

# Why So Many Dotcoms Failed

## and How to Succeed with the Internet

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- Massive failures in the dot-com sector (called “dot-bomb” by many) have caused most businesses to reconsider their Internet-based investments and strategy.
- Poor management practices, easy availability of capital, and a lack of product or service differentiation have been the primary causes of the dot-com carnage.
- For an Internet-based business to succeed, the digital strategy of the firm must be supported by business processes, financial discipline, performance measures, incentives and communication.
- The need for a value-based management system (such as EVA®) is more acute than ever, especially due to a high degree of uncertainty, the large investments required, and a serious need for management control.

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## The Dotcom Wipeout

Consider the carnage:

- Over 200 dotcom shutdowns in the year 2000.
- Another 25 in January 2001.
- Sixty-plus Internet stocks down 90% or more in the past year.
- 257 NASDAQ delistings.
- At the beginning of the year 2000 the market cap of the Internet sector was \$881 billion; at the beginning of the year 2001 it was \$208 billion.
- Most telling of all: Of the 494 Internet-related businesses that went public during the last five years, only 11% trade at more than their offering price, and nearly a third trade more than 80% below their offering price.

At some point the question is inescapable. How could so many have been so wrong about so much? And what comes next?

**With a disaster of such proportion, one wonders how anyone can succeed in e-business.**

One thing is certain: The Internet isn't going away. And the rewards of e-commerce will be great for companies that get it right. So despite the brittle skittering sound of vultures stirring the shards of broken dotcoms, the appropriate question isn't whether to have an Internet strategy, but what strategy to have.

In thinking about the dotcom disasters, it is helpful to keep in mind that the odds are overwhelmingly against any new business, no matter the industry. The vast majority of those who start new businesses eventually throw in the towel and go back to work for somebody else. Some fail because the basic concept of the new business is flawed, some because they just don't have the talent to manage, and many because they are undercapitalized and simply run out of money before the business reaches breakeven. One headache most startups don't have is deciding what to do with a flood of money from eager investors.

**Odds of any new business succeeding are slim. Over-capitalization simply compounds the problem by helping relax management control.**

That's the real irony in the dotcom shakeout. Instead of being undercapitalized, Internet companies failed in part—in some cases, in large part—because they were overcapitalized. Easy money made it possible for e-entrepreneurs to overlook business basics that are second nature to the counterman where you had lunch yesterday. It probably wouldn't occur to him to spend 12.5 times his annual revenues on marketing and advertising to generate "buzz." Or to hire people without any clear idea of what they were supposed to do. Horror stories abound about free-spending dotcom managers boasting of their "burn" rates (the rate at which they were spending venture funding and IPO proceeds).

But when money is free for the asking, why not? And for Internet entrepreneurs, money was even cheaper than free. They were paid to take it—in the form of venture funding, then IPO proceeds and then high-yield bond financing, all apparently offered with fewer tough questions than any entrepreneurs have ever faced before.

That situation is not likely to be repeated. Indeed, the risk now is that the dotcom hangover will scare many investors—and Old Economy companies—away from what could, and should, be winning technologies or business strategies. With that in mind, this study not only pinpoints the causes of e-collapse, but also identifies the necessary elements for a winning e-business strategy.

<sup>2</sup>According to a study by Webmergers.com and cited by CNNfn, January 3, 2001.

<sup>3</sup>Economist, November 18, 2000.



### **Key Findings:**

Our forensic examination of over 100 Internet companies – about 82% B2C and 18% B2B types – found four leading causes of death:

- A flawed business model – especially the failure to differentiate services or add value
- Forgetting the customer – perplexing Web sites, poor order fulfillment and delivery, lousy customer service were commonplace
- Overspending on marketing and customer acquisition
- Bad management

**Despite the lowered barriers to entry and quick start, the new businesses on the Internet still need to differentiate themselves against the established firms.**

That the Internet dramatically lowered the barriers to entry for new businesses and allowed digital upstarts to challenge the brick-and-mortar establishment is undeniable. Anyone could, and still can, set up shop on the Internet with a miniscule investment in physical capital. But constant humming of the mantra about bits replacing atoms seems to have created a widespread illusion that anything “e” automatically was a winner, while all Old Economy companies would soon be consigned to the scrap heap. Some old laws of business were in fact swept away by the digital revolution. But other business basics remain very much in force. Foremost among them: To succeed, even Internet companies have to do something better than the competition.

