Failures in B2C Companies: Two Examples and Lessons for New Players

Sian Owen

ISSN: 1036-7373
Failures in B2C Companies; Two Examples and Lessons for New Players

Sian Owen
School of Finance and Economics,
University of Technology, Sydney,
PO Box 123, Broadway,
Ultimo,
NSW 2007
Australia

E-mail: Sian.Owen@uts.edu.au
Tel : +61 2 9514 7776
Fax: +61 2 9514 7711

November 2001
Failures in B2C Companies; Two Examples and Lessons for New Players

Abstract

This paper considers the path from formation to failure of two Internet start-up companies in the context of the work of numerous academic researchers in the field of corporate financial distress and bankruptcy.

In the 1990s, several authors found evidence that small, young companies are particularly prone to failure, especially if they are in a high technology field. These authors commonly found failing companies experienced problems with management, profits, cash flow and liquidity. Two decades earlier, Argenti (1976) had set out a typical path from birth to failure of a dynamic company that behaved in a manner reminiscent of many Internet firms. Argenti’s work highlighted the importance of both injections of capital and withholding of capital in the life cycle of many companies.

This paper’s comparison of two business-to consumer (B2C) Internet start-ups with the model derived from academic research suggests some Internet start-ups of this sort may be inherently predisposed to failure. A crucial factor would appear to be that these firms have elected to retail goods that are simply unsuited to being sold via the Internet. This means that revenues are always going to be small and this problem is exacerbated by the fact that Internet start-ups have excessive expenditure in the development phase followed by fairly limited options for funding when under pressure, having no recourse to debt financing or liquidation of assets. Combine these factors and it is clear to see that the probability of failure is very high.

Keywords: Internet start-ups, financial distress, bankruptcy

JEL Classification: G33, L21, L86
Introduction

The analysis of company failure and financial distress is the subject of a large body of research going back to the 1930’s. More recently interest in the subject was revitalised after the work of Beaver (1966) and Altman (1968). In the 1990s, several authors (Mahmood, 1992; Dunne and Hughes, 1994; Audretch and Mahmood, 1995; and Brunderl and Mahmood, 1996) provided evidence that small and young companies were more likely to fail than larger or older firms. Furthermore, Mahmood (1992) and Audretch and Mahmood (1995) found that companies that are exposed to a high level of technology are more likely to fail than those firms that do not have the same level of exposure. These works made interesting sequels to the work of Argenti (1976), which had characterised the path from birth to failure of three types of firms, one of which was a ‘dynamic company’, a classification of business neatly fitting present day Internet start-ups.

The documented path to failure of two recent Internet start-ups, Boo.com and ValueAmerica.com, provides an opportunity to compare their experience with the model established by Argenti and the work of Audretch and Mahmood and other researchers.

The Life Cycle of Companies

Conventional theory says that most companies follow the pattern of growth illustrated in Figure 1 from the time of their conception to maturity. This sigmoid (S-shaped) curve demonstrates the steady expansion of a company as it gains financial strength and maturity. During the company’s early life it is possible for it to grow at a very rapid rate, but this rapid growth is difficult to maintain as the firm ages and increases in size. As Penrose explained, this is because each new investment must contribute an ever-increasing amount to the firm and, eventually, it becomes impossible to find investments that contribute sufficiently to the firm to maintain this growth rate. When this happens the growth curve flattens out and the firm faces two possible options for the future. Either the company is able to find some way to re-vitalise itself, in which case the growth rate will increase again, or the firm will become more sedentary and this may be the start of a decline to financial distress and, ultimately, failure.

The probability of failure is at its highest in the early stages of the firm’s life and many companies will fail during the first few years. Figures quoted by Altman (1993) demonstrate that approximately 50% of companies fail within five years of their creation and this figure increases to around 75% by the time the firms are ten years old. Young companies are more vulnerable than older ones as they do not have an established market and often have problems controlling their cash flows.
Most authors found that the company’s management were the primary cause of financial distress and, eventually, failure. According to Altman (1993), managerial incompetence, or simply lack of experience, is the cause of the majority of company failures. Similarly, Doumpus and Zopounidis (1999) found that company failure was linked to inappropriate management, managerial inexperience and the inability of the company to respond to changing competitive conditions. A comparable result appears in Whitaker (1999), who considered two forms of distress. The first was economic distress, which companies cannot avoid, as it is caused by a decrease in the performance of the industry as a whole and can only be rectified if the entire industry is revitalised. The second form of distress is financial distress, which is specific to a single firm rather than an entire industry and here, Whitaker concurred, that it is usually caused by managerial inability.

