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Strategic Repositioning in Changing Market Conditions

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Liam Patrick
Edwin Liang
Taylor Sakamoto

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BARNES & NOBLE
BOOKSELLERS

Table of Contents

Executive Summary

Having experienced top-line growth of more than four hundred percent over the past decade, Barnes & Noble is a highly successful company. This outstanding record has been achieved through a combination of internal growth and acquisition.

Barnes & Noble now operates in four distinct U.S. markets: (1) store-based bookselling, (2) online bookselling, (3) video game retail and (4) publishing. It is the market leader in both store-based bookselling and video game retail.

Financially, the company is doing well, although concerns do exist about its profitability. Rival Borders has significantly higher profit margins and lower leverage. Barnes & Noble stock has performed poorly over the past year, although it has recently rebounded and regained some lost value.

Barnes & Noble faces significant profit-reducing competitive pressures, but it is relatively secure with regards to pressures from the other Porter's Forces.

In this engagement, Blaisdell Consulting examines opportunities for Barnes & Noble to reposition itself in the marketplace. We analyze the strategic fit within core competencies of Barnes & Noble's holdings and assess the "multi-channel" strategy. Blaisdell Consulting concludes that in the main Barnes & Noble is currently well positioned, and that it obtains valuable synergies from its diversified focus. The company should retain the majority of its holdings.

We do recommend that the firm divest those store-based bookselling holdings that do not match its highly successful superstore model. We also recommend that the company abandon electronically formatted books and wireless commerce, where visions of market acceptance were premature.

Moving forward, Barnes & Noble should not seek radical acquisitions or transformations, but should instead focus on enhancing internal synergies and drawing strength from core competencies to augment shareholder value. Further, Barnes & Noble should avoid the temptation to follow the lead of Borders and expand into international markets.

Financial Analysis

Company Profile

Barnes & Noble is the world's largest bookseller, operating approximately 620 Barnes & Noble bookstores in 49 states, as well as 281 B. Dalton mall-based bookstores. Through acquisition of Babbages Etc. and Funco in October 1999 and June 2000, Barnes & Noble has become the largest US video game and PC entertainment software specialty retailer. A restructuring of its video game acquisitions into the company GameStop preceded GameStop's IPO in February 2002, although Barnes & Noble retained a 60% interest in the company. Barnes & Noble also embarked upon a joint venture with Bertelsmann, creating e-commerce retailer barnesandnoble.com, in which it initially held a 50% interest that fell to 40% after its IPO on May 25, 1999, and further to 36% after the venture's acquisition of Fatbrain.com with stock in November 2000. Most recently, on January 22, 2003, Barnes & Noble completed the $115 million acquisition of Sterling Publishing.

Capital Valuation

As of the market's closing on Friday, April 18, 2003, Barnes & Noble ("BKS") stock was trading at $19.04. This represents a market capitalization of $1.23 billion, based upon 64.6 million shares outstanding.

The following, Table 1, represents the closing price and market capitalization of BKS as of the end of the last five fiscal years, ending January 31, to the present. Chart 1 depicts price/volume movements in BKS over the last five FYs to the present, and includes Dow and S&P price lines for comparison.

Table 1

Fiscal Year	Shares Out.	Close	Market Cap	% Change
1997	68.2M	$31.75	$2.16B	104.61%
1998	69.0M	$37.44	$2.58B	19.35%
1999	64.1M	$20.13	$1.29B	-50.08%
2000	65.2M	$25.70	$1.68B	29.90%
2001	67.3M	$34.81	$2.34B	39.78%
2002	64.6M	$17.40	$1.12B	-52.01%
Present	64.6M	$19.04	$1.23B	9.43%

(Shares Outstanding in millions, Market Capitalization in billions)

BKS market capitalization soared just preceding the period examined in Table 1, from $1.06B at the 1996 FY close to $2.16B at the end of FY 1997. The stock price continued to rise in FY 1998, reaching $48.00, its current five-year high, during FY 1998, as management bought back nearly 5 million shares. By the end of FY 1998, the market capitalization of the firm was $2.58B. During FY 1999 and FY 2000, market capitalization dropped significantly as shares swooned, and though BKS recovered during FY 2001, it dropped again to its current position of $1.23B as of April 18, 2003.

