Wars of succession — the road to ruin in Canadian book publishing

Roy MacSkimming

The arrival of the Chapters big box superstores in 1994, and their acquisition of SmithBooks and Coles, created a dominant player in Canadian book retailing whose predatory pricing practices soon drove many long-established independent booksellers out of business. Then Chapters CEO Larry Stevenson created Pegasus, a distribution division that demanded a wholesale discount from publishers for fulfillment to Chapters and Chapters.ca. To make things worse, even as books disappeared in the Pegasus supply chain, Chapters swamped publishers with returns, while neglecting to pay its bills on time. By 2000, the entire food chain of Canadian publishing had been poisoned. By the time Heather Reisman of Indigo stepped in with her hostile takeover of Chapters, Canadian publishing was in a state of financial chaos. In this exclusive excerpt from *The Perilous Trade: Publishing Canada's Writers*, Roy MacSkimming tells the cautionary tale of Chapters, and how Larry Stevenson put Canadian book publishing on a road to ruin.

L'arrivée en 1994 de la chaîne de librairies Chapters, puis l'acquisition par celle-ci de SmithBooks and Coles, ont créé dans l'industrie canadienne du livre un géant dont la stratégie de prix vorace a bientôt provoqué la faillite de nombreuses librairies indépendantes établies de longue date. Le PDG de Chapters, Larry Stevenson, a ensuite fondé une division distribution baptisée Pegasus, qui exigeait des maisons d'édition un rabais sur les prix de gros pour avoir droit de cité chez Chapters et Chapters.ca. Pire encore : pendant même que les livres disparaissaient du circuit d'approvisionnement de Pegasus, Chapters inondait de retours les éditeurs tout en négligeant d'acquitter ses factures dans les délais prévus. Dès 2000, toute la chaîne de l'édition canadienne était contaminée. Et quand Heather Reisman, de Indigo, s'est emparé de Chapters par suite d'une prise de contrôle hostile, l'industrie était en plein marasme. Dans ce passage exclusif de T*he Perilous Trade: Publishing Canada's Writers*, Roy MacSkimming retrace le tortueux parcours de Chapters et explique comment son président a mené l'industrie canadienne du livre au bord du gouffre.

Chapters Inc. has transformed the Canadian retail book market so radically that it's startling to recall the corporation has existed only since 1994. But before its red and yellow logo and saturation advertising made its brand as ubiquitous as McDonald's, Chapters was just a bunch of venture capitalists looking for an industry to take over. They found it in the sedate, unsuspecting, underperforming world of Canadian book retailing.

Pathfinder Capital and Canadian General Capital Corporation were captained by a Canadian Forces paratrooper turned smooth-talking Harvard Business School grad named Lawrence N. Stevenson, Larry to his friends. He and his fellow acquisitors started by buying middlebrow SmithBooks, formerly W.H. Smith of Canada, in 1994. The chain had produced only modest financial returns after its purchase by Winnipeg's Federal Industries five years earlier. With lightning speed, Stevenson then bought up the other national bookstore chain, lowbrow Coles, from Southam. He merged the two and renamed the corporate entity Chapters, with himself as CEO and former Ontario premier David Peterson providing a patina of political respectability as chairman of the board.

SmithBooks had already absorbed the Melzack family's upmarket but overextended Classics chain in 1985.

And so, where a decade earlier there had been three bookstore chains, each with a different style and product mix, now there was only one. The market power of Chapters was unchallenged, combining the Chapters, World's Biggest Bookstore, Coles, SmithBooks, Librairie Smith, Classic Books, and Book Company brands. Publishers no longer had a significant alternative customer in Canada; if the Chain didn't order a title, that book automatically lost access to half the domestic retail market. And hundreds of independent local bookstores faced a single-minded, predatory foe.

With a shrewd, smooth political campaign, Chapters passed lengthy scrutiny by the federal Competition Bureau. Despite warnings from the ACP and protests from the Canadian Booksellers Association, the bureau found in 1995 that the new retail giant wouldn't "unduly limit" competition in book retailing. With the formalities out of the way, Stevenson adopted a take-no-prisoners approach toward competitors and suppliers alike. He executed his strategy to open Canada's first book superstores, modelled on big-box outlets operated in the States by the Borders and Barnes & Noble chains; indeed, Barnes & Noble acquired a 20 percent interest in Chapters. The superstores, at least ten times bigger than an average bookstore, began opening in prime retail locations across the country. Within five years, Chapters had built seventy-one superstores throughout Canada; in the same period, it closed over 150 of the more than 420 Coles and SmithBooks outlets as part of its corporate rationalization.

With the objective of knocking long-established independents out of the game, the Chapters superstores offered bestsellers at discounts of 30 percent or more (offers duplicated by Coles and SmithBooks) and featured Starbucks coffee bars, comfortable armchairs for browsing, and cheery children's play centres. The strategy worked with stunning efficiency. Between 1997 and 2000, independent bookstores that had been cherished fixtures in their communities for decades fell before the Chapters blitzkrieg. Britnell's (established 1893), the Book Cellar, the Children's Bookstore, Writers & Co., and ten Lichtman's stores, all in Toronto; nine out of ten Duthie's stores in Vancouver; four Sandpiper stores in Calgary; Books Canada and Food for Thought in Ottawa; and dozens of booksellers in other cities all went out of business.

