If you think you need to keep your Internet initiatives separate from your traditional business, think again. Many of the most innovative Internet players are integrating their virtual and physical operations. The key to success, they've found, lies in how you carry out the integration.

Get the Right Mix of Bricks & Clicks

BY RANJAY GULATI AND JASON GARINO

THE BRIGHT LINE that once distinguished the dot-com from the incumbent is rapidly fading. Companies are recognizing that success in the new economy will go to those who can execute clicks-and-mortar strategies that bridge the physical and the virtual worlds.

But in forging such strategies, executives face a decision that is as difficult as it is crucial: should we integrate our Internet business with our traditional business or should we keep the two separate? Despite the obvious benefits that integration offers – cross-promotion, shared information, purchasing leverage, distribution economies, and the like – many executives now assume that Internet businesses need to be separate to thrive. Influenced by the cautionary tales of Clayton Christensen, author of *The Innovator's Dilemma,* they believe that the very nature of a traditional business – its protectiveness of current customers, its fear of cannibalization, its general myopia – will smother any Internet initiative.

Barnes & Noble is one company that embraced such thinking. To compete with Amazon.com, it established a completely separate division – Barnesandnoble.com – which it ultimately spun off as a stand-alone company. By breaking free of the existing organization, the on-line outfit gained many advantages. It was able to speed up its decision making, maintain a high degree of flexibility, create an entrepreneurial culture, attract quality management, and tap into the vast pool of capital available to Internet start-ups. But despite those benefits, Barnesandnoble.com has struggled. In January 2000, CEO Jonathan Bulkeley resigned after only a year on the job. In February, its stock price fell to an all-time low of 7.5, down more than 50% from its offering price of 18. By divorcing its on-line business from its established stores, Barnes & Noble may have actually sacrificed more than it gained. For example, the company forfeited tremendous marketing opportunities by not promoting Barnesandnoble.com in its stores.

In studying how incumbent companies like Barnes & Noble have moved onto the Web, we have learned a lot about clicks-and-mortar strategies and their likelihood of success. Our most important finding is a simple one: the benefits of integration are almost always too great to abandon entirely. Instead of focusing on an either-or choice – Should we develop our Internet channel in-house or launch a spin-off? – executives should be asking, What degree of integration makes sense for our company? In this article, we'll look at three established retailers that have taken very different approaches to integrating their physical and virtual operations. Their experience reveals the spectrum of choices available and illustrates some of the trade-offs involved in each choice.

Office Depot's Seamless Strategy

Office Depot has found success by tightly integrating its Web site and its physical stores to form a single, seamless retailing network. As CIO Bill Seltzer puts it, "The Internet is just another channel that gets plugged into the business architecture."

The company had two very good reasons to integrate the on-line business rather than spin it off. First, its existing catalog-sales operation provided it with much of the service infrastructure needed to support an Internet store. With a professional call center and a fleet of more than 2,000 delivery trucks, Office Depot was well equipped to process individual orders and deliver directly to the consumer. Second, years earlier it had developed a sophisticated information system containing complete product, vendor, customer, and order information as well as real-time inventory data for each of the company's 1,825 stores and 30 warehouses. That system made it easy to coordinate Office Depot's on-line store and its physical outlets.

By providing information about store locations and inventory on-line, Office Depot's Web site has actually increased the traffic at its physical outlets.

For customers, the integrated channels make shopping simple and convenient. Let's say you're looking to buy a new printer. You can research your choices at OfficeDepot.com, clicking through rich information on features and prices. Once you find the best model for your needs, you can buy it on-line and have it delivered the next day free of charge. Or, if you need it immediately, you can check the site to ensure it's in stock at your neighborhood Office Depot superstore and go pick it up yourself.

By providing information about store locations and inventory on-line, Office Depot's Web site has actually increased the traffic at its physical outlets. At the same time, the company uses its stores to promote its site. It is, for example, expanding a pilot program that uses in-store kiosks to give customers Web site access. The customers can use the site to research the choices available to them in the physical store. And by learning about the capabilities of the site, they increase their likelihood of using it while at work or at home. Rather than cannibalize each other, the two channels promote each other, creating a virtuous circle.

OfficeDepot.com does cannibalize the catalog business to some degree, but that's probably a good

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thing. It's cheaper to reach customers through the Web than through catalogs, which are expensive to print and mail. Products and prices can be changed continually on the Web, whereas catalogs quickly go out of date. And it's more efficient to take orders on the Web than over the phone. On average, a Web transaction costs half as much to process as a catalog order.