Chart 1

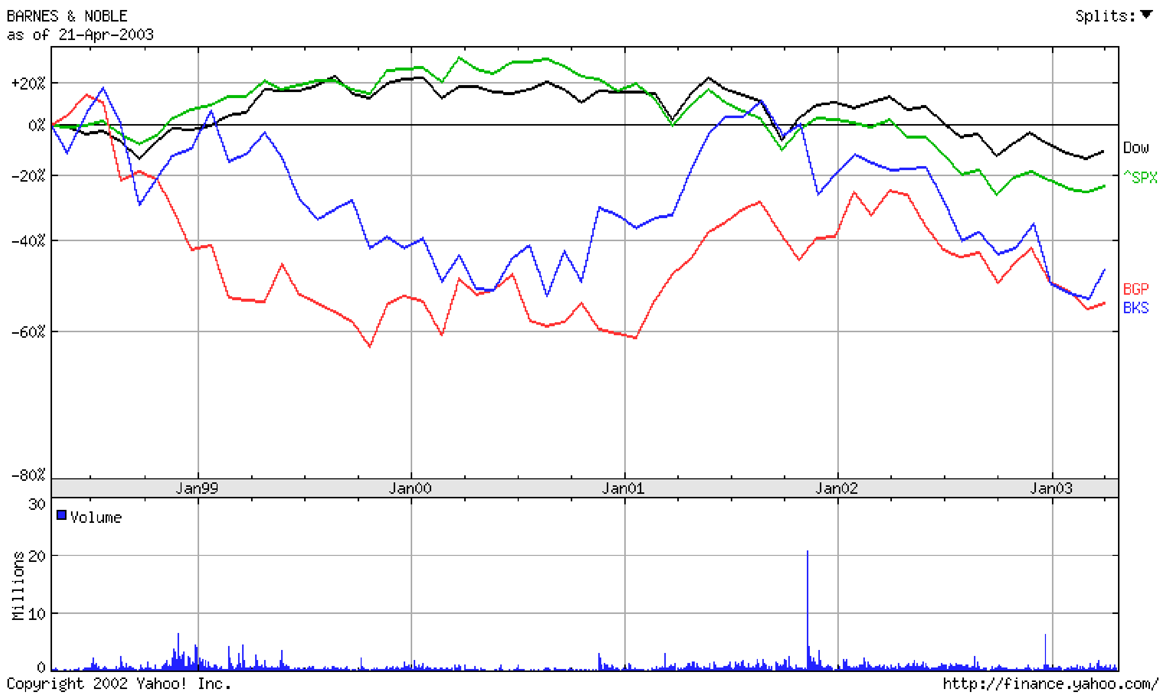

Chart 1 depicts price/volume movements during each fiscal year and shows significant volatility in the stock. BKS performance correlated highly with the Dow and S&P in FY 1998, but dropped significantly in FY 1999, unassociated with drops in the Dow or S&P. The two highest spikes in trading volume of BKS, after September 11, 2001, and after December 18, 2002, both correlated with sharp drops in the stock. The spike in late 2002 was associated with the company's announcement that lower-than-expected holiday sales would put its fourth-quarter earnings per share below Wall Street estimates, and BKS lost 18% ($3.91) on December 19.

The price movements of BKS and BGP are remarkably similar, and movement of these stocks appears to be sensitive to consumer spending data and retailing outlooks.

Analyst consensus appears to be Hold on the stock, as Standard & Poors lists 55% of ratings at this level. 18% advise to Buy, whereas 9% advocate to Sell. Whereas GameStop has performed strongly as of late and losses have decreased at barnesandnoble.com, the competitive picture has gotten tougher, potentially eating into margins and stealing market share. A drop-off in consumer spending, particularly related to war in Iraq, could also hurt this retail business.

Financial Statement Analysis

Barnes & Noble is a publicly traded company and publishes 10-K financial reports based on a January 31 fiscal year-end. Following in Table 2 is selected financial information over the last five years. This does not include the fiscal year ending January 31, 2003, as the financial report is not available until May 1.

Table 2

Selected Annual Financials[i]
Income Statement

All dollar amounts in millions except per share amounts.	Jan 02	Jan 01	Jan 00	Jan 99	Jan 98
Revenue	4870.4	4375.8	3486.0	3005.6	2796.9
Cost of Goods Sold	3557.7	3169.7	2483.3	2142.3	2017.7
Gross Profit	1312.7	1206.1	1002.7	863.3	779.2
Gross Profit Margin	27.0%	27.6%	28.8%	28.7%	27.9%
SG&A Expense	912.2	813.0	657.9	586.0	553.3
Depreciation & Amortization	150.1	144.8	112.7	88.7	78.6
Operating Income	250.4	248.3	232.1	188.6	147.3
Operating Margin	5.1%	5.7%	6.7%	6.3%	5.3%
Non-operating Income	(98.8)	(113.3)	10.3	1.0	0.4
Non-operating Expenses	37.7	53.5	23.8	25.4	38.1
Income Before Taxes	109.4	(33.0)	218.6	156.6	109.6
Income Taxes	45.4	19.0	89.6	64.2	44.9
Net Income After Taxes	64.0	(52.0)	129.0	92.4	64.7
Total Net Income	64.0	(52.0)	124.5	92.4	53.2
Net Profit Margin	1.3%	--	3.6%	3.1%	1.9%

Balance Sheet	Jan 02	Jan 01	Jan 00	Jan 99	Jan 98
Cash	108.2	26.0	24.2	31.1	12.7
Net Receivables	98.6	84.5	58.2	57.5	43.9
Inventories	1285.0	1238.6	1102.5	945.1	852.1
Other Current Assets	99.2	106.1	56.6	54.6	68.9
Total Current Assets	1591.0	1455.3	1241.5	1088.3	977.6
Net Fixed Assets	595.8	566.2	568.0	510.3	482.1
Other Noncurrent Assets	436.5	536.0	604.2	209.0	131.4
Total Assets	2623.2	2557.5	2413.8	1807.6	1591.2
Accounts Payable	695.3	582.1	599.4	498.2	459.8
Short-Term Debt	0.0	0.0	0.0	0.0	0.0
Other Current Liabilities	444.9	353.0	323.5	274.1	253.1
Total Current Liabilities	1140.2	935.1	922.9	772.3	712.8
Long-Term Debt	449.0	666.9	431.6	249.1	284.8
Other Noncurrent Liabilities	109.7	103.5	88.0	74.9	61.8
Total Liabilities	1735.1	1779.8	1567.5	1128.7	1059.5
Common Stock Equity	888.1	777.7	846.4	678.8	531.8
Total Equity	888.1	777.7	846.4	678.8	531.8

