotting "explanation meetings" or raising objections to a myriad of small details. As a result, even powerful supermarket chains such as Daiei found themselves entangled for years in local negotiations.[31]

Innovations

If Japan's fragmented and hierarchical retail sector had remained unchanged in the 1980s, it is unlikely that even so powerful a force as Toys "R" Us would have dared enter the market. But as the Japanese economy expanded and developed in the late 1980s, several cracks in the retail structure began to appear.

The Rise of Convenience Stores

The first major change in Japan's retail structure came from a quiet and unlikely source: convenience stores. Usually occupying no more than 1100 sq. ft., convenience stores were small enough to slip past restrictive laws and establish themselves in the very heart of Japan's towns and villages. By 1982, Japan had 23,235 convenience stores, accounting for 2.3% of total retail sales.[32] Between 1982 and 1985, convenience store sales rose faster than any other form of retailing sales;[33] and by 1992, they accounted for nearly 8% of Japan's total retail sales.[34]

The most successful convenience store was the 7-Eleven chain, licensed from its U.S. parent Southland in 1974 by Ito-Yokado. At first glance a 7-Eleven Japan store fit the profile of many Japanese stores: small, locally-focused, and "open all hours." At the core of this business, however, was an information-oriented strategy unlike anything dreamed of by its "mom and pop" competitors. The key to 7-Eleven's strategy was close inventory control facilitated by early and comprehensive adoption of information technology. In the late 1970s, 7-Eleven cut its wholesale suppliers from 80 to 40 by closely supervising their inventory and eliminating goods which did not generate adequate sales. From 1985 onwards, the chain used point of sales equipment to track sales of each item and ensure timely replenishment. Employees also entered specific information about shoppers with each sale to predict product-specific shopping habits. Ito-Yokado used this information to refine product offerings and inventory replacement schedules to the point of providing fresh *o nigiri* (rice balls popular as lunch snacks) at lunch time in every store as well as adequate supplies of soft drinks for children on their way home from school in the afternoon. The information was also used as a

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[31] *Business Week*, December 9, 1991.

[32] *The Economist*, January 31, 1987.

[33] Frank Upsham, "Privatizing Regulation: The Implementation of the Large-Scale Retail Stores Law," in Gary D. Allison and Yasunori Sone, eds., *Political Dynamics in Contemporary Japan*, Ithaca, 1993, p. 265. Cited in Jeff Bernstein and Thomas K. McCraw, "Convenience-Store Retailing in Two Countries: Southland and Seven-Eleven Japan," HBS Case Number N9-395-092.

[34] Cited in Jeffrey Rayport, "Japanese Retailing System: Tokugawa Period to the Present," HBS Industry Note prepared for Professor Thomas K. McCraw, April 1991.

bargaining chip with manufacturers, who could be persuaded to deliver according to 7-Eleven's precise requirements.

By 1990, almost 85% of goods in the chain's 94 wholly owned and 4,140 franchised stores throughout Japan were distributed through the chain's own elaborate regional distribution system, and 7-Eleven Japan had been described as one of the most efficient retailers in the world. As 7-Eleven grew, it also spawned a series of imitators, stores hoping to make similar use of information technologies and catering to the demands of Japan's aging population and increasing numbers of women in the workforce.

MITI's "Vision for the 1990s"

Just as the convenience stores were demonstrating the commercial potential of new retailing formats, the established format was also coming under pressure from Japan's changing demographics. Increasingly, young Japanese balked at the idea of taking over their parents' small shops and wanted instead to experiment with bolder ventures. With significantly greater international exposure than their parents, the younger generation also realized that they were paying highly inflated prices for many consumer goods. Slowly, their demands for fewer commercial restrictions and lower prices began to influence the political process.

In 1989, MITI quietly advocated reform of Japan's retailing sector. In a public document on Japan's distribution system, it first defended the existing retail structure, arguing that:

1. It cannot necessarily be said that our distribution system is inefficient; however, there is room for further rationalization as respects costs.

2. Though our country's distribution system is as a whole highly competitive, there are some factors which mitigate competition.

3. Due to unfamiliarity with commercial customs in Japan, foreign firms may feel difficulty attempting to gain access to the Japanese distribution sector; however, this system does not fundamentally discriminate against either domestic or foreign firms, and there are a large variety of distribution channels available to importing firms.

