RACE TO DOT.COM AND BACK: LESSONS ON E-BUSINESS SPIN-OFFS AND REINTEGRATION

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E-BUSINESS

RACE TO DOT.COM AND BACK: LESSONS ON E-BUSINESS SPIN-OFFS AND REINTEGRATION

Carrin Thomas, C. Ranganathan, and Kevin C. Desouza

This article describes the experiences of a firm that created a dot.com spin-off, only to reintegrate it with the parent organization the following year. Based on this case study, key considerations for creating and successfully managing an e-business spin-off are identified.

THE E-COMMERCE WAVE THAT SWEPT through the business world in the last decade has led to major changes in corporate strategies, business models, and organizational processes. To expand their business presence online, several firms have engaged in divestment strategies by forming spin-off firms to take care of their Internet-related business (Albrinck et al., 2000). Firms across several industries ranging from retailing to manufacturing spun off business units to focus on Internet-related activities and business processes (Economist, 2000). A number of firms such as Staples, Nordstrom, General Electric, and K-Mart spun off their high growth E-commerce divisions to take advantage of the market valuations for pure-play dot.com firms.

While some of the spin-off ventures have been successful, a number of others have folded, either re-merging with the parent firms or simply exiting the business (Alli et al., 2001). For instance, Disney decided to close the Go.com portal and buy back its Internet tracking stock. Within a span of nine months, print shop Kinko’s Inc. merged back its Internet venture kinkos.com into the parent company. Other companies, like Barnes & Noble Inc., fought with their spin-offs for years before remerging, in part because of limited remerger options due to divestiture to companies like Bertelsmann, which maintained a 40 percent stake in barnesandnoble.com until 2003. Initially, it seemed as though Barnes & Noble and its online spin-off were in direct competition, lacking any coordination between the two, be it for returns or their frequent-buyer program (Kermouch et al., 2001). While measures were taken to address these problems, the online venture continued to struggle with its parent and overall profitability. In late 2003, six years after the online bookstore was launched, Barnes & Noble bought out all remaining shares, having spent over $250 million to refold the online venture back into itself (Reuters, 2003).

Predating these failures was widespread debate among corporate decision makers, scholars, and experts about the potential viability and performance impacts of these divestment strategies, spawned by the significant number of e-business spin-offs in the late 1990s. Controversy over the desirability of spin-offs has arisen because of differing opinions of the business effectiveness of such spin-off firms. Proponents of e-business spin-offs argue that flexible,
TABLE 1 Different Spin-Off Options

<table>
<thead>
<tr>
<th>Type</th>
<th>Description</th>
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<tbody>
<tr>
<td>Full Spin-off</td>
<td>The transformation of an existing portion of a business into a new and independent firm separate from the parent. The parent sells or distributes new shares, effectively divesting its stake for a monetary gain.</td>
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<tr>
<td>Partial Spin-off</td>
<td>The parent company sells a minority share (usually under 20 percent) of a division through an initial public offering or rights offering. A partial spin-off allows a parent to retain majority control (the firms may even share a portion of the same board of directors) while garnering financial resources previously unavailable. The intention of the parent may be to fully spin off the entire subsidiary at a later date.</td>
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<tr>
<td>(a.k.a. carve-out or equity carve-out)</td>
<td></td>
</tr>
<tr>
<td>Tracking Stock</td>
<td>A parent company issues stock that is linked to a specific subsidiary in an effort to track performance of that specific division. All revenues and expenses of the division are separated from the parent company's financial statements and are attributed to the new tracking stock. The division does not acquire a separate board of directors and the parent company retains legal responsibility for the debts and liabilities of the division. While full ownership of the division is maintained by the parent company, the tracking stock allows for the valuation and performance measurement of the sub-entity.</td>
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leaner, market-responsive, and focused organizations typically have emerged as a result of Internet-related divestment (Gulati and Garino, 2000; Iansiti et al., 2003). Critics, however, question the sustenance of such Internet spin-offs as the complexities involved in managing the spin-offs over a longer time exceed the anticipated benefits from such decisions. Moreover, managing and sustaining a spin-off can be extremely challenging and calls for stronger leadership (Hambrick and Stucker 1998) and effective management of governance and human element issues (Corley and Gioia, 2004; Seward and Walsh, 1996). While this has been an ongoing debate, little systematic research has focused on E-business spin-offs, their drivers, and the consequences.

