From www.valueinvestorsclub.com

LONG Barnes & Noble (BKS)   April 22, 2012

Price: $11

Market Cap (fd): $800 mm

Enterprise Value: $1.3 b

Average Daily Volume: $17 mm

Thesis

BKS is a long because it has an under-appreciated asset in the Nook eReader platform, whose value will be illuminated through a partial sale of that business segment in 2012. We believe a conservative sum of the parts valuation for BKS is $11/share for the existing Retail and College bookstores and $26/share for the Nook resulting in a $37 sum of the parts valuation or 230% upside.

Business Description

BKS is 3 distinct businesses: 1) the 700 Retail bookstores that carry the Barnes & Noble brand name 2) the college bookstore business which operates campus bookstores at 640 different colleges and 3) the Nook eReader platform which sells the devices and digital content and will generate $1.5 b in platform sales in FY12 (FY ending in April).

The Retail bookstore is a dying business as we shift from physical to digital online purchasing of physical. We estimate underlying SSS are declining ~7% annually. However, due to the liquidation of Borders and downsizing of selling square feet for physical books at Wal-Mart and Target, actual SSS will be positive 1$ in FY12 and flat in FY13. EBITDA in FY12 will be $325 mm (or ~$294 mm excluding the Nook EBITDA that is accounted for in the Retail segment) and flat in FY13. Importantly, we believe there is significant value in the retail bookstores because their leases are increasingly becoming more short term (average duration of the portfolio is ~2-3 years) allowing for significant flexibility (and minimal friction costs) in downsizing the store base as 4-wall profit contribution turns negative. BKS is closing 20-30 stores annually or 3-4% of their store base.

The College bookstore is a much better business than Retail. The majority of what is sold in a campus bookstore is not trade books, but rather textbooks and college paraphernalia. SSS and EBITDA are stable ($124 mm of EBITDA in FY12). BKS operates the store on behalf of the school; BKS pays a % of revenues as rent so if sales decline the rent payments decline as well. In addition, there is flexibility to adjust the rent payment % or terminate a management contract on 60 days' notice should a store become unprofitable.

The Nook eReader is the hidden asset of BKS. Nook is the #2 player in the eBook market with 25% market share behind Amazon at 65% markets share (iPad, Kobo, and others share the remaining 10%). Nook went from a standing start in 2009 to 25% market share by leveraging their 700 physical retail stores to sell the Nook to a predominantly women audience who value the in-store customer support. Nook has grown from nothing in FY10 to $900 mm of platform sales in FY 11 to an expected $1.5 b in FY 12 (ending 4/12). While Nook currently loses money (~$250 mm in FY12) given the large R&D and marketing budget, we believe this platform has real value due to a rapidly growing market (50% expected CAGR for the next 3 years) and customer stickiness that should result in Nook maintaining its market share. We expect a positive inflection point in profitability by CY14.

<u>Short Thesis & Our Variant View</u>

There are 17 mm shares sold short which is 29% of the shares outstanding. Many smart investors do not agree with our bullish view on BKS. Below we lay out the short thesis and our variant view.

Short Thesis: Bookstores are a dying business

Variant View: We agree! However, that does not mean that the bookstore business is worthless. First, 1/3rd of the EBITDA of the bookstores comes from the College Bookstore business which is NOT dying but rather is a stable business that does not face the same secular headwinds the Retail bookstores have. We value College at 4.5x EBITDA for a $500 mm valuation. For the Retail bookstores, because of the short lease length, there is minimal friction costs as they wind down the business. We run a DCF of the Retail bookstores that assumes a hard run-down of the business and come to a valuation of $780 mm which is 3.0x EBITDA. As a reference point, BBY, another secularly challenged retailer, trades at 3.0x EBITDA.

Short Thesis: BKS is losing money… there is no margin of safety to make a valuation case on.

Variant View: You cannot look at BKS on a consolidated basis. The bookstores are quite profitable, but the cash flow is being reinvested into growing Nook market share while the eBook industry is still in its infancy and sticky customer relationships are being formed. If for whatever reason the Nook failed and was shut down you would still have the profitable bookstores. If you shut down the Nook, BKS would be trading at 3.5x EBITDA.

Short Thesis: Nook is not worth much because it is losing money and has deep-pocketed competitors.

Variant View: The argument that there is fierce competition in the eBook space is as true today as it was in 2010 when AMZN had ~100% market share. This did not prevent Nook from going from 0% market share to 25% in 2 years. The physical retail store presence is a large competitive advantage for the Nook that BKS has been able to leverage to grab share in this fast growing market. You do not need to assume further share gains in this fast growing market for the Nook to be worth a lot of money as a separate company or as a partner to a strategic investor.

Short Thesis: the recent anti-trust lawsuit and partial settlement over eBook price-fixing means that AMZN will be able to sell eBooks at a loss and drive out the competition (mainly the Nook).

Variant View: the anti-trust settlement is clearly not a positive and introduces uncertainty over the next 6 months in terms of how the eBook pricing regime will evolve. 3 of the big 5 publishers which represent ~30% of trade books have agreed to it, while Apple and the other publishers are going to fight it out However, the conclusion that AMZN will pursue a scorched earth pricing strategy and successfully destroy the competition is misguided. A key industry dynamic that is critical to understand is that the publishers despise AMZN because of their attempt to cause eBook price deflation while also trying to dis-intermediate the publishers with their own in-house publishing effort. Read Jeff Bezos' annual letter where he spent half of the entire letter talking about their publishing business, then think about what your reaction would be if you are a publisher. Because of this antagonistic relationship, the publishers are hell-bent on ensuring that there are several healthy customers, primarily BKS as the last physical bookstore of scale as well as the biggest competitor to AMZN in eBooks. This was the entire reason for forcing agency pricing scheme in the first place; to level the playing field for new entrants. The publishers will be doing everything possible to ensure that BKS is a healthy competitor that can serve as a governor on AMZN's potential to destroy the traditional publishing business. In what form this support for BKS and other competitors is still uncertain, but as an example, there is a specific clause in the anti-trust settlement agreement that expressly allows a publisher to support bricks and mortar stores (i.e. BKS) with promotional and marketing dollars.

<u>Financials & Valuation</u>

We arrive at a $37 sum of the parts valuation for BKS by using our CY12 estimates and putting 3.0x EBITDA on Retail, 4.5x EBITDA on College, and 1.0x platform sales on Nook. From this $3.3 b EV we subtract net debt and pension of $240 mm, deferred rent of $160 mm, and our estimate of Nook losses until breakeven after-tax of $200 mm. This arrives at an equity value of $2.7 b or $37/share after fully-diluting the shares outstanding to 72 mm due to the Liberty Media convertible preferred.

Obviously the most contentious part of this valuation is what the Nook is worth. It's not worth zero just because they are currently spending through the opex line to grab market share in a rapidly growing space. We think 1.0x sales is conservative if it were to trade to a strategic or be IPO'd. There are no great comps but we found several data points that we think are relevant: 1) Kobo is a smaller ($100 mm of sales) eReader platform that was sold to Rakuten in Japan for 3.0x sales 2) NFLX traded as low as 1.0x sales when it was at $70 and the world thought the company was unprofitable and in a death spiral 3) LXK is priced to go out of business at 7x EPS and 0.5x sales. Additionally our conversations with bankers and cap markets suggest 1.0x would be conservative; rather, 2-3x sales could be on the table if properly marketed. Every ½ turn of sales is worth $13/share.

Another way to frame the valuation is to think about what you are currently paying for the Nook at the current BKS price of $11/share. We think the core business ex-Nook is worth $11/share which means you are paying nothing for the Nook today. That strikes us as a particularly asymmetric risk/reward.

Management & Board

Management and the board are an important element of the story to BKS.

Len Riggio is the founder of BKS and owns 30% of the shares out. He has created a lot of shareholder value over time through the success of the Barnes & Noble concept, the acquisition and growth followed by a spin-off of Game Stop, the IPO of B&N.com during the tech bubble followed by its buy-in post the bubble, and now the successful ramp of the #2 eReader platform which will be partially monetized this year. He made what must have been an excruciatingly hard decision to take all the cash flow the bookstores generated for the last 2 years and invest it in the Nook start-up which will speed up the disintermediation of his core bookstore business. Not many management teams can destroy a sacred cow like this (ie Borders).