4. There are a variety of reasons for the gap in domestic and foreign prices, and some of them lie in the nature of the distribution system.[35]

MITI's document proceeded, though, to propose significant changes to the Large Scale Retail Stores Law, including limits on the amount of time each stage in the notification process could take. The law would remain in force, MITI explained, "since Japan still has a large number of retail stores and a limited amount of land, [and] giving large stores free rein to set up business would cause serious problems for regional communities."[36] Yet MITI did commit to "amending the system ... to reflect recent changes in socio-economic circumstances" and to removing "all practices which deviate from the original intent of the system," noting in particular that "the purpose of [the "explanation" of store plans to relevant constituencies] is not to obtain the approval of local retailers."[37]

[35] *News from MITI,* September 1989.
[36] Ibid.
[37] Ibid.

Accordingly, MITI proposed reducing the permissible time between pre-notification and approval to as little as 18 months. It even promised to re-examine restrictions on opening hours, which required large stores to close at 6pm and for at least one full day per month. If MITI succeeded in implementing these proposed changes, small store owners would at last lose their power to hold back a tidal wave of space-hungry domestic retailers.

The Structural Impediments Initiative[38]

At the same time that MITI launched its re-evaluation of the retail system, it also began to respond to demands that Japan open its market to foreign investors. Even after half a decade of dramatically increased global investment flows, Japan's stock of foreign direct investment remained low. In manufacturing, for example, which attracted 65% of total foreign investment flows, foreign affiliated companies accounted for 2.1% of total capitalization and 2.3% of sales in 1988. By comparison, FDI in the United States at the same time accounted for 14.7% of capitalization and 12.2% of sales.[39] In 1990, Japan was host to less accumulated U.S. direct investment than Canada, the United Kingdom, Germany, Switzerland, or the Netherlands.[40]

For many in the United States, the imbalance in investment levels was evidence that the Japanese market remained unfairly closed to U.S. investors. Consequently, in the fall of 1989, U.S. negotiators launched a series of discussions with their Japanese counterparts "to identify and solve structural problems in both countries that stand as impediments to trade and to balance of payments adjustment with the goal of contributing to the reduction of payments imbalances."[41] Dubbed the Structural Impediments Initiative, the talks theoretically covered "structural impediments" in both countries. The bulk of the negotiation, however, was devoted to the perennial problem of perceived trade barriers to U.S. imports and investment in Japan. In particular, U.S. negotiators pushed their Japanese counterparts to address the prevalence of keiretsu structures and other interlocked relationships which, they argued, prevented foreign firms from competing on equal terms. The U.S. team also suggested that consumer prices in Japan were higher than they should be, compared with prices in other markets, and that Japan's distribution system remained a major impediment to U.S. export sales.[42]

Toys "R" Us: The Move into Japan

For Toys "R" Us, both the Structural Impediments Initiative and MITI's changes to the Large Scale Retail Store Law came at a propitious time. Together with domestic developments in the retail sector, they seemed to indicate that the largest barriers to the chain's entry—the distribution sector and the legal restrictions on establishment—were at last about to change. And so long as they changed, Toys "R" Us felt confident that the chain could succeed in the Japanese market.

Because the Japanese market retained so many idiosyncracies, however, Toys "R" Us management decided to seek an alliance with a strong local partner. Initially, the chain followed the

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[38]This section draws heavily on Ito, *The Japanese Economy*, Chapter 12.

[39]The retail sector was host to a tiny but growing fraction of foreign direct investment in Japan. Between 1985 and 1990 U.S. investment in Japanese retailing quadrupled to reach $340m. *Business Tokyo,* May, 1992.

[40]Mark Mason, "United States Direct Investment in Japan: Trends and Prospects," *California Management Review*, Fall 1992.

[41]*Final Report of Structural Impediments Initiative.*

[42]The Large Scale Retail Law, for example, impeded the distribution of foreign goods by supporting the 1.6 million small family-run stores which were less likely to carry imported goods than were large stores.

same strategy that most foreign retailers had adopted and launched negotiations with a major Japanese retailer. But once the negotiations were underway, the Toys “R” Us representatives realized that the two sides had fundamentally different assumptions of how to run a business. According to one Toys “R” Us executive, “they pushed traditional business practices on us, like using wholesalers. That would distort the basic principle of our business.”[43] And so Toys “R” Us broke off the first round of talks and began to search for someone in Japan with a better grasp of U.S. retailing practices.