OfficeDepot.com further complements the existing physical stores by providing added value to the company's 50,000 contract customers – large and midsize corporations that spend a great deal of money on office products. For example, each contract customer has its own specialized view of the OfficeDepot.com site. When the customer's employees log onto the site, they are automatically assigned an authorization level that limits what they can buy and how much they can spend. A secretary, for instance, may be able to buy only basic products – pens, staplers, and paper – while the office manager can buy anything on the site. This authorization system eliminates paper purchase orders, which typically cost corporations anywhere from $75 to $200 each to generate and process. In addition, Office Depot gives many of its larger contract customers an additional discount if they place their orders on-line instead of phoning or faxing them in – saving money for Office Depot as well as for the customer.

While many customers have shifted from catalog purchases to Web buying, some still prefer catalogs. Even here, though, the integration of the Web site pays off. When customers call in, the agents they speak with use the Web interface to enter orders. The agents can provide detailed product information (which serves to minimize returns), check inventory, suggest alternatives to an out-of-stock product, and cross-sell complementary products. They can also pull up the customer's order history, accelerating the order entry process. Since the browser-based order entry system was installed, there has been a marked increase in the catalog operation's productivity and average order size, Seltzer says.

Office Depot's experience shows that in some cases the benefits of integration overwhelm the advantages of separation. If Office Depot had set up its Web operation as a stand-alone business, it may have achieved greater organizational focus and flexibility, but it would have sacrificed the customer benefits and the strategic advantages that come from integration, such as cross-selling, brand recognition, and purchasing leverage. As a separate operation, OfficeDepot.com would have been just another e-tailer struggling to attract customers while fighting endless price wars.

