Online Pet Supply Retailing

The pet industry is a great eulogy for the entire dot-com industry . . . Blind is the operating word. Lots of blindly, highly funded management teams and a blind anticipation that customers would use the internet.
—Frank Creer, venture capitalist, May 2001

In a world of disruptive internet technologies, how do you know if your business model is crazy or brilliant, and what do you do as management to maximize your chances of success?

From 1995 to 1999, the U.S. experienced a period of tremendous growth in its information technology (IT) sector. The IT industry, although it accounted for less than 10% of the U.S. economy’s total output, contributed disproportionately to economic growth. Consequently, as venture capital money flowed freely, many companies developed an institutional mentality of rapid expansion, with market share taking on crucial importance in their quest to dominate the competitive landscape. The mantra was “get big, fast” and the goal was to be first to IPO, so that cash could be inexpensively raised to fund more rapid expansion (and investors could reap huge returns). Hundreds of new entrants crowded the market, spending vast sums for the purposes of customer acquisition and revenue growth.

One market that was particularly contentious was online pet supply retailing. Pet supply retailing had an estimated worth of $31 billion in 1997, and in the late 1990s, several startups and brick-and-mortar-based companies launched online retail stores, hoping to become the premiere (and perhaps the only) online pet supplies retailer. Two companies emerged as pure play frontrunners: Oakland-based Petstore.com and San Francisco-based Pets.com.

Petstore.com had garnered significant investor attention in November 1999 when it closed a round of funding estimated to be worth $97 million. But in the intense race to an IPO, its competitor, Pets.com, had finished first when it went public in February 2000. Headed by startup veteran Julie Wainwright, Pets.com was distinguished by its savvy marketing and its widely-known mascot, an unnamed sock puppet dog. Its success at reaching an IPO first was not matched by the stock’s actual performance: On its opening day, the stock’s share price opened at $13.50 and rose to a high of $14, but then dipped back down to its initial offering price of $11. Afterwards, share prices steadily declined, eventually closing at $0.22 in November 2000, when the company declared it would be shuttering its operations, laying off staff, and liquidating its assets.
In the years that followed, online pet supply retailers were widely regarded by the media as epitomizing the excesses and the follies of dot-com speculative mania in the late 1990s that culminated in the 2000 stock market crash (See Exhibit 1 for a chart detailing the 2000 stock market crash in historical context). In 2008, CNet pronounced Pets.com as one of the greatest dot-com disasters in history (See Exhibit 2 for a list of selected dot-com failures). But what led to the failure, and subsequent crucifixion, of these one-time media darlings? Were Petstore.com and Pets.com the victim of poor strategic decisions, a prohibitive and crowded market, investor attitudes that destroyed their chances of success, or perhaps just bad luck or bad timing?

Background

Petstore.com

Petstore.com was co-founded in October 1998 – one month before Pets.com – by entrepreneur Josh Newman, who also served as its CEO. Newman had graduated from HBS in 1988 and worked for the Boston Consulting Group. He quit BCG in 1990 to become the first employee at a successful tech start-up that he led to an IPO (Amerigon Inc.). Subsequently he helped to create an e-commerce Web site for an internet telephony company, and was approached by a venture capitalist to create Petstore.com from scratch. He recalled:

I was called by a venture capitalist and asked if I wanted to put together a business plan for starting a pet e-tailer. At that time, Amazon.com had a lot of traction, E-Toys had a sky-high market valuation, and there was a land rush for the different verticals in the e-commerce space. This VC had done a lot of market analysis and had decided that the pet space was an attractive vertical. I was asked to pull together a team and a plan. Personally I saw this as my chance to breakthrough into the CEO role and to roll-the-dice on the wildly exciting e-commerce industry.

Pets.com

Pets.com was founded in November 1998 by Greg McLemore, a Web developer in Pasadena, California. McLemore created the company through WebMagic, his Web site design firm. Prior to Pets.com, McLemore and WebMagic were responsible for several other startups, including Toys.com, an internet commerce site that sold children’s toys. Pets.com was originally conceived as a site that would serve as a one-stop shop for pet lovers. McLemore envisioned a site full of thriving message boards, databases for locating pet-related services, and a fully stocked online store with thousands of items. “My vision is to create the world’s largest pet site, a true category killer that offers consumers the best products and services for their pets,” McLemore said.

