Background

Financial Analysis

Porter’s Five-Force Analysis

Evaluation of Key Issues

Conclusion
Background

Borders Group Inc. is a publicly-traded Fortune 500 company with sales of $3.4 billion. The company is a leading global retailer of books, music, movies, and other entertainment media. Headquartered in Ann Arbor, Michigan, Borders Group operates 435 domestic Borders superstores, 75 international chains (half of which operate under the brand Books Etc.), located mostly in Great Britain, and 750 Waldenbooks stores located in malls throughout the country. Altogether, Borders Group employs 32,000 people, and is the second largest entertainment media retail chain in the world.

Borders takes an active approach to selling books and other media. Among the company’s top priorities are inventory selection and customer service. Each store offers over 100,000 titles, and through employee attentiveness, each Borders seeks to establish itself as its community’s neighborhood bookstore. Each Borders superstore is designed and built to fit into its environment, whether it’s on the ground floor of a downtown office building, or on the corner of a suburban strip mall. By expanding their stores to include gift supplies and other media in addition to books, Borders has attempted to create a shopping experience where a customer can spend an entire afternoon in the store and make unplanned purchases. In addition, most of the larger Borders have in-store cafes where customers can get coffee and snacks while they shop.

The company is currently enjoying strong profitability, opening new stores every year and increasing sales. New Borders superstores opening in 2003 have averaged approximately 21,000 square feet in size, of which about two-thirds houses books and the rest holds other media and the cafe.

Borders’ smaller chain, Waldenbooks, focuses on convenience and customer loyalty. Since the stores are located in malls, they get many visitors who were not specifically book-shopping, but may decide to buy an item that caught their attention in the display window. Waldenbooks has also expanded membership in its Preferred Reader program in recent years. This program furnishes special discounts and other offers to customers who shop frequently at Waldenbooks. The chain recorded modestly declining revenue in 2002, mostly as a result of fewer people visiting malls and the emergence of more superstores. In response, Borders has begun a study to see why some Waldenbooks chains do much better than others, with the goal of closing non-performing stores.

Borders has also formed a partnership with Amazon.com, beginning in 2001. The company developed an In-Store Pick-Up system whereby customers could order books and media from Amazon.com, to be picked up paid for at the customer’s local Borders store. The transaction is handled by Borders and revenue is recognized at the store upon pick-up, and Amazon simply collects a fee for routing the business to Borders. Alternately, products sold over the Borders.com website are handled
exclusively by Amazon, with a fee paid to Borders for the customer referral service. In the last two years, the company has also been working hard on improving its product-flow systems and inventory management. Borders operates 13 worldwide distribution centers, 5 of which are in Tennessee. Borders also prides themselves on their Category Management, which determines how a store will be laid out and how convenient it is for customers to find what they are (and aren’t) looking for.

Borders has been opening more stores every year, both domestically and internationally, and seeks to constantly refine its strategic mix of different products and customer service. With these projects in the works, PAC Consulting expects Borders to be successful and capture growing market share in the coming years.

Financial Analysis

Basic Indicators

Market Capitalization: 1.88 billion (4/04)
P/E ratio: 15.7
Price/Book ratio: 1.62
Beta: 1.14
Dividend Yield: 1.32%

Borders stock, though stagnant since November 2003, had performed well in recent years and currently trades at around $25 per share. It has been somewhat volatile, however, posting annual returns or losses greater than industry averages.
Financial Data
(Figures in millions except EPS)