Cash Flow Statement	Jan 02	Jan 01	Jan 00	Jan 99	Jan 98
Net Operating Cash Flow	457.4	80.5	187.3	181.1	169.2
Net Investing Cash Flow	(196.4)	(302.0)	(304.8)	(145.3)	(135.1)
Net Financing Cash Flow	(178.8)	223.3	110.6	(17.4)	(33.9)
Net Change in Cash	82.2	1.8	(6.8)	18.4	0.3

- *Income Statement*
  Revenues have been growing very rapidly, and have almost doubled in the past five-year period, internally and through acquisition. The company has not been able to maintain and grow its level of profitability. The gross profit, operating, and net profit margins, after increasing from FY 1997 to FY 1999, have fallen below FY 1997 levels as of FY 2002. The most likely contributor to the drop in profitability margins is the investment in non-profitable Barnesandnoble.com, introduced in 1998. Barnes & Noble was profitable in all years except FY 2001, when it took an impairment charge and lost $52 million on the year.

- *Balance Sheet*
  Proportionate to the rise in revenues, inventories have fallen since FY 1997 and net receivables have risen. BKS is booking a great deal more assets as "Other Noncurrent Assets," which deserves examination. On the liabilities side, the firm maintains a significant accounts payable line, and its debt-to-capitalization is a healthy 32.7%, down from 43.9% at the end of fiscal 2001.

- *Cash Flow Statement*
  There are no red flags in the cash flow statement, as the company appears to be taking in cash while engaging in significant investing activity.

Segment Information

Through the end of FY 2002 (prior to the February 2002 IPO of GameStop), Barnes & Noble held its video game business financials in its books. The following, Table 3, offers a glance at its contributions to revenues and profits as well as capital expenditures. Unfortunately, the company does not yet break down its financial numbers in the publishing domain, and so this examination can only include bookstores and video game stores.

Table 3

ii

	Sales		
Fiscal Year	**2001**	**2000**	**1999**
Bookstores	$3,748,992	$3,618,240	$3,262,295
Video Game Stores	$1,121,398	$757,564	$223,748
Total	$4,870,390	$4,375,804	$3,486,043

	Operating Profit		
Fiscal Year	**2001**	**2000**	**1999**
Bookstores	$211,700	$127,812	$216,678
Operating margin	*5.65%*	*3.53%*	*6.64%*
Video Game Stores	$34,087	$6,014	$15,432
Operating margin	3.04%	0.79%	6.90%
Total	$245,787	$133,826	$232,110

	Capital Expenditures		
Fiscal Year	**2001**	**2000**	**1999**
Bookstores	$148,371	$109,161	$142,005
Video Game Stores	$20,462	$25,131	$4,289
Total	$168,833	$134,292	$146,294

Revenues at GameStop have grown very rapidly, and analysts have indicated that Barnes & Noble should be lauded for its success in turning struggling acquisitions into a flourishing business. Operating margins in the last two fiscal years have been lower in the video game industry, but capital expenditures have been far lower, and CapEx on bookstores was over seven times more than on video game stores, whereas revenues were less than four times greater. Strong performance at 60% owned GameStop should be a boon to Barnes & Noble in the future.

Business Seasonality

As a retailer, Barnes & Noble is heavily dependent upon the Christmas season. Historically, it has realized higher revenues and more importantly, far stronger profits during its fourth quarter. With the exception of 2001, when Earnings Per Share ("EPS") was -0.52 in 4Q, the large majority of profits have been taken in during the fourth quarter. (1.41 out of 1.43 annually in 2003, 1.09 out of 1.28 annually in 2002, 1.48 out of 1.81 annually in 2000, and 1.47 out of 1.29 annually in 1999.) It can be concluded then that to achieve significant profitability the company must count on success and sound financial decisions during the fourth quarter.

Competitive Landscape

Barnes & Noble faces strong competitors in each of its business segments. In store-based bookselling, it must face Borders, a well run company with healthy profit margins, as well as many others, including Books-a-million. Amazon.com is a fierce rival to 36% owned barnesandnoble.com, and Electronics Boutique faces off with 60% owned GameStop. Table 4 is an examination of key numbers and financial ratios at Barnes & Noble and three competitors: Amazon.com, Books-A-Million, and Borders. These data were obtained from Hoovers Online.