Hummer Winblad, a venture capital firm that focused on technology startups, purchased the Pets.com site and domain name in early 1999 and approached Julie Wainwright, an executive at e-commerce site Reel.com, with an offer to run the company and develop the Pets.com online store. At the time, Wainwright had a substantial background in IT startups. Prior to Reel.com, Wainwright was CEO at Berkeley Systems, a software company whose computer game, “You Don’t Know Jack,” became one of the best-selling games of the 1990s. “You Don’t Know Jack” eventually sold over 4.5 million units and generated $100 million in revenue. When Berkeley Systems was sold, Wainwright went to Reel.com, the first e-commerce site that sold movies. Within 18 months, the company had generated millions in revenue, and it was eventually sold to Hollywood Entertainment.
Building an Online Petstore

The question was, how big is the market, and can six or seven sites really survive on people who buy trinkets for their pets?

—Carrie Johnson, Analyst, Forrester Research, Nov. 2000

Of course the market couldn’t support six or seven sites – or three for that matter. The question was did we have a shot at becoming #1 and blocking out the other competitors from getting access to inexpensive public capital?


In order to get his online pet supply store off the ground, Newman set his mind to assembling a talented team and figuring out a profitable business model. Newman described his staff at Petstore.com, saying, “We had a pretty broad team. One of our team members was a Stanford GSB grad who founded and was running the leading independent pet store in San Francisco, a brick-and-mortar pet store. A Cal-Tech superstar headed-up our technology effort; a key marketing executive from Nissan was in charge of marketing; and a former BCG office-mate ran operations.” What started as a group of five individuals would eventually become 300 when the business was at its peak. “We took off like a rocket launch,” Newman said.

At the time, no other pet e-tailers had launched. A business school classmate of the founding team worked at PetSmart, one of the brick-and-mortar retailers, and the sense was that the traditional retailers were not going to move fast into e-commerce. Newman and his team saw the pet vertical as competitively similar to the books or toys verticals – the first one to “get big fast” could win. The question was how the business model looked.

Next, Newman and his team performed a detailed analysis with data from their co-founder’s brick-and-mortar pet store. Using a database that had the weight and gross margin for every product in the store, they did an analysis of what individual customers actually bought (their “shopping baskets”) and cross-correlated it with UPS shipping rates. Newman explained, “We asked the question: If people online bought the same shopping baskets that they bought in this physical store, and we shipped all these baskets around the country, would it be a profitable business? The answer was yes.” He continued:

According to our analysis, if you set up two distribution centers – one in the West and one in the East and you ship with UPS ground service, you could have one-day delivery to about 70% of U.S. households using ground shipping rates. This is very high service level with reasonably low shipping costs. Premium dog food was not sold at mass market retail or grocery stores, and super-premium food was only available though veterinarians. So it was a pain-point for customers to have to make an extra stop to buy their dog food. More importantly, the economics of shipping dog food were essentially a wash. The margin on the dog food pays for the net-shipping on the entire bundle, and then there’s 100% markups, 50% margin on the other things that people buy. So the essence of the analysis on the business plan was really built around those two discoveries: The shopping cart margin and weight data, and the shipping costs analysis married to it.

Petstore.com received $10.5 million of funding from Battery Ventures and Advanced Technology Ventures in April 1999. This made it the first VC-funded pet e-tailer to enter the market. For many emerging e-commerce companies such as Petstore.com, getting to market first was considered crucial for investors. Newman recalled:
I’d say that being first was enormously influential on everybody’s actions. [Online toy retailer] E-Toys was a model that people were looking at and at the time, it looked like that was a wildly successful company with an $8 billion public market cap! The analysis was they were wildly successful because they did it first, and that there wasn’t room then for anybody else to do it second. Amazon was felt to be that way too. Our plan was to be open for business roughly three or four months after funding. We were the first ones funded, but several days after we were funded, Julie announced her funding. In retrospect, we had an opportunity in the first few weeks to just stop and give the money back. But success looked like the potential of a billion-dollar-plus return. So with the support and encouragement of the VCs, we pulled our launch date up to five weeks. We opened a warehouse with thousands of SKUs and created a Web site and launched the company, all five weeks after funding. We were the first ones open for business. It was a total sprint.