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<tbody>
<tr>
<td>Consolidated Revenue</td>
<td>$3,486.1</td>
<td>$3,387.9</td>
<td>$3,271.2</td>
</tr>
<tr>
<td>Revenue Growth</td>
<td>2.9%</td>
<td>3.6%</td>
<td>10.2%</td>
</tr>
<tr>
<td>Net Income</td>
<td>$111.7</td>
<td>$87.4</td>
<td>$43.6</td>
</tr>
<tr>
<td>Diluted EPS</td>
<td>1.36</td>
<td>1.06</td>
<td>.54</td>
</tr>
<tr>
<td>Total Assets</td>
<td>$2,268.2</td>
<td>$2,179.3</td>
<td>$2,047.1</td>
</tr>
<tr>
<td>Stockholder’s Equity</td>
<td>$1,030.6</td>
<td>$949.9</td>
<td>$864.5</td>
</tr>
<tr>
<td>Total Net Liabilities</td>
<td>$1237.6</td>
<td>$1229.4</td>
<td>$1182.6</td>
</tr>
<tr>
<td>RoE</td>
<td>11.8%</td>
<td>10.3%</td>
<td>5.4%</td>
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Data as a percentage of sales:

<table>
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<tr>
<th></th>
<th>2003</th>
<th>2002</th>
<th>2001</th>
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<tbody>
<tr>
<td>Gross Margin</td>
<td>27.6%</td>
<td>27.7%</td>
<td>28.0%</td>
</tr>
<tr>
<td>Net Income</td>
<td>3.2%</td>
<td>2.6%</td>
<td>1.3%</td>
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In the last three complete fiscal years, Borders has enjoyed respectable growth in revenue and provided its shareholders with a high return on equity and steadily increasing net income even with a stagnant gross margin. Note also how the company is financing growth internally, as debt has increased only slightly relative to larger increases in assets and net income.

Store Data

<table>
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<tr>
<th>Store Type</th>
<th>Avg. Size</th>
<th>Avg. Annual Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>Borders Domestic Superstores</td>
<td>27,500 sq.ft.</td>
<td>237 $/sq.ft.</td>
</tr>
<tr>
<td>Borders International Superstores</td>
<td>14000-42,000 sq.ft.</td>
<td>361 $/sq.ft.</td>
</tr>
<tr>
<td>Waldenbooks</td>
<td>4,100 sq.ft.</td>
<td>263 $/sq.ft.</td>
</tr>
</tbody>
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The differences in earnings are attributed to several factors: Waldenbooks has a higher per square foot revenue, but the chain is less profitable than Borders domestic superstores. This is because Waldenbooks stores are located in malls that have higher lease rates relative to store size. Borders executives believe that the international superstores earn more revenue due to weaker competition in international markets from strong competitors like Barnes and Noble.
Porter’s Five-Force Analysis

Internal Rivalry
The U.S. retail market for books and entertainment media is fiercely competitive. Borders’ main competition is Barnes & Noble booksellers (NYSE: BKS), which operates 647 Barnes & Noble Stores and 195 B. Dalton Booksellers stores worldwide. Barnes & Noble also competes online through their subsidiary BN.com and has moved into the market for music and DVDs. Although Barnes & Noble operates fewer stores than Borders, it earned higher revenue in FY ’03 ($5.59 billion vs. $3.64 billion), and were slightly less profitable overall (profit margin of 2.71% vs. 2.93% for Borders). As of this writing, Barnes & Noble’s stock was also trading at a slight premium over Borders’ stock, relative to earnings. (PE of 16 vs. 15.7 for Borders).

Because Borders does not limit itself to book retailing, it faces diverse forms of competition from all the other retailers that sell entertainment media, gift supplies, and café products. Within the focal book category, Borders faces competition from online bookseller Amazon.com (even with their partnership in place), and also faces competition from independent bookstores and their websites, which range in size from Powell’s Books to innumerable single-location privately owned bookstores. With the emergence of the internet as a major marketing device, websites like Half.com have also brought thousands of private individuals into the book market, selling individual copies of their new and used books either for set prices or via auctions such as Ebay. This means that Border’s competition is ever-expanding.