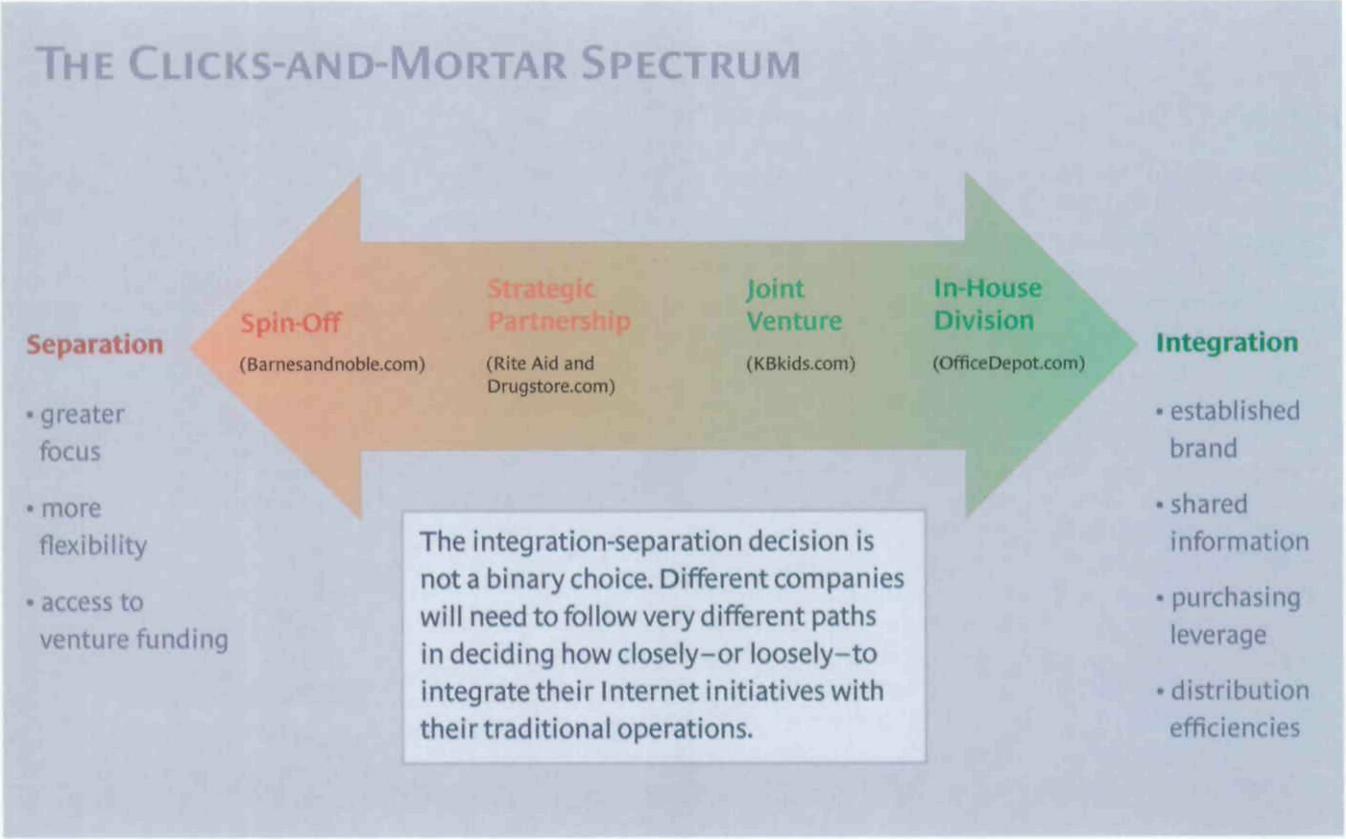
KB Toys' Joint Venture

Other retailing sectors are less amenable to a tight integration between bricks and clicks. Take toys, for instance. Big toy retailers don't have much experience with catalog retailing; they tend to focus exclusively on their physical stores. So launching a Web store would require creating a whole new direct-marketing infrastructure and developing a new set of management skills. Also, toy shoppers tend to be highly price sensitive – in stark contrast to business-supplies buyers, who place a high value on a retailer's flexibility and responsiveness. If your customers want flexibility, creating a new channel provides added value to them. If all they care about is getting the lowest price, a new channel merely creates more competition for your existing outlets.

By joining an existing e-tailer, KB Toys has been able to capitalize on the advantages of both integration and separation.

Although eToys, the largest toy e-tailer, and Toys R Us, the biggest toy retailer overall, have received most of the media attention, the toy company that has developed the smartest e-business strategy may well be Consolidated Stores Corporation's KB Toys unit. Rather than create its own Web store from scratch, KB Toys joined forces with BrainPlay.com, an e-tailer of children's products, to create KBkids.com. Consolidated Stores invested $80 million in the joint venture, as well as contributing its well-established brand, and received an 80% stake in the company. BrainPlay, which now operates exclusively under the KBkids.com name, provided the e-commerce expertise and savvy that KB Toys sorely lacked. By joining with an existing e-tailer, KB Toys has been able to capitalize on the advantages of both integration and separation.

Organizationally, KBkids keeps its distance from KB Toys. It is headquartered in BrainPlay's former offices in Denver – 2,000 miles from the Massachusetts headquarters of KB Toys – and it is run largely by the management team and technical staff that launched BrainPlay. These people are used to moving at Internet speed and dealing with the unique challenges of e-commerce, and they have been able to maintain the fast-paced and freewheeling culture of a dot-com start-up. "All we do



is the Internet," states KBkids.com CEO Srikant Srinivasan.

Although they appear to be completely separate, the two companies are actually tightly integrated in certain respects. Most obvious is the shared brand. The KB Toys name garners a striking 80% awareness among toy buyers, giving KBkids an advantage that pure-play dot-coms simply can't match – no matter how much they spend on Super Bowl ads. The physical stores also heavily promote the Web site through in-store advertising and displays. Only a few months after KBkids' launch, Gomez Advisors ranked the site number one in customer confidence in its Toy Scorecard Report. Such quick recognition and trust could not have been achieved without the strong KB brand. The brand advantage will only increase in importance. As the next wave of Internet shoppers comes online, many will be unfamiliar with the names of Internet-only toy retailers, but the overwhelming majority will immediately recognize the KB brand.

The company was also smart to name the site KBkids.com instead of KBtoys.com. By avoiding the word "toys" in its name, the site gains the advantages of the integrated brand while also enjoying the flexibility essential to Net success. Srinivasan sees KBkids as far more than an extension of KB Toys. "We want to become the leading retailer of many children's products," he says.

Another area of integration lies in customer service. Anything bought on-line at KBkids can be returned at any of the more than 1,300 bricks-and-mortar KB Toys stores. That provides an enormous convenience to Web shoppers – another advantage that pure-play e-tailers can't match. At the same time, it helps the physical stores by getting more customers to walk through the door.