The Characteristics of Companies Vulnerable to Failure

In many existing academic papers, the characteristics of companies that are vulnerable to failure have been investigated. There are several characteristics that appear repeatedly in these articles as good predictors of financial distress. Many companies that become financially distressed are found to be under-performing relative to the other companies in their industry. The first such characteristic is below average profits (Altman, 1993; Doupos and Zopounidis, 1999; Zwaig and Pickett, 2001). Falling profits have an obvious link with both financial distress and bankruptcy as the firm finds that it is not generating enough money to meet its obligations as they fall due. This leads to problems with liquidity, which is another often-mentioned characteristic of companies in financial difficulty. Poor liquidity may become apparent through changes in working capital levels as firms find that they have
insufficient funds to manage their day-to-day operations (Altman, 1993; John, 1993; Zwaig and Pickett, 2001). At this stage the vulnerable company is often seen selling some of its fixed assets in an attempt to improve liquidity, as was observed by Chen, Weston and Altman (1995).

Another feature that seems to be closely linked to liquidity problems is the fact that companies in financial distress often have higher leverage than companies that are financially secure. This was observed by authors such as Altman (1993), Hill, Perry and Andes (1996) and Zwaig and Pickett (2001). In these papers, this characteristic was linked to the declining financial health of the company as it is forced to rely more and more on debt due, perhaps, to a fall in its share price as the market responds to its poor financial performance or to the company’s inability to repay its existing debts.

There are some other factors not directly related to financial characteristics that can be used to identify companies that are in financial difficulties. Zwaig and Pickett (2001) observed that there are often significant changes in the Board of Directors shortly before the firm fails. Furthermore, bankrupt companies have often exhibited high levels of employee turnover prior to failure, a feature that was also commented upon by both Whitaker (1999) and Zwaig and Pickett (2001). Reducing staff numbers is an obvious reaction for a company in financial difficulties as it is an effective cost cutting measure that can be implemented fairly quickly.

The Argenti Model for “Dynamic” Companies

Argenti (1976) described the path from birth to failure for three different types of firms. One of these was a “dynamic company” which is typified by very rapid growth in the early stages of the firm’s life and then an equally rapid decline to failure. Argenti argued that the entire life span of such a firm would be no more than ten years from the concept stage until its liquidation. He represented the life cycle of this type of firm in the diagram reproduced as Figure 2.

Figure 2. Dynamic Companies, Argenti (1976)

Source: Argenti (1976), Page 157.
In this scenario, the company is formed by a small group of people with just a few employees. Argenti noted that the founders of this type of company are usually highly confident, extrovert individuals and are more likely to have a background in sales or marketing rather than in a technical discipline. The funds needed to establish the company will be provided by the founders, possibly with the assistance of a small number of investors.

Soon after the company begins trading, it experiences a rapid take-off as sales expand very quickly, point 3 in Figure 2. The rapid growth necessitates that more capital be injected into the firm. Argenti observed that companies often find it very easy to raise finance at this stage in their development as financiers become aware of the company’s apparently impressive performance, point 5 in Figure 2.

From this point, the company continues its rapid growth as both sales and profits increase and new sources of capital continually become available. Soon the press notice the company and the pressure to succeed grows, as the public now expect that it will continue its rapid rise, point 9 in Figure 2.

Argenti pointed out that in any other type of company a professional management would be introduced by the time the firm reaches point 10 but, owing to the personality of the founder(s) of the ‘dynamic company’, it is highly unlikely that control would be voluntarily relinquished. The company is now also at the point where it may go public, although this will not always happen. In Argenti’s scenario, the company may begin to run into trouble at this point as its profits have ceased to grow at the same rapid pace as before. At the same time, the company may begin to act in an unpredictable manner as the directors strive desperately to continue their upward path to meet the expectations of their investors.

