INFERENTIAL FOCUS BRIEFING

IF 2101
January 14, 2000

IS THE PINPRICK OF REALITY NEARING BUBBLE.COM? OR, A MOMENT OF LUCIDITY IN THE MIDST OF INTERNET MANIA

Through several Briefings, *we have outlined a context, in which to view events in the world of Internet business. In essence, that context has been one of unreality. Now that some investors have started to reassess Internet stocks, a second look at the fundamentals of the Internet business world is timely.*

The various schemes devised to wean e-commerce enterprises of the unlimited free capital that has flowed their way all have fallen short of helping the companies stand on their own. Anticipated increased sales, additional charges for shipping and handling, access fees and hype all have started to show their inability to keep businesses afloat.

As a result, Internet companies have taken to more conventional practices: creating alliances and merging with huge traditional corporations and hiring executives from those same traditional corporations. All in all, those engulfed by the mania may be experiencing an unanticipated moment of lucidity. In such a surprising manner, reality is creeping into the Internet world of business.

A Clear Outline of Unreality

Over the past year, we have placed Internet business and the mania surrounding it in a larger context. That context was one of a highly successful world that had yet to make contact with reality.

✦ First, we noted that selling on the Internet was easy. but that creating a sustainable business was trickier and that c-commerce businesses, while they might have "cool" Web pages, lacked the infrastructure and support systems to sustain repeat business. ("Selling Is the Easy Part: The Learning Curve Steepens for Internet Marketing," **IF 2002**, 2/2/99)

✦ Next, we added that the cost of capital was so low – indeed, nearly zero – that spending had become an addiction free of nagging realities such as profits or return on investment. Advertising, seen as an aid to wean e-businesses off free money, was itself facing real world difficulties. Looking at the overall picture of lnternet business, we suggested an analogy: Japan during its lofty days of a bubble economy. ('"...And Money Comes from Everywhere: Advertising – A Favorite Financial Tool – Faces a Tougher Reality on the Internet." **IF 2015**, 6/4/99)

✦ Third. we suggested that realism was starting to creep into the process of evaluating Internet business, all to the Web's detriment. We wondered whether businesses involved with the Internet were catching a "flu" something like the Asian "flu," that became a global financial crisis. ("Internet Reassessment: Does an Internet 'Flu' Mean a Crisis or What?" **IF 2026**, 9/7/99)

✦ Fourth, we outlined society's slide into maniacal behavior, especially in areas related to the Internet. Everything from advertising by online companies to stock options and initial public offerings (IPOs) seemed to indicate that addictions rather than reason were driving behavior and that such behavior amounted to obsession, even mania. ("Maniacal Behavior: America's Slow Slide Into Obsession (Not the Cologne)," **IF 2036**, 12/3/99)

Now that the stock market has started revaluing Internet-related companies *(e.g.,* etoys, Amazon.com), this might be a good time to consider a larger context for what is taking place. To the casual investor, recent revaluation of Internet stocks may look like a market adjustment – a technical aspect of stock speculation – rather than a thorough reassessment – a rethinking of overall value for the industry itself. No matter which perspective investors take, however, our observations indicate that the financial buttresses that heretofore supported Internet business are crumbling and that a careful reappraisal would be prudent.

Weaning Is Hell

The Internet business world has enjoyed a constant influx of mostly free capital to spend on whatever ideas it could conjure up. Return on investment seemed less important than a boost to stock price. As the capital inflows did, indeed, often result in skyrocketing stock prices and a return on investment from stock value (not business profits), the whole process encouraged additional amounts of venture capital. In this way, the highly speculative c-commerce world became a "solid" investment. No one dared whisper "pyramid" or mention "bubble" without a grin, an elbow to the rib and a subtle reminder that, what the heck, it was working.