Den Fujita

In 1989, Joseph Baczko, then head of Toys “R” Us International, met Den Fujita, president of McDonalds Japan. Fujita, the son of an engineer, had grown up in Osaka, a city famous for its merchant tradition. He graduated from the Law Department of Tokyo University, the most prestigious university in Japan and traditional training ground for the country’s political elite.[44] During the U.S. occupation of Japan, he had worked as a translator at McArthur’s Headquarters in Tokyo, despite having lost his father and two sisters in U.S. bombing raids.

In 1950, he took the unusual step (for a Tokyo Law graduate) of starting his own trading venture, Fujita & Company, to import a range of items, such as Dior handbags, to a luxury-starved Japan.[45] Since post-war rationing and restrictions on imports had eliminated most other luxury goods, Fujita prospered, building one of Japan’s strongest import businesses over the next two decades.

In 1971, McDonalds approached Fujita and asked him to join them in introducing U.S.-style fast food to Japan. Fujita agreed, arguing in public that McDonalds-style food would be good for Japan. As he later explained, “the Japanese are very hardworking, but very weak, very small . . . we had to strengthen ourselves.”[46] Fellow retailers, though, were not amused—the Ginza Street Association was still attempting to evict the first McDonalds from its prestigious location more than 10 years after its establishment.[47] Fujita, undaunted, told Japanese teenagers that eating beef might give them the blond hair of their American counterparts.[48] Whatever the rationale, McDonalds’ sales in Japan had topped Y50 billion by 1980 and reached Y208 billion ($1.6 billion) by 1991.

What Fujita had brought to McDonalds—retail experience, political influence, vision, and a unique understanding of both Japanese and American cultures—was equally attractive to Toys “R” Us. With strong links to influential government figures, Fujita also had unrivaled knowledge of real estate in Japan, boasting that “If you name a city, I can see the post office, the train station, everything.”[49] Fujita’s flamboyant style and frequent new ventures guaranteed publicity for each business. Often described as a heretic, he was quoted as wishing to “blow a hole in the under-developed structure of the Japanese retail industry.”[50]

So impressed was Toys “R” Us with Fujita that Robert Nakasone, the American-born Vice Chairman of Toys “R” Us, described him as not only the first choice as a partner, but “our second, third, fourth, fifth, and so on. . . . We could see he was a bit of a maverick. He was not only bilingual,

[43]*Nikkei Weekly*, May 16, 1992.
[44]*New York Times*, March 22, 1992.
[45]Ibid.
[46]Ibid.
[47] *Nihon Keizai Shimbun*, October 11, 1983.
[48]*Reuters*, February 1, 1986.
[49]*Business Week*, December 9, 1991.
[50]*Nikkei Weekly*, May 16, 1992.

but bicultural."[51] Likewise Fujita regarded Toys "R" Us as a natural partner due to the similarities in the two companies' target markets. Soon after hearing of Toys "R" Us' plans, in fact, he began to think of ways to combine Toys "R" Us, McDonalds, and Blockbuster Entertainment, another foreign business seeking his help, in specially-developed family shopping malls. In the spring of 1989, Toys "R" Us formally asked Fujita to cooperate with the company in a Japanese joint venture. McDonalds Japan took a 20% stake in the new subsidiary: Toys "R" Us Japan.

Criticism and Opposition

Almost as soon as plans for the new venture were announced, other retailers and manufacturers claimed that Toys "R" Us Japan was doomed to failure. Consumers would check out the stores initially, they elaborated, but Japanese consumers would not like warehouse stores, and it was "unrealistic" to consider bypassing wholesalers.[52]

Explicit opposition to Toys "R" Us emerged rapidly from those most threatened by the chain's expansion. In January 1990, Toys "R" Us applied to the municipal government of Niigata, a city of 500,000 on the Japan Sea coast, for permission to open the first of its Japanese superstores. Local toy sellers were horrified. At 5,000 sq. m. (54,000 sq. ft), the proposed store would be over 50 times larger than the average Niigata toy shop; projected first year revenues of Y2 billion represented half the combined sales of the city's existing toy merchants.[53] Mobilizing quickly, the Niigata toy sellers warned publicly that, "If Toys "R" Us comes in, Japanese toy shops will be wiped out."[54] The group's spokesman, owner of eight Niigata toy shops further argued that, "Toys "R" Us is making this a political problem. But toys are more than that. Toys are culture."[55]

The Niigata application was just one of ten applications that Toys "R" Us filed across Japan, many of which sparked opposition of some kind. Toy retailers and wholesalers in Fukuoka submitted a petition to their local government demanding a one-year delay to the opening of a proposed Toys "R" Us. The toy industry in Sagamihara (near Tokyo) reacted with similar defensiveness. After Toys "R" Us announced its intentions to open seven stores by 1993, with an eventual target as high as 100, a group of 520 small toy retailers formed the Japan Association of Specialty Toy Shops to help small retailers develop ways to compete with Toys "R" Us and other foreign retailers.