The company has a unique type of partnership with Amazon.com. Border’s officially closed down its website and stopped selling online in 2001, when it developed the partnership. Amazon.com actually handles the entire transaction and delivery when a customer purchases media on the Borders.com site. Amazon then gives Borders a small “referral fee,” for directing business their way. This partnership came about as a result of Borders’ management decision that such an arrangement would be a more profitable option than trying to compete with Amazon directly. Part of the reasoning behind this decision was that Amazon.com has major brand-recognition and is likely the first option people think of when intending to buy books online. Further evidence comes from the fact that Barnes & Noble has lost money on its subsidiary website BN.com for the last three years.

The markets for bookstores and online books are not perfectly identical, however. Some people enjoy going to book stores, wandering around, and being helped by employees. For this type of customer, a book is an experience good. Other customers, for whom books are a search good, simply
want the book and don’t want to have to go anywhere. For them, internet shopping will be more appealing.

In the product category of music and DVDs, Border’s competes with many major players, including all the big record stores, electronics stores such as Circuit City and Best Buy, and other big retail stores that sell CDs and DVDs such as Wal-Mart. The market for music has been in a major slump in the last few years, and this slump is commonly attributed to the rise of illegal file-sharing over the internet. While there has been a turnaround in the retail music business in the last year, internet competition has seriously challenged the record industry’s business model, and this could seriously affect all music retailers.

Fortunately for Borders, their older customer base has led them to emphasize less cyclical genres such as jazz, classical, and new age, even though Borders still stocks big-selling pop albums. There is some evidence, however, that all genres of retail music are in a secular decline. The difficulties in the music industry have also led Borders to move space out of music and into DVDs, which are a newer media and have been selling well in recent years. DVDs introduce a whole new spectrum of competition, but have so far been profitable for the company.

The other categories are magazines and newspapers (wherein Border’s competes with the respective publishers) and diaries and other gifts. While all bookstores sell magazines and newspapers, gift supplies have been a relatively new addition for Borders, and the company hopes to exploit economies of scope through selling these products.

The larger Borders stores also operate cafes, which entice customers to stay is the store longer and bring a warm and relaxed atmosphere to the shopping experience. The competition faced by the cafes is somewhat ambiguous, although PAC Consulting assumes that very few customers go to Borders specifically for coffee, which would suggest that the café exists by capitalizing on its internal monopoly.

Finally, Borders sells gift certificates, whose sales are largely based on geographic omnipotence, convenience, and customer loyalty (since satisfied customers will be more inclined to buy gift certificates for people they know). The gift certificates are especially profitable for stores like Border’s because they are a guaranteed sale, their revenues are realized sooner, and they bring in new customers who don’t have to make an independent decision to shop there. There is also a chance that the gift certificate will be lost or forgotten and never redeemed. During the holiday season, Borders gift certificates are very popular but must compete with myriad other gift certificate and tangible gift options from any number of other retailers.
Entry

The costs of opening and running a large-scale retail store are prohibitive for most entrepreneurs, and the retail market for books and music in the U.S. is saturated to the point where companies looking to grow have to capture market share from competitors. This is evident from the fact that Borders and Barnes & Noble are opening stores slowly, while they close dozens of their mall subsidiary stores every year, and independent book stores have also closed in the last few years.

However, the emergence of online auction sites such as Half.com have introduced many small scale competitors. Anyone with an computer and internet access can set up an account on Half.com or Ebay and start selling books. This phenomenon, combined with the expansion of big chains like Border’s and Barnes & Noble, have run many small independent bookstores out of business, and has caused some controversy. Powell’s Books now uses ‘We’re not a big corporate chain’ as a marketing strategy. Technically speaking, internet selling makes entry into the book market fairly easy, but even though different competitors sells the same products (books and entertainment media), competing with Borders is difficult because the firm, being so large, can capitalize on economies of scale and can offer low prices and the highest-quality customer service and shopping experience, and new competitors will not be able to realistically compete on these bases.

However, corporate online sellers have little overhead and individual sellers often furnish used books; hence, the continued entrance of these rivals means that Borders must ward off entrants by focusing on its core competency in the shopping experience area moreso than by slashing prices. Meanwhile, head-to-head entry by a new big-box media retailer is unlikely given capital costs and market saturation in this industry.

