Leadership Online: Barnes & Noble vs. Amazon.com (A)

The Next Big Thing: A Bookstore? Amazon.com is leading a wave of digital shops to invade established industries. They need no bricks and mortar, and they speak directly to their customers—these upstarts have a shot.

Headline from *Fortune,*
December 9, 1996

Why Barnes & Noble may Crush Amazon
The Amazon model is beguilingly attractive…All one needs, it would seem, is a Website to present the face that greets customers and takes their orders…Maybe low barriers to entry are a mixed blessing, however.

Headline and text from
Fortune magazine
September 29, 1997

By mid-1997, the competitive battle in electronic book retailing, between Amazon.com and Barnes & Noble, was on in earnest in cyberspace. Amazon had played a remarkable role in driving and dominating online retailing in its targeted category, books. But during the first half of 1997, Barnes & Noble, the leading traditional book retailer, committed to use its resources to attack Amazon's leadership online. The battle between the two was being watched with intense interest.

The first two sections of this case review the organization of traditional bookselling in the United States and Barnes & Noble's business models for competing within it, respectively. The next two sections describe Amazon's business model for online book retailing and Barnes & Noble's online offensive. Visits to Amazon.com's and BarnesandNoble.com's sites on the World Wide Web (WWW) are useful supplements. The final section of this case discusses some of the ways in which the online environment appeared to be changing in 1997.

Traditional Bookselling

Expenditures by U.S. consumers on books reached $26 billion in 1996. **Exhibit 1** divides them up by type of book. Consumer expenditures on books had grown at a 5.4% annual rate since 1991,

Professor Pankaj Ghemawat and Research Associate Bret Baird prepared this case from public sources as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. *The authors wish to acknowledge Thomas Kramer and Brian Lenhardt, MBAs 1998, for the ideas presented in their class reports and for their work on an earlier draft.*

and were projected to grow at a 4.8% annual rate through 2001 to reach the figure of $33 billion. The modest rates of growth reflected, among other things, the effects of a broad array of "substitutes" for books: cable TV, VCRs, video games, and so on.

On average, about 10 books were sold per U.S. citizen in 1996. The highest purchase-intensity was exhibited by adults between ages 35 and 75 with household incomes of $45,000 or more. Book purchases were often made while other books were still being read or were being left unread; many were bought on impulse. Relatedly, purchasing tended to be subject to spikes on weekends and in the fourth quarter of the year. In the aggregate, purchasers also demanded a large number of stock keeping units (SKUs). More than 50,000 new titles were published each year in the United States alone (although the number was down since the early 1990s), the number of English-language books in print was estimated to exceed 1 million titles, and the number of out-of-print titles was estimated to be an order of magnitude greater yet.

Most books began with authors, who sold the rights to their works to publishers in return for a flat royalty rate that often varied between 10% and 15%. The other players in the bookselling chain between authors and purchasers are discussed in the rest of this section.

Publishers

Estimates of the number of publishers in the United States ranged as high as 40,000.[1] But publishing was much more concentrated than such numbers might suggest: 20 publishers accounted for approximately 88% of all North American sales.[2] The largest single publisher in the United States, Simon & Schuster, a subsidiary of Viacom, held an 11% share of the total market. Concentration appeared to have increased recently, partly as a result of the acquisition of a number of large publishers by media conglomerates, a trend that had also increased cross-border ownership of publishers.

The recent takeovers, often heavily financed by debt, were also credited with—or blamed for—imposing more bottom-line discipline on the publishing industry at the expense of its traditional emphasis on building relationships with authors and crafting manuscripts into books. The induced changes included reductions in titles and headcounts, consolidation of smaller imprints, and management shake-ups at some of the larger publishers.

As indicated in **Exhibit 2**, a substantial fraction of books flowed from publishers to book buyers through wholesalers, retailers, or both rather than directly.[3] Publishers typically offered retailers volume-based discounts that ranged up to 44% to 55% off suggested list prices; wholesalers received discounts that were generally one to two percentage points larger. Publishers also provided cooperative marketing funds, estimated to represent about 2% to 3% of retail book sales, for promotions such as end-caps, in-store recommendations, and other marketing events. While publishers' terms were published in the American Booksellers Association's *Buyer Guide*, suspicions of favoritism to large chain stores were rife. Many leading publishers had recently signed a consent decree that committed them not to offer concessions on price greater than the ones they had specified in print.

Publishers had traditionally sold books to wholesalers and retailers on a consignment business: Unlike CDs or videos, books could be returned to publishers for full credit (not including shipping costs). This practice had originated during the Depression as a way for publishers to keep their books in stock. But by the mid-1990s, it had led to staggeringly high return rates: according to publishers, returns of new hardcover books exceeded 30% in 1996, up from 15% to 25% a decade earlier. Returned books had to be destroyed or "remaindered" that is, dumped through other channels at a discount.

To address the returns problem, some publishers had begun to offer additional discounts of 3% to 5% for waiving return privileges. Others were contemplating year-end rebates that would be inversely related to return levels. New technology, while slow to diffuse, was starting to help as well. The average size of first (printing) runs had decreased from 7,000 to 10,000 copies in the late 1980s to 2,000 to 5,000 copies. Quicker-response or its extreme version, on-demand publishing, promised to reduce demand forecasting errors. And improved point-of-sale technology made it easier for publishers to agree with retailers to mark down stores' overstocks instead of having them returned. Still, returns were unlikely to disappear any time soon.

Wholesalers

A few book wholesalers had national scope; many more competed by focusing on the basis of geography, subject area, type of publisher, and so on. Ingram, the leading national wholesaler, was several times the size of the next largest, Baker and Taylor, and accounted for more than one-half of total wholesaler sales in the United States. Ingram Books represented 9% of the sales of a family-controlled group, Ingram Industries. Ingram's other businesses were also leaders in distribution and included Ingram Micro, the largest distributor of microcomputer products—hardware and software—in the United States, with a 28% share of the market (82% of group sales), and Ingram Entertainment, which shipped one-third of all home videos (7% of group sales).

Ingram Books stocked nearly 500,000 titles. It shipped virtually all orders the day they were received; about 85% arrived at retailers' loading docks within 24 hours and 95% within 48 hours. It received most of its orders electronically and operated warehouses in seven locations. Ingram Books had been built up since the late 1970s by acquisitions of small wholesalers and investments in new information systems, particularly in order processing. Baker and Taylor, Ingram's largest rival, had fallen behind on such systems in the 1980s, but had recently completed a long and costly upgrade.

Wholesalers typically offered retailers volume-based discounts that ranged as high as 44% to 52% off suggested list prices. Unlike publishers, they also provided free and, in many cases, much speedier delivery. Ingram had recently instituted a vendor-of-record program under which booksellers were encouraged to agree to buy all of a publisher's titles through Ingram so as to reduce costs; Baker and Taylor was following suit.

The average wholesaler was considered to be under pressure in the mid-1990s. Thus a 1995 study for the American Wholesale Booksellers Association indicated that the average net profit margin for trade wholesalers in 1994 was less than 1.5%, down from traditional levels of about 2%.[4] It was suggested that wholesalers had been hurt by publishers offering better discounts and terms to retailers that ordered directly from them, and by the shrinking share of independent booksellers, which had traditionally been wholesalers' mainstays.

Retailers

Book retailing had traditionally been dominated by independent local bookstores, but large chain stores had substantially increased their share of the market since the 1970s. Chains mostly grew through the 1980s by adding mall-based bookstores, but shifted their focus in the 1990s to adding "superstores," large stores with more titles and space.