At the time, interest in funding companies like Pestore.com and Pets.com was at a fevered pitch (See Exhibit 3 for a chart detailing the frequency of Internet IPOs from 1996 to 2008). According to one industry observer, “In the first six months of 1999, venture capital firms invested $11.4 billion, or nearly 90% of the...$13 billion they invested during all of 1998. And [1998] was a record year.”12 In the second quarter of 1999 alone, U.S. venture capital firms invested $6.8 billion in 661 companies.13

Wainwright began work at Pets.com in March 1999 in stealth-mode, with a brand new Pets.com website scheduled to be launched in August 1999.14 She hired high-profile talent familiar with the pet supply retailing industry; John Benjamin from brick-and-mortar chain Petco came aboard as VP of merchandising and John Hallon, who was experienced with pet-lifestyle magazines such as Dog Fancy, signed on as VP of editorial content.15

In late March, Amazon announced that it was acquiring a 50% stake in Pets.com.16 Between Hummer Winblad and Amazon, Pets.com had secured about $10 million in initial funding. Pets.com received another round of funding worth $50 million from Amazon, Bowman Capital Management, and Hummer Winblad in June 1999.17 This round left Amazon with a 54% stake in the company.18

Competitive Landscape

A number of characteristics made online pet supply retailing an attractive category for investors. Worth $23 billion in 1997, the entire U.S. pet retail market was expected to grow to $27 billion by 1999 and to $32 billion in 2001.19 The online pet supply retail market had an estimated value of between $3 billion to $6 billion, comprising 10 to 20% of the total pet retail market.20 As a whole, the online retail consumer population was expected to skyrocket, bringing online shopping sales from $3 billion in 1997 to an estimated $41 billion in 2002.21 Moreover, gross margins for pet-related retail products averaged around 37% to 43%. While bulk food products had margins around 20%, certain supplies and novelty accessories had margins as high as 70%.22 At the time, Newman believed online pet supply retailing showed a great deal of promise, saying:

The pet supply category is bigger than books or toys or music and videos. And it has higher gross margins than those businesses. The brick-and-mortar retailers are weak, with the largest player controlling only 7% of the category. With a strong need for replenishment, we’re already seeing very high reorder rates. The logistics are tough to work out: it’s expensive to ship forty-pound bags of pet food. But this can be a terrific, profitable business if you reach a scale where you can lower your shipping costs by having two distribution facilities nationwide and if you can maintain gross margins at or above 30%.23
Sensing the potential to dominate a budding, profitable market, many competitors stepped into the fray. Two other major competitors, both of which sold pet supplies online, were as follows:

**Petopia.com** Originally founded as Paw.net, Petopia.com changed its name when Technology Crossover Ventures invested $9 million in the company in May 1999. In July, PETCO, the second largest brick-and-mortar chain in the U.S. (with over 450 stores), announced that it would be partnering with Petopia and acquiring a 20% equity interest in the company. By that point, over $79 million had been invested in the company.

**Petsmart.com** In May 1999, PETsMART, the leading brick- and-mortar pet retailer in the U.S., partnered with Web startup and online retailer Petjungle.com in order to bring PETsMART’s products online. The new site would be hosted at Petsmart.com and PETsMART would own a 50% stake in the venture. The company originally received $8 million in funding.

The atmosphere between these companies was intensely competitive, and the business environment was chaotic. Newman shared his perspective on his competitors’ approaches and the overall environment:

At the time, the pure-play e-tailors felt that the brick-and-mortar incumbent players would be too slow to win. This was based on the experience of Amazon and E-Toys, who had outrun Barnes & Noble and Toys “R” Us, respectively.

Remember that at that time the technology was not nearly as facile as it is today. So, if you were going to go build an e-commerce site, you had to figure it out yourself and deploy a lot of money to pull together all these different systems: a warehouse management system, an accounting system, e-commerce front end, a customer service system, content management system, to name a few. You couldn’t just go readily buy an integrated solution. So it was a pretty big job for anybody, especially a slow-moving brick-and-mortar company trying to get to market quickly.

In the pet space, the incumbent retailers had an opportunity to compete in a different and effective way, as compared to books or toys. Since there were four VC-backed pure-plays, the incumbents could partner with one of the pure-plays and thereby achieve the dual-objectives of leveraging VC Capital and accessing nimble management teams. Also, they could cut great deals since there were multiple partners to approach. So our original assessment was wrong of the relatively low competitive threat from the incumbent retailers.