Three spin-off approaches, outlined in Table 1, have emerged as the most popular techniques for separating the operations of a division or sub-business. The camouflaged company in our case study, called here Electronics Repair International (ERI), utilized a partial spin-off in which the parent company sells a minority share of a division through an initial public offering or rights offering. For the purposes of this article, E-business spin-off represents the formation of a new firm by a parent organization to take care of its Internet-related operations and activities.

The data used in this case study was assembled based on extensive interviews with senior executives who were involved with the parent firm as well as the spun-off dot.com entity. Due to nondisclosure agreements, we disguise the identity of the firm and the interviewees. In the next section, we present the details of the case study: We conclude with a discussion of the case study and key implications.

COMPANY BACKGROUND

ERI was founded in 1978 to provide a better way for electronics manufacturers to determine the value of nonrepairable electronics through local market price surveys. This data was critical to electronics companies for their warranty functions. In 1990, ERI expanded into repairable electronics estimates and developed the industry’s first PC-based estimating software. The software allowed repair facilities to retrieve part information (such as historic and current price and part numbers) easily and quickly. Two years later, ERI introduced a communications system that allowed repair information to be sent electronically between major manufacturers and electronic repair outlets. Due to this, consumers could call in a warranty repair request, then arrive at a designated repair facility and find that their service request was already in the facility’s computer system. In 1996, ERI introduced a suite of products designed to further integrate the entire warranty repair process. By 2000, ERI had grown into an industry leader driving the cutting-edge of an otherwise behind-the-scenes industry. ERI’s products eased and expedited the processing of warranty repairs and improved the decision making between all parties.

ERI’s mission was to add substantial value to the warranty repair supply chain by reducing inefficiencies in the repair process and facilitating communication among participants in the industry. By the year 2000, ERI had business relationships with more than 8500 repair facilities, more than 1000 electronics manufacturers, and a variety of supply-chain participants, giving ERI the largest warranty repair network.
In 1999 and 2000, the idea that E-business units could prosper by simply separating them from their corporate parents had become common.

**THE DECISION TO SPIN OFF**

In 1999 and 2000, the idea that E-business units could prosper by simply separating them from their corporate parents had become common. By spinning off their departments that focused on new technology into ERI.com, ERI believed it could promote sales growth, establish an increasingly required Internet presence, better combat competitive forces, introduce an opportunity for venture capital, and better exploit the unique advantages of the parent company. The President and CEO of the future ERI.com commented:

> "We expect to offer significant value to the industry that it's never seen before. Our solutions have the capacity to create $1.5 billion in new efficiencies in the $9.5 billion warranty repair industry. We plan to accomplish this by creating an Internet collaborative interchange to connect the parties in the repair supply chain while providing online applications to help these participants improve efficiencies, reduce costs, and connect better. ERI.com has the best of both worlds: the infrastructure and resources of an established company, ERI, plus the flexibility, innovation, and entrepreneurial feel of a start-up company."

Executives of ERI believed that spinning off ERI.com and creating a new organization with a distinct brand, which focused on using Internet and emerging technologies such as artificial intelligence-based computing, would allow the parent company to focus on shrinking the repair supply chain. Much like Barnes & Noble spun off barnesandnoble.com and Banyan spun off Switchboard.com, ERI wanted the dot.com division to eventually stand as an independent company. They did not want to disrupt the ERI parent goals of increased efficiency in warranty repair processing and development of new software.

ERI, being the oldest company in the warranty repair information industry, had a brand image of being robust and efficient, but was also recognized as slow to change. The management of ERI were never first movers with new technologies. Hence, opening up a dot.com division made little sense, as the culture of the parent company was not inviting. The need for developing a distinct brand name that focused around being agile, dynamic, and experimental was important. One key competitor enjoyed such a reputation due to its newness in the industry and threatened to extract market share. ERI wanted to maintain and extend its market reach and hence needed to foster a new image. A senior executive who had been with the parent ERI for nearly ten years noted:

> "ERI did not have the required expertise nor wanted to be put through the turmoil of dealing with the new technologies and new architectures. ERI.com was created so as to leave ERI undisturbed and focused on its goals: the goals of ERI.com and ERI are distinct to a large extent."