### **Getting the Basics Right**

Low prices aren’t enough. With search engines and shopping “bots” making it virtually costless to compare prices in the virtual world, it appeared to some that the Internet was all about sending buyers to the lowest-priced seller. But as with the Old Economy, the winners in the New aren’t necessarily going to be low-cost providers. In fact, none of the biggest winners are likely to compete on price alone, or even largely on price.

Consider Amazon.com. Granted, the company hasn’t made a GAAP profit, and the cloud over the dotcom sector has cast a dark shadow over the company’s prospects. But there’s no denying that Amazon has been among the most successful e-companies in terms of attracting customers and generating sales. And it didn’t succeed by slashing prices.

Virtually (maybe literally) anything Amazon sells can be found for less at another online store. Yet Amazon outsells the competition. And it has established a brand that likely will endure and a business model that will survive, and by those measures is an unqualified success.

Why is the Amazon.com brand so strong? Consider a few of Amazon’s innovations:

- One-click shopping
- Email recommendations of new products based on a customer’s past purchases
- More recommendations, and a friendly welcome back, each time a customer returns to the site
- Highly creative promotions like sheets of ten one-cent stamps (with a note signed by founder Jeff Bezos) included in customer orders around the time of the January postal rate increase

Amazon.com has successfully differentiated itself from the pack by providing a rich “experience” for online shoppers. It bears note, however, that as attractive as they are, Amazon’s technological and marketing innovations would mean nothing if it did not

**A highly customer-oriented philosophy has resulted in Amazon.com capturing a lion’s share of online books, music and video sales.**

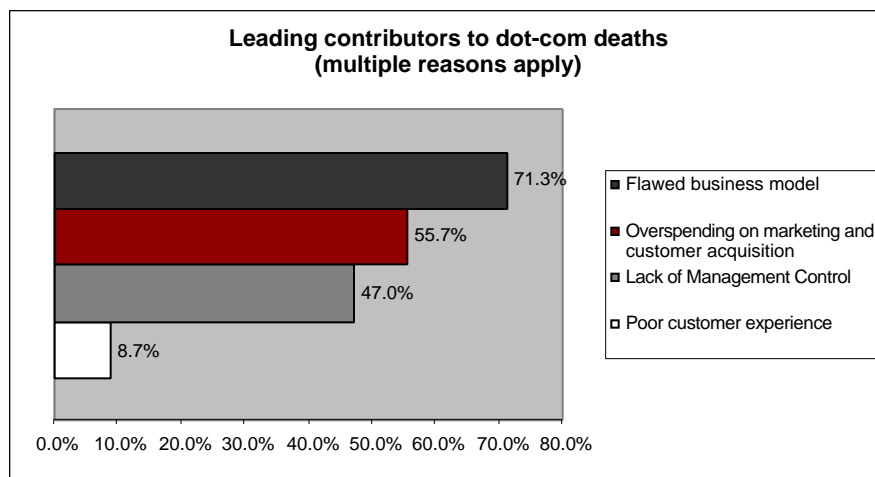


deliver on the basics. Perhaps Amazon’s greatest differentiating characteristic has been its fulfillment. When you order a book, you get it, often sooner than you expect.

### Getting the Basics Wrong

In our analysis of the companies in the study sample, we found the following to be the leading causes of failure:

**Lack of differentiation and poor management controls have been responsible for the majority of the failures.**



Multiple causes were at work in most dotcom failures. The leading contributors clearly were a flawed business model, unconstrained spending on marketing and customer acquisition, and bad management. In other words, most Internet failures collapsed not because they failed to grasp some subtle wrinkle in the fabric of digital commerce, but because they didn’t deliver on plain old-fashioned business basics. (The one thing never found in the equation is too little capital.) The following are illustrative:

#### 1) Living.com

**For most manufacturers looking to establish direct sales through the Internet “channel conflict” presents a major challenge. Compaq, a computer hardware manufacturer, is an example of this dilemma.**

This erstwhile high-flier aimed to revolutionize the furniture industry by letting customers buy directly from the factory, cutting out the traditional retail middlemen. Unsurprisingly, the retail middlemen objected.

Flush with cash from eager investors, Living.com acquired Shaw Furniture only to recognize belatedly how importantly Shaw’s business depended on retail middlemen. Because these middlemen didn’t earn anything when customers purchased online, they had no incentive to support the online venture. They were reluctant to spend time showing customers display furniture only to lose the sale to the Internet operation, and they were unwilling to handle returns for customers who’d bought product on the Internet.