John Malone via Liberty Media has a $200 mm convertible preferred that they completed in the Fall of 2011 that converts to 16% of the fully diluted shares at $17/share. Note that this preferred investment followed a terminated sale process where Liberty bid $17 for the entire company in May 2011. We believe the sale process was not terminated because Liberty found something they didn't like but rather that the financing package that was offered to Liberty was pulled in the market melt-down in the summer. Liberty has 2 board seats (Greg Maffei & Mark Carleton). Malone has one of the best track records in the media business and we take his involvement in BKS seriously. We do not think it was a coincidence that only 4 months after the Liberty investment the company announced their intention to monetize a portion of the Nook business. Trackers, spins, and financial engineering that create shareholder value is vintage Liberty Media.

Mike Huseby was recently hired as the CFO of BKS which we think is another confirmatory data point to the Nook monetization thesis. Huseby was previously the CFO of Cablevision where he had extensive experience with trackers, spin-offs, leverage, share shrink, and MBO's.

Risks

The biggest risk to our investment thesis is the future of the Nook and the execution of the Nook monetization. We could be wrong on the industry dynamics and Nook's competitive positioning vs. AMZN. The market doesn't give BKS credit for the Nook value today and without an event to illuminate the perceived value it is unlikely that the market will change its mind for the foreseeable future.

The Retail bookstores could decline faster than we expect and our DCF value could be optimistic.

The College bookstores could be less stable than we believe, most likely due to incremental pressure from digital textbook substitution. We think digital textbook disintermediation for college-level students is still several years out and even then will have a slow adoption curve.

Len Riggio has a mixed track record on corporate governance. Many investors believe the sale of College bookstores to BKS was not done on an arms-length basis. BKS also adopted a poison pill to fend off Ron Burkle in 2010. We are not concerned about this risk given Liberty's involvement on the board.

The key catalyst is the monetization of the Nook. BKS announced strategic alternatives for the Nook in January and we believe there is a parallel process being run now to investigate potential strategic interest as well as prepare for a partial IPO of the Nook.

A secondary catalyst is separate segment financial reporting for the Nook which we expect in June on the Q4 earnings release. This will allow the market to more clearly understand the cash flows from the Bookstores vs. the Nook, which currently is jumbled into both the Retail segment as well as the B&N.com segment. We expect to see more SoP analysis from the sell side following this disclosure.

While we aren't expecting it, we could see a potential bid for BKS from Liberty Media & Len Riggio again. They made an offer to buy BKS at $17 in May 2011 that we believe was pulled due to the credit markets falling apart that summer. Given the credit markets have now recovered to frothy levels we believe the original financing plan is now viable again (4x debt/EBITDA).

Barnes & Noble and Microsoft Form Strategic Partnership to Advance World-Class Digital Reading Experiences for Consumers

Newly Formed Subsidiary to Include NOOK® Digital and College Businesses

NEW YORK & REDMOND, Wash.--(BUSINESS WIRE)--

Barnes & Noble Inc. (NYSE: BKS - News) and Microsoft (NASDAQ: MSFT - News) today announced the formation of a strategic partnership in a new Barnes & Noble subsidiary, which will build upon the history of strong innovation in digital reading technologies from both companies. The partnership will accelerate the transition to e-reading, which is revolutionizing the way people consume, create, share and enjoy digital content.

The new subsidiary, referred to in this release as Newco, will bring together the digital and College businesses of Barnes & Noble. Microsoft will make a $300 million investment in Newco at a post-money valuation of $1.7 billion in exchange for an approximately 17.6% equity stake. Barnes & Noble will own approximately 82.4% of the new subsidiary, which will have an ongoing relationship with the company's retail stores. Barnes & Noble has not yet decided on the name of Newco.

One of the first benefits for customers will be a NOOK application for Windows 8, which will extend the reach of Barnes & Noble's digital bookstore by providing one of the world's largest digital catalogues of e-Books, magazines and newspapers to hundreds of millions of Windows customers in the U.S. and internationally.

The inclusion of Barnes & Noble's College business is an important component of Newco's strategic vision. Through the newly formed Newco, Barnes & Noble's industry leading NOOK Study software will provide students and educators the preeminent technology platform for the distribution and management of digital education materials in the market.

"The formation of Newco and our relationship with Microsoft are important parts of our strategy to capitalize on the rapid growth of the NOOK business, and to solidify our position as a leader in the exploding market for digital content in the consumer and education segments," said William Lynch, CEO of Barnes & Noble. "Microsoft's investment in Newco, and our exciting collaboration to bring world-class digital reading technologies and content to the Windows platform and its hundreds of millions of users, will allow us to significantly expand the business."

"The shift to digital is putting the world's libraries and newsstands in the palm of every person's hand, and is the beginning of a journey that will impact how people read, interact with, and enjoy new forms of content," said Andy Lees, President at Microsoft. "Our complementary assets will accelerate e-reading innovation across a broad range of Windows devices, enabling people to not just read stories, but to be part of them. We're on the cusp of a revolution in reading."

Barnes & Noble and Microsoft have settled their patent litigation, and moving forward, Barnes & Noble and Newco will have a royalty-bearing license under Microsoft's patents for its NOOK eReader and Tablet products. This paves the way for both companies to collaborate and reach a broader set of customers.

NewCo

On January 5, Barnes & Noble announced that it was exploring the strategic separation of its digital business in order to maximize shareholder value. Barnes & Noble is actively engaged in the formation of Newco, which will include Barnes & Noble's digital and College businesses. The company intends to explore all alternatives for how a strategic separation of Newco may occur. There can be no assurance that the review will result in a strategic separation or the creation of a stand-alone public company, and there is no set timetable for this review. Barnes & Noble does not intend to comment further regarding the review unless and until a decision is made.

Additional information will be contained in a Current Report on Form 8-K to be filed by Barnes & Noble.

Barnes & Noble and Microsoft will host an investor call and webcast beginning at 8:30 A.M. ET on Monday, April 30, 2012. To join the webcast, please visit: www.barnesandnobleinc.com/webcasts.

EDITOR: As a warning: The early analysis on BKS could not foresee the technological disruption from digital readers and Amazon. Note the question and answer discussion. This might have been a classic value trap where the business has been disrupted by new competitive forces.

Barnes & Noble(BKS) - $32.00 on Jan 3, 2005 by andreas947

			2011	2012
Price:	$32.00	EarningsPerShare:		
Shares Outstanding (in M):	N/M	P/E:		
Market Cap (in $M):	2,300	P/FCF:		
Net Debt (in $M):	N/M	EBIT (in $M):	N/M	N/M
TEV (in $M):	N/M	TEV/EBIT:		

Description...

BKS has appeared on VIC before but we think it deserves another look - we think BKS offers a nearly 10%+ free cash flow yield at today's prices and that its substantial free cash flow capabilities will become increasingly evident to the market over the next 12 months. BKS is the larger of only 2 major superstore book retailers - these 2 players (BKS and BGP) have made substantial investments that would be difficult to duplicate. BKS is the world's largest book retailer, operating 665 book superstores, 175 mall based stores (B. Dalton), and selling books on-line through barnes&noble.com (100% owned as of May 04). BKS also self publishes books and is one of the largest publishers in the world through its Sterling Publishing subsidiary, acquired in Jan 03.

BKS recently completed the spin-off of its 63% ownership of Game Stop (GME) to shareholders and is now a simpler, clearer story for investors. What attracts us to BKS is its very strong and stable free cash flow. We believe BKS offers investors a free cash flow yield of nearly 10% at today's prices – based on our version of free cash flow (net income plus depreciation and amortization minus maintenance capital expenditures) to market cap – with a very strong balance sheet and owner-oriented mgmt team. Excluding GME, BKS mgmt estimates their version of free cash flow of $175m to $200m for FYE Jan 05 but, importantly, this estimate is after about $150m of capital expenditures. (In fact, the CFO stated on the Q3 call that a) BKS would probably exceed $200m of free cash flow for FYE Jan 05 and b) $175m to $200m of free cash flow was a sustainable level). Management's definition of free cash flow appears to include working capital gains and deferred tax benefits that we do not include in our definition of free cash flow. We believe at least $100m of BKS' $150m of capital expenditures to be growth-oriented rather than maintenance. Based on management's comments, we expect BKS to generate $350m of cash from operations (excluding GME) for FYE 1/05. Again, this cash from operations includes gains from working capital and deferred taxes which we have not included in our definition of free cash flow. Based on net income plus depreciation and amortization minus maintenance capital expenditures, we come up with free cash flow of $225m, or over $3 per share of free cash flow ($225m / 72m shares). At the current prices BKS is trading about 10x this free cash flow number. Moreover, we think BKS' free cash flow has the potential to grow over the next few years – BKS currently has about 650 superstores in the U.S. and mgmt thinks it can get to 950 to 1,000 stores. We also think BKS can generate substantial additional cash flow beyond the $225m number from deferred taxes and continued improvements in working capital / inventory turns.