B. Dalton and Waldenbooks emerged early on as the two largest mall-based bookstore chains. Both chains were started in the 1960s and were operated by general merchandise retailers through the 1970s. These chains and their imitators revolutionized bookselling by importing techniques from other retailing categories: Their emphasis on pitching books piled high on tables led some to compare them to department stores; others discerned a supermarket mentality in their tendency to order a little of everything and quickly restock fast-moving titles. Mall-based bookstores also spearheaded a change in book purchasing patterns that was labeled as democratization by some and as vulgarization by others. According to an article in early 1982 in *Forbes*, "Books are no longer bought just to be read but, like any other consumer item, to be owned, to be looked at, to be given as presents."[5]

By early 1982, B. Dalton and Waldenbooks operated 575 stores and 750 stores, respectively. They continued to expand over the next few years but both ended up changing owners: B. Dalton was bought in 1986 by Barnes & Noble, previously the third largest U.S. book retailer; K-mart, the second largest retailer in the country at the time, purchased Waldenbooks in 1984. Both acquirers subsequently turned to superstores as a better growth vehicle for the 1990s. Barnes & Noble, aided by a successful initial public offering in 1993, was particularly aggressive in rolling out its superstore format nationally. And K-mart added to Waldenbooks by buying Borders, Barnes & Noble's leading superstore competitor, in 1992. In 1995, however, disappointing earnings led K-mart to spin off its book retailing operations (including Waldenbooks) as a debt-free entity also called Borders.

Superstores relied on destination shopping rather than convenience to build traffic, although they *were* open for extended hours (generally 9:00 A.M. to 11:00 P.M., seven days a week). Most superstores had convenient access to major roads and parking. Inside, they tried to replicate the feel of an old-world library with their fixtures and furnishings, and typically offered a café as well as ample public space and public restrooms. They encouraged browsing, staged events such as book signings, and otherwise tried to build a sense of community, akin to the pioneering efforts of some of the major independents in the 1970s. Even though there was no pressure to buy, studies demonstrated a positive relationship between the time consumers spent in a bookstore and the money they spent there. The average transaction value in superstores was about $20, about twice as large as in mall-based bookstores.

Between 1991 and 1996, the number of superstores operated in the United States by the four largest chains—Barnes & Noble, Borders, Crown, and Books-A-Million—increased from 97 to 788 and the sales of their superstores grew from $280 million to $3.3 billion, or from 16% of the chains' total revenues to 66%. Some of this growth was effectively achieved by cannibalizing the sales or growth options of mall-based stores. Nevertheless, on a net basis (i.e., netting in their mall-based operations), the top four chainstore owners managed to more than double their share of retail purchases of books in the United States in the 1990s, to 25% by 1996, with Barnes & Noble and Borders accounting for 14% of the total.[6] According to one forecast, continued growth in superstores would raise these figures to 37% and 26%, respectively, by the year 2000.[7] **Exhibit 3** compares the two leading chains, Barnes & Noble and Borders, along selected dimensions. The two leading chains reported significantly higher sales per superstore than their smaller rivals and shared, at least in public, plans to double the number of their superstores over the next five years or so.

There were still about 12,000 independent bookstores left in the United States. Independent bookstores generally lacked the leverage with publishers and the other economies of scale enjoyed by chain stores, operated out of cramped locations, and had a somewhat "less commercial" approach to merchandising books, reflecting ownership by bibliophiles. Most also offered significantly fewer titles than did superstores. The factors that tended to keep them going included local reputation and expertise, a business model that generated a lower level of returns than the superstore model (20% vs. 30%, according to one estimate) and, in some instances, noneconomic motives for staying in business. Some of the most successful independent bookstores managed to achieve significantly higher sales per square foot than the largest chains. Still, 200 independent bookstores had gone out of business since 1994, and even larger reductions in their numbers were expected if the economy softened or if independents' collective share of the market was squeezed further by chains—or by any other channel.

Barnes & Noble' s Traditional Business Model(s)

Barnes & Noble was the largest bookstore chain in the world, with sales of $2.45 billion in 1996. It sold books only in the United States and owned at least one store in every major U.S. city. At the end of 1996, it operated 11.5 million square feet of selling space, 80% of it in superstores, and employed more than 20,000 employees, half of them full-time. Its net income for 1996 amounted to $51.2 million on sales of $2.45 billion, versus figures of -$53 million and $1.98 billion for 1995.[8] The market value of its equity at the end of 1996 stood at $883.23 million, and increased to $1,416 million at the end of June 1997. Barnes & Noble went public in 1993, but 26% of its equity was still controlled personally by Chairman and CEO Leonard Riggio. **Exhibit 4** supplies some accounting data on the company after it went public.

Leonard Riggio had purchased the fledgling Barnes & Noble chain for $1.2 million in 1971. It opened its first superstore in 1975 by combining the Barnes & Noble Main Store and the Sale Annex in New York City into a store with nearly 100,000 square feet of total selling space. Similar stores were opened in mid-town Manhattan and downtown Boston in the wake of this store's success, but the company continued to derive most of its sales from a chain of more modestly sized discount stores in the Northeast. In 1985, Barnes & Noble acquired the much larger mall-based B. Dalton chain for $300 million. Its subsequent moves, however focused on growing its superstore operations from four units to more than 400. In 1987, the company started to test several superstore prototypes in suburban locations. In 1989, it acquired 23 large stores in Texas, Florida, and southern California from Bookstop. National rollout of the superstores accelerated sharply in the 1990s: Annual additions ran at 70 plus stores in 1992, 1993, and 1994, and at 90 plus stores in 1995 and 1996. By then, superstores accounted for 77% of Barnes & Nobles sales and more than 85% of its operating income. The company planned to add 70 superstores in 1997.

Over the years, Barnes & Noble had also developed a number of other book-related businesses. It published some 1,500 titles under the Barnes & Noble imprint, many of them reprints of old titles (e.g., the *Yale Shakespeare* and *Webster's Dictionary*) that could be offered at significant discounts. These books were sold through various channels, and accounted for 3% of total revenues in 1996. On the direct marketing side, Barnes & Noble had acquired a mail-order book business, Marboro, in 1979, ran a membership club called Book$aver that made selected titles available at large discounts, and was the largest supplier of books through catalogs in the United States. In 1996, Barnes & Noble expanded its scope further by acquiring a 20% stake in Chapters, Canada's largest book retailer, and a 50% stake in Calendar Club, which operated seasonal calendar kiosks in the United States.

Despite this broadening of scope, and its stated intent of participating in every significant channel for distributing books to consumers, Barnes & Noble's revenues and profits continued to be dominated by its bookstores in the United States. The rest of this section describes Barnes & Noble's mall-based and superstore business models, particularly the latter. These models are delineated in terms of three sets of business processes that are also used to organize the sections that follow: procurement and logistics, store operations, and marketing.

Procurement and Logistics

Barnes & Noble centralized the procurement of books for both its superstore and mall-store operations. This approach was actually a relatively old element of its strategy, not a new one: One of Barnes & Noble's first moves after its takeover of B. Dalton was to get rid of most of the latter's buyers in Minneapolis and relocate the procurement function to its own headquarters in Manhattan.

Centralization facilitated attempts to leverage scale economies in procurement. Barnes & Noble, along with Borders, was generally thought to be able to obtain greater discounts from publishers than other book retailers. It was also assumed to enjoy superior access to books in short supply and longer payment terms, which reduced inventory costs. Still, relationships with publishers were clouded by the higher returns generated by superstores. Barnes & Noble's COO, Stephen Riggio, was a particularly outspoken proponent of solving this problem by increasing point-of-sale markdowns by retailers, accompanied by rebates on the prices they originally agreed to pay publishers.

Barnes & Noble dealt with more than 1,200 publishers and approximately 50 wholesale distributors. Purchases from the top five suppliers accounted for 48% of the company's book purchases in 1996, with the top supplier contributing 19%. Direct purchasing from publishers, always high by industry standards, was increasing further: About 40% of the books sold by the company were supplied by a large warehouse in New Jersey that had been opened in September 1996. Books in stock in the warehouse could be shipped to stores in two to three days, compared with typical lags of several weeks in getting books from publishers. The company planned to increase the fraction of book sales that passed through the warehouse to 50% by the end of 1998 to further improve gross margins, availability, and inventory turns. Even so, Barnes & Noble would continue to trail Borders on this measure.