But it may no longer be working, and moving from a world awash in free money to one where money comes with a price and an obligation may present a formidable obstacle for many companies. Here is what has taken place lately:

Sales – Now that the television advertising blitz that online companies deployed to boost holiday sales has ended, the damage is becoming clear. For example, RedEnvelope.com, a high-end gift site, is ranked around 1,500 among Web sites in terms of "hits" or visits. It spent $10 million to lift its status into the first 1,000 sites. After spending the money across various media, RedEnvelope.com found itself hovering around…1,500. In advertising spending, Pets.com ranked seventh among pet-related Web sites, yet its traffic still lagged behind that of the already popular Petsmart.com and Petopia.com, both of which spent substantially less on advertising. In fact, only those sites that already were established domains, such as eBay, Amazon, and CDNow, or were among the leading clicks-and-mortar merchants such as Gap.com and Barnesandnoble.com, or were among the top ten television advertisers, benefited from the year-end advertising whirlwind. The rest of the advertising failed to generate correlative traffic and sales. Such a failure sufficiently worried Angeltips.com, a site that matches individual investors with entreprenuers, that the company has pulled its Super Bowl ads. *(Industry Standard,* 12/27/99; *New York Times,* 1/2/00; *USA Today,* 1/4/00)

When it became clear that advertising would not generate sufficient transactions for the holiday season, retailers resorted to other traditional techniques: sales and promotions. Barnesandnoble.com offered a$ 10 discount on orders over $40, while Amazon.com subtracted $10 from any order over *$25.* Giftpoint.com sold *$25* gift certificates for *$15,* while Petstore.com took a *$15* discount on all $30 purchases, only to be outdone by Petopia.com with its $20 rebate on any $30 purchase. Mercata.com offered $50 off a $100 video recorder. These types of promotions eventually led to a promise from Familywonder.com, a family-oriented shopping site, to send a $20 check to anyone who spent $20 at its site and agreed to answer a short survey. (No, these figures are not typos.) When a journalist brought to the attention of Amazon.com's spokesman Bill Curry that the company's rebate when subtracted from the price of already discounted best-seller books resulted in a sale below cost, he candidly replied, "**No one's ever accused us of being profitable."** *(International Herald Tribune,* 12/20/99)

During the holiday shopping season, 73 percent of consumers waited for a better deal before making a purchase. Given that early talk about the holiday season placed anticipated online sales at nearly $8 billion, the final tally as determined by BizRate.com of *$3.35* billion may be cause for alarm. Moreover, customer satisfaction with online buying actually declined from the 1998 holiday season. *(Atlanta Journal & Constitution,* 12/28/99; *New York Times,* 12/17/99)

Shipping & Handling – Online retailers have used the "shipping and handling" category on the final invoice to bolster profits. With price competition and lagging sales taking a toll, many upped the price of delivery to bring the bottom line closer to a positive number. Eddie Bauer charged *$7.95* to ship a *$58* wool sweater. Harry and David customers saw 23 percent added to their tab for small orders (18 percent for larger ones) just to deliver the goods. The Consumer Federation of America noted that a DVD player arrived from one online seller with a *$25* shipping fee added, even though the actual cost was *$5.08. (US. News & World Report,* 12/13/99)

But now the shipping-and-handling revenue stream may be running dry. According to a Forrester survey, roughly 82 percent of online shoppers said they took shipping costs into consideration when making a purchase, and that has directly impacted sales. When Circuit City offered free delivery for online purchases, its sales jumped, the company said. Freeshipping.com, a site that does not sell its own products but rather directs customers to companies that deliver their products for free, is banking on that consumer attitude. The company earns a commission for every sale and then delivers the item free. In short, the ability to charge elevated delivery costs to combat pricing pressures elsewhere in the marketplace may be disappearing. *(Los Angeles Times,* 12/31/99)

Access Fees – Monthly fees for access to the Internet have come under pricing pressure, leading to slow declines on the wholesale side, but retail costs have remained steady. When AOL entered the highly competitive British market, it had to offer Internet access service for free. Now, free access has reached the U.S. AltaVista and IstUp offer free Internet access, and Kmart, Yahoo and Softbank just created an alliance to offer their own free service. *(New York Times,* 12/16/99)

Given the fact that advertising is not generating needed revenues on the Internet, eliminating access fees, while perhaps good for market share battles, bodes ill for profits. For example, Netzero, which has roughly 2 million users paying nothing for Internet access, lost $14.9 million in the third quarter last year. Nonetheless, Netzero outbid Prudential Insurance, the largest insurance company in the nation, for the right to sponsor half-time programming for National Basketball Association (NBA) television broadcasts. Evidently, Netzero is advertising for advertisers. *(USA Today,* 12/16/99)