Summary financial history

These are for the bookselling unit only (superstores, mall stores, and on-line):

FYE 1/31	2001	2002	2003	2004	9mos	9mos
Sales	3,618	3,749	3,917	4,372	2,788	3,201
EBITDA	251	330	303	361	135	153
EBIT	128	212	177	226	37	41
Cash from operations	80	379	237	440	89	46
Capital expenditures	-109	-148	-140	-100	-62	-93
Net debt (a)	641	341	32	-187	175	59
Shareholders' equity (a)	778	888	1,028	1,260	1,098	1,321

(a) Balance sheet numbers are for BKS including GME.

Superstores (yr end) 569 591 628 647 663
Mall stores (yr. end) 339 305 258 198 176

Comp stores - Super 4.9% 2.7% 0.0% 3.2% 3.4%
Comp stores – Mall -1.7% -3.7% -6.4% -0.2% -1.6%

Mall stores (B. Dalton) are being gradually closed as their leases come up. Borders is pursuing the same strategy with its mall chain. Mall store sales are now only about 3% of BKS total sales.

Valuation numbers (book selling units only)

P / Rev (LTM) = 0.48x
P / EBITDA (LTM) = 6.0x
P / EBIT (LTM) = 9.9x
P / FCF (LTM) = 10x

LTM EBITDA = $379m
LTM Revenues = $4,787m
LTM EBIT = $230m
LTM FCF = $225m+
FYE 1/05 Est. EPS = $1.78 - $1.84 (including losses for now consolidated bn.com)
P = $2,250m
Net debt = $200m (a)

(a) Based on the 7/31/04 balance sheet excluding GME filed as an 8K post GME's spin-off. We believe net debt will be significantly negative for the stand-alone book selling operations at FYE Jan 05.

Unit economics

Mgmt says it costs about $1.9m to open a superstore, including the inventory investment. An average store does about $5.5m in its first year with an after tax return of about $360k or 19%. Comp stores generally grow in low double digits in the initial years and trend towards the chain average by year 5. The capital spent on these investments is growing the business and should further increase consolidated cash flow going forward.

Capital expenditures

BKS expects to spend about $150m on capital expenditures for the book segment during FYE Jan 05 the major components of which are as follows: 35 new superstores at $1.2m each (plus $0.7m each in working capital) ($42m); $35m for new distribution center; $25m for store maintenance capital expenditures (paint and carpet); $25m (our estimate and should be also considered maintenance) for systems, etc.

BKS spent about $93m on capital expenditures during FYE Jan 04, opening 47 new superstores.

Balance sheet

BKS has a very strong balance sheet. Inventories are built up in Q3 and liquidated in the Q4 holiday season. Consequently, we expect BKS to end Q4 (1/31/05) with a large pile of cash. The Q3 balance sheet (including GME) was as follows (an 8-K was recently filed for BKS 7/31/04 balance sheet excluding GME):

Cash $186
Inventories $1,811
Total assets $3,656

Payables $1,076
LTD $245
S/E $1,321

Keep in mind that this represents the seasonal peak of borrowing for Q4 - the balance sheet will only get stronger into FYE 1/06. For that reason, and because we think mgmt has made all the strategic cash investments it thinks necessary at this point (mgmt has stated they are "not in an acquisition mode"), we think meaningful buyback and/or dividend actions are a very good possibility.

Recent strategic & financial investments:

BKS (excluding GME) has generated substantial free cash flow in recent years but has redeployed this capital into strategic investments that now appear to be complete - these investments were as follows:

(a) Purchase of Sterling Publishing for $123m (Jan 03)
(b) Purchase of Bertelsmann's bn.com ownership for $165m (Sept 03)
(c) Purchase of public's ownership of bn.com for $156m (May 04)
(d) Call of 5.25% converts for $295m (July 04)

Total cash deployed = $739m

Despite all these strategic expenditures, plus investing substantial capital in new superstores in the past three years, BKS enjoys a very strong balance sheet, which could clearly support purchases of its undervalued stock. We view the retirement of the converts effectively as a large share repurchase and perhaps an indicator of where management is headed.

These $700m+ of strategic expenditures made within the last 3 years represent almost 30%+ of BKS market cap today - yet BKS balance sheet remains almost debt free. We think this demonstrates the powerful cash-generating capability of the BKS franchise.

BKS purchased Sterling Publishing in Jan 03 for $123m in cash. Sterling was one of the top 25 publishers in the U.S. and the leading publisher of how-to books. BKS purchased Sterling to backward integrate and capture additional margin as well as acquire proprietary book titles -- BKS is one of the largest book publishers in the world as a result. Sterling publishes over 1,300 new titles per year and has an active list of over 6,000 titles. Sterling is currently about 5% of BKS total sales with the goal of getting to 10%. BKS is highly focused on differentiating itself with proprietary product.

Barnes&Noble.com (bn.com)

BKS recently completed the complete repurchase (first from Bertelsmann and then from the public)of its online bookselling operation which is 100% owned as of May 04. Bn.com is the #2 seller of books online behind Amazon. Bn.com is still not profitable but mgmt is improving its profitability with the goal of breakeven EBITDA for FYE 1/05. Q3 sales decreased 8% to $92m resulting in a net loss of $6.4m or ($0.09) per share. This compares to a loss of ($0.11) per share for last year's Q3 (on a pro forma basis as if Barnes&Noble.com was 100% owned the entire year). Sales are down as mgmt has started eliminating marketing deals that were unprofitable for the online business. We do not think mgmt would have spent over $300m to own 100% of bn.com unless it firmly believed profitability could be achieved.

Mgmt & moat

Mgmt owns a significant stake in BKS and appears motivated to enhance shareholder value. (One negative is that mgmt has been pretty liberal with their option programs). Bloomberg indicates that on Dec 6 – 8 CEO Leonard Riggio purchased 685,000 shares at $27.54 to $28.00 per share. Mgmt has stated they are not really in an acquisition mode – they do not categorically rule anything out but one gets the sense they have all the pieces they currently require – superstores, online selling, and self-publishing.

Mgmt is very focused on supporting and expanding the "moat" surrounding its business, and frequently discusses the "moat" in presentations. This is something we like. Some of BKS competitive advantages (which we buy into) include:

• only 2 major players in the superstore bookselling space – BKS is the strongest in our opinion (but we also own BGP and think its undervalued);
• significant inventory of book titles (over 1m titles in inventory, the most of any book retailer), representing an inventory investment of over $1 billion;
• proprietary book titles through Sterling Publishing (mgmt is very focused on having proprietary product in its stores),
• established base of attractive and comfortable stores (exclusive arrangement with Starbucks for café, etc.);
• its membership base of over 2m (and growing) card club members (10% discount on in-store books and 5% online) (BGP does not have a card club program);
• large investment in information technology, warehouse, and distribution facilities (the Book-master system in stores is able to search for titles at other local stores, warehouse facilities, and even with wholesalers in an effort to get the book to customers as quickly as possible)

Bookselling industry

While the domestic book industry is expect to grow only modestly (2% to 3% per annum), we think the superstore operators will continue to increase market share, enabling them to grow sales faster than the industry. BGP has a presentation on its website which shows superstores with a 24% share in 2003 (up from 5% in 1993), independents with a 12% share (down from 19% in 1993), internet with a 9% share (up from 0% in 1993), malls with a 3% share (down from 10% in 1993), and other with a 52% share (down from 66% in 1993) (other includes book clubs, mass merchandisers, etc. which are lower "value add" and focused exclusively on front list / best seller product). We think BKS can use its substantial purchasing power to continue to strengthen its hand with publishers and also continue to add higher margin proprietary product in its stores.

We realize there are concerns about BKS competitive position versus mass merchant bookselling, Amazon's on-line business, and used book sales. While we plan to closely monitor these trends we do not believe they will significantly impair the superstores' long-term competitive position. We think the average customer spends about an hour in a BKS store and we think they frequently purchase books based on browsing the merchandise. We think the BKS stores are built as localized destination centers that provide a service and experience that extends beyond just the purchase of a book. Mass merchants are selling a significant share of books within the industry but their focus will continue to be on higher turn bestseller items. Best sellers represent only 3% to 5% of BKS annual sales, and have lower gross margins than average, primarily as a traffic driver into the store. We think Amazon's share of the book industry has stabilized - it provides a great service at a great price (also offered by bn.com) but it's a different service than the superstore experience.