In the planning phase, Newman had developed what he believed to be a sound business model that would eventually take his company to an IPO, and hopefully, to profitability. “We were going to be profitable at somewhere around $250 million of annual revenue,” said Newman, “but the model did not assume three or four competitors with $300 or $400 million collectively between them shooting bazookas at each other. So, the model quickly went out the window. The key question was what might replace it.”

**Strategy**

Using a distribution center in Emeryville, CA, Petstore.com’s Web site debuted in May 1999 with 1,200 SKUs, which featured a full line of cat and dog supplies. The company also partnered with the American Animal Hospital Association, which provided content for the site geared towards pet owners. By August, Petstore.com had 4,500 SKUs and was adding them at a rate of 500 per week. While its most popular item was pet food, Petstore.com offered a wide range of products; describing
his product mix in a 1999 interview, Newman commented, “We have a large variety of products for your animals. We have things to help them travel. We have carriers, leashes, bowls, toys and treats – all the items that empirically customers readily purchase in traditional stores.” Additionally, Petstore.com acquired Flying Fish in August 1999, an online tropical fish retailer, adding live fish to its expanding offerings.

Wainwright launched the Pets.com website in August 1999. The site offered 12,000 products for dogs, cats, birds, fish, reptiles, and many other types of pets, positioning itself as a “one stop shop” for pet owners. The site had functionality similar to those from other e-commerce sites, allowing people to mark certain items as “Favorites,” or to subscribe to a newsletter for special offers. Initially, Pets.com offered a special promotion of 50% off all pet food, with a flat delivery fee of $4.95.

In the months that followed, Wainwright and Newman executed on several measures that made each of their sites more visible and more attractive to potential customers.

Infrastructure

In September, Pets.com opened a new 140,000 square foot distribution facility in Union City, CA. The new building effectively increased the company’s distribution square footage by five fold, allowing it to handle up to 40,000 SKUs. Although Pets.com purchased products from manufacturers, it handled every other component of the distribution process. “We pick the products. We pack and seal the box. We’re the last ones to see it out the door,” Wainwright said at the time. Pets.com announced in December that it would be utilizing 300,000 square feet in a facility in Greenwood, IN as a distribution center. Indiana state officials gave the company over $1 million in incentives for choosing Greenwood, a location that also helped Pets.com cut down on shipping costs.

Meanwhile, Petstore.com opened two new distribution centers in October 1999 to keep up with its growth. One Petstore.com executive commented on the openings, saying, “Our business has increased seven fold over the past few months and we expect that growth to accelerate as more Americans shop online this holiday season.” In San Leandro, CA, Petstore.com opened a brand new 130,000 square foot facility. It also opened a separate 5,000 square foot warehouse in Inglewood CA to facilitate its online sales in live saltwater fish, which was a highly-profitable niche business.

Financing and Partnerships

Pets.com received a third round of financing in November 1999, amounting to $35 million from Amazon.com and other investors; in total, the company had raised $100 million after its first three rounds of funding. That month, Pets.com re-launched its Web site with an entirely new design, streamlining the order process and increasing the number of products sold on the site to 13,000. “We now offer 60% [more] products than an average superstore,” Wainwright claimed at the time. The Pets.com homepage linked to community message boards and site resources, such as Veterinarian Finder and Pet Sitter Finder. The site also introduced a Gift Center feature, which recommended presents to pets based on 10 pre-determined “pet lifestyles.”

In the same month, Petstore.com made a significant step to its corporate strategy when it received $97 million worth of second-round funding from Discovery Communications, Battery Ventures, and Advanced Technology. This round made Discovery Communications the largest stakeholder in Petstore.com. Discovery Communications had a market capitalization estimated at $12 billion, and its most compelling asset was its television network, which featured programs such as Animal Planet.
a popular documentary-style show about various animals. Under the terms of the agreement, Petstore.com received promotion on television and on Discovery’s Web site, as well as a license to the Animal Planet trademark. Newman recalled, “The theory was that we’d essentially have this enormous Animal Planet brand, largely free media, and cross-promotional opportunities with their other product lines and the like. I think it was a decent theory. Could Animal Planet, the leading media brand in the animal space have an attractive online commerce operation that complemented it? We certainly thought so.”