The dynamic company is now at the apex of its growth and its situation is precarious. All it takes is one negative event to start its decline to failure. This event will be unique in each case; it could be as little as the failure of a new product to meet expectations or a poor set of financial figures. This event occurs at point 15 and the company’s rapid growth is quickly replaced with an equally steep decline. The company’s financial backers soon realise that there is a problem and refuse to advance more funds. The decline becomes more and more steep as other people realise that the firm is in trouble and look for alternative investments. It is now inevitable that the company will fail and it is just a matter of time before the receivers are called in, point 18 in Figure 2.

Argenti based his work on observations taken on companies that failed in the 1970’s. The description of a dynamic company is, however, reminiscent of an Internet start-up in many regards. The rapid growth followed by the equally rapid decline was experienced by both of the companies featured in the next section and many other Internet companies exhibited similar patterns of behaviour.
**Boo.com and ValueAmerica.com**

Boo.com and ValueAmerica.com were both created specifically to retail goods directly to consumers via the Internet, so-called business-to-consumer (B2C) companies. Both firms were supported with large sums of money from investors, and both failed within a very few years of their creation. The experiences of these firms were typical of many Internet companies that were created during the initial explosion of interest in Internet firms.

In September 1998, Boo.com (Boo) was formed in the UK with just seven staff. The three founders, Kajsa Leander, Ernst Malmsten and Patrik Hedelin, devised a plan to sell designer sports and leisurewear directly to customers via the Boo website. The venture was backed by a small group of investors, including some major business names and two merchant banks. In total, this small group of backers provided about £125 million in start-up funds for the company. From its beginnings in September 1998 to its liquidation in May 2000, Boo managed to spend all of its seed capital. The firm was unable to attract customers in large numbers, nor was it able to generate a sufficient level of repeat custom from the small number of clients that did use its services. There were several reasons for these problems but most of them lay with the fact that few people are happy to buy clothes without first trying them on, which represented a fundamental problem for Boo. This difficulty was exacerbated by the fact that the web site could be slow to respond and rather difficult to use. This combination of factors meant that the costs of running the company always exceeded the sales revenues and, in liquidation, the receivers were only able to generate funds in the region of £650,000 through the sales of the company’s brand name and part of the computer system. The investors who had funded Boo throughout its short life were unable to recover more than a small proportion of their total investment and the rest of their funds were lost.

ValueAmerica.com (VA) was created in the United States by entrepreneur Craig Winn as a B2C company that would offer customers the chance to buy everything from caviar to computers. The idea was not, however, to buy from VA directly but to use the firm as a conduit between the consumer and the manufacturer. This meant that VA would carry no inventory and the firm would be, effectively, “free” of overheads. Winn wanted to produce “frictionless” commerce in which there would be no need for a conventional middleman, as the web site would provide a way for the consumers to deal directly with the manufacturers.

Winn and his co-founder Rex Scatena each provided $150,000 for the start-up and launch of VA in July 1996. In December of 1997, the Union Labor Life Insurance Company invested $10 million and also provided VA with an introduction to other new investors. During 1988, these investors contributed $7 million to the firm, regardless of the fact that it was having problems making money. Despite an accumulated deficit of $65.4 million at the end of 1988, the company was able to attract yet more funds in the following months and, in April 1999, floated on the NASDAQ. At that time, Internet stocks were very popular and the sale was a triumph. The initial public offering (IPO) sold 5.5 million shares at $23 each, raising $126.5 million before floatation expenses. The IPO was a great success and the share
price rose rapidly throughout the first day of trading giving the company a market capitalisation of $3.2 billion when the market closed.

As was the case with Boo, VA was simply unable to make sufficient revenues to exceed its costs and the company could not retain customer loyalty, so there were few repeat purchases. The main problem was, again, with the company’s business plan, which relied upon the manufacturers to supply items to the customers whilst VA itself simply passed on the orders and kept a premium for its services. Unfortunately, many of the manufacturers simply did not have the ability to ship items in small numbers to individual purchasers. This meant that there were mistakes with orders and long delays between orders being made and the delivery of the goods. Few customers made repeat purchases, making it difficult for the company to establish a stable client base.