The Chain's drive for market share accelerated after it emerged from a three-year monitoring period imposed by the Competition Bureau. In 1998 it opened Chapters Online (listed, like Chapters Inc., on the Toronto Stock Exchange) to grab a slice of the expanding Internet book market pioneered by Amazon.com. Like many e-commerce ventures, Chapters.ca proved costly and unprofitable. It was soon followed by more dangerous developments.

In 1999 Chapters converted its huge warehouse and distribution centre in Brampton, Ontario, into a "wholesale" operation called Pegasus Inc. The actual core functions of Pegasus were filling orders for Chapters.ca customers and supplying books to the Chain's own stores. But by claiming Pegasus as a wholesaler, Chapters could demand the higher wholesaler discount from publishers. To make the pretense more credible, Pegasus pursued sales to libraries and schools and announced its intention of supplying the very independent bookstores that Chapters was driving out of existence.

> By the dawn of 2000, it was apparent that the Chapters business model wasn't working. For all its dominance, the behemoth had grown too quickly: no doubt expanding the market, as Stevenson often claimed, but also far outstripping the market's ability to grow. Publishers realized Stevenson hadn't been buying their books so much as borrowing them.

Until then Canadian publishers had been ambivalently complicit in the gutting of the retail sector. They'd been happy with the sharp spike in sales resulting from the Chapters building boom, yet nervous about the unrealistic size of its orders and troubled by the loss of so many traditional bookstore customers. With the advent of Pegasus, publishers' worst suspicions were confirmed. Pegasus demanded from them a wholesaler discount of 50 percent-plus, in place of the 45 to 48 percent they'd been giving Chapters. Although the Chain claimed otherwise, publishers understood that if they wanted their books on sale at any Chapters, Coles, or SmithBooks outlets, they'd have to ship to Pegasus on its terms.

Since the extra discount points wiped out publishers' already paper-thin profit margins, they faced an invidious choice: either absorb the higher discount, raise book prices, and risk consumer resistance (as Stoddart did), or refuse to extend the discount and lose the Chain's business (as Firefly did). Some independent booksellers, such as Jim Munro of Victoria, mocked the publishers' dilemma, say-

> Physical distribution at Pegasus was as chaotic as its accounting practices. Thousands of books sat marooned in transport trucks lined up outside its warehouse. Rather than streamlining the supply chain, as advertised, Pegasus had created a bottleneck that delayed deliveries by weeks.

ing they'd helped create the monster in the first place and were now suffering the consequences. Most publishers felt they had no realistic choice but to play the Chain's game.

Firefly furnished an object lesson in what would happen if they didn't cooperate. Chapters responded by returning $1 million worth of books for credit, including titles from Annick, Owl, and the other presses distributed by Firefly.

Larry Stevenson became notorious in the trade for browbeating suppliers over the phone. Anna Porter complained to him that Key Porter's new book by Allan Fotheringham, who was then crossing the country on tour, had been shipped to Pegasus but still hadn't reached Chapters stores; if the Chain didn't get its act together, Fotheringham was going to blast its inefficiency in Maclean's. In that case, Stevenson replied, he'd return every Key Porter book in his possession.

By the dawn of 2000, however, it was apparent that the belligerent business model wasn't working. For all its dominance, the behemoth had grown too quickly: no doubt expanding the market, as Stevenson often claimed, but also far outstripping the market's ability to grow. Publishers realized Stevenson hadn't been buying their books so much as borrowing them, fully returnable, to wallpaper his edifice complex. He'd extracted steep discounts and supermarket-type display fees, even charging publishers to attend his sales conventions; but his numbers didn't add up to a healthy business. Yet the Chapters stock price had stayed buoyant long enough, breaking $30 at its height, that Stevenson and other company executives made a killing selling their shares.

Mere days after the Globe and Mail's Report on Business magazine put the grinning, denim-shirted Stevenson on its cover as "Man of the Year" for 1999, Pegasus began returning books to publishers in unprecedented quantities. Receiving a credit note for a big round sum, indicating their receivables from Pegasus were being reduced accordingly, publishers would wait, sometimes for weeks, for the books to come back. Often they arrived damaged, bearing the telltale traces of coffee-slurping browsers, even though industry standards require returns to be in resaleable condition. Equally disturbing, publishers found the value of the returns sometimes varied wildly from the credit being claimed. Physical distribution at Pegasus was as chaotic as its accounting practices. Thousands of books sat marooned in transport trucks lined up outside its warehouse. Rather than streamlining the supply chain, as advertised, Pegasus had created a bottleneck that delayed deliveries by weeks.

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Heather Reisman and her husband, takeover artist Gerry Schwartz, "outmanoeuvred Larry Stevenson and his management group at every turn," ultimately buying out Chapters and creating a new retailing behemoth, Chapters-Indigo.