Probably our biggest question with BKS is the long term impact of used book sales on its business. You can get a sense of these discounts on Amazon, which lists discounted books alongside new book sale prices. They are significant and we will watch this trend closely. However, are people going to give used books as gifts (Q4 is BKS largest by far)? Also, how quickly do customers get these books? - having product immediately available is very important to many book purchasers (no one is better at this than BKS). We think the lower priced used books may appeal to different segment that the typical BKS customer. We think, perhaps, it is more an issue for publishers than BKS.

Our belief is that BKS will continue to be successful with its superstores as destination-type trips where customers will spend an average of an hour in the store and purchase higher margin books that may not be something they initially came into the store to purchase. BKS customizes its stores to their individual locations and customer base and works to integrate itself into the local community via special events in the stores. BKS substantial IT system allows it to monitor lower turning items and customize individual store inventories.

Comp store sales trends by quarter

Barnes & Noble B. Dalton

10/04 0.9% -3.3%
07/04 1.4% -6.8%
04/04 9.4% 6.0%
01/04 6.4% 4.1%
10/03 4.5% -1.3%
07/03 5.6% 0.7%
04/03 -5.2% -14.0%
01/03 -3.0% -11.4%
10/02 1.6% -6.5%
07/02 0.3% -3.7%
04/02 2.5% -1.0%

Conclusion

We think BKS current valuation at about 10x current free cash flow is attractive for a stable, billion dollar plus stock. BKS is a business with a unique niche – we essentially view BKS as an important component of the distribution of new books in the country - that produces stable financial results. We think Wall Street remains overly focused on monthly comp store sales and EPS, while the real story of BKS is its steady and growing cash flow. With annual free cash flow of $225m, modest growth, and a reasonable discount rate, we value BKS at over $45 per share.

Catalyst...

Potential Catalysts

a) Liquid b/s at FYE 1/05 gives mgmt alternatives to enhance s/h value
b) Mgmt allocation of free cash flow and excess capital towards buybacks and/or dividends - we think they are done with strategic investments for the near term.
c) Market recognition of BKS strong free cash flow capabilities.
d) Continued reduction in losses at bn.com could significant increase EPS.

Q&A

#	Author	Date	Subject	Private
56	ruby831	11/30/11 03:07 PM	RE: RE: RE: RE: RE: re:re: re current update?	

The tablet and eReader are becoming a commoditized product. BKS subsidizes hardware that are "on sale" now (for example the models it sold for $139 now sell for $99, don't think they made $39 in

#	Author	Date	Subject	Private

gross margin on them if you look at their financials...) Gross margin on digital content is low currently, mgmt thinks 'long term' eBooks will be in 30% range, though this is a long term goal. BKS has diverted most of the cash generated from its superstore and college store to funding nook development. Once it needs to subsidize hardware sales, the company will have serious trouble. It doesn't give guidance on the "lifetime value" of the nook, but my guess is they assume users have the device for at least 4-5 years. Let's say users only use for 2 years - the company will have to subsidize twice as often to get the same income stream from the device. Think of amazon vs. bks - who has the greater capacity to shoulder a subsidy? the player that is selling more on its tablet. amzn plans to monetize more - sell movies, games, and so on. bks has said its intention is to focus on eBooks and let app developers use the nook for other purposes.
the only argument that makes any sense for nook value is high switching costs given readers purchase books through b&n and then have them saved in the b&n library. however, since you can download the nook app on an iPad or other tablet, the argument goes out the window.
take a look at bks liabilities. company is growing debt and running out of cash. even used its asset backed revolver to fund digital investment (says this explicitly in filings), $207mm preferred from liberty, $200mm junior notes payable (which it counts under 'other liabilities' but is debt due in 2014), plus has already cancelled its dividend, refinanced revolver to save on interest and have more lax covenants, running out of options (and time). just my 2 cents...

55	Siren81	11/30/11 01:38 PM	RE: RE: RE: RE: re:re: re current update?	

Ok – so the long thesis is predicated on the value of the digital bookstore for tablets? BKS has a $1.6B+ EV, so that implies a lot of value for a business that barely exists right now where BKS holds a questionable competitive advantage at best…

54	rjm59	11/30/11 01:03 PM	RE: RE: RE: re:re: re current update?	

I don't know about the secular decline of books in general, the numbers I had heard was that book consumption overall was growing basically in line with GDP, it hasn't been displaced by videos or something more interactive, at least I hadn't seen numbers that suggested that. It's more of a secular shift away bricks and mortar towards eCommerce.
I agree in the future the tablets will be better than the ereaders - probably only in a few years, the lcd's keep getting much better. I think the current trends of 1) The "store" is an app on any tablet - like for kindle or nook, they have apps you can install on your ipad to access your books and 2) The eReaders keep converging towards tablets and they are competitors in that space too and the book retail stores sell more of those.
There is hardly anything certain about this and I'm not long at these prices, though probably would be at $5 or $10... The key insight I would say is that the publishers have learned from the mp3 lesson and won't let the layer be totally disintermediated or let it go to one player (iTunes)...

53	Siren81	11/30/11 11:09 AM	RE: RE: re:re: re current update?	

Ask yourself - will mass market book retail exist in 5yrs? I think it could in some form, but it will be much smaller than today. There is significant secular decline and high operating leverage here which will cause the category to become materially smaller, if not disappear.

Now – will e-readers exist in 5yrs? Frankly, I doubt it. Much like blackberrys, MP3 players and digital cameras, I'd expect e-readers to become integrated into tables/phones as the price declines and

#	Author	Date	Subject	Private

functionality improves

What are your thoughts on the secular challenges? I have not done a lot of work on this, but my initial inclination is to be short.

#	Author	Date	Subject	Private
52	rjm59	11/29/11 02:11 PM	RE: re:re: re current update?	

I used to be short BKS but am more inclined to be a long after rethinking it.
Originally the short thesis was that the thing that BKS had in the non-digital world that's unique is the stores in good locations that a competitor couldn't copy easily. Borders and others didn't have the good locations so went under first. In a disintermediated world, store location doesn't matter all that much if you just get a book like an mp3 file from any digital location anywhere.
However, once I started thinking about BKS's Nook as itself a storefront and a convenient, fairly exclusive one (though not quite as exclusive as iTunes), the picture looks different. They still have their good "store" locations with the nook and it shows with the market share they've been getting with it. Plus publishers learned a lot from mp3's and won't let books become as open-sourced as music became so will make sure that distribution isn't totally disintermediated so you couldn't have a case with a million independent book stores where nobody makes money in that layer (like music stores until iTunes).
So that's my perspective on it now - it's possible that they could be even more profitable under Nook and gradually convert the store locations to more mixed products in addition to books, Indigo in Canada has done this pretty well and sells a lot of lifestyle stuff too like toys and health stuff.

#	Author	Date	Subject	Private
51	Biffins	11/29/11 01:30 PM	RE: RE: current update?	

BKS has jumped back up recently and I was wondering if anyone was following this still.
Seems like a terminal short no? All book sales eventually migrate online?

#	Author	Date	Subject	Private
50	andreas947	07/17/08 11:59 AM	RE: current update?	

agree that BKS is really cheap here...there hasn't been a lot of top line growth but the cash flow statement is certainly pretty interesting...they have bought back over $400m in last four quarters against a market cap of $1.3 billion...and balance sheet is still debt free....IMHO share repurchases speak loudly about what the riggio's think about their stock price...and borders is certainly weaker at this point which should help pricing and gross margins....risk reward looks pretty attractive here....moreover, if mr. market ever decides that main street is actually hanging in there reasonably well in this tough economy, some of these beaten down retailers may be in for a massive rally...at least thats what i have been telling my investors!
Hope this helps a bit.

#	Author	Date	Subject	Private
49	wolfman973	07/16/08 06:12 PM	current update?	

andreas (or anyone else)- would love to hear your current take given the current stock price? ignoring today's short-covering driven 9% gain, the company is trading just over 3x EBITDA and 10x ttm EPS? i understand the lack of harry and Secret, but does anyone believe that there won't be new blockbuster titles in the future?

#	Author	Date	Subject	Private
48	paul118	05/12/08 09:52 AM	RE: Short thesis?	

no harry this year
no secret
modest sqft growth (net 15-20 stores) but planned CapEx remains above 200m
tepid forecast
Q1 comp said to be negative
recorded music dying to be killed

#	Author	Date	Subject	Private

"consumer stock trading at 15x earnings lets short it guys"

from what I see, all the analyst reports are completely focused on tepid EPS forecast for year so nothing else gets thru

just guesses - I'm long, but don't have 6 month time horizon either

47	andreas947	05/09/08 06:22 PM	short thesis	

sorry, not following this closely right now

46	dj927	05/09/08 02:07 AM	Short thesis?	

