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Will Barnes & Noble win the book wars?

Long criticized for driving local shops out of business, mega-booksellers are now fighting each other and even-bigger competitors. Barnes & Noble could win by becoming your 'local' bookstore.

By [Michael Brush](#)

It's a plot twist that might make any book lover smile. After a decade of feasting on folksy independent booksellers, mega-chains Barnes & Noble ([BKS](#), [news](#), [msgs](#)) and Borders Group ([BGP](#), [news](#), [msgs](#)) are now doing it to each other.

The smaller shops couldn't compete with the giants' lower prices. Now, the two big-box booksellers are fighting each other in a bloody price war.

At the same time, they're taking flak from even-bigger retail giants Wal-Mart Stores ([WMT](#), [news](#), [msgs](#)) and Costco Wholesale ([COST](#), [news](#), [msgs](#)), which do a brisk business in discounted best-sellers, and from online rival Amazon.com ([AMZN](#), [news](#), [msgs](#)).

Even the experts don't know how this tale will end. Wall Street analysts have mostly stepped to the sidelines with "neutral" ratings on the mega-bookstores.

But if I had to write the ending today, I'd say Barnes & Noble, with 800 stores in 50 states, will prevail. It has the financial strength. And it will win over book lovers, if not the purists who mourn the local shops, with its own brand of community created through in-store cafes, visits from authors and kids' sections that invite families to plop on the floor and stay awhile.

"What other store can you go into and feel comfortable sitting on the ground?" asks Abhay Deshpande, a portfolio manager at First Eagle Funds, which owns shares of the bookseller. "The idea is to make it a comfort zone. They want you to stay because they think eventually you will make a purchase. If you can make shopping a delightful experience, then it improves the value of your franchise."

Here's look inside the bookstore battle.

No sympathy

The giants likely won't get a lot of sympathy from the ranks of book aficionados. For their take, rent the 1998 film "[You've Got Mail](#)," in which Tom Hanks portrays a manager at a predatory New York City mega-store that's strangling an independent neighborhood competitor called The Shop Around the Corner.

That plot line has played out all across the country as big-box book retailers have pushed aside independents. Purists aren't happy about that.

"Those places were charming and wonderful, and the people who ran them were quirky and unique. They would hand-sell the books they personally loved in a way that is harder to do in a chain store," laments Shel Horowitz, an industry veteran and the author of "[Grassroots Marketing for Authors and Publishers](#)."

The market share of independent bookshops has fallen to 25% from 35% in the past five years, estimates Deshpande. That's not a great development for anyone who likes books from lesser-known authors and small publishers, the kind independent shops are more likely to stock.

"Barnes & Noble is really complicit in pushing the industry to emphasize blockbusters and best-sellers," says indie author April Hamilton, who has successfully self-published two novels using tools provided by Amazon.com. Horowitz says Barnes & Noble has contributed to "homogenizing America's tastes."

The tale takes a twist

But in an ironic twist, the mega-bookstores have now turned on each other, and the focus on blockbusters has made it easier for larger retailers like Wal-Mart and Costco to compete.

The results have been ugly for bookstore investors. Barnes & Noble's operating profit margins sank by 20% last year to 4.5%. Its stock fell 30% in the past year as the price wars intensified, to trade recently around \$30 a share.

Borders has been wounded even more severely. It was facing serious financial troubles before Pershing Square Capital, its largest stockholder, rescued it with a capital infusion this month. That may only prolong the price wars, which some industry insiders describe as the most damaging they have ever seen.

Video on MSN Money





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Why aren't the presidential candidates talking about taxes? The debate about making the Bush tax cuts permanent is a sideshow, MSN Money's Jim Jubak says. The real worry is how we'll cover the rising costs of things like health care, national defense and debt payments.

"I do not expect the promotional environment is going to all of a sudden just miraculously change," said George Jones, Borders' chief executive officer, in a call recently with investors.

Meanwhile, a recession and high gas prices are cutting into consumer spending. And unlike last year, the industry doesn't have a Harry Potter book to magically boost sales. "We believe that the recessionary pressures in this uncertain economic environment will make 2008 an especially challenging retail year," Barnes & Noble finance chief Joseph Lombardi told investors recently.

Wall Street expects a gloomy chapter. Deutsche Bank Securities analyst Dave Weiner recently reiterated a "hold" rating on Barnes & Noble stock and cut his price target to just \$31 a share, citing the tough competition.

[Continued: A 'town hall' feeling](#)

Do insiders know better?

Yet industry insiders and "smart money" investors are betting Barnes & Noble will not just prevail but prosper. Consider these two bets.

