

Zapped!

How the toy industry is being outplayed by video games this holiday season

By DAREN FONDA TIME Magazine
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Left unfettered, Anthony Konieczka, 9, would happily thumb away at his Game Boy Advance or PlayStation2 from the minute he gets up to the moment he crawls into bed, 14 bleary-eyed hours later. Anthony's basement in Naperville, Ill., is stocked with traditional toys — board games, puzzles, art supplies — and as far as he's concerned, they're relics of Christmases past. His sister Michaely, 6, still likes dressing her Barbies. "But once she starts playing Game Boy," says their mom Scharmen, "it's hard to get her away."

Play patterns like this could Grinch another Christmas for the toy department. Through September, toy sales were down 5% compared with the first nine months of 2003, according to the NDP Group. Meanwhile, the video-game industry is heading for another record year, with sales of \$12 billion in the U.S., up 7% over 2003, including consoles and PC titles. And thanks to hot new games like Halo 2 for the Xbox, the industry is light-years ahead of the toy business when it comes to buzz. With distractions such as instant messaging, cell-phone games and iPods angling for kids' minds and allowances, the digital revolution is making life miserable for the \$20 billion toy industry. "Kids are playing on computers at earlier ages; they're picking up Game Boys and PlayStations younger than they were five years ago," says analyst Anthony Gikas of Piper Jaffray. "These are good, sexy products. They're cannibalizing the traditional toy market."

While some hard-to-find toys emerge every holiday season, toymakers are heading into this one without a monster hit. Indeed, there has not been a Furby-style frenzy in years. Of 10 toy segments — yes folks, there are that many to the people who take toys seriously — only two, arts and crafts, and dolls, have generated sales growth over a recent 12-month period, according to investment firm Harris Nesbitt. Some of the weakest categories like construction sets (down 10%) and action figures (down 9%) are the ones aimed at boys, who suffer the most blisters from video games. Analysts expect one of the top stocking stuffers this season to be not a traditional toy but the new generation of Nintendo's Game Boy, the DS, which hit stores last week. Next year will bring more competition in handheld gaming, when Sony launches the PSP. Cell-phone makers like Nokia are also targeting kids with game gadgets. A recent Roper poll found

that parents plan to curtail toy purchases this season in favor of gifts such as video games and consumer electronics.

But a runaway smash alone would not solve the woes of the toy business. Toy stores see little Christmas cheer in tackling the big-box discounters Target and Wal-Mart, and many are shutting down. Since last season's brutal price war — led by Wal-Mart — KB Toys and FAO Schwarz have closed roughly 600 stores between them. Toys are increasingly merchandised as impulse items at drugstores, supermarkets and even coffee shops. Starbucks has sold loads of the Cranium board game. KB, operating under bankruptcy protection, says it will close 164 of its remaining 820 stores in January. FAO now consists of just two stores and a luxury catalog hawking, uh, toys like a tyke-size Mercedes convertible — a bargain at \$15,000 (top speed: 15 m.p.h.).

What really worries manufacturers is wobbly Toys "R" Us. The retailer recently put its toy stores up for sale and plans to focus on its fast-growing and less seasonal Babies "R" Us stores. Buyout firms are circling — quite the comeuppance for a company once feared as the Darth Vader of mom-and-pop toy shops (a helmet now worn by Wal-Mart).

Analysts expect dozens if not hundreds of Toys "R" Us stores to close next year — funneling more shoppers to the discounters where they can just as easily pop a Harry Potter DVD in the cart and scrap the toy altogether. To help keep Toys "R" Us afloat, manufacturers are supplying it with more exclusives this year, like a Big Air Ball Tower from K'nex, though Target, for one, is also selling more exclusive toys.

The deeper issue is that shifts in play patterns are forcing toymakers to fight for shelf space in a tightening market. Boys in particular seem to be abandoning traditional toys at earlier ages in favor of consumer electronics, trendy video games, PC software and the Internet. The notion that kids are growing more sophisticated and tech savvy, a trend called age compression, has bedeviled toy companies for at least a decade. While young children still role-play with dollhouses and Tonka trucks (and cheap plastic toys will always play their pacifying role on shopping trips), the market for action figures, for instance, used to be considered healthy for boys up to age 12. Now, the items are mainly marketed to boys 4 to 6, says Chris Byrne, an independent toy-industry consultant. And "boys 9 and up have pretty much gravitated away from traditional toys," says NDP analyst Anita Frazier. A recent study by her firm found that nearly half of U.S. children start on video games at 4 to 5 years old — and 20% at age 3 or younger.