Living.com couldn’t ignore the objections since it was easier for retailers to replace a manufacturer than for Living.com/Shaw to replace a distribution network. So the original strategy had to go, and Living.com agreed to offer only 20% of Shaw’s SKUs (mostly low-end products) online. In other words, Living.com agreed to offer through the online channel only products that most customers did not want. The company compounded its strategic misstep with tactical errors, such as choosing a new and inexperienced delivery service. As a result, one Living.com executive commented, “We would



find part of an order to ship but not the rest. The next week we would find the second part of the order, but couldn't find the first."

Could Living.com's original strategy have worked if it had been better executed? Perhaps. But it is clear that its fallback position of offering limited merchandise online, and then failing to deliver, did not work.

2) Pets.com

The Pets.com story points to different but related problems. A glance at the company's 1999 financial results almost tells the whole story:

Sales:	\$ 5.4M
Cost of Goods Sold:	\$ 12.4M
Sales and General Expense:	\$ 53.2M
Net Income:	\$(61.8M)
Market Value:	\$ 4.0M

Note that for fiscal 1999, Pets.com's SG&A expenses were a staggering 9.2 times revenue. Pets.com spent \$180 or so per head in customer acquisition cost. And while it was spending so heavily to acquire customers, the company was competing solely on price, without offering any differentiation in service or selection.

Not that a whole lot of differentiation is possible in a business that sells commodity products and operates on thin margins. Unsurprisingly, the combination of high marketing and customer acquisition cost, an absence of special economies in product shipment, and lack of product or services differentiation spelled disaster for Pets.com. Its wreckage was sold for an undisclosed sum in November 2000.

**Shipping costs could significantly hurt profit margins for heavy products. Amazon.com, for instance, is considering getting out of some of its business lines.**

In the famous television commercials Pets.com's sock puppet used to sing "What goes up, must come down..." How true.



**A Framework for Successfully Leveraging the Internet:**

What are the lessons to be drawn from these failures? How can other companies increase the probability of success in online ventures?

We propose testing Internet initiatives against the following value model:





**Technology alone doesn't constitute a digital strategy. It needs to be complemented by other key elements of the organization.**

We suggest that a company first develop a digital strategy. For an existing brick-and-mortar establishment, the digital strategy needs to support the overall business objectives of the firm. Once the digital strategy is established, the company needs to look at its internal functional levers—its organizational structure, management skills, performance metrics and incentives, and appropriate training and education. Technology, while a key component of the digital strategy implementation, is simply an enabler of the strategy and not the driver. In order to maximize the benefits derived from the Internet, the organization must be properly structured (integrated with the core business or created as a separate unit) with appropriate performance metrics, incentives, and training, and led by management with sound business skills.

The first crucial point that emerges from the dotcom carnage is that technology must not drive strategy. Technology is a tool whose use should be determined by strategy.

The questions that an entrepreneur (or Old Economy company venturing into the e-world) must answer before launching an Internet-based initiative are old-fashioned, basic, non-technological ones. For example:

**Exploring basic business issues still remains one the first priorities for e-businesses. One can't overlook the basics.**

- Who are the customers and what do they want?
- Who are the suppliers and what do they want?
- Does the technology of the Internet make it possible to:
  - Better serve existing customers?
  - Attract new customers?
  - Improve supply chain management and achieve greater efficiencies?

Digital strategy is a subset of the business strategy. Technology alone cannot transform a business. Transformation only comes from technology harnessed to a program of radical business improvement. Yes, technology can make strategic opportunities more attractive or more powerful. But it is costly, and many web businesses failed to strike the appropriate balance between technology investment and the underlying business realities.

Webvan and other Internet grocers, for example, built sophisticated technical and physical infrastructures long before they had enough customer orders to support or justify those investments. In fact, the underlying realities of the grocery business—razor thin margins, a competitive marketplace, the fact that many grocery buyers actually enjoy shopping—would have made it extremely difficult to justify those technology investments in any reasonable business environment. More typically, startups fail to invest enough in infrastructure and then cannot scale up fast enough to keep pace with increasing customer demands. In the Internet sector, however, the abundance of readily available capital led to exactly the opposite problem. Cheap capital allowed the dotcom firms to overspend on technology.