Substitutes and Complements

For a store like Borders, which sells a wide variety of similar products, complements and substitutes exist on two levels. For the experience of shopping at Borders and browsing through books before buying one, a substitute would be going to the library or visiting a movie theatre. This is part of the motivation behind the emphasis on store experience, in that Borders is competing with other types of entertainment generally speaking.

On the other hand, books, DVDs, and CDs tend to be substitutes for each other, though the relationship is obviously imperfect. The products are similarly-priced consumption goods purchased for their entertainment value. If a customer goes into Border’s to buy a book, they may also buy a DVD, but they may also just buy the DVD and not buy the book. This is where Borders can capitalize on its economies of scope. They can capture business from people who want products from a single category,
and then try to entice customers to buy from the other categories as they walk through the store’s various sections.

The recently-added stationery and gift supply category offers products that complement Borders’ media selection. These products also complement gift certificates, and provide an extra convenience for people shopping for gifts.

The in-store cafes offer complements in the form of drinks and snacks since, presumably, as demand for store inventory rises, so will demand for café items. The question then arises to what degree demand for the café might drive demand for core Borders merchandise—i.e. can the café draw customers to the store? (This question forshadows the strategic recommendation below.)

**Supplier Power**

Most entertainment media comes with a Manufacturer’s Suggested Retail Price (MSRP), which appears on the packaging. Media publishing companies charge a price to the buyer proportional to this price, and leave it up to the retail store to offer discounts. While Borders does buy in large quantities, neither the company nor its suppliers have special power over the other party. In general, publishing companies simply want to sell as many units as possible, and depend on retail stores to make this process happen. At the same time, Borders depends on the publishing companies to come out with popular books that will sell well in the store. This mutual interdependence makes for a supplier-retailer relationship more based on cooperation than on competition and price negotiation.

One potential issue in this vein is that Barnes & Noble has recently entered the market for publishing: it publishes its own line of classic literature whose copyright has expired and which can be published by anyone. It is possible that Borders will be able to gain favor with publishers in the future by choosing not to compete with them in this area.

**Buyer Power**

Bookstores like Borders price most of their products at the MSRP. This is the price at which most entertainment media are sold to the consumer, though this price point is not often enforced by the supplier. Some sellers, such as Amazon.com, offer across-the-board discounts of up to 25% on new media. Borders usually only offers discounts off the MSRP on hot new bestsellers. Waldenbooks offers 10% across-the-board discounts for members of its Preferred Readers program, for a small annual membership fee. Although Borders and Waldenbooks utilize such discounts to entice demand, buyer power is not an issue in the media market. No single buyer is large enough to negotiate bulk discounts. Purchases are frequent and relatively small.
Evaluation of Key Issues

Issue One: Waldenbooks

Borders executives report that combined revenues for the Waldenbooks chain were down 5.5% in 2002 and down 0.6% in 2003. The smaller decline in 2003 was attributable to continued decline in Waldenbooks sales partially offset by an increase in revenue from seasonal kiosks at malls: at Waldenbooks stores alone, the revenue decrease was 3.2%. Borders management believes that the decline in revenue is primarily the result of decreasing mall traffic, a trend that has lasted several years and that Borders management expects to continue. Combined with this trend, management also believes sales from large superstores have been cannibalizing sales from the small mall-based outlets. (Note that Waldenbooks existed before the Borders superstores and represents an older business model.) Since sales have been increasing at Borders superstores, as well as at Barnes and Noble superstores, this trend is expected to continue and would imply revenue declines at Waldenbooks independent of changes in mall traffic.

Despite these circumstances, the Waldenbooks chain is still profitable and earned a net income of $41.4m in 2002 and $49m in 2003. During these years, there was a net decrease in number of stores totaling 49 closures in 2002 and 62 closures in 2003. In 2003, the profit margin increased from 4.9% to 6%.