Petstore.com had also entertained an offer for funding from a consortium, comprised of a television network, a grocery store chain, and a European conglomerate. The consortium would have taken a smaller stake in Petstore.com, in exchange for a smaller amount of money. From a competitive standpoint, Petstore.com management had agreed that Discovery Communications’ offer was more attractive. Newman described their reasoning:

> When Pets.com was funded by Amazon, we knew we needed a gorilla in our corner. It came down to a choice between three 200-pound partners who all brought something different and important to our company, and one 800-pound gorilla (Discovery Communications), who brought tremendous brand equity and a powerful ability to drive traffic to our site. At its core, the Discovery deal was driven by the decision to lower risk by selling ourselves to a massive strategic partner.

**Advertising**

Petstore.com’s newfound partnership gave it a formidable ally, bolstering its advertising potential and visibility. In November, the company launched a five month-long nationwide advertising campaign, costing an estimated $15 million. However, it was Pets.com’s campaign that garnered lasting, nationwide attention. Pets.com hired ad agency TBWA\Chiat\Day to handle its marketing campaign, estimated to be worth $20 million. The campaign prominently featured a sock puppet dog who was voiced by Michael Ian Black, a comedic actor. In television commercials, the dog spoke energetically to the camera and interacted with pets, usually before the ad concluded with the tagline, “Pets.com. Because pets can’t drive.”

The campaign included television commercials, but eventually grew to encompass a variety of media outlets. By November 1999, Pets.com had received 2,000 e-mails inquiring about the sock puppet. Additionally, the sock puppet became a sought-after media guest, doing “interviews” with publications such as Entertainment Weekly and appearing on several television programs, such as “Live with Regis and Kathy Lee,” “Good Morning America,” and even ABC’s late-night news show, “Nightline.” In winter 2000, the puppet rose to new heights of nationwide fame. The 73rd annual Macy’s day parade in New York City, which was watched by 50 million people around the country, featured a 36-foot tall float version of the sock puppet.

Pets.com bought advertising time during the Super Bowl in January 2000, prominently featuring the sock puppet in their first-ever national ad (The average 30-second ad at the Super Bowl that year had an estimated cost of over $2 million. Pets.com’s ad buy cost $1.2 million). Of 31 Super Bowl campaigns tested by an advertising surveying agency, Pets.com’s TV commercials were rated most liked and most effective. The puppet became so ubiquitous that Pets.com’s VP of marketing once proclaimed, “Our sock puppet is one of the reasons why we’re going to win the Internet space for pet supplies and accessories.”
Brand Extensions

Pets.com capitalized on ways to extend its brand to areas outside of e-commerce. The company launched a bi-monthly magazine in November 1999, *Pets.com: The Magazine*. The magazine included columns about pet products and articles about the pet-owning lifestyle. In April 2000, Pets.com announced that it would be launching its own branded line of pet products. The line of 19 SKUs included dog and cat food, and cat litter, and it was positioned as “super-premium” for discerning pet owners. The rationale behind the launch was to increase the company’s profit margins on sales.

Pets.com also founded a charity foundation called the Pets.commitment Fund in October 1999. Its purpose was to provide funding to organizations that focused on animal welfare and emphasized the importance of pets. In a press release describing the organization’s impetus, Wainwright said, “There are thousand of organizations that bring animals and pets together in special, life-changing ways. However, many of them are drastically under funded, making it difficult to fulfill their missions.”

The Road to IPO

The roller coaster took us all the way up to the clouds and then dropped everybody down into the depths of the ocean.

—Josh Newman, Nov. 2008

The online pet supply retailers employed costly tactics in their battle for market share, borne out of the belief that the market leader would benefit disproportionately. “There’s a laser-like focus on our category; prospective investors are watching to see whether anyone is pulling ahead of the pack or falling behind,” said Newman at the time. “In the current market, you could reasonably argue that every additional $1 of revenue this quarter might increase your market capitalization by $300 next quarter.” For its part, in December 1999, Petstore.com offered customers free shipping and a $15 discount on purchases $30 or more.