Just over a year after the stock market floatation, in August 2000, ValueAmerica.com filed for Chapter 11 bankruptcy. Under American law, this arrangement allows the directors to seek protection from the company’s creditors, whilst simultaneously trying to revive the firm's fortunes. Companies in Chapter 11 are allowed to continue trading in the hope that they can solve their problems and become profitable as this is deemed to be better for the economy as a whole than the liquidation of the firm. VA, however, was unable to recover and was sold to Merisel, a company specialising in distributing technology products, for just $2.4 million in November 2000.

Comparing the Characteristics of Boo and VA with Academic Models of Corporate Distress

Profitability

The two companies featured here were both incapable of achieving a level of sales that would make them profitable. One reason for this was that neither company could retain customers. It is always difficult for B2C firms to retain customers as on-line shopping has no geographical constraints, as there are with traditional shopping outlets, nor does a web site generate an emotional response as a familiar and well-known shop might. As both Nemzow (1999) and Wiegran and Koth (1999) observed, long-term customer retention, sometimes called “web site stickiness”, is hard to develop. According to the research reported in these papers, once a web site has attracted a customer it must work hard to maintain that individual’s loyalty. Since there is very little to prevent a customer using another web site in future, a B2C site must be pro-active in maintaining its customer base. This is a far bigger problem for web sites than it is for traditional shopping venues since the Internet removes geographical constraints from its users. The authors recommend that a web site should offer clear information, a quick response, interesting products and, if possible, financial incentives if it is to retain customers. If this is not possible, then the company will have problems establishing a secure share of the market.

In the case of Boo there were two distinct reasons for its failure to secure and retain customers. Firstly, when the company began trading, the web site was complicated to use and incompatible with the computers of many would-be purchasers. When a prospective purchaser started looking at clothes, the Boo web site spawned five new
pop-up windows. The first of these contained the entire range of clothes under examination, the second held a detailed image of the specific item that the shopper was looking at, which could be rotated and examined from all angles, and the third window contained a graphical mannequin “modelling” the item in question. The fourth window held the user’s “Boo Bag”, which was the site’s term for a shopping basket and, finally, in the fifth window was Miss Boo, the website’s animated guide and on-line shopping assistant. This level of complexity meant that the web site was originally intended for people to use with a 56K modem and a high bandwidth Internet connection. Unfortunately, such a high-speed link is rare in recreational computers. Figures quoted by Ward (2000) suggest that only one percent of European home computers and just two percent of American home computers have equipment of this standard. For everybody else, the Boo site was very slow to respond and the graphics were difficult to see. According to a recent survey conducted by Mori (2000) for the National Consumer Council in the UK, the speed and ease with which transactions are completed are major attractions when shopping on the Internet. In these respects, Boo failed to meet customer’s requirements and could not generate repeat custom.

The second problem with the Boo web site was that it was very complicated to navigate through, which meant that it was very difficult to make comparisons between the different brands that were stocked. According to Mori (2000) the ability to find product information and to compare prices is a very attractive feature for Internet shoppers. Once again, Boo failed to meet people’s expectations concerning the characteristics of a good B2C site and the company suffered from very low rates of customer retention.

ValueAmerica.com suffered similar problems with customer retention, but with slightly different reasons. When the company began trading, a major advertising campaign was used to publicize the web site, which featured more than 1000 brand names. The campaign generated a lot of interest in VA and large numbers of potential customers attempted to make purchases. However, the firm’s computer system proved to be incapable of handling such a high volume of Internet traffic and there were problems with frequent crashes. As a result, a high number of orders were not filled. A second difficulty arose when orders were filled incorrectly. This problem stemmed from the fact that many of the manufacturers that were involved with VA are not capable of shipping a small number of items direct to the public and do not have the appropriate facilities. Their logistics are designed to ship large numbers of items to retail outlets, which then distribute the products to the public. The incompatibility between the customer’s requirements and the manufacturer’s capabilities meant there were problems with incomplete orders, incorrect orders and long time delays before consumers received their goods. There was no obvious solution to this problem, as it was not cost effective for the manufacturers to alter their distribution systems simply to satisfy the requirements of a relatively small number of customers. This made many customers unwilling to attempt repeat purchases from the site, so VA was unable to develop a stable customer base. According to both Nemzow (1999) and Wiegman and Koth (1999), Internet retailers should concentrate on developing fast and effective web sites that offer good value for money. Whilst VA may have offered good value for money, particularly after their introduction of ValueDollars (a discount voucher system which sometimes enabled customers to
purchase goods at prices below cost), the slow delivery of goods and problems with incomplete orders meant few customers returned to the site.