The closest comparable store to Waldenbooks is B. Dalton, the 258-stores subsidiary of Barnes and Noble. Since B. Dalton operates stores of similar size to Waldenbooks, and operates out of malls, one would expect economic trends affecting Waldenbooks to affect B. Dalton in a similar manner. This turns out to be the case, with the B. Dalton chain experiencing net revenue declines of 1.7%, 3.7%, and 6.4% in 2000, 2001, and 2002, respectively. B Dalton is also closing down stores at a rate of about 30 per year, similar to Waldenbooks’ closure rate.

It is therefore the recommendation of PAC consulting that Borders continue to close unprofitable Waldenbooks outlets. Identifying these stores is simple based on same-store sales data collected by the company. Some Waldenbooks stores are running same-stores sales declines, but are still profitable for the company. Others will be unprofitable outright and should be closed as soon as is feasible, based on leases and other practicalities. Overall, Borders management should keep in mind the long-term decline in the viability of the small mall-based bookstore model, as they are slowly replaced by superstores. That being said, the proper decision for each Waldenbooks store will be different. Though some should be closed immediately; most of them will have more years of profitability ahead of them before eventual closure (as indicated by the present profitability of the entire chain as underperforming stores close
down). Waldenbooks stores sell only books and magazines, and we do not recommend changing this product composition.

Finally, the company should consider renegotiating its lease rates to the various malls in which underperforming Waldenbooks stores are located. Since malls collect data on customer visits, a systemic decline in traffic would be measurable. This decline would lower the fair rental price of the real estate, which is important for a store like Waldenbooks because lease expenses are as major cost for a store like Waldenbooks. Leases expenses are accounted for by Borders under Selling, General, and Administrative Expenses on the Income Statement. This expense accounted for 21.2% of total revenue in 2003 and 27.5% in 2002, so the company seems to making progress cutting costs in this area.

**Issue Two: Border’s Cafe**

Borders Group has already taken laudable steps via the Category Management program to look at product segments as distinct sub-businesses. This approach will offer strategic benefits. It presents a disaggregated bottom-line that reveals target problem areas where revenues have fallen or costs have risen and then charges overseers who have expertise in the given segment area with trouble-shooting.

The firm should use this new type of thinking to focus on the café as a unique element under the Borders superstore umbrella. This category deserves special attention because (a) it is not purely a product like books, magazines, music, DVDs, and gift items are, (b) it has great potential that has not yet been realized, and (c) this latent potential could help Borders to overcome the increasing internal rivalry challenges that it faces.

The café presently resides in a strategic “no-man’s-land” where it neither represents a draw for customers by virtue of quality nor a service to them by virtue of price. The café relies on its in-store monopoly on food and beverages and has hence brought in revenues in spite of its lack of emphasis on high quality or low price.

Borders must evaluate which is more profitable in the long-term: a café that offers high-quality items at high prices (thus relying on patronage from high-income store patrons) or a café that offers decent items at low prices (thus potentially attracting customers from outside and pleasing those who had entered to shop). The former option may be profitable, depending on price-elasticity of demand and it might dress-up the image of Borders. The latter option would, however, likely build more customer loyalty by functioning almost like a customer service. In an ideal world, Borders would of course offer high-quality items at low prices by leveraging its buyer power and thus succeed on multiple axes.
At present, though, Borders offers medium-quality items at medium-quality prices. The menu is not especially inspired and the products lack respected labels and often do not appear fresh or delectable. Essentially, any cursory examination of the store reveals that the café is an afterthought. Thus it represents a gross lost opportunity because, while profitable, it neither attracts customers to the store nor builds the loyalty of customers to the Borders brand. It seems that Borders Group has lost touch with its strategic decision to make “Books · Music · Café” a part of its logo and its brand generally. Meanwhile, Barnes and Noble stores have begun to beat Borders stores at their own game by creating an equal-or-better shopping experience. This rival has installed cushy chairs throughout their aesthetically-pleasing stores and it has begun to showcase Starbucks coffee in their cafes. On the face, it seems that Barnes and Noble noticed how Borders had begun to build its brand and then caught up to speed while Borders truncated its brand development.