Central to this concern was the effect Toys "R" Us would have on the long-standing ties between Japan's toy manufacturers and toy wholesalers. To leverage the economies of scale inherent in their large stores, Toys "R" Us would have to replicate in Japan the same buying structure that had worked so effectively elsewhere. That is, the chain would have to buy directly from the manufacturers, using the sheer size of its outlets to circumvent the wholesalers and win price concessions from the toy makers. If Toys "R" Us had to rely on Japan's cumbersome system of wholesale distribution, it would inevitably have to charge much higher retail prices, undermining its whole competitive strategy. If the chain did not use the wholesalers, though, it risked raising the ire of the manufacturers, who were tied so tightly to both the wholesalers and the small retail outlets. As one newspaper explained, "Japanese toy makers drool at the prospect of supplying Toys "R" Us, but worry they'll be locked out of their current distribution channels if they play ball with the U.S. company."[56] Accordingly, there were indications that toy manufacturers would resist, if not actually

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[51] *New York Times*, March 22, 1992.

[52] Ibid.

[53] *The Economist*, June 16, 1990.

[54] *Wall Street Journal*, February 7, 1990.

[55] Ibid.

[56] *Japan Economic Journal*, February 16, 1991.

oppose, the U.S. discounter. Top toy manufacturers such as Bandai Co. refused to comment on whether they would deal directly with Toys "R" Us, insisting that anything they (Bandai) said could "have a great influence on toy wholesalers. . . . [E]ven the smallest comments cause concern."[57]

Meanwhile, like all foreign retailers hoping to invest in Japan, Toys "R" Us still faced major problems in obtaining suitable real estate. With a population density of 322 people per square kilometer and a land-mass filled 80% with mountains, Japan had very limited amounts of land suitable or desirable for retailing.[58] In the late 1980s, land prices around Tokyo were at an all time high, with a 540 sq. ft. shop in the exclusive Ginza area renting for about $11,500 per month.[59] Finding local workers also presented a serious and potentially expensive challenge. With the Japanese economy in a state of virtual full employment, competition for top male graduates was intense, particularly for foreign firms, which remained less prestigious employers than their Japanese counterparts.[60] Searching for something positive to say on the labor front, one report could only comment that "for flexible firms willing to hunt around, there is a strong supply of bright, well educated women."[61]

A final set of concerns centered on the company's choice of partner: the maverick Fujita had his detractors. In a letter to *The New York Times*, he was accused of anti-Semitism and of supporting Communism to provoke the Americans.[62] These criticisms stemmed from Fujita's well-known claim that Osaka-born Japanese (like himself) were more business-oriented than their Tokyo cousins because Jews had settled in Osaka hundreds of years ago. He had also written several books on "the Jewish way of doing business" and described himself as "the Ginza Jew."

As a result of all the resistance that Toys "R" Us Japan faced, the schedule of store openings began to slip steadily. Though initial publicity had suggested six stores by the end of 1991, subsequent plans slated only the first store to open in December 1991.[63] Without direct distribution deals, the high land prices and labor costs would render the cost structure of the superstores almost insurmountable.

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[57] *Wall Street Journal*, September 10, 1990.

[58] The U.S. population density was only 26 people per square kilometer.

[59] *Business Tokyo*, May 1992.

[60] *Business Asia*, April 16, 1990.

[61] Ibid.

[62] Harold Solomon, "To the Editor: Beware the Agenda of Den Fujita," *New York Times*, April 12, 1992.

[63] *The Daily Yomiuri*, November 12, 1991.