Hype and Free Money – When real business activity has failed Internet enterprises, they have often resorted to high-profile marketing or another round of meetings with venture capitalists. Pixelon tried hype with its $12 million launch party, but two **months** later Michael Fenne, the company's founder and chairman, was without a job. The company's product – software to deliver streaming video over the Internet – failed to broadcast the launch party over the Internet as promised, and the bad publicity cost the company valuable business. *(Industry Standard,* 1/10/00)

That was not the only bad news for hype. As the charts below reveal, Internet stocks have risen in direct proportion to the number of press-release headlines that mention the Internet. But in the middle of December, for some reason, "buzz" on the Internet quieted.

We are tempted to conclude: Those who live by hype "die" by hype. That aphorism may be even more applicable to those who live by "free money," because that, too, is starting to get harder to find. CookExpress.com, for example, offered a seemingly "cool" service for busy professionals looking for healthy home-cooked meals. Quickly finding 5,000 customers in its hometown, San Francisco, the company soon added overnight delivery of its specially prepared foods to other cities. However, even though the market spread, the company burned *$3.5* million in venture capital and needed more. When its owners made the rounds of Internet investors, they found no interest and had to shut down operations. *(Industry Standard,* 1/10/00)

What's a Cash-Addicted Business to Do?

Value America has started retrenching. The company that enjoyed venture capital galore and had the likes of Fred Smith, founder of Federal Express, and Paul Allen, a Microsoft cofounder, on its board, failed to perform in the real world of consumer markets. Despite the company's increased advertising spending in newspapers and on spot TV from $1.9 million in 1998 to $12.7 million in 1999, the consumer did not respond. As part of its "strategic refinement," the company is terminating 47 percent of its workforce, closing several facilities and narrowing its market from consumers and businesses to just the latter. During the first nine months of 1999, the company had after-tax losses of $98 million on $121 million in sales. *(Financial Times,* 12/30/99)

While many companies certainly face similar realities, others are not waiting for deep trouble to hit.

✦ American Online (AOL) signed a deal with Wal-Mart to create an Internet connection for the giant retailer's customers. The announcement of this collaboration followed by one day a similar arrangement between Yahoo! and Kmart. *(Women 's Wear Daily,* 12/17/99)

✦ Microsoft signed a deal with Tandy to promote the Seattle software company's Internet service, Microsoft Network (MSN). AOL inked a similar deal with Circuit City. Microsoft went further by investing $300 million in Best Buy in return for special promotions of its products, including MSN. *(New York Times,* 12/16/99 and 12/17/99)

✦ AOL is acquiring Time Warner, the world's largest media and entertainment company, for about S 166 million in stock, the biggest corporate merger ever. This merger was announced at a time when big media companies are trying to devise an Internet strategy and Internet companies are trying to figure out how to attract more customers to their Web sites and thereby generate more revenue. *(AP Online,* 1/10/00)

✦ A study of top-level hires at 500 Internet companies revealed that 88 percent of those hired in the final quarter of 1999 came from traditional companies, a considerable jump from the 38 percent in early 1998. *(Wall Street Journal,* 1/4/00)

As the resources that have kept Internet businesses independent start to dwindle, many are turning to large existing businesses, either as partners or as a source of executives with experience in traditional business practices. Their actions are implicit acknowledgments that the situation is changing. As we have discussed in client meetings *(When the Internet is Not Enough),* they need to change their behavior quickly in order to address successfully the challenges of e-commerce: business models that are not working, advertising that is not paying off, the physical shipping and servicing difficulties that are creating unsatisfied customers and volunteer workers who are becoming disgruntled.

Those engulfed by the mania that has surrounded Internet business are experiencing a moment of lucidity. They are realizing that real businesses require real revenues to remain in existence. During the recent holiday rush, many new capital resources, ones that were intended to help the industry wean itself from endless venture capital, proved deficient. Actual customer sales from Web sites, advertising revenues, "buzz" and even shipping and handling fees all proved insufficient. As a result, a period of adjustment has started. Back-door money has kept the enterprise going, and if that flow slows, then what is left for companies to do? Their actions so far suggest that many of them are turning to traditional business resources to stabilize and advance their enterprises. Reality is creeping into the Internet world.