Table 4

Key Numbers[iii]	Top Competitors					
	Barnes & Noble	Amazon.com	Books-A-Million	Borders		
Annual Sales ($mil.)	4,870.4	3,932.9	442.9	3,387.9		
Employees	37,000	7,800	5,100	32,000		
Market Value ($mil.)	1,101.4	8,178.6	36.5	1,177.2		
Profitability	Barnes & Noble	Amazon.com	Books-A-Million	Borders	Industry	Market
Gross Profit Margin	26.67%	30.26%	26.27%	**30.61%**	31.11%	46.93%
Pre-Tax Profit Margin	2.62%	(3.75%)	1.25%	**5.37%**	2.55%	4.29%
Net Profit Margin	1.39%	(3.81%)	0.78%	**3.31%**	1.32%	1.79%
Return on Equity	7.9%	--	2.9%	**12.4%**	7.3%	3.6%
Return on Assets	2.3%	(10.0%)	1.1%	**4.9%**	2.7%	0.6%
Return on Invested Capital	5.3%	(19.1%)	2.2%	**11.2%**	4.6%	1.7%
Valuation	Barnes & Noble	Amazon.com	Books-A-Million	Borders	Industry	Market
Price/Sales Ratio	0.21	2.08	**0.08**	0.34	0.47	0.99
Price/Earnings Ratio	16.08	--	10.71	**10.62**	52.74	59.39
Price/Book Ratio	1.19	--	**0.31**	1.27	2.57	1.97
Price/Cash Flow Ratio	4.91	**(51.05)**	1.88	5.57	11.77	12.25
Operations	Barnes & Noble	Amazon.com	Books-A-Million	Borders	Industry[2]	Market[3]
Days of Sales Outstanding	7.45	**0.00**	6.85	7.49	13.94	54.75
Inventory Turnover	2.2	**19.4**	1.3	1.7	4.1	7.7
Days Cost of Goods Sold in Inventory	160	**19**	269	213	88	47
Asset Turnover	1.7	**2.8**	1.4	1.5	2.0	0.4
Net Receivables Turnover Flow	46.1	--	**47.7**	47.1	25.7	6.5
Effective Tax Rate	41.5%	**0.0%**	37.5%	38.3%	44.1%	--
Financial	Barnes & Noble	Amazon.com	Books-A-Million	Borders	Industry[2]	Market[3]
Current Ratio	1.54	1.57	**1.60**	1.28	1.45	1.31
Quick Ratio	0.2	**1.2**	0.1	0.1	0.4	0.9
Leverage Ratio	3.46	--	2.78	**2.52**	2.72	5.73
Total Debt/Equity	0.48	--	0.63	**0.29**	0.67	1.47
Interest Coverage	6.0	0.0	2.4	**17.1**	3.2	1.6

- *Profitability*
  Borders handily exceeds the profit margins of Barnes & Noble, whereas Books-A-Million, a much smaller retailer, realizes lower profit margins than both of the giants. Amazon.com, on the other hand, is still losing money, as is barnesandnoble.com.

- *Valuation*
  The Price/Sales ratio indicates that Barnes & Noble is undervalued relative to Borders, the Specialty Retail industry and the market. The other three ratios, Price/Earnings, Price/Book and Price/Cash Flow indicate undervaluation relative to the overall industry and market but not necessarily against Borders and Books-a-Million.

- *Operations*
  Operations ratios line up well with Borders & Books-a-Million, with strong inventory turnover, days costs of good sold in inventory, and asset turnover, although Amazon.com, relying on fast inventory turnover, has the best performance in these ratios.

- *Financial*
  Barnes & Noble holds a higher leverage ratio than its competitors, and its debt-to-equity ratio is not quite as low as that of Borders. It has a higher current ratio than Borders as well, while a bit lower than that of Amazon.com and Books-A-Million.

Conclusion

On the whole, Barnes & Noble is financially healthier than Books-A-Million but less healthy than Borders. Amazon.com and Barnes & Noble are difficult to compare as their products and businesses are considerably different.

Porter's Five Forces Market Analysis

Market Definition

Barnes & Noble faces strong competition in its industry. As classified by the North American Industrial Classification System (NAICS), Barnes & Noble Inc.'s primary business, bookstores, fits into category 451, "Sporting Goods, Hobby, Book, and Music Stores." Bookselling is a subcategory of this, 451211, and fell under the old SIC code of 5942. 60% owned subsidiary GameStop Inc. falls into category 443120, "Software Stores, Computer," and fell under SIC code 5734. Barnes & Noble has also been expanding into the book publishing industry, acquiring Sterling Publishing in a deal completed in January 2003 and has eyed major purchases such as the AOL publishing unit. Publishing is defined by category 511, "Publishing Industries (Except Internet)," under the sub-category 511130, "Book Publishers," which fell under the old SIC code of 2731.

Internal Rivalry

In each of its core businesses, store-based bookselling, online bookselling and video game retail, Barnes & Noble faces strong competition from a single major rival and many smaller rivals.

In store-based bookselling, Barnes & Noble faces Borders, a competitor with relatively equivalent market share but strong financials including better profitability ratios. Barnes & Noble holds 15 to 20% of the US market, while Borders is a close second. Both of these industry players have increased share rapidly over the last decade, due to the success of the superstore format. They face other chains such as the smaller Books-A-Million, a multitude of independent booksellers and competition from the Internet sales of Amazon.com, 36% owned Barnesandnoble.com, and other upstarts such as BookSense.com. The online industry is increasingly capturing market share – it held 5.3% of the market in 1999 – but will likely never dominate the bookselling industry, for people love the convenience and feel of traditional store-based shopping. The many sellers in this market help to contribute to significant internal rivalry in the industry, and there are other contributing factors as well. Firms have different costs; Barnes & Noble and Borders operate large superstores which benefit from economies of scale, whereas most of its competitors sell from small stores. Another factor is that bookselling is a relatively low growth industry, so most sales growth is obtained by stealing market share from competitors. The undifferentiated nature of the product, books, and the fact that buyers have low switching costs further contribute to internal rivalry.