One reason for the difference was that Borders had moved earlier to install a sophisticated inventory tracking system developed for it by Louis Borders, one of the two brothers who had founded that company in 1971. Barnes & Noble had introduced its own online inventory tracking system, WINGS, in the early 1990s. Further improvements were expected as the company rolled out a new generation of store systems, "BookMaster," that is described in the next section. Thus, in 1997, Barnes & Noble's aggregate inventories were expected to fall by 1% despite higher gross margins, in-stock percentages, and sales.

Store Operations

All but one of the Barnes & Noble's stores were leased, often with one or more renewal options (especially for the superstores). Like other bookstore chains, Barnes & Noble kept its commitments under long-term operating leases off its balance sheet. But if these leases had been capitalized, Barnes & Noble's average invested capital in 1996 would have been $2.97 billion rather than the $694 million that it reported.[9]

Barnes & Noble's superstores varied from 10,000 to 60,000 square feet in size. The company had started off with superstores toward the low end of that range, but had judged them to be too small. It then set out to relocate and expand its stores. By 1997, the average superstore within the Barnes & Noble system averaged 22,000 square feet, and the average new superstore being 27,000 square feet. A new superstore of this size was estimated to cost about $2 million and to need average daily sales of $11,000, or the equivalent of about 400 hardcover books, to break even.[10]

The number of titles carried by individual superstores ranged from 60,000 to 175,000, of which approximately 50,000 were common to all stores. Barnes & Noble's buyers customized the title selection before a store opened; after the opening, this task became the store manager's responsibility. In 1997, Barnes & Noble had begun to roll out BookMaster, a significantly improved store system that supported faster register transactions, real-time communications among stores, the distribution center, and wholesalers, and a 2.5 million title database designed specifically for book browsing. Rollout to all stores was expected to be completed in two years. The only computer terminals in the stores continued, however, to be behind sales/service desks.

In addition to its superstores, Barnes & Noble operated several other chains under the B. Dalton Bookseller, Doubleday Book Shops, and Scribner's Bookstore trademarks. These stores, often located in malls, were smaller in size than superstores and had smaller selections, higher prices, and fewer markdowns. B. Dalton bookstores ranged from 2,800 to 6,000 square feet in size and stocked between 15,000 and 25,000 titles. The 24 Doubleday and 9 Scribner's bookstores were more upscale and placed greater emphasis on hardcover and gift books. The B. Dalton chain, in particular, had been cannibalized by the growth of superstores: Since 1991, Barnes & Noble had closed more than 50 B. Dalton stores per year.

While the reductions in the number of mall-based stores offset much of the growth in the number of superstores, the net increase in selling space was much larger. Thus, the February 1997 figure of 9.3 million square feet of selling space represented an increase of one-third over the previous year's. Superstores were projected to continue to drive Barnes & Noble's growth into the next millennium, both through penetration of new markets and clustering within existing ones: By its own reckoning, the company operated one or more superstores in only 132 of the 208 potential geographic markets in the United States, and two or more superstores in only 61 of them. The company stated in public that it planned to operate about 1,000 superstores within five to six years—despite increasing head-to-head competition with Borders, in particular, for new sites. The softness in 1996 earnings and concerns about cannibalization had, however, led the company to scale back its expansion plans for 1997 to 70 superstores, down from more than 90 in each of the two previous years.

Marketing

Marketing as well as store operations varied substantially across the mall-based stores and the superstores. The B. Dalton chain, which relied on convenience to draw traffic, discounted selectively from market to market but generally priced hardcover bestsellers at 15% to 25% off the publisher's suggested list price. A Book$aver card offered an additional 10% discount on substantially all merchandise to those willing to pay an annual membership fee.

The superstores had a lower price structure aimed at attracting destination shoppers: 10% off *all* hardcovers, and up to 30% off a selection of bestsellers, new editions, and special promotional items that were located in the front of the store. Bestsellers played a critical role in building traffic, but were estimated to account for only 3% of superstores' sales. The deep discounts on them were partially funded by publishers, which earmarked more of their cooperative marketing allowances for Barnes & Noble and Borders than for other retailers. Support by publishers played a critical role in determining which items were placed in the front of a superstore.

Barnes & Noble's and Borders' chains of superstores actually priced on par with one another and sought to differentiate themselves along other dimensions, particularly selection and service as well as location. As the geographic overlap between them had grown, so had friction over which was more "literary," did a better job of customizing stores to local conditions, had more knowledgeable salespeople, and offered more in-store service[11]—with additional heat being generated by the fact that many independent bookstores thought that these characteristics were *their* advantages There were also many less lofty differences between Barnes & Noble and Borders: for example, in terms of décor (Barnes & Noble favored green and gold), coffee served (Barnes & Noble had signed up Starbucks in 1994), and the ability to pull authors into stores for book signings, talks, and other events (Barnes & Noble thought that its greater scale gave it more clout with authors). What was generally agreed was that each of the two chains had developed a large base of customers who, other things being reasonably equal, would visit its superstores rather than its rival's.

The Barnes & Noble brand name, which had originally been built up through pioneering, humorous TV advertisements, was reserved for the superstore business. Great care was now taken to ensure that the brand consistently evoked the attributes that the company's customers had come to value: a large selection, everyday low prices, an unpretentious, unintimidating atmosphere, and so on. The opening campaigns for new superstores—involving extensive print and radio advertising, direct-mail marketing, and community events—also revolved around the Barnes & Noble brand.

Amazon.com's Online Business Model

While Barnes & Noble and other chains were busy expanding their networks of superstores, interest began to build in another, radically different approach to book retailing: online, over the Internet. Several hundred book "cyberstores" were estimated to be in operation on the WWW in mid-1997, ranging from simple Web sites to ones that actually helped process transactions with the general public. Book Stacks Unlimited (www.books.com or www.bookstacks.com) had been one of the pioneers: It began selling books online through a bulletin board service (BBS) in 1992 and in October 1994 launched a Web site that now offered a selection of more than 500,000 titles, mostly to members. In the interim, it was acquired by CUC International, a leading direct marketing company.

Book Stacks was still a significant player in online book retailing but had clearly been overtaken by Amazon.com. Amazon was expected to post sales between $100 million and $150 million in 1997, up from $16 million in 1996, and to account for a dominant share of total online sales in its product category—estimates ranged as high as 90%. Amazon's losses were up as well, from $6 million in 1996 to an estimated $28 million in 1997. According to a company prospectus, it expected "to continue to incur substantial losses for the foreseeable future." It nevertheless managed, in May 1997, to raise $49 million from an initial public offering (IPO) that assigned it a total stock market value of $561 million. After the IPO, Amazon's 33-year-old founder, Jeff Bezos, owned approximately 41% of the company and another 10% was accounted for by members of his family and trusts that they controlled.

Bezos, who had a *summa cum laude* degree in electrical engineering and computer science from Princeton, was working as a "quant" at a hedge fund on Wall Street in spring 1994 when, in the course of surfing the WWW, he came across a site projecting annual Web growth at more than 2,000%. This explosion in demand inspired him to think about opportunities in online retailing. After analyzing over 20 products on the basis of a number of criteria—including the size of the market, the number of SKUs, and traditional margins, distribution patterns, and competitors as well as how value could be added relative to the traditional business models by the Internet—Bezos decided to focus on books. As he was quoted as saying in 1996, "There aren't any 800-pound gorillas in bookselling."[12] In addition, he thought that mastery and control of the book-retailing interface might prove a good base for branching out later into the online sale of other products, such as CDs, that also fit well with the Internet.