Liquidity and Cash Flow

Many Internet companies have problems controlling the rate at which they spend their available funds, sometimes called their “cash burn” rate. Boo and VA both suffered from this problem throughout their lives. These companies spent very large amounts setting up their systems and, funded generously by individual investors, they were able to pay for massive advertising campaigns before they began trading to publicise their web sites. Once trading began, however, both firms became notorious for lavish spending on unnecessary items.

Boo had set out to create a state-of-the-art on-line retail service. The costs of developing the front end of the Boo system are unknown, but approximately £35 million was spent on the back-end of the system, which translated the clicks on the web site to sales and distribution. Here Boo succeeded in creating a first class system, which could price goods in the purchaser’s domestic currency. The company could either set specific prices for each country or set one price for an item and then translate that price into another currency using a set exchange rate whenever an order was made. This enabled the consumer to avoid any exchange rate risk by fixing the price in their domestic currency at the time of purchase.

The construction of these highly sophisticated systems took longer than originally planned and the launch of the web site had to be delayed by six months until November 1999. By this time, the company had grown to have approximately 400 employees. When the web site was finally launched and trading began, the company simultaneously opened offices in London, Munich, New York, Paris and Stockholm. Boo started trading in eighteen different countries and information from the web site could be assessed in seven different languages. Initially, the web site was incompatible with Macintosh computers, but this oversight was resolved fairly quickly.

The company continued spending money at a great rate and the directors seemed to be unable to control their cash burn. At one point, the firm was reputed to be spending US$1 million each week flying the managers and their assistants first class from office to office. Similarly, in 1999, VA made a down payment on the purchase of a corporate jet and hired two pilots, which was an unnecessary expense for the company. In the same year, VA also started proceedings to purchase 34.4 acres of land, at a cost of $5 million, which was intended for the firm’s new corporate headquarters. The purchase was re-appraised before the deal was finalised and the land was valued at less than $2 million. Realising that this was not a good buy, VA cancelled the contract but still had to pay $400,000 to compensate the vendor.

This sort of cash burn would have been high, but not particularly problematic if either Boo or VA had been making money. However, since neither firm was in the black, this simply represented unnecessary expenditure and placed further strain on the companies’ finances. Argenti (1976) said that management defects, such as a lack of understanding of business practises and the importance accurate record systems, are both symptoms and catalysts of failure for dynamic companies. The problems
experienced by both Boo and VA with respect to their cash burn are typical of these sorts of managerial shortcomings.

**Funding Options**

Many Internet start-ups are financed through venture capital when they are first formed. Owing to the high level of enthusiasm that existed for Internet companies a few years ago, venture capitalists were happy to provide very large sums to firms like Boo and VA. Naturally, these investors expected to get a good return on their money and many of them would have wanted an equity stake in the firm, in the event that it floated, as well. The problem was that venture capital, whilst generously provided to many Internet companies, is not a limitless source of funds and, eventually, investors can become disillusioned and withdraw their support if the company is not performing to their satisfaction. In the case of many Internet companies, this can leave them bereft of any alternative sources of funding, as was discussed in Owen (2001).

It is in the nature of Internet companies to have high start-up costs as a result of the need to purchase hardware and hire technical staff long before the firm can begin trading. Once the company is trading, however, the overheads should be relatively low. One major saving is that the company does not have to maintain a physical presence, such as a shop, in order to conduct its business although some warehousing facilities may be required. Nevertheless, the company’s cash flows must be controlled very carefully once it begins trading or it will soon reach the end of the available venture capital funding before it is capable of making money on its own. If this happens, the firm will have to either look for other means of raising funds on its own, or be forced into bankruptcy.