Also does anyone know what the short thesis is or is it just "consumer stock trading at 15X earnings lets short it guys"

45	dj927	05/09/08 02:04 AM	update?	

Just wondering if anyone was still following this and what members current thoughts are. Thanks

44	dj927	01/10/08 04:13 PM	wow!	

Some hit today and what looked like no news, well not exactly no news but nothing that surprising or disturbing. after all earnings are still expected to be ahead of beginning of the year guidance (while the stocks now wayyyy down). Anyone have any thoughts?

43	dj927	08/20/07 04:02 PM	thanks	

for the reply, can't wait to see how things develop.

42	andreas947	08/20/07 12:19 PM	reply to DJ	

I think BKS mgmt is trying to put pressure on BGP and protect/take market share.

41	dj927	08/18/07 12:27 PM	quick question	

Do you think bks management would have upped their benefits had they know that bgp was about to reduce theirs, or in alternate did management raise their benefits because they new bgp was about to lower theirs and wanted to make a grab for market share? Thanks

40	andreas947	08/17/07 06:56 PM	reply to DJ	

i think ur analysis is reasonable...i think mgmt at BKS was understandably alarmed by how quickly BGP was building up members and had to respond to not lose mkt share...BKS has a much stronger balance sheet vs BGP...i agree pricing will likely improve materially over next 12 to 18 mos...i would not bet against riggios in long run...they also created value at GAMESTOP...all that said, sales growth has been difficult to come by in this industry...but the large buyback will help drive EPS...i would also point out that BGP has a long list of activist shareholder types at this point...thanks for your thoughts

39	dj927	08/17/07 05:26 PM	thanks for the update	

The way I see it these guys have done a great job creating value over the long term. If we look at Q1 numbers we see BKS had a SSS increase while Borders had a decrease. Additionally, talking to store employees the vast majority of their customers are currently members, and I have to assume, if one is going to shell out $25 for a BKS reward card they'll want to take advantage of it and go to BKS exclusively over BGP. When they initially came out with the membership program margins recovered after 18 months (I'm talking about when they very first introduced the rewards program years ago). The increase in the membership benefits is going to depress earnings by ~ $40 million this year and looking at it, I believe (and if you disagree please share) the choice was entirely voluntary, that earnings wouldn't have declined if they hadn't done this, and that management believes that the intrinsic value of the business is enhanced by the change. Additionally, if the Reggio's believe the intrinsic value of the business is enhanced by this move, given their history, I'll give them the benefit of the doubt. I guess it's sort of a "leap of faith". One interesting thought I've had and I would love some comments on is this, given that they finally closed the Internet distribution facility, does Amazon have any structural competitive advantage that should allow it to have better margins on book sales.

#	Author	Date	Subject	Private

Historically, they've had a revenue advantage, but now that looks like a moot point given that bks sells more books. In any event. I'm assuming that margins recover to pre-reward change levels by 2009, that they buy back 10 million shares between now and then leaving a 60 million share count, leaving earnings at $3 a share for '09 with considerable excess free cash flow. I believe this should result in a stockprice in the low 50's within a year and a half or a 60% enhancement from current levels. I believe this is reasonable considering the trends with their gross margin over the past several years and the closing of the Internet distribution facility. I admit it might be somewhat bullish but not terribly so, and any way I think there's a decent margin of safety and even if it takes until 2010 for the margins to fully recover, that doesn't change the present value of the business materially, the important thing is that they do eventually recover. Lastly, I'd have to assume that if they don't management would raise the price of the rewards program by a small amount (say $2) which should certainly facilitate a margin recovery. Or as an alternate they could have two levels of membership rewards cards (old rewards level, new level at a slightly higher price) although mngmt might think that is too complicated.

38	andreas947	08/17/07 04:43 PM	reply to DJ	

We are still long some BKS (but less than before) despite tepid revenue growth and margins and think something could happen with them. The price war between BKS and BGP has impacted intrinsic value but one can make a case these circumstances won't last indefinitely. Expectations are certainly pretty low at this point...which might be how mgmt wants it.

37	dj927	08/17/07 12:07 AM	Whole Foods and Wild Oat's Mer	

This should be good news for BKS and BGP as it at least puts the possibility of a future merger back out there. Anywho what do you think of BKS today, I've been loading up at the current stock price.

< 1 2 3 >

#	Author	Date	Subject	Private
36	dj927	03/07/07 06:15 PM	Ringo	

Thanks for posting that. What is described on the board is exactly what the employee told me the program is going forward. Also, when I called the company about the matter they asked detailed questions like "what store did I hear that from" and other questions, so obviously something is in the mist. The company said in it's year end sales release that they are going to change the program and results were disappointing. Taken together it seems that the posts should be taken as indicative that at least the $5 back on $150 was something seriously considered by the company, although I guess we'll find out next week won't we.

35	andreas947	03/07/07 01:44 PM	thanks. would not be surprise	

thanks. would not be surprised to see BGP back off their rewards prgm. i think share gains were limited and they just drove down margins during the important holiday season. guess we'll find out.

34	dj927	03/06/07 03:57 PM	Schutelbutt (or however you sp	

I was talking to an employee at borders earlier today who informed me that Borders is discontinuing it's 5% discount program (right now you get a credit of 5% off all purchases to be redeemed at the end of the year). Now it's going to be replaced with a $5 coupon for every $150 you spend or a 3.5% reduction in price if you are a cardmember. The website (www.bordersrewards.com) doesn't indicate

#	Author	Date	Subject	Private

any changes so I called the company to reconcile the conflicting information. They told me they are currently in the process of reevaluating their rewards program and are planning on making various changes although none have yet been announced. However, the fact that she went into as much detail about the program as she did indicates to me that she didn't just "make it up" so to speak. Anyway, having comparison shopped it seems that the prices are almost 100% comparable between the two companies with a much much better price for BKS customers who are members of their rewards program (especially in hardcover obviously). It would be interesting if BGP is reducing its rewards program at the same time BKS is upping the anti.

33	andreas947	03/06/07 02:58 PM	response	

Agree the Riggio's could drive down price as prelude to lower priced LBO. The on-going options investigations has stopped share repurchases. Being private might seem more attractive now. I believe BKS said they expected $400m+ of cash at year end, although some will be seasonal, and I think cash flow will continue to be good, even with reduced gross margins. BGP, which we own also, is becoming a tougher competitor but the new CEO should explain whether his market share, price driven strategy justifies the damage its doing to industry gross margins. It seems both cos are using aggressive pricing on internet to drive traffic. Don't know how this will play out but short term industry fundamentals are worse and that probably lowers intrinsic value. That said, I don't think BKS remains a public company forever...would not be surprised at all to see Riggio's put up an offer. That opinion and $3.20 will buy you a latte at Starbucks. Ideally someone could just take them both private together and call it a day. I think Pershing could have very significant influence at what happens at BGP, but probably less so at BKS. How options issues at BKS play out is another wild card here. Mgmt has been very generous to themselves over the years. More thts, for what they are worth...

32	dj927	03/06/07 11:37 AM	thoughts continued..	

Sorry I accidentally prematurely hit post message. Anyway, one thought I had is that Reggio is purposely driving down the shareprice. They haven't been able to buy back shares lately as a result of the stock options shenanigans and once that's resolved they'd probably like to continue their buyback. It wouldn't be out of character for him to temporarily depress margins while doing so, and it doesn't seem that the intrinsic value of the business would be seriously impaired either (which should result in a greater long term return for shareholders). Also, since the company says that the membership program is more popular than originally anticipated there's a very easy solution. Just raise the price! that way existing members won't be upset (until they're up for renewal) and margins can recover. Lastly, I believe that part of the earnings shortfall may be do to timing, for instance if they are anticipating selling a large # of memberships in the fourth quarter and people immediately go ahead and buy books the lowered margins will be felt immediately while the income from the membership sales is amortized over the life of the membership. Anyway any thoughts on whether the value of the business has been impaired would be greatly appreciated (I realize there's not much to go on), thanks

31	dj927	03/06/07 11:26 AM	thoughts	

I agree BKS was in somewhat of a pickle. I mean, I was walking through their store last night and saw most paperbacks are sold at the publishers price, I assume the same is true of borders (going to check it out later today). So the cost conscious customer had the option of paying $25 and getting a 10% discount or paying nothing and getting a 5% discount at borders. It significantly decreased the appeal of the Barnes and Noble program. The difference between the new discount program and the old is entirely on hardcovers. the 40% discount for bestsellers was (in the store I checked) really a 15% discount since all the books eligible were already marked down 30%. I don't think that hardcovers are a large % of their sales but I do believe they are a larger percentage of their profits than they are % of sales (I'm going to put a call into the company later this week to confirm, but if you have any comments on this matter it would be appreciated). Anyway, the pain here seems largely self inflicted and being the margin leader (and they do have sustainable margin advantages over borders) in a price war is definetly the better place to be.