Bezos' new company, named Amazon.com after the river ("Earth's biggest river—Earth's biggest bookstore"), shipped its first book in July 1995. Sales reached $0.5 million in the rest of 1995 before surging to $16 million in 1996 and reaching an annualized run rate of $82 million in the first half of 1997. The company's cumulated deficit through the first few months of 1997 was largely financed by $8 million in venture capital from Kleiner Perkins Caufield & Byer—that firm's largest single placement ever, and more than its initial investment in Netscape. Amazon's successful IPO in May 1997 relaxed immediate cash constraints. The rest of this section describes the "sell all, carry few" business model that investors as well as some book buyers found so compelling.

Procurement and Logistics

While Amazon.com had offered customers more than 1 million titles from the outset, it still carried only 2,000 of them in its own warehouse in Seattle. It processed orders for the million-plus titles that it listed but did not carry by obtaining them from the publisher or a wholesaler. Packages of books were shipped from the publisher or wholesaler's warehouse to Amazon's, where they usually had to be "broken down" and repacked before being shipped out to customers.

Amazon's dependence on others to stock most of the books that it sold prompted it to place more emphasis on going through wholesalers rather than dealing with publishers. Orders from publishers could take weeks to arrive. Wholesalers, in contrast, could ship a book within one to five days if they had it in stock, permitting most books to be delivered within four to seven business days at a cost of $3 per shipment plus 95 cents per book; second-day air cost $6 per shipment plus $1.95 per book and next-day air $8 per shipment plus $2.95 per book. As of mid-1997, Amazon obtained 59% of its books from just one wholesaler, Ingram, which had a warehouse in Oregon; Baker and Taylor was its second largest supplier.

The most obvious benefit of this "just-in-time" procurement system was that it multiplied inventory turns and reduced working capital requirements. Amazon turned its inventory over 70 times in 1996, although this figure had declined by the second quarter of 1997 to 56 times. Average inventory holding periods of five to six days plus accounts payable terms of up to 180 days reduced working capital levels, which were positive only because of the excess cash Amazon maintained on hand. The IPO, in particular, left Amazon with roughly four times the absolute cash level ($12 million) reported by Barnes & Noble at the end of 1996.

Another potential advantage of Amazon's procurement and logistics model stemmed from the fact that it generated returns at the rate of only 1% to 2%. Capitalizing on this difference would probably require Amazon to work more closely with publishers, which had the largest stake in reducing returns. Deutsche Morgan Grenfell (DMG), one of the lead underwriters of Amazon's IPO, predicted that over a five-year horizon (i.e., by 2001), this advantage would offset Amazon's smaller scale and allow it to source books on roughly the same terms as Barnes & Noble did.

Store Operations

Amazon.com's business model revolved around a virtual storefront, but its operations had physical as well as informational elements, both of which were centralized in Seattle, Washington. Bezos had selected this location for a number of specific reasons. First, it was close to the largest book distribution warehouse in the world, that owned by Ingram, in Oregon. Second, the region had a large pool of high-tech talent. Third, the fact that Washington state's population was relatively limited mitigated tax burdens: Amazon wouldn't, under existing legislation, have to make customers in other states pay sales tax on their online purchases. Finally, a West Coast location permitted more (in-stock) books to be shipped the same day to the East Coast than would have been possible the other way around.

Amazon's physical operations in Seattle were decidedly spartan: The corporate headquarters were located in a lower-rent downtown district, office space was cramped, and desks, including Bezos', tended to be unfinished doors with 4-by-4s for legs. Bezos liked to say that Amazon skimped on everything except people and computers. As of the end of March 1997, Amazon employed about 250 people, roughly half of whom were involved in packing, shipping, and customer service, and the other half in computer programming, the editorial function, marketing, accounting, and management. Top managers' backgrounds were generally computer-related rather than book-related: The only significant exception was the Vice President of Business Expansion, Scott Lipsky, who had joined Amazon in July 1996 after more than two years as Barnes & Noble's Chief Information Officer. A stock option program helped bind key employees to the company.

Amazon's investment in computer technology was focused on software rather than hardware. Amazon's Web page, which limited graphic content so that it could be downloaded quickly, was the most visible manifestation of the company's efforts to develop proprietary computer systems and had been named one of the 10 "Best Web sites of 1996" by *Time* magazine. About 80% of the resources spent on software development since the company's founding, however had been devoted to back-office operations, which Bezos described as "the iceberg below the waterline of online bookselling."[13] This internal development effort, costing millions of dollars, was mandated by the limitations of existing software. Thus Amazon needed a customer service center for handling e-mails rather than phone calls and inventory management software that could track millions rather than thousands of SKUs, all integrated on a Web site that automatically sent e-mail messages when orders were placed and shipped.

Systems development challenges did not cease with the successful initial development. Amazon's infrastructure required major reworking to cope with the explosive growth that it was experiencing. In addition, according to a prospectus issued at the time of the IPO, "The Company's current management information system, which produces frequent operational reports, is inefficient with respect to traditional accounting-oriented reporting and requires a significant amount of manual effort to prepare information for financial and accounting reporting."[14] Amazon did not have redundant systems or a formal disaster recovery plan and had experienced periodic systems outages, which it expected to recur from time to time. Still, such outages were deemed less of a problem for a bookseller than for an online service provider (e.g., America Online, which had experienced highly publicized problems) or an online brokerage on which customers might rely for critical business.

Marketing

Average daily visits to Amazon's Web site had increased from about 2,000 in December 1995 to close to 100,000. Repeat customers accounted for more than 50% of orders, and the total customer base had reached 610,000.[15] The company expected to become the first electronic retailer to hit the 1 million customer mark later in 1997. Approximately 30% of its sales were international, although this figure was down from 40% one year earlier, and was expected to fall further. The average transaction value was about $50, and sales were dominated by technical and business books.

One noted Amazon customer, Microsoft chairman Bill Gates, summarized the company's appeal as follows: "Time is short and they have a big inventory and they're very reliable."[16] According to Bezos, "Those are three of our four core value propositions ... The only one Gates left out is price: We are the broadest discounters in the world in any product category. But maybe price isn't so important to Bill Gates."[17]

Customers were able to shop at Amazon any time of the day, any day of the week. They could search through its catalog, which originally consisted of 1.1 million titles, by author, title, or subject. First-time shoppers had to fill out a simple order form with their names, addresses, and credit card numbers.[18] Password protection meant that this information would not have to be reentered in the future unless an order was to be shipped to a different address. Customers were instantly informed of the prices and inventory status of the items they had ordered. Through mid-1997, Amazon discounted approximately one-third of its titles by 10% and bestsellers by 30%. Orders were confirmed online, and customers were also e-mailed when their order was shipped from Amazon's warehouse.

Amazon did more, however, than just sell books. It also provided a range of services, including information about books: interviews with authors (often undertaken by robot reviewers), book reviews and recommendations from other customers and other media, links to other sites, new-release data, and a number of other daily features. Two personalized services, *Eyes* and *Editors*, helped build traffic by e-mailing customers when books by selected authors, on selected subjects, or recommendations in selected categories became available.

Traffic was built up in a number of other ways as well. Through the first half of 1996, Amazon had primarily relied on word-of-mouth among tightly knit online communities to improve its visibility. In the second half of that year, it began to advertise in print media and online—a move that, along with the novelty of its business model, helped generate stories about the company in publications such as *The Wall Street Journal*, *Business Week*, and the *New Yorker*. And in July 1996, it inaugurated an Associates Program under which other Web sites could display the Amazon.com hot-link and offer specific books of interest to their visitors. Instead of paying directly for this exposure, Amazon offered Associates referral fees of 8% on sales of titles that were in print. The referral fees applied only to sales that resulted from the initial "clickthrough": Subsequent purchases made by a customer did not qualify. Amazon had enlisted several thousand Associates by mid-1997.