Petsmart.com CEO Tom McGovern specifically remembered one catalyzing incident dating back to August 1999. “This plane flew by dragging a banner that said, ‘50% off dog food, Pets.com.’ So we upped it: Buy one, get one free. Then Pets.com went to free shipping.” He added, “There was a suspension of reality . . . In the fourth quarter of ’99, we were shipping and selling at a loss.” Executives such as McGovern also felt pressure to respond to Pets.com’s marketing blitz. Petsmart.com spent $18 million on TV advertisements in fall 1999. “We spent lots of money talking to people who never would give us a sale in the next five years,” McGovern reflected.

For many online retailers during this period, such cutthroat tactics not only ate away at profit margins; they also had the potential to create operational difficulties. Companies whose executives focused intensely on Web traffic and customer acquisition sometimes found themselves unable to cope with growth, as technological infrastructures were ill-equipped to track inventory and orders. This resulted in poor fulfillment rates and customer dissatisfaction.

As competition grew more intense, each of the online pet retailers was under increasing pressure to go public, bringing in a fresh infusion of cash that would allow for more rapid expansion. A venture capitalist for Petstore.com explained, “We wanted to get to IPO in six to nine months.” Newman explained the investors’ perspective:

At that time there was this huge conventional wisdom that speed to market and first mover advantage would confer a lasting defensible competitive advantage through “first IPO.” An IPO is a branding event and that branding event wins. The real pressure that they were putting
on us was to have a grand slam. Their math is driven by supernova IPOs. It was either shoot the moon, or flame out.

**Filing**

In December 1999, Pets.com filed its preliminary prospectus for an IPO.65 The financial data revealed in the filing were sobering. Although the company reported $5.8 million in revenue, it had incurred $61.8 million worth of losses since inception, $42.4 million of which took place in the three months prior to December alone (See Exhibit 4 for selected financial data from Pets.com’s prospectus).66 According to the company’s prospectus, “We believe that we will continue to incur operating and net losses for at least the next four years, and possibly longer, and that the rate at which we will incur these losses will increase significantly from current levels.”67

Moreover, Pets.com’s brand visibility had not definitively translated into greater market share. According to one survey, in October 1999, Petsmart.com had 1.1 million unique visitors, followed by Petopia, which had 559,000, while Pets.com had 551,000 (Petstore.com had 303,000).68 Nonetheless, many competitor companies were not profitable either. While Petsmart.com had earned almost twice the revenue of Pets.com, it had incurred $47 million in losses in the process.69 Given its financial state, its plans for future expansion, and the competitive environment, Pets.com was dependent upon outside funding for survival.

When Pets.com went public on February 11, 2000, its share price opened at $13.50, above its initial $11 offering price, and rose as high as $14 before falling back to $11.70 By all measures, it had been a tepid performance. Yet despite its stock price, coverage on Pets.com remained relatively upbeat. In March, investment banks Bear Stearns and Warburg Dillon Read both initiated coverage on Pets.com, rating it as an attractive investment. Others were not so optimistic; discussing his own company’s prospects, Newman recalled that, beginning in fall 1999:

Our objective had moved from winning to trying to eke out a save. And then when Julie went public and was having trouble raising a secondary offering — in late 1999 and early 2000 – there was a feeling that the whole space was running into problems. And then, of course, there was the market crash in March 2000, and that was the end for everyone.

**The Dot-Com Crash**

Between early 1998 and early 2000, the internet sector was equivalent to 6% of the market capitalization of all U.S. public companies and the sector as a whole earned in excess of 1,000% returns on public equity.71 This concentration of new high technology companies in the market index made the dot-com crash even more exceptional. Between the high point in March 2000 and the low point in October 2002 $4.4 trillion dollars of market value disappeared.72 Beyond the companies that did reach an IPO, during the late 1990s it is estimated that 7,000-10,000 new dot-com companies were established and operating from online web sites, with the vast majority of these companies faltering in the environment of the dot-com crash and its immediate aftermath.73 According to one estimate at least 3,892 dot-coms were sold and 962 closed or declared bankruptcy between mid-2000 and mid-2003.74

Pets.com had been caught up in a speculative mania that witnessed a wave of optimism as new technology startups attempted to accelerate the pace of innovation and race for market leadership. While the nascent internet industry was far from being profitable, expectations of a new technological revolution in information and communications that would raise the valuation of all companies drove
equity prices upwards (Refer to Exhibit 1). Few internet companies, however, created business models that were sustainable over the long run (See Exhibit 5 for an example of media coverage relating to these events).