A third integration advantage lies at the opposite end of the business – in the purchasing function, where KBkids has been able to fully leverage KB Toys' relationships with suppliers. As the second largest specialty toy retailer, KB Toys enjoys enormous market power, enabling it to negotiate advantageous prices and terms with toy manufacturers. To tap into this power, KBkids integrates its buyers with those from KB Toys. While they technically exist as two separate staffs, they work together in the Massachusetts facility, coordinating and consolidating purchases. Lacking this kind of purchasing leverage, the pure-play e-tailers are hard pressed to match KBkids' prices without falling ever further into the red. Even better, the integrated companies have the clout to negotiate exclusives with suppliers. This past holiday season, the popular Talk Together Teletubbies were available only at KBkids, while the Toy Story 2 Interactive Talking Train Set was available exclusively at KB Toys and KBkids.

The advantages of integration don't all flow to the Web operation, either. The physical stores also gain greater buying power. Srinivasan believes the successful clicks-and-mortar retailer is a supplier's dream: "[The physical stores] offer the scale; we offer the growth." A manufacturer of a hot, hard-to-find toy is far more likely to send its next shipment to a high-growth, innovative distributor like KB than to a weakening bricks-and-mortar retailer or to a pure-play that may account for just a tiny fraction of its total sales.

Finally, although the two companies' management teams are distinct, KBkids is nevertheless able to draw on KB Toys' 70 years of experience selling toys. Naturally, KB Toys' management has instincts about the industry that no start-up team can match. To ensure a healthy cross-fertilization of ideas, three members of the KBkids board of directors are executives in either KB Toys or Consolidated Stores. The companies also encourage frequent communication among managers at all levels.

What about that nasty issue of channel conflict? "We see very little cannibalization between the Web site and the stores," contends Srinivasan. "KB Toys is a mall store chain, driven by impulse purchases, not destination purchases. But when people come to our Web site, they are looking for something specific." Bricks-and-mortar toy retailers that maintain big, stand-alone destination stores, like Toys R Us, will usually have much greater channel conflicts with Web operations than KB Toys does.

Rite Aid's Virtual Partnership

The drugstore industry has seen the rise of a variety of clicks-and-mortar strategies. Walgreens.com, for example, is fully owned and operated by its bricks-and-mortar parent. Last June, CVS acquired Soma.com, which it promptly renamed CVS.com in order to "leverage the brand recognition, customer satisfaction, and reputation of CVS," according to Tom Pigott, president and CEO of CVS.com. Although CVS.com is fully owned by CVS, it maintains a separate management team in Washington – across the country from CVS's Rhode Island headquarters. Drugstore giant Rite Aid took a different approach, one centered on partnership rather than ownership.

Because Rite Aid assumed that only a small fraction of its sales would come through the Internet, its initial in-house efforts to launch an on-line channel were tentative. Four months after Soma.com was up and running, Rite Aid's site only let customers schedule an in-store prescription pickup; they couldn't buy a thing on-line. When it became clear that the Net would be a critical retail channel, Rite Aid needed a real Web presence–fast. So in June 1999, Rite Aid bought a 25.3% equity stake in Drugstore.com for a mere $7.6 million (plus additional noncash considerations). As former Rite Aid chairman and CEO Martin Grass explained in a press release, a strategic partnership with Drugstore.com "makes a lot more economic sense...than spending the money and time it would take away from our core businesses to develop, own, and manage our own site." Drugstore.com was an ideal partner because it brought Internet capabilities and strong investors, thus limiting Rite Aid's investment risk in e-commerce.

The partnership between Rite Aid and Drugstore.com lets each company take advantage of the other's expertise without sacrificing flexibility.

Like CVS, Rite Aid opted to import Internet expertise, but that's where the similarity ends. Rite Aid and Drugstore.com are separately owned and managed, and although both brands are promoted in both channels, they remain distinct. For instance, Rite Aid hasn't pushed to rename Drugstore.com "RiteAid.com." To do so would be a mistake: after all, venues like Drugstore.com cropped up because the traditional bricks-and-mortar stores weren't delivering an ideal customer experience. (Kids love running through toy stores, but hardly anyone looks forward to browsing through drugstore aisles.)