In his book *A New Brand World*, Scott Bedbury notes that brands are not about throwing around advertising money. The new brand ideology focuses on the emotional experience of the consumer and what unique core attributes differentiate a company from the pack. Perhaps most importantly, the brand helps the firm to justify its prices and earn greater profits than homogenous counterparts. Bedbury elucidates how branding lies at the foundation of success for one firm he advised:

> Was Starbucks any more convenient than a home-made cup of coffee? Not really. Most customers have to drive or walk to their nearest Starbucks, and wait another six or seven minutes to get their morning drink. Was it cheaper? Hardly…Rather than compromise on product quality in order to have money to spend on expensive media campaigns, Starbucks served up a steady stream of hand-crafted, customized products in a welcoming, well-lit, clean, and comforting environment. The Starbucks experience proved relevant from Times Square in New York to Kings Road in London to the Ginza in Tokyo. (8-9)

The same logic applies to Borders as its products are also largely search goods framed as experience goods: Starbucks is to coffee as Borders must be to books, magazines, music, DVDs, and gifts. Borders must similarly offer a unique experience that transcends obtaining a search good. It must offer an *experience* or else it will fall victim to its rivals much as Starbucks would have fallen to Dunkin Donuts and Maxwell House in the absence of its lauded brand (and quality product). As clicks-and-mortar rivals make myriad books readily and conveniently attainable at low prices and Barnes and Noble offers a better experience itself, the branding question pushes to the strategic fore in this case.

As Bedbury explains, a brand is comprised of many concrete components despite being in some necessary sense abstract. For Borders, the café represents the central incarnation or driver of the brand. It underpins an atmosphere that welcomes the customer, takes him or her by the hand, and says, “What
can I do for you? I hope you are having a great lazy day.” Thus, the café must provide tasty food and drink, a warm and effective counter staff, and comfortable seating in a casual, Sunday atmosphere. The extent to which these requirements are met of course varies by store, but homogeneity at a higher standard must be sought.

To improve its menu, Borders should assess how to partner further with Starbucks (with whom it’s already allied internationally while Barnes and Noble enjoys the domestic relationship) and similar vendors to ensure a stable supply of recognized high-end products. Alternately or perhaps in addition, Borders could look into the financial viability of backward integrating into the production of coffee and pastry-type items. One way or the other, though, the stores need a consistent line of savory products that will build customer satisfaction and potentially draw shoppers into the store. As of now, it is unlikely that anyone goes to Borders for its café or has the optimal café experience when he or she does purchase these goods.

Certainly, Borders Group’s core business is selling books and other entertainment media. Its core competency, however, is in providing a shopping experience that differentiates it from on-line purchasing, single-media retailers, and small scale or independent stores. People go to Borders to browse, sip, chat, and buy. Looking at the bottom line can often cause a myopic focus on the “buy” component of this sequence. But without browse, sip, and chat, buy will decline as the internal rivalry force takes over. Thus, it is our strong strategic recommendation that Borders reverse the erosion of its brand, starting with an examination and eventual revitalization of its cafes.

**Conclusion**

PAC Consulting believes Borders is currently on the right track, delivering consistent profits to investors and expanding the scope of its operations and the number of stores it runs. The most significant issue facing Borders in the future is competition. This competition comes primarily from Barnes and Noble, assuming no major changes in the terms and the effectiveness of Borders’ Amazon.com partnership. We believe that each of our recommendations offers a strategy to optimize Borders’ operations and future profitability potential. Smart management of the Waldenbooks contraction will ensure good profitability, and a new approach to the in-store cafes could especially help same-store sales growth and brand loyalty. If Borders can effectively pursue these two goals, it should capture market share and continue to deliver consistent profits.