Since most Internet start-ups have little by way of tangible assets, funds cannot be raised through the sale of assets, nor can assets be used to provide security for debt financing. As a consequence, Internet companies find their financing options are limited to further venture capital or becoming a public company. The latter course is a very expensive way of raising finance and a highly risky one, as it forces the company to list on a Stock Exchange at a time when it is still trying to develop a secure market share. Once floated, the company must satisfy the expectations of the investors with respect to capital gains and dividends as well as meeting the requirements of the Exchange in order to maintain its listing. Many young firms are not capable of meeting these demands and so the investors will, eventually, become disillusioned and sell their stock. If a large number of investors sell their shares at the same time, then the supply of stock will exceed the demand and the price will fall. This may be exacerbated by herd behaviour amongst investors which can result in panic selling, as was discussed in Owen (2001). If the share price falls by a considerable amount then this will eliminate equity issues as a potential source of finance.

As the recent crash in Internet share prices has demonstrated, many investors have lost faith in Internet start-ups because of their inability to generate substantial and sustainable profits. If these companies cannot maintain elevated share prices to encourage further investment, and they have exhausted their supply of venture capital, they have no other viable sources of funding. Once a company finds itself in this position, the probability of failure is very high.
In early 2000, the directors of Boo appeared to realise that they were running out of funds and the company launched an enormous, but ultimately fruitless, promotional campaign. In May 2000 the company was forced to ask its backers to invest another £20 million, having already spent in excess of £100 million in less than two years. Unfortunately, the company’s backers had lost faith in Boo by this time and they refused to provide another injection of funding. Without the continued support of these investors, the company had insufficient funds to continue operating and, on May 18 2000, after just six months of trading, Boo.com went into liquidation.

Throughout its entire life, Boo relied on the generosity of this small group of speculative investors and, when these individuals withdrew their support, the company had nothing to fall back on. Boo had insufficient revenue to sustain itself without help and it had no other options for income. The firm had no income with which it could repay a loan and few assets that could be offered as security or for sale. Boo had purchased some tangible assets during its life, such as computers and servers, but the main assets of the firm were the intellectual capacity of the programmers that it employed, coupled with a fairly well-known brand name and these items cannot be used to provide security for debts. Many Internet start-ups might have considered floating on one of the many speculative Stock Exchanges that exist, but Boo was in such extreme financial difficulties that it failed as soon as the backers refused to invest further funds and there was not sufficient time to consider this option.

VA was in a similar situation to Boo, although VA did survive long enough to float on the NASDAQ. Nevertheless, in the first part of the company’s life, it also raised all its funds from a group of speculative investors and, for the same reasons as Boo, could not use debt as an alternative source of finance. VA elected to float on the NASDAQ at a time when Internet IPO's were very popular and this gave the company a large financial boost, although this was not enough to solve the company’s financial problems. The flotation took place when the firm was still at a very high-risk time of its life and the enthusiasm of the shareholders elevated the share price to a value far in excess of the company’s fundamentals. VA was not generating enough money to get into the black and it was only a matter of time before the shareholders realised that the firm was not financially secure. Once this happened, the investors lost confidence and the share price began to slip inexorably down. First the price fell to $6, well below the $23 initial offer price, and later it slipped lower again, to just $2 per share. At this point, the firm could not consider issuing new shares as a source of funding as there was insufficient demand for the stock and any new issue would be substantially under-subscribed. The Board of Directors briefly discussed a buyout with another firm, Cedant, but talks foundered when the Board could not agree whether to proceed or not. The company was in obvious financial distress and, when the initial backers refused to advance more money, VA had no alternative but to take refuge in Chapter 11 bankruptcy.

Changes in Board, Management and Employees

According to Zwaig and Pickett (2001) significant changes in the composition of the Board of Directors can be an indicator that a company is in financial distress. Boo did not conform to this supposition, however, and there was very few managerial changes, although one of the founders did leave early in the firm’s life. In the case of
VA, however, there were some substantial changes in the Board of Directors in the last few months before the company went into Chapter 11. Craig Winn, the company’s founder, stepped aside as CEO just before the company floated, but retained the position of Chairman. A new Chief Executive Officer was appointed but resigned in November 1999, complaining that Winn interfered too much. The Board of Directors then said that they had lost confidence in Winn and he was forced to resign as Chairman, although he maintained a seat on the Board until both he and his co-founder, Rex Scatena, resigned in protest at the company’s restructuring plans. This sequence of changes in the Board of Directors is illustrative of the sort of alterations that Zwaig and Pickett (2001) were referring to, as the Board of Directors of VA attempted to find a solution to the company’s problems.