From a product innovation standpoint, ERI did not want to burden the new organization with the legacy systems of the parent. Hence, spinning off a company gave authorities at the new company more freedom as to choice of technology and a clean product development slate. An executive familiar with parent ERI’s computer systems remarked:

> "I think one of the advantages of spinning off the dot.com was that they wouldn’t be a burden on ERI [information system] architecture and structure. Really what they want to do is start with a blank piece of paper and screen; that was one of the reasons that they wanted to spin it off."

ERI wanted the new dot.com entity to attract sufficient venture capital to fund its activities, similar to the rationale used by several other established firms that spun off new dot.com firms at that time. The idea was to have the dot.com firm generate sufficient capital to run itself. Moreover, the executives at ERI wanted it to attract new technology stockholders who had a higher threshold for losses. Finally, spinning off ERI.com was seen as a way to attract top human talent with potentially valuable stock options.

**CARRYING OUT THE SPIN-OFF**

"Our vision for ERI.com is to create a new technology model for warranty
repair processing, using the best emerging technologies like Internet, wireless, and database warehousing."

—President and CEO of ERI

In June of 2000, ERI announced the spin-off of ERI.com and more than $25 million in initial support. The new company aimed to provide comprehensive, end-to-end Internet collaborative interchange and online applications for the repair supply chain and was designed to reduce warranty repair processing by leveraging ERI’s 22 years of industry experience, customer relationships, and market leadership. ERI.com began with a 35-person staff and had full support and resources of ERI dedicated to its cause. ERI.com expected to have a 120-person staff by the end of 2000. ERI.com planned to have four major product offerings by March of 2001: an Internet collaborative interchange, a resource management solution, a parts procurement tool, and a repair portal. But an executive who remained at ERI parent noted:

“The drive to talk up the potential for ERI.com left ERI unimportant. ERI.com seemed to get whatever they needed without much regard for what ERI needed. There was no equity in the split of resources.”

Even from the earliest stages, differences started to emerge between ERI and ERI.com. The interview process that was used to select the personnel from parent ERI company for ERI.com left many employees sour and unhappy. Despite being reported as an open interview process, many employees felt it was elitist and by-invitation only because those who were selected seemed to be from an existing social and work group within the company.

Those who were chosen to move to ERI.com carried an air of superiority as they represented “the new innovation and future of the industry.” Conversely, those who were left behind felt their sense of job security dwindle. Moreover, the E-commerce hype in the business press was at its peak immediately surrounding the early to mid-2000 dot.com bubble burst, and all the hype was not helping the cause of employees who remained at the parent company.

There were no clear directions on the division of work between the parent ERI and the ERI.com entity. The biggest sufferers were the outstanding projects at ERI. ERI.com had attracted the stronger people out of the ERI parent, leaving many key projects at the parent firm in limbo. One senior executive who had left the parent company to join ERI.com said:

“ERI.com could take anybody they want without regard for impact. Eventually a lot of people went and complained, saying that this has got to stop. There has to be some kind of equity and who they can take and who they cannot.”

To address these concerns, the transition of personnel from ERI to ERI.com was slowed down and the transferred employees were asked to remain in ERI for three to four weeks to wrap up their pending tasks. Little was done, however, to fill the lost positions within ERI. ERI.com continued to pull away from its parent and become its own entity. It was noted by one senior executive of ERI that:

“We [ERI parent] were treated like a third-party vendor. We were invited for a meeting in ERI.com’s First Avenue location and we were made to wait in the lobby. They had us check in, made us sit in the lobby until they were all assembled, and then we could go in the conference room and meet. Why were we not allowed to talk to our friends who were in ERI.com from ERI?”

Another significant outcome with no clear solution was that the sales forces at the two organizations were now competing for the same dollar. An added complication was ERI.com’s dependence on the parent company; while ERI.com wanted to be free to innovate to the demands of the dot.com markets, it relied heavily on the resources of ERI. If ERI.com were to be successful, it had to exploit ERI’s well-established marketplace and customer base. However, at times, both the parent and child were competing for the same revenue from the same client. This not only confused the company’s clients, but also led to considerable hostility between the sales forces of the two firms. A senior executive at ERI parent commented that:

“... rather than exploiting the connections of ERI for the good of both companies. ERI.com used ERI’s contacts for its own good without thinking of implications for the parent organization. The ERI sales force eventually caught up to their tactic and became more cautious and defensive of contacts.”
DECISION TO REINTEGRA TE

"Integrating ERI.com with ERI makes good business sense, and enables us to fully leverage existing investments in technology and resources. We are coming together to create one trusted source of solutions to our customers. No other warranty repair information provider can match this extensive offering."