Looking forward, Bezos stressed that Amazon's online business model could revolutionize the generation of information about customers as well as the provision of books and related information to them. According to him, "Ultimately, we're an information broker. On the left side we have lots of products; on the right side we have lots of customers. We're in the middle making the connections. The consequence is that we have two sets of customers: consumers looking for books and publishers looking for consumers. Readers find books or books find readers."[19] Bezos went on to predict that, with the help of information about customers' browsing and purchasing behavior, "We'll be redecorating the store for every customer."[20]

Barnes & Noble's Online Offensive

Barnes & Noble had begun monitoring developments in online book retailing shortly after Book Stacks started up its Web site in late 1994. According to Stephen Riggio, the company tracked all the early online efforts but did not benchmark itself against any particular one because it saw a unique mission for itself: leveraging the Barnes & Noble brand name online.[21] In 1995, College Bookstores, a sister company that was privately held by the Riggios, launched a Web site that offered college students a place to chat online and order college apparel, posters, and magazines as well as books and helped build experience with online commerce for Barnes & Noble. In 1996, the company decided to launch its own transaction-oriented Web site and, in August of that year, it formed a New Media division that consisted of seven people.

On January 28, 1997, Barnes & Noble publicly announced its plans to become the exclusive bookseller on America Online's (AOL's) Marketplace and to launch its own Web site later in the spring. On March 10, Barnes & Noble announced that its Web site (but not its storefront on AOL) would feature a personalized book recommendation service that the company had been working on since 1996 with a Cambridge, Massachusetts-based software start-up, Firefly. On March 18, Barnes & Noble went online at AOL with deep discounts: 30% for hardcovers and 20% for paperbacks. Barnes & Noble launched its own Web site, with a similar deeply discounted price structure, on May 13, 1997. On the same day, it also filed a lawsuit against Amazon challenging its claim to be the "Earth's biggest bookstore." According to the suit, "Amazon is not a bookstore at all. Rather, it is a book broker making use of the Internet exclusively to generate sales to the public." Amazon's IPO had been scheduled for the following week.

According to Barnes & Noble's annual report for the year ending February 1, 1997, "Our goal is nothing short of being the dominant marketer of books through this [online] channel."[22] The company's initial plans called for achieving leadership online by the end of 1998, but Stephen Riggio disclaimed interest in buying market share for the sake of buying market share. According to him,

> We believe our online business had an opportunity to add incremental sales to our company... There are still too many places where people can't get to a bookstore with a big selection... Second, there are many people today who do not have the time or the affinity to shop retail... Third, our international business, or sales of English-language books abroad, is untapped... Finally we believe the concept of having an online bookstore on your desktop will cause an explosion of interest in books.[23]

The organization that had been built up to accomplish these objectives, BarnesandNoble.com, numbered more than 50 people by spring 1997. "Dotcom," as it was often referred to internally, was organized as an entirely separate company from Barnes & Noble, Inc., and had its own Chief

Operating Officer, who reported directly to the Riggios. This separation was partly motivated by the desire to avoid paying taxes on online sales, as described below. It also reflected a sense that this entrepreneurial venture needed to attract different kinds of people and create a different kind of identity from the traditional bookselling business if it was to succeed.

The rest of this section describes Barnes & Noble's online business model and then turns to Amazon's response and projections about the financial implications.

Procurement and Logistics

Procurement was the activity that was most tightly coupled across Barnes & Noble's online and traditional businesses: Most books for both types of businesses were centrally purchased by the company's buyers. Publishers delivered books for the online business to the company's distribution center in Jamesburg, New Jersey, where they were physically segregated from the much larger flow of books to the traditional bookstores to avoid any ambiguity about whether sales tax needed to be paid in states other than the ones in with BarnesandNoble.com officially operated (New York and New Jersey). Barnes & Noble was expanding the Jamesburg facility, leading Stephen Riggio to claim, "By the fall [of 1997], our 350,000 square foot distribution center will have 90% of the books we believe people are going to be buying online."[24]

BarnesandNoble.com actually shipped books to customers from a warehouse dedicated to the online business in Dayton, New Jersey, that obtained "in-stock" titles from the nearby Jamesburg center and others from wholesalers. In-stock titles were ready for shipment the same day, permitting BarnesandNoble.com to claim that it was typically able to beat Amazon.com on delivery times. Shipping charges, however, were set at the same level as Amazon's.

Store Operations

BarnesandNoble.com's virtual storefront was graphically richer than Amazon.com's and took a bit longer to download. "Front-end" operations, that is, the customer interface were kept entirely separate from Barnes & Noble's extensive store network to minimize online sales' exposure to sales tax. Thus, the option of placing kiosks in the traditional bookstores that customers could use to order books online had been rejected so far, as had been the idea of shipping books ordered online to the stores closest to customers and having them pick up the books themselves.

"Back-end" operations offered more room for exploiting synergies. As Stephen Riggio put it, "It's a core competency that we have the infrastructure to know how to do business with all these folks [publishers] and all the back-end apparatus of paying publishers, systems, and the like. It's all there. The Internet company plugs into it. As a result, our online company has been able to hit the ground running without having to invest the extraordinary sums that startups would [need] in such an operation."[25] Systems recently developed for the traditional bookstore business that had proved particularly helpful online included the creation of an extensive book database that could be searched electronically and the initiation of real-time inventory checks with book suppliers.[26] However, considerable systems development and upgradation dedicated to the online business were required as well.

Marketing

BarnesandNoble.com expected to achieve about $15 million in sales in 1997 and more than $100 million in 1998. It offered customers 2.5 million titles and deep discounts off suggested list prices: 20% on all paperbacks that were in stock, 30% on most in-stock hardcovers, and 40% off some best-selling hardcovers. As Stephen Riggio put it, "Online customers complete their own transactions and therefore not only expect to receive, but are entitled to receive, direct-from-warehouse pricing."[27]

In addition to selling books at its Web site, BarnesandNoble.com offered a range of services, including book-related information, to visitors. While many of these services resembled the ones already available on the Amazon.com Web site, BarnesandNoble.com broke new ground with its use of a suite of software tools licensed from Firefly. that permitted Web sites to personalize the experience of each visitor while protecting his or her privacy. Firefly's Passport Office product stored details about users' personal profiles on their own computers but let Web sites request access to these profiles, and its Catalog Navigator product added to personal profiles based on choices made by each customer as he or she navigated through online catalogs. BarnesandNoble.com used Firefly's technology to offer "collaborative filtering," a technology with roots in computerized dating. A customer who completed an online survey rating different books within a subject area was presented with new book recommendations based on ratings by other customers with similar profiles.

BarnesandNoble.com also strove to build online traffic by linking up with other major Web sites. Signing up to be the exclusive seller of books on AOL's Marketplace, starting in March 1997, was an early example. AOL was the world's most popular Internet online service with 8 million members, to whom it provided services such as software and computing support, online classes, interactive magazines and newspapers, e-mail, and conferencing as well as easy access to the Net. Given AOL's consumer orientation, sales at BarnesandNoble@aol were led by the general interest and fiction categories, in contrast to Amazon's (and later BarnesandNoble.com's own) Web site, where computer, technical, and business books led. Barnes & Noble announced a second major agreement on May 21, 1997: starting in the fall, visitors to the Book Review section of *The New York Times* on the Web would be able to purchase almost any of the roughly 50,000 titles reviewed there by following a link to BarnesandNoble.com (whose visitors could go the other way and look up reviews in the *Times)*, with BarnesandNoble.com paying the New York Times Electronic Media Company a commission on each book that it sold through this referral mechanism. Other major joint ventures of this sort were reportedly being negotiated, and BarnesandNoble.com was thought to be working on introducing a counterpart to Amazon.com's Associates Program.

Last but not least—perhaps even first—among the traffic builders on which BarnesandNoble.com pinned its hopes was the Barnes & Noble brand name. While this brand name had yet to be advertised (offline) in an online context, company spokesmen thought that it would become a major asset in driving sales online, especially as Internet usage expanded from a select segment toward a mass market.