**A well thought-out strategy must be in alignment with various elements of the organization management for it to succeed.**

Developing a pragmatic digital strategy is the first step toward online success, but appropriate organizational management and governance systems are critical to the execution of the strategy. At the very least, companies must align their business objectives with their organizational processes, knowledge sharing, performance measures and incentive structures. Old Economy firms beginning to do business online may find it necessary to build new organizational structures and practices supported by revamped performance metrics and incentives.

In a fiercely competitive environment where speed to market can be crucial, this alignment phase is often difficult. Of course, the alignment of business objectives and organizational processes is an issue that nearly all businesses face, but many digital



businesses failed to develop the appropriate measurements and governance to ensure performance and right mindset.

Most existing financial metrics and management systems unfortunately focus on accounting measures and have serious limitations in the context of the Internet. Whether they are de novo companies or online initiatives by established brick-and-mortar firms, Internet startups require heavy capital investment. But most of the investments—in things such as Internet storefronts, back-end infrastructure, customer acquisition and brand building—will be treated as period expenses under standard accounting practices. A strong argument can be made for treating them as investments. After all, they are intended to provide benefits for years into the future.

**A value-based management system is even more relevant for Internet businesses to instill capital discipline and a long-term business view.**

EVA<sup>®</sup> (or Economic Value Added) is a sophisticated governance system that takes a more realistic approach to these outlays. Since these “expenses” in fact contribute to the long-term growth of the company, EVA carries them as assets on the balance sheet and amortizes them over the appropriate number of years. This approach doesn’t punish the company’s short-term profitability as severely as do accounting measures, but still holds managers accountable for producing adequate returns on the investments in the future.

In addition to choosing the appropriate metrics, companies must create an appropriate organizational structure. It should be flexible and complementary to any existing brick-and-mortar operations. Companies with existing offline businesses must decide whether the new online venture should be managed as part of the traditional business, run as a separate business, or even spun off. The pros and cons of each alternative must be evaluated in the context of the existing corporate culture, the product or service offering, the value (or lack thereof) of brand, and the business model. Once the structure has been determined, metrics and milestones must be determined in order to make it possible to assess performance. These must be complemented with an incentive plan that is appropriate for the Internet business yet is not in conflict with the traditional business’s incentive plan.

**A better approach to Internet-based investments is to invest a little, learn, and subsequently scale up, down, or redirect the investment.**

It is crucial that any Internet strategy be subjected to the same rigor and discipline as offline initiatives. Most Internet start-ups failed because they were treated differently, and weren’t required to produce a comprehensive business plan that identified the necessary investments, alliances, resources, and expected returns. Tangible economic value is derived from the coordination and alignment of digital strategy, reliable and innovative technology, and management. Value creation requires identifying unique digital opportunities, a rigorous economic approach to planning, prioritizing, and assessing those initiatives, tight execution, and a commitment to continuous monitoring and modification based on performance and changing dynamics of the competitive environment. An appropriate approach to managing the organization, including business processes, internal and external communications, and incentive structure, is essential.



## Summary

During the past two years, most dotcom companies have closed their doors, merged or been acquired—usually for a fraction of their peak market value. For example, Boo.com, a fashion e-retailer, spent over \$150 million on marketing in just 9 months, only to sell its web address, customer list and trademarks to Fashionmall.com for a meager \$1 million in May 2000.

**Applying time-tested business discipline and financial rigor are still the key to succeeding with the Internet-based businesses.**

Ironically, it's possible that more online companies would have prospered if investors had liked them less. Too much easy money gave the e-entrepreneurs liberty to ignore basic management disciplines. For awhile, that is. Now the easy money is gone, and it may be tempting to write off the whole digital economy as a foolish fling of online youth. That would be a mistake. The case for digital business is still sound even if most dotcoms are not. Bits do trump atoms—or can, if they are managed right.

Virtually every industry has excess manufacturing capacity, so investments in physical capital are hard to justify, especially when information technology allows one to knit existing pools of capacity into a tightly managed supply chain. That same information technology has put the writing on the wall for anyone whose business model depends on the ignorance of others. Many dotcoms may have gone bust, but anyone who's seriously interested can find suppliers of almost anything on the web, and compare their prices instantly and almost costlessly.

So despite the downturn, companies must face the fact that the Internet is not going away. If they do not use it and make the most of it, their competitors will. This means it's imperative that firms continue to leverage digital technology, extend their geographic reach, expand their product line, and improve relationships with customers, suppliers, employees and other stakeholders. But they must approach the job with overdue discipline. Without it, failure is assured. With it, success is possible. And that's the closest thing any business person ever gets to a guarantee.



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