Boo and VA both significantly reduced staff in the last few months before they failed. In March 2000, Boo reduced staff at its London head office and at several other locations worldwide and, at the same time, re-launched its redesigned and more streamlined web site. In a similar move, VA undertook some major re-structuring a few months before it failed and nearly half of its employees were fired as the Board of Directors attempted to salvage the company and cut overheads. This sort of behaviour corresponds to the actions observed by Whitaker (1999), who commented on the high level of employee turnover just prior to bankruptcy.

Other Factors

In February 2000, VA’s problems escalated when a group of dissatisfied shareholders launched a class action suit against the firm and some of its directors. These shareholders claimed that they had been misinformed about the company’s true operating condition and financial status. Matters became worse again in the following month when VA filed its annual report with the American Securities and Exchange Commission (SEC). In this report, VA was forced to reveal that it was under investigation by the Federal Trade Commission (FTC). VA was accused of using misleading advertising in its sales of computers, and also for failing to comply with the rules covering the retailing of goods via mail order and telephone sales. Ultimately, the company managed to come to an agreement with the FTC on these matters and, thus, avoided being fined by the regulator but these events damaged the firm’s public image and reduced sales even further.

Comparing the Characteristics of Boo and VA with the Argenti Model

Comparing Argenti’s (1976) observations for dynamic companies with Boo and VA, it is possible to see several parallels between his dynamic companies and these Internet firms. Boo expanded rapidly during the early part of its life, opening offices in five separate locations and recruiting nearly 400 new staff members. Despite this rapid expansion, control was never passed on to a professional management team and, when things started to go wrong, the company’s decline was even more dramatic than its initial growth. Boo did not follow Argenti’s model entirely, however, as it did not rapidly generate profits. However, following this theory, the company did begin to react in a desperate way to its lack of profits in March and April 2000. The event that triggered the downturn in Boo’s fortunes was the realisation that the company had almost exhausted its start-up funds and still showed no sign of making a profit. In an
ill-advised attempt to generate further sales the company launched another expensive advertising campaign and issued thousands of discount vouchers. This did nothing to help generate sales, but it was yet another expense that Boo could not afford. Inevitably, the financiers became disillusioned and refused to continue funding the company. Without their support Boo was unable to survive and the receivers were called in almost immediately. The firm’s demise was so rapid that it did not have the opportunity to consider a Stock Market listing. In total, Boo’s entire life cycle lasted little more than eighteen months from the company’s formation to its ultimate demise, which is a far shorter time period than Argenti expected, but in many other respects this firm acted almost exactly as he had predicted that a dynamic company would behave.

VA followed the pattern laid down by Argenti for a dynamic company even more closely. The firm was created with seed money provided by just two individuals, which echoed Argenti’s belief that dynamic firms are started by very small numbers of people. It demonstrated a phenomenally high growth rate in terms of numbers of staff, web-site activity and public recognition during the first part of its life. As predicted in Argenti’s research, VA readily attracted large quantities of outside investment, as the company became a reasonably well-known brand name. Argenti believed that once the company had reached this point, it was time to consider involving a professional management team and the possibility of taking the company public. VA went someway towards this goal and many of the Board members had considerable experience in successful companies. However, one of the complaints levelled at VA’s founder, Craig Winn, was that he did not relinquish control to professional managers, despite the fact he had agreed to do so when the firm was floated. This reluctance to hand over control is akin to Argenti’s description of the founder of a dynamic company as someone with ‘almost pathological’ ambition (Argenti, 1976, page 158).