—President and CEO of ERI

During late 2001, the market saw the fall of new economy companies and ERI.com was no different. The senior management from the two companies began considering bringing ERI.com back into ERI. An executive within ERI parent remarked:

"... I think the biggest failure was that they could not come up with the venture capital that they needed to fund. They got all caught up in the dot.com mania. They thought that if we spun out ERI.com we will get the venture capital to fund it and therefore it won't cost ERI the capital, but what happened is we got into the market at the wrong time right in the peak and drop out. When we got in, all the investors were washed out. There was nothing to fund everything by itself; that's when they said no."

ERI.com, which originally expected to be able to tap outside sources of venture capital, faced a major financial problem as the markets seemed less willing to fund new Internet ventures and ERI did not have the capital to continue to maintain ERI.com independently. The cost of maintaining two separate offices with duplication in personnel and information infrastructure was taking its toll on ERI. The company was under pressure, both from investors and the board of directors, to return to profitability. An executive from ERI.com commented:

"Look how much we are spending for product development in ERI and look how much we are spending for product development in ERI.com, and there are a lot of things we are doing the same: two architectural teams, two CIOs, and [two] CTOs. We need to bring these two together into one and save costs."

CARRYING OUT THE REINTEGRATION

On September 26, 2001, ERI announced a number of strategic decisions aimed at providing better service to its customers, the largest of which was the reintegration of ERI.com with ERI's core business operations. During the reintegration, the management team of ERI.com moved into management positions within ERI and the company-wide (ERI and ERI.com) workforce was reduced in size by 170 people, a little less than 20 percent of the total workforce.

The physical reintegration only took around four to six weeks, and senior management declared the reintegration an almost immediate success. However, the organizational culture and personnel remained split. To expedite the reintegration, the previous ERI.com group had been formed into a new division that remained distinct from the rest of company. The two companies' disparate computer systems, architectures, methodologies, and tools were still not integrated. On top of all this, there was a lack of trust of the new management team at ERI, as they primarily came from ERI.com. Within the organization, people were reflecting on how the situation would be different if the job market had not been so badly affected by the slowing economy. One manager who had significant tenure (almost 15 years) with ERI, and had transitioned from the ERI parent to ERI.com and back again, lamented:

"I would say this is a [IT] job market that if you have a job, you should be happy. If ERI can do [the reintegration], then anybody can do it. Even if you don't like it, you can't do anything about it. You have to stay here, you can't complain, and you have to play the good employee, or else you are on the streets."

ERI turned its focus toward minimizing its expenses and attempted to slowly bring the company back to profitability. With the competition from ERI.com removed and the increased cooperation between the disparate organizations, the return to black seemed far more attainable. Despite the emotional, cultural, and technological difficulties that arose, ERI achieved better financial performance almost immediately with a positive net income being reported for the fourth quarter of 2001. This was a marked improvement over the multi-million net losses experienced in the prior quarters. The President and CEO of ERI parent captured this when he said:
“It is clear that we have restored ERI to a company that generates consistently positive cash flows and to one that has a far smaller expense base.”

**KEY CONSIDERATIONS FOR E-BUSINESS SPIN-OFFS**

The case of ERI provides a jumping off point for a discussion about the key considerations that practitioners and scholars must consider when evaluating spin-offs, especially E-Business divestitures. Around the time that the ERI case took place, there was a particular urgency in the business press and financial markets for companies to act quickly and take advantage of the unprecedented availability of venture capital. Moreover, spin-offs at this time in the United States offered major tax advantages over sales of a business division (Cornell, 2000). That is, if a spin-off entity represented a natural extension of the parent firm’s business, the firm could qualify for certain exemptions from IRS and SEC stipulations (Frieswick, 2000; SEC, 1999). [Note: In a regular spin-off, to obtain tax-free status, the IRS requires that the division being spun off must have been in business for at least five years and the SEC requires three years of audited financials. However, E-Business spin-offs could be exempted, provided the parent’s business was at least five years old.] The .com frenzy, buoyant stock markets, coupled with these types of monetary/tax benefits, prompted many firms to spin off their Internet operations. However, in many cases, the E-Business spin-offs did not produce the desired outcome and had to be closed down or reintegrated. The experience of ERI in forming ERI.com, managing this spin-off, and the ensuing reintegration thus offers an opportunity to extract key lessons that largely remain relevant for E-Business spin-offs and similar restructuring efforts. These lessons pertain to the initial decision processes about the formation of the spin-off and the subsequent execution and management of E-Business spin-offs.