30	dj927	03/05/07 01:08 PM	recent earnings guidance	

Seems like the new membership program is really going to hit margins over the next year. I'm not sure how much of this is due to timing (new membership card sales depress margins right away but income from the sale is amortized over the life of the membership). But it is certainly concerning. I

#	Author	Date	Subject	Private

spoke with investor relations and they indicated that when the first introduced the original membership program it resulted in depressed margins for the first 18 months or so of the program until they returned to normal. Does anyone have any insights into whether mr. market is overreacting to this guidance or if it is the case that the business was overearning before and the reduced profitability is the wave of the future for B&N?

29	dj927	08/25/06 06:17 PM	Anyone still following this	

Looks like it's all the way back in the mid 30's. Anyone have any comments?

28	andreas947	06/21/05 01:37 PM	reply	

thanks. i hope some members have made some money on this. the short answer is that i still really like it here. it remains one of my largest positions. results have been kind of as mgmt advertised. as i hoped, mgmt went ahead with a $200m buyback and cash flow from operations for last year (ended Jan 05) was extremely strong. cash from operations has been really strong several years in a row - some of its working capital (which i think can continue to be improved) - but a lot of is not. i am hoping a lot of their excess cash going forward goes into share repurchases. it will be interesting to see how quickly they are working through the $200m authorization at end of next quarter. my back of the envelope intrinsic value is about $45 per share, so the margin of safety has come down but i am hopeful there is still some upside remaining. i hope this is helpful.

27	biv930	06/17/05 02:31 PM	update	

Great idea - looks like it has done very well. Just wondering what your thoughts were on the stock at current levels.

26	paul118	03/22/05 02:41 PM	thx andreas	

prob allowing some of my frustration to creep in - you make a good point, it isn't like the CEO is just a casual observer, so...

25	andreas947	03/21/05 02:21 PM	will it be enough? don't know	

the short answer is i don't know for sure...you raise a lot of very fair questions...but i think the odds are decent that this will not turn into a dead money value trap for next few years...i think they could spend $300m to $350m of the cash on their b/s at year end (admittedly, some is seasonal)on a buyback and still easily have an invest grade b/s going forward...then they have $150m of free cash flow coming in this year and going forward....after investing in the store base (admittedly, not a large growth in store base)...i am hoping store base inv can grow cash from ops (which drives intrinsic value) at least mid single digits or higher...then they can take out at 5% to 8% of shs o/s per year...and this excludes the overcapitalized b/s...so you could have modest earnings / cash flow growth on the top and shrinking share base on the bottom...i am not sure what mgmt will do here...they could just sit back and be pissed about their valuation and the excessive focus on eps (which is now lugging around their dot com losses)...but they have a lot of skin in the game and the ceo recently bought a lot of stock at prices not too far from here...would be really odd to sit there with a poor capital structure on top of a good, but slow growth business...but i admit a lot of mgmt teams will make that mistake...i am hoping this is not one of them......on the dot com losses...i do believe while rev growth is not much they are attacking the expense side of things (unwinding lousy mrktg deals, etc)...i am not that troubled by the slow store growth as i would rather see strong returns on capital deployed helping to growth cash from ops going forward than a lower return (but faster) expansion prgm....i hope this is helpful...appreciate your good points...i can tell from your prior posts we are treading in a lot of the same waters...

24	paul118	03/19/05 12:39 PM	will it be enough?	

To move the stock more than 5% or 10% though? Sqft growth seems pretty minimal next year (net 18-23 stores) and this doesn't include the BD closings. They are buying shares but somehow you wonder if they will be any more aggressive than 100m a year or so given the past couple quarters.

They keep saying that there are synergies between bn.com and the bookstores but as a shopper I

#	Author	Date	Subject	Private

don't see it, believing that bn.com lack of customer reviews and general presentation is pretty tepid. Plus, with 3% growth forecasted in .com biz, looks like it will still loose money.

Meanwhile, you are right, analysts seem overfocused on earnings numbers and don't seem to give a rip about free cash flow but why will investors end up seeing this differently? I've held a number of free cash flow stories in the past couple years and the only ones that seem to move experience either 1) some sort of earnings growth or 2) a tender (or both). With options and that redundant DC earnings look to be going nowhere and my guess is a tender will not happen, at least this close to the last financial stuff.

So what does that leave us? Being patient? I own this stock, added in the latest downturn, but wonder if I'm doomed to money market type rates for the forseeable future...

23	andreas947	03/17/05 10:44 PM	more thoughts	

i talked a bit w mgmt today...and looked closer at the numbers...on a comparable basis (as if bn.com had been owned 100% both periods) ebit and ebitda growth was in the double digits for the bookselling business....in my opinion the mkt is reacting to eps figures that are less reflective of how the core business is doing...these guys had a really solid year...they know they have a slow growing, but solid business...and a lot of excess cash and free cash flow...i would be really surprised if they don't use it to drive s/h value rather than letting it earn 2% on the b/s...their primary weapon to drive s/h value is cash and cash flow, not rapid growth...and i think they know it...i am hopeful patient investors will be appropriately rewarded here...

22	angus309	03/17/05 06:37 PM		

Thanks so much for the thoughtful reply

21	andreas947	03/17/05 03:26 PM	Q4 thoughts	

Have not yet talked to the company (have a call into them) but I thought it was a good quarter, although the market doesnt seem to like it today. They piled up over $500m of cash, about $300m of net cash. They also forecast about $150m of free cash flow for the calendar 05 period...I think this is after all their capex needs. These numbers are attractive to me given the mkt cap is still hovering near $2.2b or so. I think mgmt already has everything it needs in place for its multichannel retailing strategy... I am expecting and hoping for a major stock buyback of some kind...when the question came up on the conf call today about expanding their buyback (which is almost used up) they abruptly said no comment. With their b/s and free cash flow, I think they could buy a lot of stock back. However, I do not know for sure they are going to do this. I am willing to wait because I think this mgmt team is careful about capital allocation and I think value is building up. My thts for what they are worth.

20	angus309	03/17/05 02:44 PM	Q4	

What are your thoughts if you don't mind sharing on the quarter.

19	andreas947	02/22/05 10:11 AM	write up	

you are welcome...lets see what happens w Q4

18	paul118	02/19/05 10:11 PM	thanks for the writeup	

nice idea and nice writeup

17	andreas947	01/18/05 06:30 PM	excess FCF usage?	

i am hopeful for a signficant share repurchase. i think its likely but not guaranteed. they have said they basically are not in an acquisition mode. they have the pieces they think they need. the cfo recently commented that they were a "cash flow story". top line growth is mid single digits - nothing to write home about. ceo appears to like the stock here - he bought a lot in the open market recently (almost $20m). the "weapons" they have to get the market's attention are their strong balance sheet and strong free cash flow. they have already retired their $300m convertible issue for (primarily) cash. their balance sheet will be at maximum liquidity at fye 1/31. i look for them to take some action, most likely a share repurchase. the odds favor it, but its not a certainty.

<
1
2
3
>

#	Author	Date	Subject	Private
16	bentley883	01/18/05 02:54 PM	Excess FCF use?	

Interesting analysis, I have a questions. Any thougts on what management will do with the excess FCF (after cap-exp), any thought to share repurchases or paying a dividend?
Thanks

15	andreas947	01/05/05 01:42 PM	used books

i think they have been asked this question and have responded that, basically, they have decided not to at this point, although they don't rule it out. the discounts are definitely significant.

14	andreas947	01/05/05 01:34 PM	demographics

i ran your point about demographics by the company and it clearly reasonates with them. their target customer is college educated, 25 to 64 year old (some surveys indicate 45 to 64 year olds). they clearly think there is going to be some tailwind benefits over the long run. thanks for the interest.

13	andreas947	01/05/05 01:31 PM	music

thanks for the interest and i am glad you find the idea interesting. regarding music, mgmt says its about 8% of their business. the focus is on classical, jazz, and showtunes segments, which most appeals to their college educated, 25 - 64 year old demographic (their demographic does not include a lot of "brittany spears customers"). mgmt claims its "pretty happy" with their music, as comps have been positive while music industry comps have generally been soft. i get the sense they do make money in music but didn't really get a direct response to the question. as you would expect, their inventory system manages the music titles to the chain's demographic, the specific local market, and to what is selling. hope this is helpful.