Barnes & Noble's online bookselling holding, barnesandnoble.com, faces significant competition from Amazon.com. Amazon.com is a large-scale e-commerce retailer, offering everything from books to toys, DVD's, video games and clothing. There has been significant competition in the e-commerce domain, despite the fact that firms in this market are not profitable. Last holiday season, Amazon.com made an aggressive competitive move, removing shipping charges on orders exceeding $25. To counter this move, barnesandnoble.com has offered no shipping charges on orders of two items or more. This type of discounting will continue, and it will eat into margins in an industry that is still struggling to find profit.

Video game retailer GameStop also faces significant internal rivalry. It does not use the same superstore format as Barnes & Noble, focusing instead on a mall-based retail model which competes directly with that of Electronics Boutique. GameStop edged Electronics Boutique in revenues in the fiscal year ending January 2002, reporting $1121.1 million in sales versus their competitor's $1015.1 million. The mall-based model is challenged by the superstores such as Best Buy and Toys "R" Us, among many others, which also offer video games amongst many other products. The internal rivalry in this industry is much like that found in the store-based book industry; many sellers are present, firms have different costs, and the firms offer an undifferentiated product. However, unlike the store-based bookselling industry, whose growth is largely stagnant, the market for video games is growing rapidly.

Entry

A significant barrier to entry in retailing is that customers are highly brand loyal. Many consumers will visit the same store for all their related needs. Of these consumers, some may be attracted to other stores by the knowledge of lower prices there, while some stores may try to maintain their traditional purchasing routines such as service quality. The best way to steal customers from existing firms, though, is to offer low prices, attracting those consumers who place savings before sentimental attachments. This is what made the superstore format successful under such names as WalMart, Home Depot, Barnes & Noble and Borders. They were able to offer lower prices due to economies of scale and they thus captured market share from existing "mom and pop" stores, putting many of them out of business.

The threat of significant entry in the current bookselling market is moderate. It is very expensive to enter the market with a superstore format and may be very capital-intensive, both in constructing the stores and building the necessary inventory. The presence of major players, Borders and Barnes & Noble, and the significance of internal rivalry may deter ambitious entry into this segment of the market. Small bookstores may continue to open, though the threat posed by them is negligible. However, as manifested by the continued superstore expansion of Barnes & Noble and Borders into new markets, the domestic market is not saturated. The threat of entry exists, particularly by an already large retailer with the resources to finance entry into the bookselling superstore market.

Barnesandnoble.com faces few threats, as Internet retailing is largely propelled by branding and the availability of Internet addresses to consumers. It would be difficult for new competitors to compete with Amazon.com and barnesandnoble.com. Further, the lack of current profitability in this market would deter entrepreneurs.

The threat of significant entry in the video game industry is also low. Smaller firms, such as GameStop and Electronics Boutique, are already powerful, and the presence of superstores in the market increases price-competition and minimizes opportunity.

Substitutes and Complements

The bookstore and online bookselling industries face threats to demand in the form of substitutes. The reading of books can be considered an educational pursuit or for entertainment, or both. Other forms of education and entertainment thus can serve as substitutes for books. In terms of education, e-Learning, where training is conducted online or books can be read in an electronic format, has increased in popularity, and the Internet has become an important source of information, available to all with access to a computer. In terms of entertainment, video games, particularly among the younger segments of the population, can be a strong substitute for books, and their market is widening. The popularity of television is also threatening to book sales, and sporting goods and music may also pose threats as substitutes. GameStop and its video games, on the other hand, face substitutes in the form of books and television in the realm of entertainment. The coupling of products which serve as substitutes to each other – books and video games, in the case of Barnes & Noble – can be seen as beneficial as this diversification reduces risk.

The effect of complements to the bookselling industry is negligible. It could be theorized that coffee sold at coffeehouses serves as a complement to books, as many read while sipping coffee at their table. For video games, on the other hand, the technological mediums upon which the games are played, computers and video game systems, are very important in fueling growth in the industry. Technological progress makes more involving games with better graphics possible, inducing consumers to buy more to try the next new phenomenon.

Supplier Power

The power of book suppliers, the publishers, is relatively low as there are many suppliers and many books to be sold. Only in the case of books that are expected to draw very high demand, such as Harry Potter, do the publishers possess significant power. Recently, Scholastic Books, the publisher of Harry Potter, attempted to engage in pre-selling of the book, a practice that publishers traditionally have not attempted. The pressure from booksellers forced them to back down and abandon this strategy.

Barnes & Noble executives have noted in the past that publishers have given preferential price treatment to smaller, discount bookstores. To address this, Barnes & Noble attempted to buy Ingram Books, the largest US distributor of books, in 1999, in a deal that would have greatly enhanced its negotiating power with publishers. The acquisition, however, was called off due to antitrust concerns. Most recently, they have been aggressively building their publishing business, aiming to have 10% of book sales published in-house by 2008. Analysts have noted that this position in the publishing market will give Barnes & Noble negotiating leverage and force publishers to lower their prices. Jim Milliot, an editor with *Publisher's Weekly*, said, "The publishers, let's make no mistake about it, are not happy. But there's nothing they can do about it. If Barnes & Noble increases its publishing sales, other titles are going to lose shelf space to Barnes and Nobles."[iv] Barnes & Noble must be careful in its proceedings, however, as they have suffered lawsuits to publishers over price coercion, settling a suit by independent publishers, along with Borders, in 2001 for $4.7 million.