Amazon's Response

Jeff Bezos once said, in apparent reference to Barnes & Noble, "Frankly, I am more concerned about two guys in a garage."[28] Still, Amazon.com did seem to pay attention to Barnes & Noble's entry online. On March 17, 1997, the day before the launch of BarnesandNoble@aol, Amazon. com added 1.5 million titles to the more than 1 million that it already listed, expanded discounts on bestsellers, and announced that it would offer a personalized book recommendation service of its own (using software developed by Firefly's main competitor). On May 13, 1997, the day that BarnesandNoble.com was launched with deep discounts, Amazon announced that it would expand its discounts to 40% on the Amazon.com 500, a list of bestsellers and company picks for future bestsellers.

In the wake of Amazon's successful initial public offering on May 20, it took an even more aggressive tack. In early June, it responded to BarnesandNoble.com's lower prices by offering 20% to 30% off on 400,000 titles (virtually all its sales), but narrowing the range of titles on which 40% discounts were offered to a reported 100 to 150. **Exhibit 5** compares the prices that resulted on a small but representative sample of books. Amazon increased the commissions it paid to Associates on first-time sales from 8% to 15%. It also began negotiating deals with "Web landlords" and was reported to have clinched agreements with two leading search engines, Yahoo! and Excite, and with AOL for aol.com and NetFind (AOL's search engine), which fell outside the scope of Barnes & Noble's deal with AOL Marketplace. Amazon continued to advertise offline, unlike BarnesandNoble.com, which was ramping up to do so, but continued to refrain from allowing advertising on its own Web site, despite the allure of 85% gross margins. On the back end, it decided to build its own large warehouse in Delaware as a way of speeding up deliveries, even though that changed a central tenet of its original business plan: keeping inventory and fixed assets to a minimum.

Exhibit 6 summarizes the impact of these moves on Amazon's (and Barnes & Noble's) market values, and **Exhibit 7** traces some of the financial implications for Amazon, based on estimates by Deutsche Morgan Grenfell. DMG arrived at its figures by starting with top-down revenue forecasts—that were built up from specific assumptions about segments of the book market—and superimposing assumptions about trends in Amazon's margins. DMG's estimates reflected the effects of Amazon's price cuts in early June—often described as a shift from a 10% discount business model to one offering 25% discounts—but did not fully account for the extra costs associated with changes in the Associates Program, competition for Web real estate, and back-end investments. Break-even was predicted to take place in 1999.

The Future of Online Book Retailing

Virtually everyone agreed that the Internet's growth would continue to be explosive. Thus, according to International Data Corporation, the current base of 25 million users of the WWW would increase to more than 80 million by 2000. And based on projections concerning the U.S. population, sales of computers, modem ownership, and subscription rates to online services, the number of U.S. households with access to the Internet was expected to increase from 17 million in 1996 to 48 million by the year 2000, out of a total of about 100 million households (see **Exhibit 8**). While this figure represented a slackening of growth rates that had reached 50% to 100% in the recent past, it did mean unprecedented numbers of users would connect to the Net for the first time in the next few years.

The profiles of "netizens" were also changing. While only 12% of users were female in 1994,[29] that percentage had increased to an estimated 40% to 45% by 1997.[30] The average user's age was 36 years, most were between 30 and 50,[31] and many expected the average age to decline further. According to surveys, 54% of users had completed a college degree,[32] down from 71% in 1994.[33] In 1997, the average user was still fairly affluent, with 42% making more than $50,000 per year.[34]

Net-based business-to-customer transactions were dwarfed by business-to-business electronic transactions but were finally starting to make their mark—despite the early reluctance of retailers to cannibalize their in-store sales and customers' concerns about payment systems. Thus a February 1997 "estimate" by BancAmerica Robertson Stephens that pegged aggregate "e-tailing" revenues at $421 million in 1996 (up from $85 million in 1995) had to be nearly tripled (to $1.13 billion) when the actual numbers came in. Given this larger 1996 base, and the expectations that growth would nevertheless continue at close-to-100% rates until the millennium, Robertson Stephens increased its forecasts for online retailing revenues in the year 2000 from $8 billion to $16 billion. High-end forecasts assumed that online sales would continue to be exempt from state and local taxes—a dispensation that had considerable political support at the national level, but was opposed by state and local governments.

Books ranked behind computer products and travel services as the third-largest product category in online retailing. Books lent themselves to online retailing because of the large number of SKUs, the standardization of products, and the limited importance, some argued, of physical interactions. Estimates of the fraction of books that would be retailed online by the year 2000 varied between 2% and 10%.

There was also considerable disagreement about the toughness of price competition that would ensue, in books as well as other categories of online retailing. Some argued that new technologies were leading to a shift of historic proportions in bargaining power, from producers and retailers to consumers. They pointed to merchant-brokerage agents such as Arthur Andersen's prototype, BargainFinder, that searched for the lowest prices on particular products across merchants on behalf of customers, as the wave of the future. Others noted that existing merchant-brokerage agents were overly focused on price at the expense of other criteria, that their speed and efficacy was limited even when it came to searching out the lowest prices, and that they could be blocked by retailers. They also emphasized that intelligent agents were as likely to be used for the purposes of product-brokerage (what to buy) as merchant-brokerage (whom to buy from).[35] In fact, many experts thought that the new technologies increased rather than decreased the scope for product differentiation by permitting customization—although electronic retailers' efforts along this dimensions were clouded by concerns over privacy and were potentially subject to governmental restrictions. In addition, a lively debate continued about the extent to which online customers, particularly new ones, would persist in being loyal to brand names that had been established offline.

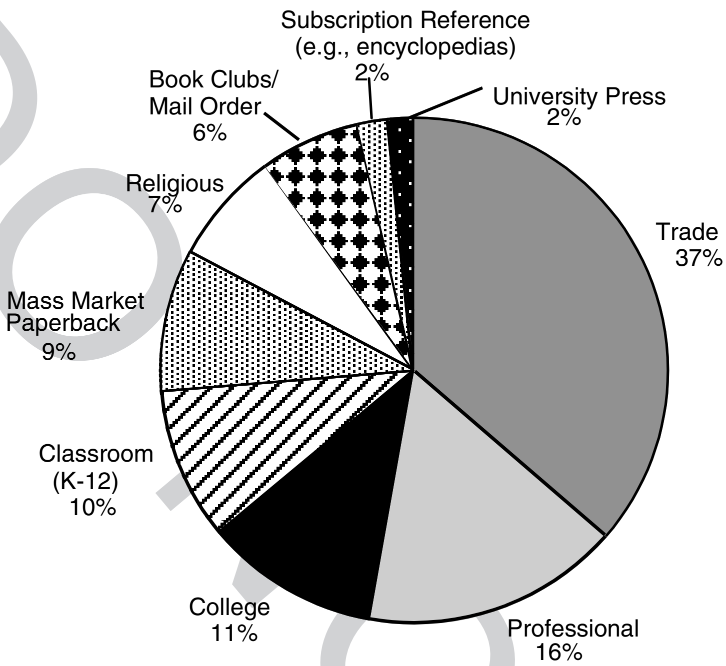
Other uncertainties concerned the impact of the strategies adopted by traditional participants in the bookselling industry: publishers, wholesalers, and retailers. Some leading publishers had set up their own electronic retailing operations. Simon & Schuster, for example, had launched a consumer book-ordering service in spring 1997, based on the book club model, that was limited to its own titles, and Bertelsmann, the German media conglomerate, was constructing the equivalent of an international mall online that would sell books in English, French, Spanish, German, and Dutch and ship them through its extensive distribution network in Europe and the United States. A longer-term threat was from organizations that might decide to publish directly on the Web, bypassing all traditional print publishing steps: A number of small publishers, nonprofit organizations, and university presses had already begun to do so.

At the wholesaling stage, Ingram was testing a service to create new online book retailers that would focus on luring shoppers; Ingram would handle everything else, from maintaining the Web site to taking orders and shipping the books. Ingram was also readying a "drop-shipping" service for online retailers that would, as an alternative to their continuing to receive bulk shipments themselves, authorize the wholesaler to ship orders directly to consumers. By mid-1997, Ingram had signed up Crown Books, the 125-store Lauriat chain, and cbs.sportsline.com to sell books online. But Baker and Taylor, the number two wholesaler, was expected to beat it to market with a drop-shipping service later in the year.