12	danarb860	01/04/05 08:41 PM	options

re options... I would expect that there will be fewer options as gme management probably had their options converted into gme options and same for bks management, but my guess would also be a lower exercise price.

11	andreas947	01/04/05 06:27 PM	dilution

i have a call into mgmt regarding this question and will get back to you. at last proxy, which is dated, there were 8.9m options at $21 (pre GME). i adjusted the exercise price down to $15 based on the GME dividend. need to run this assumption by mgmt. thanks.

10	andreas947	01/04/05 06:23 PM	dilution

the short (and possibly too simple) answer is that i used 72m shares, the fully diluted number at the end of Q3. the following alternative approach is based on my assumptions which i have not yet confirmed w mgmt. the spin off was treated as a tax free dividend. there are about 69m primary shares and options in the last proxy (admittedly dated) were 8.9m at $21 average price pre spin. i adjust the exercise price down 30% to reflect the GME dividend ($10.20) resulting in a $15 exercise price. 8.9m shares at $15 = $134m (proceeds to co) vs 8.9m shares at $32 = $285m (value given out. So there is about $150m of "value leakage" due to the options at current prices, in my eyes at least. let me know if i am missing something. thanks for the interest.

9	andreas947	01/04/05 02:48 PM	i agree riggio is shrewd opera

i agree riggio is shrewd operator who would not have bought in the rest of bn.com with some semi-economic game plan. i don't have any special insights on how you get to that valuation for bn.com. they are consolidating distribution, unwinding non economic marketing deals, etc to boost profitability.

#	Author	Date	Subject	Private

bn.com will apparently come close to break even ebitda for fye 1/05. i don't see how that justifies what they paid for it. i guess you could look at amazon's value but, since i value everything on cash flow, i think that is ridiculous. i would guess there are significant cost improvements achieveable for bn.com or i don't think this mgmt team would have used so much capital to own it all. that said, they are pretty vague about where they think they can take it from here.

8	andreas947	01/04/05 02:34 PM	thanks for your thoughts. hav	

thanks for your thoughts. have not thought about demographic trends that much but what you are saying makes some sense to me. i think the BKS stores have a chance to become community fixtures - its seems many customers enjoy browsing thru their wide book assortments. i dont think thats going away. i was also impressed that, after 9-11, BKS posted its sales trends and they snapped back pretty quickly. i do think this value story can actually grow via additional units and comp improvements over time. hope this helps.

7	dman976	01/04/05 02:00 PM	met	

I have to believe that the boomers will go for the new book. Don't forget, this is the generation that has given us the SUV, the McMansion, plastic surgery on any part of your body, and the lowest savings rate in generations.

My thought is that the upper middle and wealthy class (highest consumers of books) amongst the boomer generation are definitively NOT bargain shoppers.

6	danarb860	01/04/05 01:48 PM	options	

post GME spin, how many BKS options are outstanding and at what prices?

5	met99	01/04/05 12:51 PM	Used Books	

Is it possible that their web site establishes used book sales in the future? I recently bought some used books at Amazon, and am awaiting delivery. (Timing was not critical on these, but it has been two weeks for those not yet here.) Used book condition on my limited experience has been as advertised.

Interesting demographic comment previously posted. Will Boomers insist on new books or value pricing?

Met99

4	dj927	01/04/05 12:22 PM	correction	

sorry I meant "shrewd" not "screwed" operator

3	kid929	01/04/05 11:54 AM	dilution	

our valuation was a bit more conservative. we also noticed that when we penalized the valuation for potential options exercises, we lost almost all of the discount-to-instrinsic-value. Just curious how you incorporated the potential dilution into your valuation. Thanks.

2	dj927	01/04/05 10:29 AM	Comments	

I agree that this stock looks cheap and I think that Riggio is a screwed operator and that he probably wouldn't have allowed the company to purchase the remainder of B&N.com unless he saw value there. Based on the price the company paid for the B&N.Com shares the implied value of B&N.com is about $500 million. I was just wondering if you had any insight into whether or not the website might be worth that much?

1	dman976	01/04/05 10:12 AM	I like it	

this idea is a good one, I believe. I have owned both BKS and BGP for a while and agree with your thesis.

One thought I have had is that the booksellers are an interesting play on upcoming demographic

#	Author	Date	Subject	Private

trends. As more boomers retire the propensity to actually sit down and read will increase and the consumption of books could see a sustainable bump in growth rates. No reimbursement risk (healthcare), and little terrorist/dollar risk (travel).

What do you think? Could analysts be missing a future growth story here?

Not that I have bought it depending on growth, just saw this story as having some nice upside beyond the value story.

< 1 2 3 >

Will Bookstores Survive?

The forces at work deconstructing physical book retailing

February 22, 2011 By Richard Rumelt

On Sunday I went to the local Borders in Santa Fe (New Mexico), looking at its going-out-of-business bargains. I selected some books and audio books and stood in the long check-out line.

In New York or Los Angeles you don't normally speak in public to people you don't already know. If you do, they tend to ignore you or even turn and move away. Santa Fe is a small town and people will talk with strangers. In the line at Borders, the man behind me remarked that he would miss Borders. "I love to spend an afternoon browsing and having a coffee," he said. We chatted about bookstores in general for a bit, but were then distracted by the young woman in front of me. She had been reading one of her book choices in line, but then used her iPhone to download an electronic version from Amazon. Putting the physical version down, she began to read the e-version on her iPhone's Kindle App. "Cheaper and quicker" she said to us with a smile. (The book was *The Convenient Marriage, by* Georgette Heyer*,* Borders' special-discount priced at $10 with the Kindle edition priced at $7.99 from Amazon.)
After fifteen minutes of waiting in line I gave up. The line was moving very slowly and it looked as if it would take another hour to get to the cashier. I handed my selections to a store clerk and left. I wondered what new retailer would occupy the space.

Each of the three of us in that line—the man who loved to spend afternoons at the store, the woman who browsed at the store but bought via Amazon, and myself, too impatient to wait in line, illustrate some of the strong forces deconstructing book retailing. But, before looking at those forces, it is important to understand Borders' past success.

Some Background

Those of us over 35 or 40 remember Borders stores opening up across the United States. Tom and Louis Borders opened their first store 1971 in Ann Arbor, near the university. Fourteen years later, the brothers opened their first "superstore" and began to expand into a national footprint. The chain's phenomenal growth startled the book industry.

At that time, the chatter in many quarters was about big chains driving the small independent bookstore out of business, a viewpoint exemplified by the 1998 hit movie *You've Got Mail* which featured the tension between charming Meg Ryan's small childrens' bookstore and the big bad chain owned by Tom Hanks.
My own experience was different. When I lived and worked in Boston, I grew used to the many bookstores around Harvard Square, near MIT, and Boston University. Moving to UCLA in 1976, I was amazed at the lack of bookstores. There was a small Walden Books in Santa Monica, a Science Fiction Bookstore, a small store specializing in medical books. In Brentwood, Dutton's held forth with a reasonable selection of literature (and a whole section devoted to Noam Chomsky). Most of the small independent booksellers specialized in counter-culture, new-age, and anti-capitalist materials. In Westwood itself, supposedly a college town serving UCLA, there were no private bookstores. Later, I served for a year on the board of the student-run non-profit that ran the internal UCLA bookstore and discovered why. The student association-run bookstore refused to share the lists of course books with outside companies, ensuring their monopoly over sales, thereby increasing the funding for student activities. To browse books within my own specialty, I visited book stores on occasional trips to Boston or London.

When Borders arrived in the area, it was a breath of fresh air. Clean, well-organized, with a very broad selection, the store not only encouraged browsing, it provided leather armchairs and a coffee bar. From the very beginning, it was flooded with business.

In the industry, Borders developed a reputation for high-quality inventory management, reasonably knowledgeable staff, and regional managers who were helpful in arranging the special events publishers and authors cherished. Of course, publishers now had a large powerful company to deal with, one with substantial bargaining power.

In 1992, the Borders brothers sold the company to Kmart, which also owed Walden Books. Two years later, the Borders Group was formed, holding Borders, Walden Books, CD Superstores, and Planet Music. Spun off from Kmart, Borders Group went public and continued its rapid growth.