Buyer Power

Select instances occur where the buyer has significant power, such as in the case of textbooks, which are often bought in bulk with great competition. Bookselling also tend to be price-competitive as stores are competing for the same price-sensitive consumers. However, as a whole, the power of each individual buyer in the bookselling and video game retail industries is relatively low, for they do not tend to buy in large quantities and there are many buyers. Further, in publishing, Barnes & Noble would be buying its own books, and would give their holdings favorable treatment.

Conclusion

Force	***Threat to Profits***
Internal Rivalry	High
Entry	Medium
Substitutes and Complements	Low
Supplier Power	Low
Buyer Power	Low

Strategic Repositioning and Core Competencies

Summary

While Barnes & Noble built its success and powerful brand name through traditional, store-based bookselling, it has since diversified its product offerings, and now pursues a multi-channel retail strategy. The firm has expanded into online bookselling, video game retailing and publishing, with varying percentages of ownership in their holdings. Acquisition has been a key strategy during this expansion, with numerous purchases across each line of business. Recently, many analysts have questioned the wisdom of acquisitions outside of core competencies, contending that much-hyped synergies never materialize. This is particularly the case with the high-profile failures of mergers such as AOL Time Warner and of serial acquirers such as Tyco and Vivendi. Multi-channel and cross-selling synergies that may have existed were overwhelmed by difficulty in uniting corporate cultures, market changes, and the sheer difficulty of operating outside of core competencies.

Many companies are now divesting acquisitions and abandoning ventures of the overly ambitious late 1990's, bringing their focus back to core markets. Should Barnes & Noble do the same? Should BKS fall back to its core competencies, abandon its multi-channel strategy and shore up its financials?

Blaisdell Consulting turns now to an analysis of these questions which will be followed by recommendations. The emphasis will be on strategic fit and market share gains.

Preliminary Analysis

Barnes & Noble has built its success very rapidly. In the past decade, firm revenues have increased over four times to more than $5 billion, and the firm now operates over 900 bookstores. The firm has extended itself into other markets, at each occasion publicly extolling the value of what it calls its multi-channel model. In the 2000 annual report, the firm notes its determination to stay the multi-channel course:

> In every respect, we are pleased with the progress and performance of our multi-channel strategy and intend to keep vigorously investing in the seamless network we are building with our customers across product lines and platforms. We've been at the leading edge of the two most powerful forces in our industry - "super" stores and e-commerce - and we intend to preside over the next big explosion of content - the marriage of low-cost publishing technology with the Internet.[v]

The company's expansion has been fueled by acquisition. It bought Babbages and Funco in video games, J. B. Fairfax International USA, Sterling Publishing and iUniverse in publishing, and Fatbrain.com in online bookselling. Through initial public offerings, partial sales to other companies, and joint ventures, they have diluted their ownership in many of their holdings. BKS has also pursued other business development strategies, creating barnesandnoble.com in 1997 and also forming strategic partnerships, particularly in the e-commerce market, with firms such as Microsoft, Yahoo! and netMorf. Each of these has been an ambitious foray into visions of the future, teaming with Microsoft for the development of a huge library of e-books, Yahoo! for a co-branded Internet Service

Provider offering, and netMorf for a mobile commerce unit, selling thousands of books over wireless mediums. Stephen Riggio, CEO of Barnes & Noble and vice-chairman of barnesandnoble.com, has played a critical role in each of these ventures, believing strongly in the power of technology to change markets and lives. While the company's eye for innovation and vision for the future is valuable to Barnes & Noble, it is questionable whether this ambition is drawn from the excess and extreme optimism of the late 1990's or is a viable approach.

A notable case for comparison of a retreat to core competencies is Barnes & Noble's chief competitor in store-based bookselling, Borders Group Inc. In 2001, it closed up its online unit, Borders.com, choosing instead to partner with Amazon.com. Borders has also withdrawn from its ventures into publishing. This strategy of Borders is particularly significant, as its retreat enabled it to recover from a near-forced sale in 2000 that was avoided only because of a weak bond market which interfered with buyers financing plans[vi]. Through its repositioning, it now appears to be in an even stronger financial position than Barnes & Noble, with much stronger profitability ratios and lower leverage (see pages 7 & 8).