Exhibit 1 Toys "R" Us Inc. Balance Sheet (millions of US$)

	January 1990	January 1991
Assets		
Cash and cash equivalents	40.9	35.0
Net receivables	53.1	73.2
Inventories	1,230.4	1,275.2
Prepaid expenses	14.0	21.0
Current assets – total	1,338.4	1,404.3
Net property, plant, and equipment	1,703.0	2,141.3
Other assets	33.4	36.8
Total assets	3,074.7	3,582.4
Liabilities		
Long term debt due within year	1.4	1.6
Notes payable	205.5	386.5
Accounts payable	517.9	483.9
Taxes payable	96.0	81.6
Other current liabilities	279.1	274.0
Total current liabilities	1,100.0	1,227.6
Long term debt	173.0	195.2
Deferred taxes	96.4	113.4
Equity		
Common stock	19.8	29.8
Capital surplus	322.7	352.6
Retained earnings	1,459.9	1,793.2
Less: treasury stock	97.0	129.3
Total equity	1,705.3	2,046.3
Total liabilities and equity	3,074.7	3,582.4

Source: *Standard & Poor's Compustat, Compustat PC Plus*

Note: Numbers may not add due to rounding.

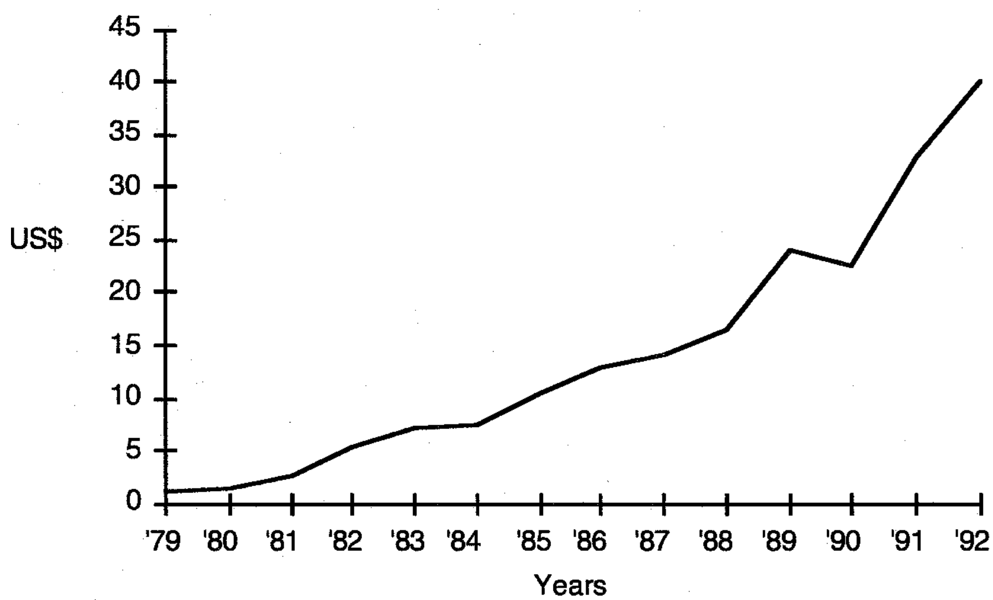
Exhibit 2 Toys "R" Us Inc. Income Statement (millions of US$)

	January 1990	January 1991
Sales	4,787.8	5,510.0
Cost of goods sold	3,309.7	3,820.8
Gross profit	1,478.2	1,689.2
Selling, general, and administrative expense	866.4	1,024.8
Operating income before depreciation	611.8	664.4
Depreciation, depletion, and amortization	65.8	79.1
Operating profit	545.9	585.3
Interest expense	52.8	82.7
Non-operating income/expense	20.5	19.7
Special items	0.0	1.0
Pretax income	513.7	523.2
Total income taxes	192.6	197.2
Net income	321.1	326.0