A 10 percent decline in profits during 2005 alarmed Wall Street and Borders replaced CEO Gregory P. Josefowicz, who had been an executive with a food and drug retailer, with George L. Jones, who had been CEO of Saks Department Store Group. Jones' "strategic plan" was to increase EBIT margins from 1.8 percent to 5-6 percent by paring back investments in international operations and Waldenbooks and by "reinventing" the company as a "center for knowledge and entertainment." With regard to reinvention, Borders opened a number of "new concept" stores. The new store design brought a fresh look, emphasized "popular" categories like children's books, graphic novels, travel, cooking, and wellness. It had computer kiosks to make recommendations, video interviews with authors, piped music, and a section where a customer could publish their own books, make their own CDs and create their own photo books.

By 2009, it was clear that the new initiatives were not paying off. Results at the new concept stores were mixed. Selected titles sold better at the new stores, but the whole busy "entertainment" atmosphere went against the grain of old-style browsing. The table below compares the 2009 financial results for Borders with its chief competitor, Barnes & Noble.

	Borders	B&N
Sales	100%	100%
Cost of Goods Sold	74%	71%
Gross Margin	26%	29%
Selling Gen. & Admin.	26%	24%
Depreciation & Amort.	3%	4%
EBIT	-3%	1%
Net Income	-4%	1%
Assets/Sales	50%	64%
Inventory/Sales	31%	24%

2009 Financial Results

Borders had made some mistakes. It pushed heavily into music just before the advent of downloading wiped out the music retailing chains. It pushed heavily into DVDs just before Netflix wiped out Blockbuster. It opened too many superstores and pushed abroad too fast. It had state-of-the-art IT in 1990, but didn't keep it up to date or integrate it with the Internet.

Struggling to break the downward trend in sales, Borders also pushed its prices down, especially with regard to its "Rewards" program. As the table shows, Barnes & Nobel's prices were about 41 percent above its cost (cost of the book before operating expense), whereas Borders' prices were about 35 percent above cost. (The cost-of-goods sold figures are the prices paid to publishers. Since these are comparable between the two chains, the differences in these ratios are mostly due to differences in retail prices.) This difference in prices accounts for most of the difference in profit rates between the two chains.

Forces at Work

Internet Retailing. The most obvious force at work is online book retailing, especially Amazon. For some people, Amazon is the preferred source because its prices are lower. Its prices are lower because confused governments have exempted Internet sales from state sales tax, a hefty nine percent in some places. And, its prices are lower because it doesn't have to pay for easy chairs, sales staff, stolen merchandise, or clean up after all-day-campers.

However, it is wrong to see Amazon as simply a discount outlet. Many people (like me) prefer Amazon because it is quicker. To buy a book from a bookstore I have to get in the car, drive to the store, find the book, get in line, pay, and drive home. If they don't have it in stock, I have to repeat the process at another bookstore. By contrast, to buy a book from Amazon takes a few moments and it arrives in the mail two days later. Yes there is a wait, but I am working or entertained during the wait, not standing in line or fighting the traffic. I would buy from Amazon even if its prices were higher than those of the local bookstore.

Thirdly, Amazon, from its very beginning, understood that the real Internet killer-app was *search*. Amazon's Web software provides a powerful substitute for physically browsing books in a library or bookstore. Not only does it quickly list books on a subject, it gives you a peek inside many books, and it provides useful feedback from other readers as well as unbiased information such as statistics on titles that buyers of a book also bought.

Finally, Amazon has the broadest selection. For people who simply want a bestseller this matters little. But for many book customers, access to less well-stocked titles is a big plus. Whereas the typical modern big-box "super" store carries 90,000-110,000 titles, Amazon lists close to 3 million. The increase in consumer surplus from this much-wider selection has been estimated to be 7 to 10 times as large as the gains from its slightly lower prices.[1] Interestingly, a physical store with this much inventory would be almost impossible to browse. Search makes it possible to access this huge selection.

Wal-Mart & Target. The second force undermining the standard broad-range bookstore is extreme discounting of best-sellers by the low-end national retailers: Wal-Mart and Target. These stores focus on moving large volumes of best-selling titles, often pricing near or below cost. This denies other book retailers some of the profit and a great deal of the revenue associated with these very important high-volume titles.

Uncaptured Value. In general, people like bookstores. The man behind me in that line at Borders valued the calm atmosphere and liked to "browse." What he really meant by "browse" was the service traditionally provided by a public library—a wide selection of books, free access to chairs, and a quiet room. Even better than the public library, Borders had a coffee shop and did not have books missing from the shelf because they were out on loan. But this customer did not pay Borders for the value he received.

Similarly, a great many parents bring their young children to Borders, using the kid's book section as a combination play-area and public library. Again, the business does not receive any payment for providing this valuable environment.

The woman in line in front of me who put aside her paperback book in favor of downloading an e-version also received a free service. She had benefited from the physical display of books at the store, leafing through several, and then began to read one. Having used the physical bookstore to make a choice, she made an instant electronic purchase from Amazon.

Many customers at physical book stores value the knowledge of the staff and ask for recommendations and referrals. But it is now easy to take advantage of this free service and simply go home and order the recommended volume online.

This issue has a long history in retailing. Whenever a retailer bundles product with a free service, it is exposed to the risk that the customer will absorb the service and then buy the product from a discount channel. High-end audio shops can spend hours showing off components to prospective buyers, only to have them leave and buy from a discount channel. Hardware stores that try to employ skilled staff will see customers take advice only to buy a few bolts, deferring the purchase of a more expensive item until they are at the Home Depot.

Overuse. When a service is free and valuable it will be overused. Thus, because it costs almost nothing to send 10,000 emails, spam is a problem. In the pre-Wi-Fi era, the reading and lounging areas at Borders were rarely crowded. But with the advent of Wi-Fi, it became attractive for many people, especially students, to camp-out at the bookstore while doing homework, managing email and social networking, and drinking coffee. Not only are they receiving a service without paying for it, their overuse decreases the value provided to paying customers.

Summary

Despite Borders' mistakes, none would sink a ship what wasn't already awash in a storm. One cannot help but conclude that Borders is simply the canary in the coal mine for book retailing. The forces at work are substantial and will not leave any bookstore unscathed.

Look at the online commentary on Borders and you will find an undue emphasis on its e-book strategy—perhaps a mistake, but not the current reason physical book retailing is in trouble. You will also find the fallacious belief that e-books will save Barnes & Noble from a similar fate. They may save Barnes & Noble's corporate name, but not its physical bookstores.

Given the existence of online book retailing, one does not need to visit a bookstore to buy a bestseller, a famous children's book, or a birthday present for dad. Only those who do not shop online will be customers for these offerings and most of them will be price-sensitive, preferring Wal-Mart or Target. Squeezed between Amazon and Wal-Mart, bookstores' room for maneuver keeps shrinking. I imagine that once the chains fold, die-hard book lovers will push back into quaint neighborhood bookstores only to complain about the lack of coffee bars and easy chairs.

Footnotes

1. Brynjolfsson, Erik; Hu, Yu; and Michael Smith, "Consumer Surplus in the Digital Economy: Estimating the Value of Increased Product Variety at Online Booksellers," *Management Science*, 49 (11), 2003: 1580-96. [↩]

Tagged industry analysis, strategy | 5 Comments

«—Earlier

Entry navigation

More recent—»

5 Responses to *Will Bookstores Survive?*

1. *Tom Lempar* [February 24, 2011 at 10:07 pm]
   I suspect that the Borders loyalty program was really meant to create a mailing list they can use for marketing. As you say, the discount involved may not have been worth it.

   Reply
2. *Paula B.* [February 25, 2011 at 8:22 pm]
   A fact that you did not emphasize is that Borders' creditors are mainly book publishers who have not been paid for its unsold inventory. Penguin is on the hook for $41 million, Random House for $34 million, and so on.

   Reply
3. *Mitch Kramer* [March 2, 2011 at 10:44 pm]
   Borders stopped listening to its customers. A successful company must work to please the customer, not management.

   Reply
   - *Richard Rumelt* [March 3, 2011 at 10:12 pm]
     You can always please the customer by giving books away for free. Being deaf to customers is a huge mistake but there is more to competitive success than pleasing customers—you have to please them more than competitors do and not lose money in the process.

     Reply
4. *Divya* [July 29, 2011 at 1:56 am]
   It was insightful reading this article after hearing that Borders has filed for bankruptcy. The key asset of their stores was the free service and inventory. They could have combined both – (have eBook Readers) – and more sofa space – to create the next gen retailers. Its the inventory overhead that

hurts them. So ditch it and focus on what Amazon doesn't provide.
Thanks anyway

Reply