By that time, financial reporters had got wind that the book industry was in trouble again. Sniffing a story, they discovered that publishers' returns from the Chain were running at 50 to 60 percent of sales in early 2000, instead of the industry average 20 to 30 percent. And since Chapters/Pegasus was returning books in lieu of paying its bills, publishers' cash flow was drying up. Money that was trickling in paid for inventory that the retailer had purchased 120, 150, even 180 days earlier, instead of the standard 90 days. As the news became public, the Chain's share price sagged below $10. Larry Stevenson went on a counteroffensive, sniping at publishers over the phone and in the media. "Chapters Shoots Back at Publishers" ran a typical headline in the *Globe and Mail*.

By July 2000, Chapters was so delinquent in paying publishers that some had put the entire Chain on credit hold. Since Chapters by then represented 65 percent of Canada's English-language retail book trade, this was akin to publishers taking themselves off life support. It was reported that Chapters owed HarperCollins Canada over $10 million, much of it dating to before Christmas 1999. A few other firms also had Chapters on hold, but most were biting their tongues. Invited to go public before the House of Commons Standing Committee on Canadian Heritage, which was convening hearings into the book trade at the CBA's request, most publishers remained meekly silent, fearing Stevenson's retribution. Notable exceptions who gave evidence at the hearings, either in public or in private, were the ACP president, Michael Harrison of Broadview Press, the ACP vice-president, Susan Renouf of Key Porter, Karl Siegler of Talon Books on behalf of the Literary Press Group, Patsy Aldana of Groundwood, Sharon Fitzhenry of Fitzhenry & Whiteside, and Lionel Koffler of Firefly.

Publicly shamed at last, Chapters reached an agreement with HarperCollins and became somewhat more amenable to paying its other suppliers. Problems with payables and returns persisted, however, until late in 2000, when the drama took an unexpected twist. A battle for control of Chapters, and consequently for the Canadian retail book market, broke out between Stevenson and his only serious rival, Toronto-based Indigo Books and Music. The smaller but well-financed Indigo, with its chain of fifteen superstores, smelled blood.

Indigo had been founded in 1996 by the entrepreneur Heather Reisman, with whom Stevenson had conducted a bitter running feud. Reisman and her husband, the financier and takeover artist Gerry Schwartz, CEO of Onex Corporation, launched a takeover bid with an offer to Chapters shareholders in November 2000. The wealthy couple became media darlings as they shrewdly outmanoeuvred Stevenson and his management group at every turn. At the end of a four-month battle, marked by Stevenson's foiled attempt to snooker his rivals by merging with the Future Shop electronics chain, Indigo's gamble was crowned with success: first when Chapters shareholders accepted an enriched offer, and ultimately by rulings in Reisman's favour by federal regulators.

This time the Competition Bureau listened more diligently to publishers' concerns. With the aid of pressure from the bureau, the ACP and the CBPC entered into a form of collective bargaining with Reisman, hammering out a detailed code of conduct to govern terms of trade between the industry and the ever more dominant super-Chain. The five-year agreement placed limits, to be lowered in stages, on the new Chain's permissible returns levels and payment periods. The code of conduct reflected a truth that had never been understood by the previous Chapters management: if the book business is waged as a winner-take-all military campaign, it fails for everybody.

The prime casualty of Larry Stevenson's Seven Years' War had been Canadian publishers' domestic market. Chapters superstores had proved to be efficient vehicles for making bestsellers. But by 2000, Chapters had killed off so many of the independents, whose aggregate market share had shrunk from 60 percent a decade earlier to about 35 percent, that Canadian literary, children's, and regional publishers lost market share also.

The prime casualty of Larry Stevenson's Seven Years' War had been Canadian publishers' domestic market. Chapters superstores had proved to be efficient vehicles for making bestsellers — celebrity bios, happiness guides, Oprah picks — sell even better. But selling literary fiction, history, children's books, or regional titles is a different matter. To market those genres effectively requires knowledge, taste, and an ability to marry customers with the right book. That skill, known as "hand selling" in the trade, had always been the strength of independent booksellers. But by 2000, Chapters had killed off so many of the independents, whose aggregate market share had shrunk from 60 percent a decade earlier to about 35 percent, that Canadian literary, children's, and regional publishers lost market share also.

Domestic publishers had another problem with Chapters. Consumers browsing the Chain's bestseller walls or new releases displayed face-up on its "power tables" naturally assume the books have merited that placement because of their quality or popularity. In reality, suppliers have paid hefty premiums to the Chain to place their books there. Since most Canadian-owned publishers can't pay that kind of money, their books have to make do with spine-out positions on the shelves, where a book can easily get lost in a 100,000-title inventory. In a parody of the free market, superstore bestsellers are decided in advance: they are the books whose publishers can afford to publish bestsellers.

It was scarcely any wonder that Canadian publishers had begun working the American market so feverishly. But even before the Chapters debacle, other forces of change had begun pushing them closer to the margins at home.

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