**Winding Down**

Pets.com’s stock price steadily declined through 2000; as early as February, its price had dropped to the $6 range. However, despite the worsening economic climate, the company continued to operate through the summer. By June 2000, the price was hovering around $2 (See Exhibit 6 for Pets.com’s price per share over time). That month, Discovery Communications announced that it would be closing a deal to divest Petstore.com and that Pets.com would be its new owner. As part of the deal, Pets.com would issue $13.7 million in stock. Pets.com would also receive $3 million in cash from Discovery Communications and other investors. “We actually think there will end up being one (online pet site) and it’s going to be us,” Wainwright declared at the time. Newman commented:

> Discovery Communications was planning on a huge initiative to launch a major online portal, based on their four media properties (Animal Planet, Discovery Channel, the History Channel and The Travel Channel). Each would have an e-commerce play associated with it. It probably was a $200 million initiative of theirs. They were planning on spinning it out and doing a public offering. It was very ambitious and it was exciting to be part of it. But their crystal ball was telling them that the internet bubble was getting ready to burst, so they backed off of their strategic portal initiative.

At the time, Pets.com was perceived to be the leader. The perception was that Amazon was king and the player that was affiliated with Amazon was the winner, so it was pretty straightforward in the math of the moment to think that getting shares of Pets.com was a good bet. And so it was an easy strategic decision for Discovery to try to divest Petstore.com to Pets.com.

Despite its potential benefits, the transaction ended up being a difficult one for Petstore.com. The worsening economic climate and the vagaries of the acquisition process took their toll on Newman and his company. He recalled:

> The transaction occurred in the middle of the meltdown. We struck a term sheet in early 2000, when Pets.com was trading at around $11. They had taken the company public. We signed the final papers when Pets.com was trading at something like $7. When you sign the final transaction papers, there are some conditions to close, so the deal didn’t close right away. It closed several weeks later, and they were trading at $2. We struck the deal when they were at $11 and everybody was thinking that it was going up to $40. Then we ended up closing the deal at $2 when it was on its way down to $0.30 or $0.20. So, that was a pretty tough transaction.

On November 7, 2000, Pets.com announced that it would be shuttering its operations, laying off 255 of its 320 employees, and liquidating its assets. That day, the company’s stock closed at $.22 per share. Pets.com sold its domain name, www.pets.com, to competitor PetsMART in December 2000. In January 2001, the company’s shareholders approved its formal liquidation plan. In a final act of kindness, Pets.com donated 21 tons of dog food to mushers in Alaska, who faced a severe shortfall of the commodity in winter 2000.
Exhibit 1  The 2000 stock market crash in historical context

## Exhibit 2  List of selected dot-com failures

<table>
<thead>
<tr>
<th>Company</th>
<th>Segment</th>
<th>Founded</th>
<th>IPO</th>
<th>Raised at IPO</th>
<th>Closed</th>
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<tr>
<td>Kozmo.com</td>
<td>Generic online store and delivery (e.g., movies, snack food etc.)</td>
<td>Mar. 1998</td>
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<td>-</td>
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<td>Did not</td>
<td>-</td>
<td>Aug. 2001</td>
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<td>Online toys store</td>
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<td>May. 1999</td>
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<td>Mar. 2001</td>
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<td>Did not</td>
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<td>Did not</td>
<td>-</td>
<td>Jan. 2001</td>
</tr>
</tbody>
</table>