As with Boo, VA began taking desperate measures once it’s fortunes changed. The factors that triggered the company’s decline included a slump in the share price, the class action suit launched against the firm by some of its shareholders and the FTC investigation. VA responded by restructuring itself significantly and the company eliminated all but a few product lines after analysis of the company’s sales revealed that a very small number of products were generating almost 95% of the firm’s sales. At the same time, VA cut prices and abandoned off-line advertising, relying only on on-line promotion. These price cuts meant that the company was selling some items at a loss. As in the Argenti model, the company’s position rapidly deteriorated as its share price slid downwards. The slide in VA’s shares was accentuated by a general downturn in the share prices of Internet companies, which occurred at approximately the same time. Before long the company was forced to seek the protection from its creditors in Chapter 11 bankruptcy, whilst the Directors made a lost effort to resolve the company’s problems. VA was only able to operate for three months in this situation before it became clear that the situation was irreversible and the company was finally liquidated and sold to a rival firm.
Conclusion

The life cycles of the two Internet start-up companies profiled here, Boo.com and ValueAmerica.com, corresponded well with predictions derived from academic models relating to new, small companies operating in a high technology sector. Neither of these companies was able to generate sufficient sales to become profitable and they both failed to control their expenditure once they began trading. This failure resulted in serious problems with liquidity, which, combined with the limited funding options available to these types of firm, served to rapidly drive the companies to bankruptcy.

In 1976, Argenti depicted the life cycle of a dynamic company that would grow very quickly in the period immediately after its inception and then fail equally rapidly. The two companies discussed here follow this pattern very closely as they both rapidly increased employee numbers and expenditure in the first part of their lives. Initially, both Boo and VA found it easy to attract funding, as they became well-known company names, and Internet companies were very popular investment vehicles at that time. When their backers became disillusioned, however, both companies resorted to desperate measures in an attempt to reverse their failing fortunes but, ultimately, the investors refused to advance further funds and the companies quickly failed.

Experience with other Internet start-ups will demonstrate whether B2C companies are inherently prone to failure, or if there are simply some items that do not sell well via the Internet. In the cases illustrated here, there were problems with the company’s business plans rather than with the technology that was being used. It is true to say that both companies suffered problems with their web sites, but this was not due to any fundamental problems with the technology that they were trying to apply. In contrast, however, the business plans that the companies used were subject to more fundamental problems and the reasons for failure may be found in the choice of products that they were selling. This suggests that great care must be exercised in the construction of Internet start-ups, as these firms must combine well-constructed systems with products that are suitable for B2C retail.

This is not to say that these companies would have survived if they had sold other products. There were problems with the management and the rate of cash burn that they exhibited was too high to be sustainable. These issues, coupled with the limited funding options available to companies of this type, meant that the companies were in a precarious position where failure could occur very quickly. Nevertheless, the fundamental problem with these firms lay in the fact that they simply could not make money and the characteristics of these companies simply served to exacerbate an already precarious situation.
References


This is, in fact, a frequently used definition of financial distress.

The investors were:

- The Italian Benetton family, who are major shareholders in the international clothing company of the same name
- Bernard Arnault, chairman of the international leisure products company, Louis Vuitton Moet Hennessey.
- Omnia, an investment fund backed by the Hariri family from the Lebanon and
- Two merchant banks, Goldman Sachs and J P Morgan

Exchange rate risk can be a problem with Internet retail. The goods are usually priced in the web site’s domestic currency and the purchaser, knowing the exchange rate at that time, can calculate the price in their home currency. The purchaser then supplies their credit card details but most B2C sites do not take payment until the goods are dispatched. If there is a delay between ordering and dispatch then the exchange rate may alter and the final price for the goods will change accordingly. This is not a problem for the retailer as they always get the price they originally set but this can be a problem for the buyer as the price of their purchase may increase between ordering the item and receiving it. There is, of course, always the possibility that the exchange rate movement will decrease the final price that they pay but, nevertheless, there is always an element of uncertainty in transactions of this sort.

There are many Stock Exchanges that are designed to allow young, high risk ventures to float. For example, there is the Alternative Investment Market (AIM) in London, the Paris Nouveau Marche and New Zealand’s New Capital Market. In many cases, these Exchanges are designed to be an interim step for companies that wish to float their shares but are unable to meet the more rigorous Listing rules insisted upon by the Main Boards of many Stock Exchanges. By electing to list on one of these newer Exchanges, the company is effectively signalling its high-risk status to potential investors.

The securities class action lawsuit was filed in the United States District Court for the Western District of Virginia on behalf of a group of investors who bought Value America, Inc. shares between the Initial Public Offering (April 7 1999) and December 28 1999. The shareholders claim that the company directors made inaccurate and misleading statements that concealed VA’s true financial condition. The case received an initial hearing in April 2001 but, to date, no final judgement has been made.