Source: *Standard & Poor's Compustat, Compustat PC Plus*

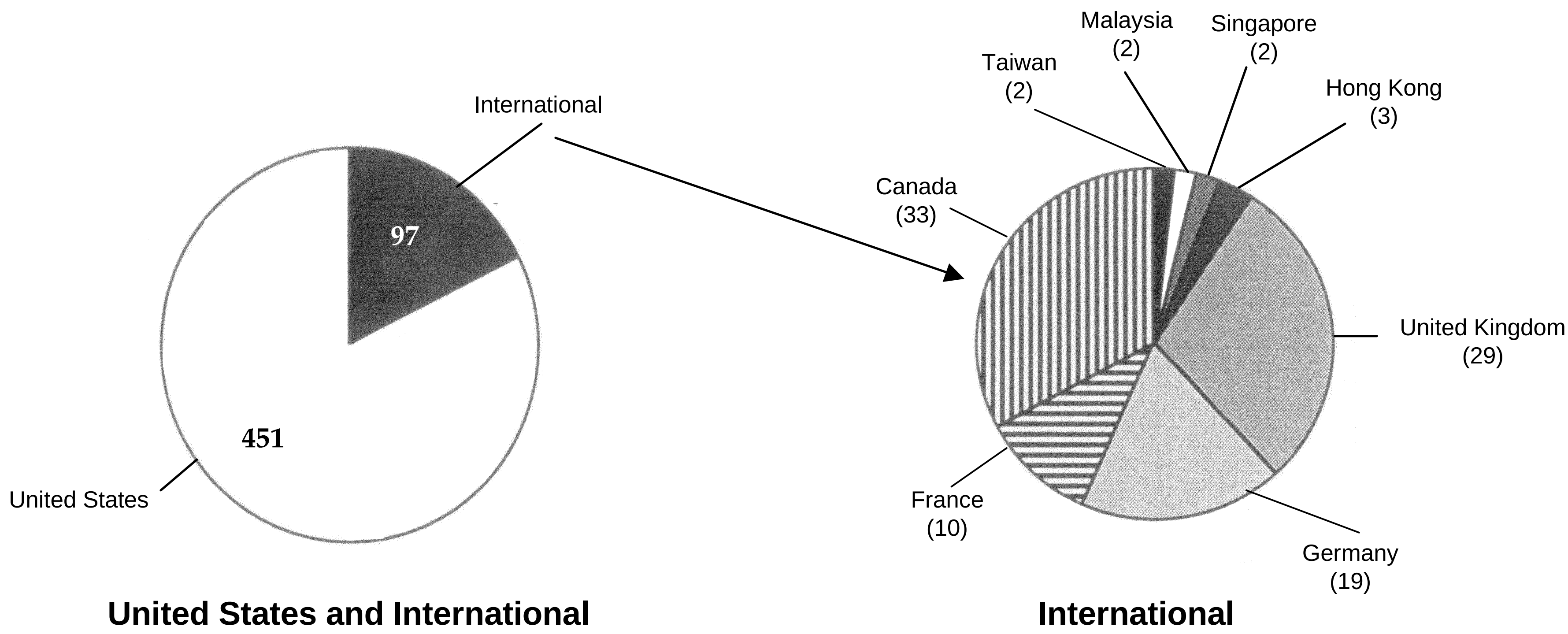
Note: Numbers may not add due to rounding.

Exhibit 3 Toys "R" Stock Price (US$), 1979-1992



Source: *Standard & Poor's Compustat, Compustat PC Plus*

Exhibit 4 Distribution of Toys "R" Us Stores, 1991



Source: Toys "R" Us Annual Report, 1991

Exhibit 5 Total Retail Sales of Toys and Games, Selected Countries, 1992

Country	Sales of Toys & Games (Millions of US$)
Canada	1,033.0
China	140.0
Hong Kong	200.0
India	260.0
Japan	7,884.0
Malaysia	20.0
Mexico	220.0
Philippines	32.0
Singapore	55.0
South Korea	425.0
Taiwan	375.0
United States	20,684.0

Source: *International Marketing Data and Statistics 1994*

Exhibit 6 Index of Urban Land Prices in Japan, 1982-1991 (end of March 1990 = 100)

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
All urban land										
Total average	61.5	64.4	66.5	68.3	70.2	74.1	81.5	87.6	100.0	110.4
Commercial	55.6	58.0	59.8	61.7	64.2	69.2	78.4	86.3	100.0	111.5
Residential	64.6	68.3	70.7	72.7	74.2	77.6	84.0	88.7	100.0	109.7
Industrial	66.2	68.8	70.7	72.4	73.9	76.4	82.3	88.2	100.0	109.8
6 major cities										
Total average	28.4	29.7	31.3	33.6	38.4	48.3	61.8	76.9	100.0	103.0
Commercial	19.5	20.8	22.7	25.6	33.0	44.2	62.6	78.3	100.0	103.3
Residential	33.5	34.8	36.0	38.0	41.7	52.9	65.2	75.1	100.0	102.1
Industrial	35.7	37.0	38.2	39.6	41.6	48.7	58.1	77.2	100.0	103.8

Source: *Japan Statistical Yearbook 1995*

Exhibit 7 Monthly Living Expenditure per Average Household in Japan, 1980-1991 (value in yen)

	1980	1985	1990	1991
Food	66,923	73,735	78,956	82,130
Medical care	5,865	6,931	8,866	9,016
Transportation/communication	18,416	24,754	29,469	30,533
Education	8,325	10,853	14,471	14,211
Reading/recreation	19,620	24,191	30,122	31,442
Housing	10,682	12,686	14,814	16,712
Fuel/light/water	13,225	17,724	17,147	17,981
Furniture/household items	9,875	11,665	12,396	13,401
Clothes/footwear	18,163	19,606	22,967	23,814
Miscellaneous/personal	12,411	15,589	17,207	19,173
Pocket money	21,002	24,345	27,569	28,502
Social expenses	21,504	25,573	29,830	32,543
Annual rate of inflation (% growth)	7.7	2.0	3.1	3.3

Source: *Japan Statistical Yearbook 1995, International Marketing Data and Statistics 1995*

Note: Numbers may not add due to rounding.