Finally, a host of traditional booksellers as well as new entrants had gone online. According to the American Booksellers Association, 28% of independent booksellers had access to the Internet, 14% maintained a Web site, and 36% planned to launch one in the near future. The impending online entry of the number two chainstore, Borders, while delayed, garnered even more attention. According to Carl Rosendorf, BarnesandNoble.com's Vice President for New Business Development,

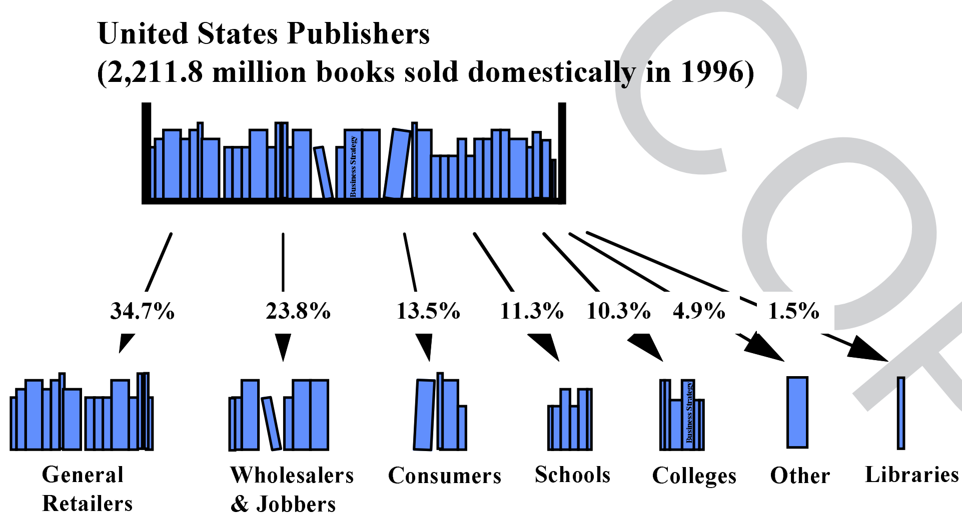
> Our customer until a few months ago couldn't come to us because we weren't here, and they had to go to Amazon. Now we are here and Borders will be here. So our customers and their customers will have a lot to choose from. The business is going to be very, very different two years from now.[36]

Exhibit 1 Breakdown of Consumer Expenditures in the U.S. Book Market ,1996



Source: John P. Dessauer, *Book Industry Trends* (New York: Prepared for the Book Industry Study Group, Inc., by the Statistical Service Center, 1997)

Exhibit 2 Flow of Books in the U.S. Market



Source: John P. Dessauer, *Book Industry Trends* (New York: Prepared for the Book Industry Study Group, Inc., by the Statistical Service Center, 1997)

Exhibit 3 Barnes & Noble vs. Borders, 1996*

	Barnes & Noble	Borders Group
Superstores		
Superstore Sales/Total Sales	76%	50%
Number of Superstores	431	157
Sales per Superstore ($M)	4.3	6.2
Prototype Superstore Size (Sq. Ft.)	27,000	30,000
Sales Per Average Square Foot (E)	$228	$284
Same Store Sales Growth	5.2%	9.9%
Financial Performance		
Total Sales ($ M)	2,448	1,749
Five-year Sales Growth	+24%	+12%
Operating Margin	4.9%	5.3%
Interest Coverage Ratio	3.1x	14.7x
Pretax Margin	3.3%	4.9%
Inventory Turns	2.1x	2.1x

*Figures for 1996 unless otherwise specified.

Source: Adapted from D.G. Magee, et al, *Book Retail Industry - Industry Report*, The Robinson-Humphrey Company, Inc., September 24, 1997

Exhibit 4 Barnes & Noble Financials ($ Thousands)

Fiscal Year	1992	1993	1994	1995	1996
Income Statement Items					
Revenues	$1,086,703	1,337,386	1,622,731	1,976,900	2,448,124
Cost of sales, buying, and occupancy*	711,845	874,038	1,050,011	1,269,001	1,569,448
SG&A expenses	221,266	262,861	311,344	376,773	456,181
Rental expense	91,792	120,326	147,225	182,473	225,450
Depreciation & amortization	25,082	29,077	36,617	47,881	59,806
Pre-opening expenses	6,004	8,940	9,021	12,160	17,571
Operating Profit	30,714	42,144	68,513	(35,156)†	119,668
Interest expense and amortization of deferred financing fees	26,858	25,807	22,955	28,142	38,286
Income tax	3,646	8,584	20,085	(10,322)	30,157
Net Income	($8,505)	7,753	25,473	(52,976)	51,225
Balance Sheet Items					
Cash and equivalents	40,494	138,316	55,422	9,276	$12,447
Inventories	319,597	366,393	503,969	740,351	732,203
Working capital	114,677	182,403	155,976	226,500	212,692
Total assets	712,055	895,863	1,026,418	1,315,342	1,446,647
Long-term debt, less current portions	190,000	190,000	190,000	262,400	290,000
Shareholders' equity	146,754	328,841	358,173	400,235	455,989

*Includes occupancy costs (such as common-area maintenance, merchant association dues, and lease-required advertising, but excluding rental expense), certain overhead costs of the buying departments, and adjustment for LIFO.

†Includes a $123,768,000 restructuring charge.

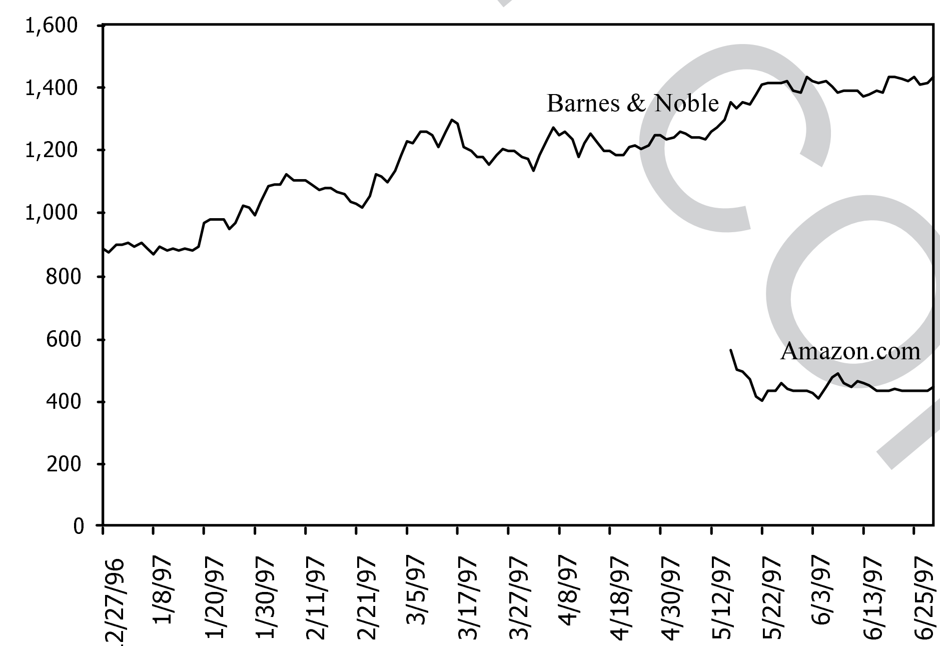
Source: Barnes & Noble 1996 Annual Report

Exhibit 5 Book Pricing

	Stores		Internet	
	Borders	**Barnes & Noble**	**Amazon**	**BarnesandNoble.com**
Bestseller Hardcover				
Into Thin Air- Jon Krakauer				
List Price	24.95	24.95	24.95	24.95
Discount	30%	30%	40%	30%
Price	17.47	17.47	14.97	17.46
NY Tax @8.25%	1.44	1.44	-	-
Shipping & Handling	-	-	3.95	3.95
Total Cost	18.91	18.91	18.92	21.41
Hardcover				
Debt of Honor-Tom Clancy				
List Price	25.95	25.95	25.95	25.95
Discount	10%	10%	30%	30%
Price	23.35	23.35	18.17	18.16
NY Tax @8.25%	1.93	1.93	-	-
Shipping & Handling	-	-	3.95	3.95
Total Cost	25.28	25.28	22.12	22.11
Paperback				
Horse Whisper-Nicholas Evans				
List Price	7.50	7.50	7.50	7.50
Discount	0%	0%	20%	20%
Price	7.50	7.50	6.00	6.00
NY Tax @8.25%	.62	.62	-	-
Shipping & Handling	-	-	3.95	3.95
Total Cost	8.12	8.12	9.95	9.95

Source: D. Barry, et al, *Book Retailing-Industry Report,* Merrill Lynch Capital Markets, June 23, 1997. Reprinted by permission. Copyright © 1997. Merrill Lynch, Pierce, Fenner & Smith Incorporated.