Even though the companies maintain their individual brands, they want the pharmacies to appear integrated to consumers. To that end, Drugstore.com has launched several initiatives to build its brand among Rite Aid customers. "From a branding perspective, all Rite Aid prescription bottle caps, shopping bags, and payment receipts contain the Drugstore.com logo," says Jackie Erickson, business manager at Drugstore.com. "From a merchandising perspective, we're working with Rite Aid to make in-store offers and calendar-related activities complement each other." During the holiday season, for example, Rite Aid put $15 Drugstore.com coupons in customers' bags. Keeping separate names while promoting the partnership accomplishes two things, explains Debby Fry Wilson, PR director at Drugstore.com: it protects the trust and recognition associated with the Rite Aid name and at the same time establishes a "clean brand that fits on-line expectations."

Rite Aid and Drugstore.com have also integrated many of their business functions, including fulfillment. The operational integration was crucial to Drugstore.com because it gave the company access to PCS Health Systems, Rite Aid's pharmacy benefits management (PBM) subsidiary that serves more than 50 million people. Earlier, the leading PBMs were reluctant to do business with Drugstore.com because they considered the company a threat to their own Internet strategies. Since prescription sales are an important revenue stream for Drugstore.com – and since 80% of Americans are covered by a PBM – losing that business would have been disastrous. But now, since its fulfillment operations are integrated with Rite Aid's, customers who can make a copayment at Rite Aid can also do so at Drugstore.com. Rite Aid benefits as well because its PBM gains increased business. The integrated fulfillment functions give both companies greater buying power, providing significant cost savings.

Clicks-and-Mortar Strategies

	Brand	Management
Office Depot and OfficeDepot.com	**Fully Integrated** Office Depot and OfficeDepot.com	**Fully Integrated** OfficeDepot.com is technically part of the business services division, although its reach extends to the stores and international divisions
KB Toys and KBkids.com	**Mostly Integrated** KB Toys and KBkids.com Leverages KB brand name without losing flexibility	**Slightly Integrated** Independent management teams Frequent interaction between counterparts Three executives from KB Toys or Consolidated Stores serve as members of KBkids.com's board
Rite Aid and Drugstore.com	**Slightly Integrated** Cobranded Rite Aid and Drugstore.com pharmacies	**Slightly Integrated** Independent management teams Frequent interaction between counterparts Rite Aid's president sits on Drugstore.com's board

The Rite Aid – Drugstore.com partnership benefits consumers as well as the two businesses. Customers can elect to pick up their Drugstore.com prescriptions at their local Rite Aid rather than wait for them to be shipped – a huge advantage since 30% of all prescriptions are needed immediately. Because people who choose that option complete the entire transaction on-line, they still pay the Drugstore.com price. This arrangement lets Drugstore.com serve the acute-needs market for same-day prescriptions and allows the two companies to capture a larger share of the customer's wallet. Rite Aid also enjoys increased store traffic.

To get the most value out of their partnership, Rite Aid and Drugstore.com have even established an integration team. Although the two companies are managed separately, the team gives executives a forum for regularly sharing ideas about their businesses. More formally, Mary Sammons, Rite Aid's president and COO, sits on Drugstore.com's board of directors. Drugstore.com reaps the advantages of her experience and connections, but its strategic decisions are made autonomously. Ultimately, the partnership between Rite Aid and Drugstore.com lets each company take advantage of the other's expertise without sacrificing flexibility. Although Rite Aid's traditional business has had its share of problems recently, its innovative partnership with Drugstore.com remains a bright spot for the company – and a useful model for others.

A Spectrum of Choices

As the divergent strategies of Office Depot, KB Toys, and Rite Aid reveal, the integration-separation decision is not a binary choice. There are infinite permutations along the integration spec-

Operations	Equity
Fully Integrated Internet systems are simply a layer on top of existing information systems Uses bricks-and-mortar distribution systems to guarantee next-day delivery	**Fully Integrated** OfficeDepot.com is wholly owned by Office Depot Not likely to spin off anytime soon
Moderately Integrated Separate distribution systems Shared buying power Customers can return toys bought on-line to bricks-and-mortar stores	**Separate** KBkids.com is a joint venture with BrainPlay.com KB Toys owns 80% and BrainPlay owns 20%
Moderately Integrated New, integrated distribution center Shared buying power Customers can pick up prescriptions ordered on-line at bricks-and-mortar stores	**Separate** Rite Aid received more than 25% of Drugstore.com

trum. By thinking carefully about which aspects of a business to integrate and which to keep distinct, companies can tailor their clicks-and-mortar strategy to their own particular market and competitive situation, dramatically increasing the odds of e-business success.