Exhibit 8 Employees and Establishments in Japan, 1970-1991

Year	Retail Establishments	Employees (000s)	Average/ Outlet	Wholesale Establishments	Employees (000s)	Average/ Business
1970	1,471,297	4,926	3.35	255,974	2,861	11.18
1972	1,495,510	5,141	3.44	259,163	3,008	11.61
1974	1,548,184	5,303	3.43	292,155	3,290	11.26
1976	1,614,067	5,580	3.46	340,249	3,513	10.32
1979	1,673,667	5,960	3.56	368,608	3,673	9.96
1982	1,721,465	6,369	3.70	428,858	4,091	9.54
1985	1,628,644	6,329	3.89	413,016	3,998	9.68
1988	1,619,752	6,851	4.23	436,421	4,332	9.93
1991	1,591,223	6,937	4.36	475,983	4,773	10.03

Source: Census of Commerce, MITI

Exhibit 9 Number of Outlets in Japan by Format, 1988 and 1991

Outlet Format	1988	1991
Department store	433	455
General supermarket	1,478	1,549
Other general supermarket	373	375
Specialty supermarket	6,397	7,130
Convenience store	34,550	41,847
Other supermarket	53,834	67,473
Specialty store	1,007,756	1,000,166
Miscellaneous retail stores	513,338	470,289
Others	1,593	1,939
Total	1,619,752	1,591,223

Source: *Retail Trade International*, Euromonitor 1995

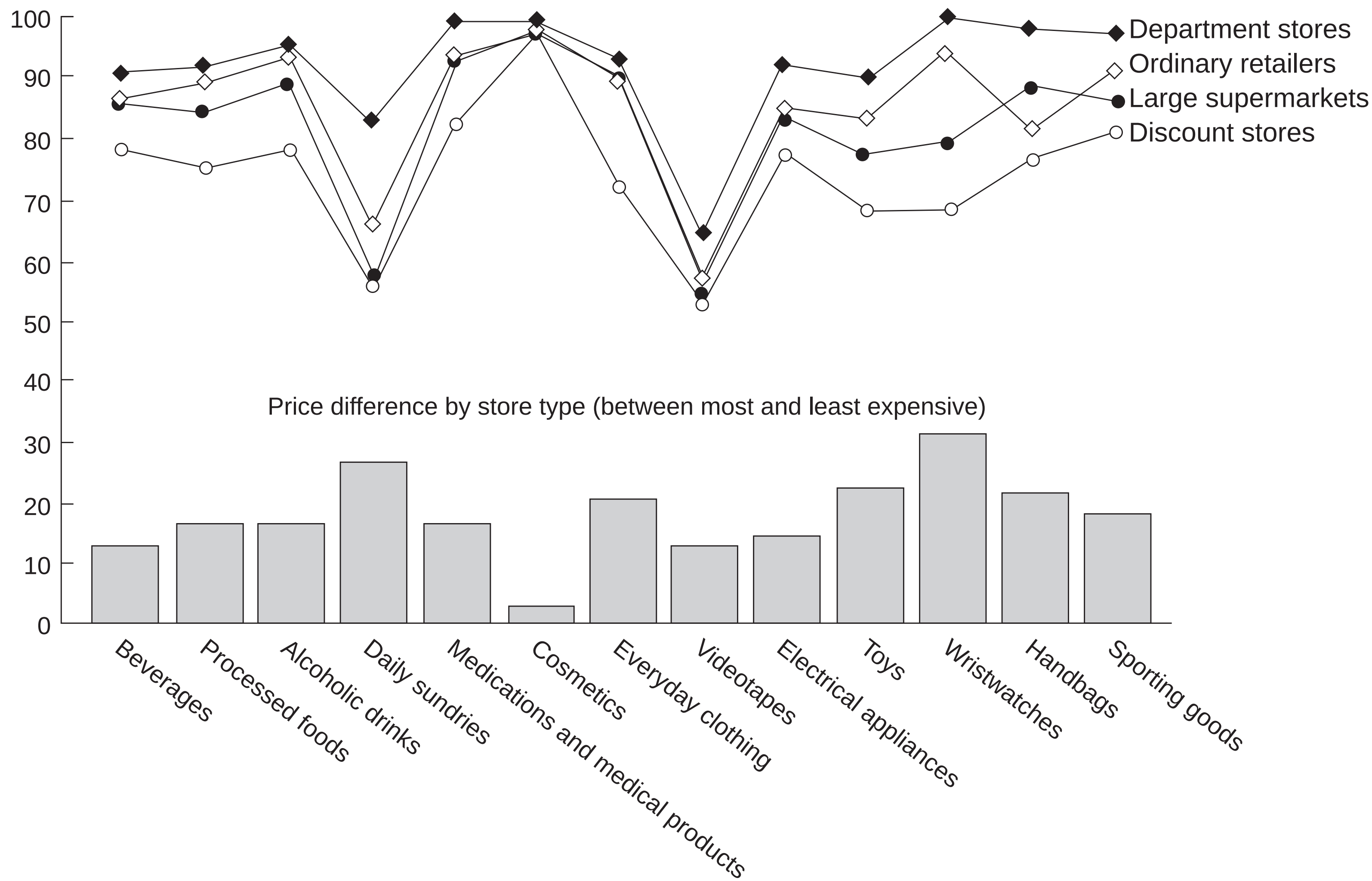
Exhibit 10 Number of Outlets in Japan by Size, 1988 and 1991