Exhibit 3  Frequency of Internet IPOs from 1996 to 2008

### Exhibit 4  Pets.com Statement of Operations (in Thousands)

<table>
<thead>
<tr>
<th></th>
<th>Quarter ended 6/30/1999</th>
<th>Quarter ended 9/30/1999</th>
<th>Quarter ended 12/31/1999</th>
<th>Period from 2/17/1999 (inception) to 12/31/1999</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$39</td>
<td>$568</td>
<td>$5,168</td>
<td>$5,787</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>76</td>
<td>1,766</td>
<td>11,570</td>
<td>13,412</td>
</tr>
<tr>
<td>Gross margin</td>
<td>$(37)</td>
<td>$(1,198)</td>
<td>$(6,402)</td>
<td>$(7,625)</td>
</tr>
<tr>
<td>Operating expenses:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Marketing and sales</td>
<td>$1,122</td>
<td>$10,693</td>
<td>$30,676</td>
<td>$42,491</td>
</tr>
<tr>
<td>Product development</td>
<td>1,624</td>
<td>2,194</td>
<td>2,646</td>
<td>6,481</td>
</tr>
<tr>
<td>General and administrative</td>
<td>838</td>
<td>1,205</td>
<td>2,211</td>
<td>4,254</td>
</tr>
<tr>
<td>Amortization of stock-based compensation</td>
<td>--</td>
<td>1,139</td>
<td>979</td>
<td>2,118</td>
</tr>
<tr>
<td>Total operating expenses</td>
<td>$3,584</td>
<td>$15,231</td>
<td>$36,512</td>
<td>$55,344</td>
</tr>
<tr>
<td>Operating loss</td>
<td>(3,621)</td>
<td>(16,529)</td>
<td>(42,914)</td>
<td>(62,969)</td>
</tr>
<tr>
<td>Interest income, net</td>
<td>123</td>
<td>577</td>
<td>491</td>
<td>1,191</td>
</tr>
<tr>
<td>Net loss</td>
<td>$(3,498)</td>
<td>$(15,852)</td>
<td>$(42,423)</td>
<td>$(61,778)</td>
</tr>
</tbody>
</table>

Exhibit 5   Excerpt from “Burning Up,” a March 2000 Barron’s article by Jack Willoughby

When will the Internet Bubble burst? For scores of `Net upstarts, that unpleasant popping sound is likely to be heard before the end of this year. Starved for cash, many of these companies will try to raise fresh funds by issuing more stock or bonds. But a lot of them won’t succeed. As a result, they will be forced to sell out to stronger rivals or go out of business altogether. Already, many cash-strapped Internet firms are scrambling to find financing.

An exclusive study conducted for Barron’s by the Internet stock evaluation firm Pegasus Research International indicates that at least 51 `Net firms will burn through their cash within the next 12 months. This amounts to a quarter of the 207 companies included in our study. Among the outfits likely to run out of funds soon are CDNow, Secure Computing, drkoop.com, Medscape, Infonautics, Intraware and Peapod.

The ramifications are far-reaching. To begin with, America’s 371 publicly traded Internet companies have grown to the point that they are collectively valued at $1.3 trillion, which amounts to about 8% of the entire U.S. stock market. Any financial problems at these Internet firms would affect the myriad companies that supply them with equipment, including such giants as Cisco Systems and Intel. Another consideration is that a collapse in highflying Internet stocks could have a depressing effect on the overall market and on consumer confidence, too. This, in turn, could make Americans feel less wealthy and cause them to spend less money on everything from cars to clothing to houses.

It’s no secret that most Internet companies continue to be money-burners. Of the companies in the Pegasus survey, 74% had negative cash flows. For many, there seems to be little realistic hope of profits in the near term. And it’s not just the small fry who are running out of cash. Perhaps one of the best-known companies on our list, Amazon.com, showed up with only 10 months’ worth of cash left in the till.

“That’s the problem with these IPO run-ups. They introduce so much hype and emotion, when what’s really needed is stability,” says William Hambrecht, founder of Hambrecht & Quist, owner of W.R. Hambrecht, a pioneer in offering IPOs to investors via the Internet. “A volatile price on a new stock kills your ability to finance in the future. It’s very destructive.”

The evidence shows the race for the exits is especially pronounced among Internet companies. So far this year, in two-thirds of the secondary stock offerings by Internet companies, 25% or more of the shares were sold by insiders, according to CommScan. In non-Internet deals, only about one-quarter of the deals involved insider selling of 25% or more.

The Internet investing game has been kept alive in large part by a massive flow of money out of Old Economy stocks and into New Economy stocks. Last week’s steep slide in the Nasdaq and the sharp recovery of the Dow Jones Industrial Average may mark a reversal of this trend. As illustrated last week, once psychology changes, cash-poor Internet issues tend to fall farthest, fastest.

Exhibit 6  Pets.com’s price per share over time

Source: Compiled from Chicago Research Center in Securities Prices, accessed November 2008.
Endnotes