As a useful starting point, we recommend examining four business dimensions – brand, management, operations, and equity – and determining the degree of integration that makes sense along each. The exhibit "Clicks-and-Mortar Strategies" shows how the three companies we looked at have positioned themselves on the integration spectrum for each dimension.

Brand. The choice to integrate brands or keep them separate is largely a choice between trust and flexibility. Extending a company's current brand to the Internet gives instant credibility to a Web site (assuming, of course, that the brand is both recognized and respected). The company's current Internet-savvy customers will provide nearly immediate traffic and revenue, new consumers will know the site is legit, and fewer buyers will fear credit card fraud – a frequent inhibitor of on-line transactions. Furthermore, as we saw with Office Depot and KB Toys, brand integration can result in a virtuous circle, sending on-line customers to the stores and bricks-and-mortar customers on-line, all the while continuing to build the brand. But in integrating a brand, a company often loses flexibility. An on-line store may be forced to offer the same products and prices as its physical counterparts – or risk leaving customers confused and distrustful. With a shared brand, it also becomes more difficult to use the Internet to target a different customer segment. KBkids sidestepped this trade-off, using a slight variation on the KB Toys name to leverage the existing brand without limiting its scope to toys. A little creativity can pay huge dividends in the Internet space.

Management. Whether a firm should integrate or separate its management teams is a subtler question whose answer hinges both on management attitudes and on the company's business model. An integrated team can better align strategic objectives, find and exploit synergies, and share knowledge. Separate teams can focus more sharply, innovate more freely, and avoid contaminating one business model with another. Even here, companies don't have to make an all-or-nothing decision – they can integrate certain functions and leave others separate. The purchasing staffs of KB Toys and KBkids.com are managed together, while the companies' senior executives operate autonomously.

Operations. Decisions about integrating operations should be based on the strength of a company's existing distribution and information systems and their transferability to the Internet. Integration can provide significant cost savings, a more compelling and informative site, and a competitive advantage over pure-play competitors – as was the case with Office Depot. Separation lets a company build state-of-the art, customized systems without the flaws of older systems and develop sophisticated Internet-specific distribution capabilities that could provide a superior customer experience.

Equity. To own or to spin off? Of all the integration decisions, that's the one that will get the most attention. Integration allows the parent to capture the entire value of its Internet business, as Office Depot is doing. Separation can help attract and retain talented managers and provide access to outside capital. By establishing its KBkids.com venture as a separate business, KB Toys garnered the management expertise of pure-play BrainPlay, saved itself the expense of starting an Internet channel from scratch, and maintained the option of an initial public offering. Separate ownership can also offer greater flexibility in partnering with other companies. Finally, by maintaining an equity stake in a separate Internet company, a bricks-and-mortar company could reap a windfall in the stock market.

Clicks-and-mortar businesses are here to stay. The question is, Which models will win? The answer will, to a large extent, be determined by a company's ability to manage the trade-offs between separation and integration. (See the exhibit "A Road Map Through the Decision Process.") By avoiding an either-or choice and considering each aspect of its business on its own, a company can strike the right balance between the freedom, flexibility, and creativity that come with separation and the operating, marketing, and information economies that come with integration.

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A Road Map Through the Decision Process

Which clicks-and-mortar approach should you adopt? Although the integration-separation decision is not an either-or choice, the following questions will help you discover which aspects of your on-line channel you should integrate and which you should keep distinct.

Separation | **Integration**

Brand

- Does the brand extend naturally to the Internet? — yes (Integration)
- Will we target a different customer segment or offer a different product mix on-line than in stores? — yes (Separation)
- Will we need to price differently on-line than in stores to stay competitive? — yes (Separation)

Management

- Do current executives have the skills and experience needed to pursue the Internet channel? — yes (Integration)
- Are they willing to judge the Internet initiatives by a different set of performance criteria? — yes (Integration)
- Will there be major channel conflict? — yes (Separation)
- Does the Internet fundamentally threaten the current business model? — yes (Separation)

Operations

- Do our distribution systems translate well to the Internet? — yes (Integration)
- Do our information systems provide a solid foundation on which to build? — yes (Integration)
- Does either system constitute a significant competitive advantage? — yes (Integration)

Equity

- Are we having trouble attracting or maintaining talented executives for the Internet division? — yes (Separation)
- Do we need outside capital to fund the venture? — yes (Separation)
- Is a certain supplier, distributor, or other partner key to the venture's success? — yes (Separation)