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Spinning Off Can Mean Big Money, but Big Danger Too

By HILLARY APPELMAN

When Wal-Mart Stores Inc. got serious about the Internet, it set up an online company in the heart of Silicon Valley, complete with couches, foosball and late-night brainstorming sessions over pizza and Chinese takeout.

The cultural divide between Wal-Mart, the nation's largest retailer, and its dot-com offspring is as great as the 1,500 miles between Wal-Mart's headquarters in Bentonville, Ark., and California -- and that is on purpose. As establishing an Internet presence becomes imperative for brick-and-mortar companies, they face the urgent question of how much distance, physical and logistical, to put between themselves and their online operations.

Spinning off an Internet business offers the lure of cashing in on the new economy's lofty valuations while creating a company that, at least in theory, can respond more quickly to the turmoil of the online marketplace because it is less bureaucratic.

It is too early to measure the success of that strategy. But analysts say that, in the long run, the winners may be companies that successfully integrate their online and offline businesses, like the Charles Schwab Corporation.

"Customers are really looking to do business with companies through a variety of channels," said Michael Bernstein, senior analyst with the Gartner Group, the technology consulting firm.

Brick-and-mortar companies have the advantage of familiar brand names and established infrastructures. But with no rule book on how to parlay those strengths into Internet success, companies are trying everything from tightly integrated e-commerce divisions to independent spinoffs with license to cannibalize the parent's business by undercutting its prices.

Wall Street's tolerance of huge losses by Internet start-ups and the triple-digit price-to-earnings multiples they command are a seductive incentive to separate the balance sheets. Barnes & Noble Inc. netted \$486 million when it took its online business public last May. Staples Inc. expects to raise as much as \$250 million in an initial offering of Staples.com stock this year.

"When you're under a lot of pressure to create value for shareholders, it's really hard to say no," said Prof. Brandt Allen, associate dean of the Darden Graduate School of Business at the University of Virginia in Charlottesville.

Established companies hope that spinoffs, and their stock options, will help them compete for the scarce talent they need.

"The chance to be part of something that's changing the world, as well as potentially making people very well off at a very young age, that's hard to resist," said Richard Kurovsky, marketing director at the Haas School of Management, at the University of California at Berkeley. At the Haas School, interview slots with old-line companies like General Electric, Clorox and Nestlé have gone unfilled, Mr. Kurovsky, adding that the Internet is "a siren call."

Locating Wal-Mart.com in Palo Alto, Calif., was a strategic decision, said James W. Breyer, the managing partner of Accel Partners, the venture capital firm in Palo Alto that joined with Wal-Mart to create Wal-Mart.com. "We're able to attract a level of personnel that's simply impossible to attract elsewhere in the country," Mr. Breyer said.

He insisted that Wal-Mart and Wal-Mart.com would work "seamlessly" together, even after the dot-com business goes public. But not everyone believes the model can work.

At Charles Schwab, the Internet business was run separately at first, which was crucial to its development, said Vincent Phillips, senior vice president for Web systems at the brokerage firm. But Schwab's customers eventually spurred a decision to integrate the online and offline operations, he said.

"Customers don't see us as two different channels; they see us as one entity. And that's really the answer you need, not what makes sense from a business-planning model."

Schwab cannot offer employees start-up-style stock options, but it offers the resources to ensure that projects get done, a huge customer base and the chance to live a more balanced life, Mr. Phillips said. "At Schwab, you're not going to have to work 22 hours a day to participate in a dot-com experience," he said.

Like most companies entering the untested waters of the Internet, Schwab had to face the possibility that the online business would undercut its original business. After a barrage of objections to a double-pricing standard for regular and online-only customers, Schwab shifted to a flat rate in 1998, knowing it would lose more than

\$100 million in commissions. The gamble paid off: trading volume surged and by the end of the year, revenues and profits were up.

The reluctant consensus among chief executives was that if you do not cannibalize your own business, someone else will.

Cooling the spinoff fever is the dismal experience of Barnesandnoble.com, whose stock price has dropped by more than half since the business went public last May.

Analysts attribute the performance to poor integration of the online and offline businesses. Customers in stores cannot use computers to look for books online where the selection is greater -- although the company says that will change this year -- and customers cannot return books bought online to stores.

"The barriers between the store and the site are unbelievable," said Evan Schwartz, author of "Digital Darwinism," a guide to business survival on the Web.

From the point of view of employees, Mr. Schwartz said, spinoffs, with their separate compensation plans and potentially lucrative stock options, can demoralize employees at the parent company and create friction in what should be a partnership. "Who wouldn't want to jump to the other side?" he asked.

Trying to prevent such internal strife, Staples is giving dot-com stock options to some employees in the brick-and-mortar business. Other companies are issuing dot-com options to their offline sales forces or giving double commissions on Internet advertising sales.

The greatest danger of spinning off an Internet business may be that it represents the company's future, said Professor Allen of the University of Virginia. When a company enters a partnership to set up a dot-com, as Barnes & Noble did with the European publishing company Bertelsmann, it is easy to wind up holding less than 50 percent of the spinoff's stock, he said. "There's a temptation for people to say 'Don't worry about the future, I'll just go ahead and take whatever I can get right now.' "

Some companies try to avoid this danger by employing a halfway step known as a tracking stock. Instead of spinning off an operation, the company issues shares that are tied specifically to the division's performance. Although the tracking shares trade like normal stock, investors who buy them do not actually buy a piece of the subsidiary, as they do when purchasing normal common shares. The tracking shares usually focus on a popular piece of the company, so they normally receive a higher

market valuation than the parent's stock. This allows the company to unlock some of the value in its assets without selling them.

Media companies, in particular, have found that this tool permits them to maintain control of the part of the business -- their online content -- that may well determine their futures. Several companies have each isolated their Internet assets in a single division, laying the groundwork for later public offerings. The New York Times Company announced earlier this year that it would issue a tracking stock for New York Times Digital, the company's Internet division.

Whether an Internet business is spun off or not, analysts agree that it must have independent management and accountability.

"These e-businesses have to be free to operate and do things in nontraditional ways," said Bruce Buckland, president of Inforonics Inc. of Littleton, Mass., which provides Internet support services. "If they're not, they can't possibly keep up with the rapid pace of change.

"Two guys in a garage who are risking nothing are going to come and eat your lunch," he added.

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