Store-Based Bookselling

The store-based bookselling business is Barnes & Noble's core historical market. The company's bookstores are divided between the popular superstore format under the name of Barnes & Noble and the fading mall-based model under the names of Scribner's and B. Dalton. The mall-based model is of questionable profitability moving forward and has seen little to no growth, whereas the superstore format is widely successful and should enjoy solid growth throughout the decade.[vii] Indeed, Barnes & Noble has been closing its B. Dalton stores at a rate of about 30 per year, opening superstores to replace them at a rate of 40-50 stores per year.[viii] This is similar to the current actions of Borders, which has been downsizing its Waldenbooks mall-based subsidiary. Barnes & Noble must continue to aggressively reassess their store base, opening new superstores in attractive locations and evaluating the viability of B. Dalton locations in order to achieve growth and maximize margins. The firm should explore a divestiture of B. Dalton, as it would be foolish to simply dissolve the value of a brand which still carries significant weight, particularly with older customers, who make up the largest group of purchasers of books. Smaller booksellers may be able to make a significant offer for B. Dalton, finding synergies of cost and scale and allowing Barnes & Noble to concentrate on its flourishing superstore format. Blaisdell Consulting also recommends that Barnes & Noble pursue the divestiture of Calendar Club, a mall kiosk-based sales medium which no longer fits the Barnes & Noble portfolio. The firms should wait in exploring these divestitures, as the current economic uncertainty has resulted in a poor M&A market. The uncertainty has led to difficulty in having confidence about expected financial performance. Thus, there is diminished willingness to take risk amongst buyers, even if the opportunity is compelling. Clearer economic conditions and resolution to conflict abroad should lead to a stronger market for M&A.

Borders has been exploring expansion into international markets with its bookstores, opening stores in the U. K., Australia, New Zealand and Singapore. Blaisdell Consulting recommends against this strategy for Barnes & Noble, as we do not see significant profit opportunities for American booksellers operating internationally. Barnes & Noble has succeeded largely by understanding which books people will want and which they will not, and a significant change in their customer base would eliminate this competitive advantage. Further, significant opportunity remains for opening new stores in the domestic market. Doing so would not only expand Barnes & Noble's base but would also diminish opportunity for entry into the superstore-based bookselling market.

Online Bookselling

Much like the majority of online retailers, Barnesandnoble.com is currently losing money. While the bleeding has recently decreased, BKS' 36% stake in the troubled company has hurt profit margins and sapped cash. Given this and fierce competition in the market from Amazon.com, the strategic fit within the company deserves examination.

Following in Table 5 is a glance at the top-line growth of Barnesandnoble.com and Amazon.com. The market has been expanding, and Barnesandnoble.com has done an admirable job maintaining market share as it competes with the much larger Amazon.com.

Table 5

Revenue	Barnesandnoble.com	Amazon.com
1999	$193.7M	$1.6B
2000	$320.1M	$2.8B
2001	$404.6M	$3.1B

Barnesandnoble.com has made numerous strategic moves to address the fierce competition it receives from Amazon.com, which has included leveraging its association with the Barnes & Noble Inc. The most significant move was the close integration of operations with Barnes & Noble superstores, placing Internet service counters in each store. There, customers are be able to order from the huge inventory of books of barnesandnoble.com, choose between home delivery or store pickup, and even return books ordered from the website with which they are not satisfied. About the move, Stephen Riggio said,

We know that multi-channel customers spend more, and we see our new Internet Service Counters as keys to increasing sales in both the retail and online channels. The counters, as well as the other initiatives announced today, leverage the real strength of Barnes & Noble - tens of millions of affluent, educated consumers who are the most desirable retail demographic group in America. We believe this is the most extensive and comprehensive deployment of technology in the clicks-and-mortar age.

In 2000, they reached an agreement with Yahoo! to become the exclusive bookseller for their websites, a position previously held by Amazon.com. Most recently, to counter Amazon.com's aggressive holiday announcement of no shipping charges on orders exceeding $25, barnesandnoble.com has offered no shipping charges and orders of two items or more. This counter is extremely aggressive, and may power market share gains. However, it will further eat into margins in an industry that is still struggling to find profit. Fortunately, with Barnes & Noble's scale, it has ample funds to fuel its strategy in the ongoing discounting wars.

A close look at the repositioning performed by a rival is constructive in examining Barnes & Noble's holdings in online bookselling. Borders Group closed its struggling online store, Borders.com, in April 2001. Borders concluded that its initial motivation, running an Internet unit in order to protect its core business, was no longer viable, as its difficulties were significant and its positives few. The unit was small, booking only $27 million in revenues in 2000, compared with $1.7 billion in books, music and videos sold at Amazon.com and $320 million at barnesandnoble.com in the same year. Upon closing the store, Border's announced it would have Amazon.com serve its customers instead, managing the new Borders.com and implementing their successful online retail strategy. This enabled Borders to trade a steady stream of losses for commission payments from Amazon on customers it refers. To do this, Borders was willing to take a one-time charge of more than $20 million.

Blaisdell Consulting recommends that Barnes & Noble not follow the footsteps of Borders, for a number of reasons. First, exiting the online bookselling segment would require BKS to sell its remaining stake in a venture which carries its name. Relinquishing control of your remaining stake in a company which carries your brand name, particularly for a brand as strong as Barnes & Noble, is never a prudent decision. Second, the integration of Barnes & Noble with barnesandnoble.com, particularly through the Internet Service Counters, was a wise decision, providing synergies to both businesses. Lastly, it seems that the worst of times for barnesandnoble.com have passed, and as it and Amazon.com near profitability, Barnes & Noble's scale and integrated structure may provide competitive advantages in both store-based bookselling and online bookselling which cannot be matched by the partnership which currently exists between Borders and Amazon.com. Retaining its stake in barnesandnoble.com is recommended.