**Distinguish the Spin-off from its Parent**

Before rolling out an E-Business spin-off, the parent firm must evaluate how the demarcation between parent firm and spin-off will be established and maintained. Many E-Business divestitures try to closely resemble their parent firms, but yet have different operations and policies. Such differences might not only confuse the customers and other stakeholders, but could impair and erode the principal competitive advantages of the parent firm. Maintaining closer identities and leveraging the strengths of a parent firm would ultimately help reduce identity problems (Corley and Gioia, 2004) as well as realize potential synergies. As ERI’s experience showed, it is important to address competitive issues between a parent and child at the outset. An E-Business spin-off could allow a parent to sell its products and services in entirely new ways, but will these new opportunities result in a cannibalization of the parent firm’s market or create channel conflicts, or will they offer an enhancement or expansion of existing products and markets? Issues such as sales territories, transfer agreements, and channel conflicts must be discussed early.

**Prepare for Uncertainties**

While forming a spin-off, it is important to prepare for uncertainties that could stem from unexpected costs of running the spin-off. The very decision to create a new entity implies a loss in economies of scale and increased administrative and overhead costs. As in the case of ERI, maintaining two management structures and processes created additional overheads. Although the parent and the E-Business spin-off intended to work closely together, the managers of both firms had distinct, yet conflicting goals. Such conflicting goals can bear their own additional, unforeseen costs. Uncertainties could also arise due to additional investments and funding that might be required to sustain the spin-off. Given the uncertainties for a spin-off to stand on its own, the parent firm must be ready to commit additional funding as necessary. This resource commitment was a serious issue in ERI that ultimately led to the reintegration of the spin-off.

**Prepare your Personnel**

When executing a spin-off, firms must be mindful of common human resource-related pitfalls as highlighted in the ERI case. It is important to recognize and address personnel issues that may arise. A chasm may form between the personnel at the parent firm and the new spin-off, if only as a result of the fact that they are now working for two separate entities. There also exists a good chance that the top talent within an organization may migrate to the new spin-off; actions should be taken to compensate for a brain-drain from the parent.
Balance the Parent-Child Relationship
While the spin-off may represent a significant departure from the traditional way of doing business, personnel should be reminded that the very foundation of the spin-off lies in the parent firm’s expertise. Ways must be established to tap into the expertise, without eroding the parent firm’s strengths. ERI management’s focus on the ERI.com initiative left the parent organization’s employees with bruised morale. While ERI.com’s employees were given access to new technologies and resources, the parent was told to optimize existing processes and save costs. The public relations department and the media featured ERI.com as the new promise for the organization, thus leaving the parent firm in limbo about its future. This imbalance in attention between ERI and ERI.com harmed the bottom line and relationships between peer organizations. In addition to personnel migrating from the parent to the spin-off, intangibles such as business intelligence and tangibles such as computer system access represent interdependencies between the parent and spin-off that must be negotiated. Careful analysis and execution is needed to minimize competition for internal resources and ensure the appropriate use of intellectual and physical capital.

Acknowledge the Possibility of Reintegrating
Ideally, a spin-off should be a one-time decision without the prospect of reintegrating a failed orphan organization. However, despite measures taken to assure the long-term success of a spin-off, it may be necessary to eventually reintegrate it with the parent. More than the pooling of physical and financial assets, reintegration of personnel and a restructuring of a top management team can become challenging. ERI.com’s executives claimed senior positions in the management circle of the parent firm after the reintegration. From the perspective of some ERI employees, these executives who had apparently “failed to deliver the goods” were now being rewarded by getting plum positions in the parent firm. The potential for reintegration only underscores the importance of harboring positive and strong connections between the parent and the spin-off, not only for reduced anti-competitive behavior, but also for future well-being.

CONCLUSION
While the ERI case occurred during a time period of significant E-business flux, the lessons remain valid for E-business spin-offs and other similar restructuring efforts today. A firm faces significant challenges in deciding the ideal spin-off form, creating and maintaining boundaries between the parent and new firm while minimizing costs and competition, and in keeping morale high when the spin-off appears to be siphoning off the future viability of the parent. A spin-off presents significant opportunities for success and failure, and only through appropriate and careful management will it become a business opportunity worth pursuing as well as maintaining.

References