- Since September, Barnes & Noble's chairman and founder, Leonard Riggio, has spent \$107 million buying 3.5 million shares at an average cost of \$30.40, according to my analysis of data at Thomson Financial. This could be a telling development because, on average, the stock goes up 15.3% in the six months after he buys. "He's done well for himself buying stock on weakness," says Deshpande. (Riggio and his brother Stephen Riggio, who is chief executive, own about a third of the company's stock.)
- First Eagle Global Fund ([SGENX](#)), for which Deshpande works, upped its position to 3.1 million shares of Barnes & Noble stock as of the end of January. That's a sizable bet at more than 5% of the fund's portfolio. The fund has beaten its competitors by 2.5 percentage points a year in annualized gains over the past three years.

Here's why Barnes & Noble may pull through.

Barnes & Noble, community builder

The folksy bookshop owners may be gone. But Barnes & Noble still sponsors speaking events that spotlight writers, including local talent, as well as any "shop around the corner" once did.

One recent evening, the Barnes & Noble in my Manhattan neighborhood featured a New York Times reporter who had stumbled across a crumbling diary from the 1930s while Dumpster diving on her way to work one morning. The reporter, Lily Koppel, became enraptured by the diarist. She tracked her down with the help of a private eye and wrote a biography called "[The Red Leather Diary](#)."

By sponsoring this lecture, Barnes & Noble offered book lovers the kind of heartwarming evening they'll never be able to download or pick up at Costco.

It's just one of the ways Barnes & Noble tries to become the local bookstore. The chain partners with Starbucks to provide in-store cafes, sponsors reading groups and encourages students and families to hang out.

Morningstar ([MORN](#), [news](#), [msgs](#)) analyst Joseph Beaulieu says this creates a kind of "town hall" feeling. "It gets people to the store, and then they think, 'Yes, I could order a book on Amazon and save a few dollars, but I am here, so I will buy it now.'"

As for the stock, Beaulieu suggests buying it below \$30 for a possible move to \$52 in the medium term.

Barnes & Noble, profit-margin builder

While Barnes & Noble lures customers with lattes and lectures, it is taking steps to bring down costs. "We are looking at every expense and giving everything a second look," says finance chief Lombardi.

A priority will be reducing rents -- the chain's largest single expense, says Deshpande. "As they get larger, they have stronger bargaining power with landlords," he says. He also expects sales to pick up in the second half of the year.

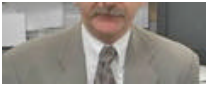
Barnes & Noble, shareholder friend

Investors bullish on Barnes & Noble are also banking on management's record of rewarding shareholders. The company uses its strong cash flow to regularly buy back shares, and it recently upped its dividend, says Justin Akin, an analyst at Aston/River Road Small-Mid Cap Fund ([ARSMX](#)), which owns the stock.

Investors like Akin also recall how Barnes & Noble has come up with plot twists to help out investors. The company spun out video-game retailer GameStop ([GME](#), [news](#), [msgs](#)) to investors six years ago; the stock went on to advance fivefold. And it spun off its [Barnesandnoble.com](#) Web site during the tech bubble, only to buy it back after the bubble burst.

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Those moves have helped give Barnes & Noble the financial strength to prevail in a price war today. It started the year with \$349 million in cash. And investors expect a few more surprises, even if the moves aren't as dramatic. "The Riggio brothers take care of their shareholders," says Akin.

Will books go digital?

Of course, the final chapter for brick-and-mortar bookshops like Barnes & Noble may be written online. Through services like [CreateSpace](#), Amazon offers a home for indie authors like Hamilton who find it hard to get on the shelves at Barnes & Noble.

"It is no longer necessary to have brick-and-mortar presence to be a successful author," says Hamilton, who has published two books, "[Adelaide Einstein](#)" and "[Snow Ball](#)," through CreateSpace.

Amazon.com is also getting good reviews for its Kindle e-book device, which lets readers download books quickly and easily. Will the digital-book format ultimately kill off brick-and-mortar booksellers the way digitized music put music retailers such as Tower Records out of business?

"It's too early to tell what's going to be the better formula," Barnesandnoble.com chief Marie Toulantis recently told investors.

"The total e-book market is still very, very small."

Of course, Barnes & Noble has a foothold in that market, too. Though Barnesandnoble.com may not be the first name in online book sales, its revenue grew a healthy 13.4% to \$477 million last year. That's still a relatively small piece of the chain's \$4.6 billion in annual sales, but it gives Barnes & Noble a toehold in the future if bookstores ever start to disappear.

At the time of publication, Michael Brush did not own or control shares of any company mentioned in this column.