Video Game Retailing

Barnes & Noble's 60% stake in GameStop has proved valuable, as the video game business has enjoyed great success with the launch of new platforms and wide assortment of games.

Aiming to build a multi-channel retail operation which took advantage of its existing distribution network, Barnes & Noble formed GameStop through a series of acquisitions. They bought Babbages Etc. and Funco in October 1999 and June 2000, respectively, which they then restructured under the GameStop moniker and IPO'd in February 2002. Speaking of the Funco acquisition, Chairman and then CEO of Barnes & Noble, Leonard Riggio said, "With this acquisition, we bring together the most knowledgeable specialists in this industry and dramatically accelerate our multi-channel capability. As the leader in providing video-game entertainment in retail outlets and on the Internet, we are in a strong position to serve the rapidly growing and diversifying video-game market, wherever and however video games are sold."

The cost synergies involved in using the book distribution network for the video game retail business are enough to justify Barnes & Noble's stake in GameStop.

Publishing

Many have questioned the wisdom of combining bookselling and publishing operations, questioning the synergies involved. In the past, there has been a tendency for publishers to move into bookselling: Penguin started Penguin bookshops, Collins owns Hatchards - but it has never worked.

However, analysts are particularly fond of Barnes & Noble's foray into publishing, which one analyst called a "great profit opportunity." They like its concentration upon finding a niche which corresponds well with the buying preferences of its store-based customers. They also like its concentration upon low-cost, high-margin areas, including reprints of classics, and "lifestyle" and coffee-table books.

Of the most recent Sterling Publishing acquisition, completed in January of 2003, Stephen Riggio wrote:

> We are very excited about this acquisition, because it brings two companies together with very similar publishing visions. Sterling has a winning combination of superior content and value pricing. They have their finger on the pulse of what American consumers buy, and it directly overlaps many of Barnes & Noble's strongest categories. We believe that the strengths of each company will enable us to maximize value out of our respective retail and publishing enterprises. We expect this acquisition will enhance the earnings of Barnes & Noble, as it will be a catalyst to driving sales growth in our stores via the publication and promotion of exciting and highly profitable titles that represent exceptional value to our customers. Additionally, Sterling's well-developed sales force gives us an immediate solution to distributing Barnes & Noble publications to the trade and special markets.[ix]

Synergies appear to exist in the case of Barnes & Noble between bookselling and publishing, largely because of the scale of Barnes & Noble operations. TheStreet.com's Kristen French wrote, "Publishing its own books will give Barnes & Noble some exclusive product that other retailers, such as Borders, don't have . . . The whole idea behind a bookstore publishing books is that it can control both ends of distribution, and the more scale, the better."[x] The exclusivity of titles which results from the diversified operations gives Barnes & Noble an edge over its rivals, most significantly Borders. Stephen Riggio estimates 4% of current book sales are published by the company and he expects that figure to reach 10% within five years.

One area in which Barnes & Noble should downscale their operations is in "e-books," where individuals can purchase books in an electronic format to read at their leisure. Visions of a world where traditional books are replaced by e-books were premature and overly ambitious.

The competitive advantage and cost synergies involved in publishing for a retailer of Barnes & Noble's scale have convinced Blaisdell Consulting that BKS should continue its expansion into appropriate publishing niches. They must continue, however, to be prudent in their consideration of opportunities, concentrating on profitable ventures. Comprehensive entry into publishing is not advised, for it would not be sensible to maintain exclusivity of books with widespread appeal, as this would decrease profit opportunities as a publisher.

Conclusions

Blaisdell Consulting finds that Barnes & Noble is currently well positioned in the marketplace. We applaud the company's multi-channel strategy by which it seeks synergies from a diversified focus. Barnes & Noble should therefore retain the majority of its holdings. The firm should, however, divest the store-based bookselling holdings that do not match its highly successful superstore model. And where visions of public acceptance have turned out to be premature, we think it would be prudent for Barnes & Noble to abandon its ventures into electronically formatted books and wireless commerce. They should wait, however, until economic uncertainty subsides, which will improve the M&A market and maximize selling price.

Avoiding radical acquisitions and transformations, Barnes & Noble should utilize a well conceived strategy moving forward that focuses on enhancing internal synergies and drawing strength from core competencies in order to grow market share. The company should especially avoid the temptation to follow Borders lead to expand into international markets. Barnes & Noble should instead continue to expand domestically and thereby retain its competitive advantage which draws on extensive knowledge of its customer base.

[i] Hoovers Online
[ii] Barnes & Noble 10-K, 2002
[iii] Hoovers Online
[iv] French, Kristen. "Barnes & Noble Flexing Publishing Muscle. *TheStreet.com*, February 16, 2002. Available at: http://www.thestreet.com/markets/kristenfrench/10009418.html
[v] Barnes & Noble Annual Report, 2000
[vi] Hansell, Saul and David D. Kirkpatrick. "Borders Turns Over Its Online Book Sales to Amazon." *New York Times*, April 11, 2001.
[vii] ValueLine, November 15, 2002.
[viii] ValueLine, November 15, 2002.
[ix] Barnes & Noble Press Release, December 12, 2002
[x] French, Kristen. "Barnes & Noble Flexing Publishing Muscle. *TheStreet.com*, February 16, 2002. Available at: http://www.thestreet.com/markets/kristenfrench/10009418.html