Toy companies, of course, have long seen this coming. Mattel attempted to get into educational software in the late 1990s, spending \$3.6 billion to buy the Learning Company. But "Mattel just didn't understand the software business," says analyst Gikas. The blunder led to more than \$400 million in losses and cost then CEO Jill Barad, who had revived Barbie, her job. Under CEO Robert Eckert, Mattel got back to building basic brands like Barbie and Hot Wheels. But Barbie's sales slump — domestically down 21% this year through September — may also be a victim of kids growing older at younger ages. Barbie has been badly rattled by Bratz, a line of hip, trendy dolls launched in 2001 by MGA Entertainment. Mattel's turnaround plan for Barbie has entailed everything from a breakup with Ken to trendier fashions to launching a girls' line of Barbie clothing and perfume — even enlisting Hilary Duff to talk her up. For all that, Barbie still seems stuck. She is trying "to out-hooker Bratz," says analyst Sean McGowan of Harris Nesbitt. Several of the toys expected to sell well this season are, in fact, those that incorporate video gaming and DVD technologies. Mattel's Fisher-Price introduced a game system

called InteracTV this year, featuring DVDs with characters like Dora the Explorer; children as young as 3 interact with the videos via a push-button controller. VTech has a new video-game platform aimed at kids 3 to 7, called VSmile — for learning, of course. "Moms aren't happy when their kids want to play video games," says Julia Fitzgerald, a VTech marketing executive. "We wanted to take this play pattern and make it work for moms." Hasbro came out with a portable color video player this year, called VideoNow, and has been putting classic games like Battleship, Boggle and Yahtzee into handheld electronic format.

Sony, meanwhile, is trying to extend its PlayStation franchise to younger kids with its EyeToy technology, which features a camera that puts the player onscreen. In EyeToy: Groove, players bob to the likes of Madonna and Fatboy Slim, and a calorie counter shows how much of that Big Mac you have burned up — a nod to parents concerned that too much sedentary screen time is making their kids fat. Plug 'n' play games — cheap cartridges that plug directly into the TV — are also expected to do well this season, thanks to a revival of classics like old Atari titles and tie-ins to popular characters like SpongeBob SquarePants.

The popularity of retro items like My Little Pony also suggests that when kids do want traditional toys, the classics resonate. "Kids love horses and playing with hair, and My Little Pony speaks to that," says toy expert Byrne. A recent survey by the consulting firm Funosophy found that kids 6 to 8 prefer toys over consumer electronics 49% to 30%. Trouble is, kids a little older (9 to 11) favor the electronics 42% to 24%.

Since more than half of annual toy sales occur in the fourth quarter, some analysts say it's too soon to call the year a bust. Retailers are stocking less toy inventory this season, which should help them avoid profit-killing sales. Recent price surveys suggest that Toys "R" Us is more competitive with Wal-Mart this year, and Wal-Mart appears to be devoting less shelf space to its Kid Connection private-label toys — good news for brand names like Mattel and Hasbro. A weakening buck may also translate overseas sales into higher profits when converted back into dollars.

Yet regardless of how sales go this season, age compression is here to stay. Some analysts think the worst of it may be over and that toymakers have figured out how to adapt. Kids "expect a bit more electronic sizzle from their toys, but they are still kids at heart, and kids love toys," analyst McGowan recently wrote in an industry report.

Nonetheless, as many parents can attest, weaning your kid off Mario can be tougher than confiscating the Cocoa Puffs. When Kathy Gregovich of Roseville, Mich., suggests to her children Jacob, 9, and Ashley, 6, that they put away the Game Boy and play a board game, "they go through withdrawal," she says. "If they had a choice between playing with electronic games and a friend, they would pick the games."

— With reporting by Leslie Whitaker/Chicago