Outlet Size (sq. m.)	1988	1991
Under 10	83,510	72,387
10-19	280,761	246,657
20-29	267,077	239,425
30-49	367,266	360,059
50-99	271,227	282,388
100-199	96,260	109,050
200-499	48,423	56,490
500-999	8,408	8,799
1,000-1,499	3,888	4,358
1,500-2,999	2,047	2,269
Over 3,000	2,107	2,371
Not reported	188,778	206,970
Total	1,619,752	1,591,223

Source: *Retail Trade International,* Euromonitor 1995

Note: 1 sq. m. = 0.092 sq. ft.

Exhibit 11 Comparison of Price Levels by Store Type in Japan (manufacturer's suggested retail price = 100)



Source: Adapted from the Japanese Economic Planning Agency, *Price Survey by Store Type*, July 1994.

Notes 1: Prices of specific brands were surveyed. Does not include private brands.

2: 'Electrical appliances' is the average for TVs and air conditioners, and includes delivery, piping and installation charges.

Exhibit 12 Leading Foreign Retailers in Japan, 1991

Company	Year Opened	Number of Stores	Owners
Clothing/Accessories			
Brooks Brothers (Japan)	1979	3	Brooks Brothers Inc. (51%)
			Daidoh Ltd. (49%)
Hermes Japan Co.	1979	1	Hermes S.A. (50%)
			Seibu Department Stores Ltd. (50%)
Laura Ashley Japan	1986	12	Aeon Group (40%)
			Laura Ashley Group Plc. (40%)
Louis Vuitton Japan	1981	1	Louis Vuitton Malletier (99%)
Audio/Visual			
Blockbuster Japan	1990	1	Blockbuster Entertainment (50%)
			Fujita & Co. (50%)
HMV Japan	1990	3	HMV Group Ltd. (100%)
Tower Records	1980	14	MTS Inc. (100%)
Virgin Mega Stores Japan	1990	1	Virgin Group Ltd. (50%)
			Marui Co. (50%)
Others			
Tireplus	1990	3	Sears, Roebuck & Co. (50%)
			Saison Group (50%)
Toys “R” Us	1991	0	Toys “R” Us Inc. (80%)
			McDonald’s Co. (Japan) (20%)

Source: *Nikkei Weekly,* November 16, 1991

Note: The first Toys “R” Us store in Japan opened on December 20, 1991.

Exhibit 13 Foreign Direct Investment in the United States and Japan, 1985 and 1991 (millions of US$)

	United States		Japan	
Year	Total Stock of Foreign Investment	Stock of Japanese-owned Foreign Investment	Total Stock of Foreign Investment	Stock of U.S.-owned Foreign Investment
1985	184,615	19,313	6,397	3,067
1991	414,358	92,896	22,771	9,907

Source: International Direct Investment Statistics Yearbook 1994