Exhibit 6 Market Valuation ($ Million)



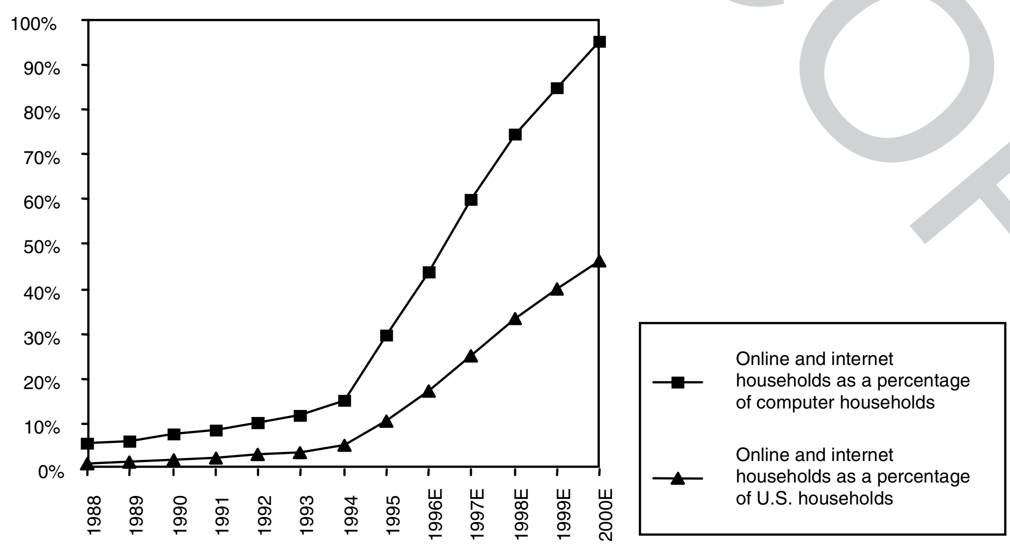
Source: Datastream

Exhibit 7 Amazon.com Financials ($ Thousands)

	F1995A	F1996A	F1997E	F1998E	F1999E	F2000E	F2001E
Income Statement Items							
Revenue	$511	15,746	100,751	201,858	339,122	508,683	668,918
Cost of sales	409	12,288	83,431	162,569	261,124	391,686	506,706
Sales & marketing	200	6,090	27,678	39,337	47,795	58,310	68,806
Product development	171	2,314	12,733	15,951	17,546	19,301	21,231
General & administrative	35	1,034	6,281	7,025	7,306	7,671	8,055
Operating profit	(304)	(5,980)	(29,371)	(23,024)	5,351	31,715	64,121
Interest income	1	203	1,330	1,208	1,419	2,884	5,471
Pre-tax income	(303)	(5,777)	(28,041)	(21,817)	6,770	34,599	69,592
Income tax	-	-	-	-	-	-	21,024
Net Income	($303)	(5,777)	(28,041)	(21,817)	6,770	34,599	48,568
Ratios (As % of Sales)							
Cost of sales	80.04%	78.04	82.81	80.54	77.00	77.00	75.75
Sales & marketing	39.14%	38.68	27.47	19.49	14.09	11.46	10.29
Product development	33.46%	14.70	12.64	7.90	5.17	3.79	3.17
General & administrative	6.85%	6.57	6.23	3.48	2.15	1.51	1.20
Operating profit	-59.94%	-37.98	-29.15	-11.41	1.58	6.23	9.59
Net Income	-59.30%	-36.69	-27.83	-10.81	2.00	6.80	7.26
Balance Sheet Items							
Cash and equivalents	$996	6,248	36,808	22,084	35,106	81,589	139,289
Inventories	$16	571	2,746	5,636	9,689	14,534	19,112
Working capital	$920	2,270	22,299	456	7,596	41,851	89,736
Total assets	$1,084	8,272	46,012	35,984	54,200	106,665	170,291
Long-term debt, less current portions	$0	0	0	0	0	0	0
Shareholders' equity	$977	3,401	27,697	6,806	14,376	49,218	97,786

Source: Adapted from J. William Gurley and Eric Grosse, *Amazon.com: The Quintessential Wave Rider,* Deutsche Morgan Grenfell Technology Group, June 9, 1997

Exhibit 8 Internet Penetration



Source: S. Kernkraut, et al , *Retail Industry/Retail2000 - Industry Report,* Bear, Stearns & Co., Inc., March 1, 1997

Endnotes

[1] The higher-end estimates were generally agreed to be padded by the ranks of very small desktop publishers.

[2] "20 Largest North American Book Publishers," *Subtext,* Open Book Publishing, Inc., Darien, Conn., Online.

[3] **Exhibit 2** does not include the relatively small "gray market" in offprice books, such as the books sold on sidewalk tables in parts of New York City.

[4] John Mutter and Jim Milliot, "Wholesale Change," *Publishers Weekly*, January 1, 1996, p. 8.

[5] *Forbes*, January 18, 1982, p. 47.

[6] These figures are based on a somewhat narrower definition of the U.S. market for books than the one cited earlier in the context of **Exhibits 1** and **2**.

[7] D.G. Magee, et al, *Book Retail Industry - Industry Report*, The Robinson-Humphrey Company, Inc. September 24, 1997.

[8] The 1995 figure for net income reflected a change in Barnes & Noble's accounting procedures, which resulted in a loss for that year.

[9] The comparable figures for Borders would be $2.37 billion and $570 million. See J. William Gurley and Eric Grosse, "Amazon.com: the Quintessential Wave Rider," Deutsche Morgan Grenfell Technology Group, June 9, 1997, pp. 37-38.

[10] Doreen Carvajal, "Reading the Bottom Line," *New York Times Magazine*, April 6, 1997, p. 76.

[11] Patrick Reilly, "Where Borders Group and Barnes & Noble Compete, It's a War," *Wall Street Journal*, September 3, 1996.

[12] G. Bruce Knecht, "How Wall Street Whiz Found a Niche Selling Books on the Internet," *Wall Street Journal*, May 16, 1996.

[13] Anthony Bianco, "Virtual Bookstores Start to Get Real," *Business Week*, October 27, 1997, p. 146.

[14] Prospectus, Amazon.com, May 15, 1997, pp. 7-8.

[15] A customer was defined as anyone who had handed over a credit card number, made a purchase, or entered his or her e-mail and home addresses.

[16] *PC Week,* Online edition, May 30, 1996.

[17] William C. Taylor, "Who's Writing the Book on Web Business?" *Fast Company*, October/November 1996.

[18] Customers also had the option of providing credit card information over the telephone. Amazon had yet to accept "e-cash" and digital dollars, however.

[19] *Ibid.*

[20] Jonathan Littman, "The Book on Amazon.com," *Los Angeles Times Magazine*, July 20, 1997.

[21] Michael Schrage, "Steve Riggio," *Interactive Quarterly,* August 18, 1997, p. 20.

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