

Lessons from Dot-Com Boom and Bust

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INTRODUCTION

The dot-com industry began in the early 1990s as a collection of startup companies using the Internet as their primary means to conduct business. These companies typically used the “.com” suffix in their company names, such as Amazon.com, and proliferated in the late 90’s with the massive investments in Internet-related stocks and enterprises. But with the failure and consolidation of many of these companies their numbers have since dwindled.

The catastrophic collapse of the dot-coms that shook the U.S. economy started in May 2000. More than 210 dot-com companies failed in 2000 (Hirakubo & Friedman, 2002) and a total of 762 dot-coms closed for the period January 2000 to December 2001 (Pather, Erwin, & Remenyi, 2003). Since many of these dot-coms began to lay off their staff, the unemployment rate also increased from 3.9% to 6% by 2002 (Callahan & Garrison, 2003; Howard, 2001).

The dot-com bubble burst because the boom was based on the false premise that new technology would eliminate the need for brick-and-mortar stores as this new business model would supplant the old one, thereby converting the “Old Economy,” which is based on the production of physical goods into a “New Economy,” which is based on heavy use of information and communication technology (Rauch, 2001). Although a great deal can be learned from examining the dot-com successes, it is equally important to study reasons for the failures. Examining the mistakes made by the dot-coms can provide insight into the evolution of e-commerce as a means of conducting business and furthermore help to form the basis on which new strategies can be developed for the future e-commerce environment.

BACKGROUND

In the 1990s, the commercialization of the Internet started a revolution in the way business is conducted. In particular, the growth of the World Wide Web has offered a unique opportunity for many companies to increase effi-

ciency, forge better customer relationships, and expand their markets through “global visibility” (Medjahed, Benatallah, Bouguettaya, Ngu, & Elmagarmid, 2003). These advantages have led many companies to move their primary operations to the Web. According to CNN and BBC reports, an estimated 20 million Web-based companies came into existence (Pather, Erwin, & Remenyi, 2003). With the flourishing of these companies, the economy faced a new challenge: business transaction over the Internet, or e-commerce. In the early stages of e-commerce, however, the terms Web-based company, Internet-based company, and dot-com company were all used interchangeably to refer to the same sort of online retailer.

As traditional and new companies continued to establish themselves as online retailers, mass media often exaggerated the enthusiasm with such one-liners as “Be Digital or Be Toast!”, “Get Web or Be Dead!”, and “Dot-Com or Be Gone” (as cited in Pather et al., 2003). At the same time, as the number of Internet users increased exponentially, and online shopping became a popular consumer activity. According to Giga Information Group (2000), it was once estimated that U.S. online retail sales would increase from \$26 billion in 1999 to \$152 billion in 2002 and \$233 billion in 2004. Another prediction suggested that consumers would spend \$200 billion on the Internet in 2005 (Chartier, 2000).

Investors also showed their enthusiasm for Web-based companies. In 1999, venture investments in Internet-related businesses exploded, increasing to nearly \$20 billion from \$3.4 billion in 1998. This was due to the fact that many investors considered technological innovation to be the promising “future value” of a company. Subramani and Walden (2003) confirmed that the public announcement of a company’s e-commerce initiative would enhance the market value of that company and thus create value for the company’s stockholders. In fact, rather than measuring business performance in traditional ways, many investors demonstrated little concern about gains and losses in profit margins. One recurring comment was that “as long as an e-commerce business ‘makes sense’ (it does not need to ‘make cents’), it may still be backed by numerous investors” (Chan, Lee, Dillon, & Chang, 2001, p. 7).

With the massive investments, the U.S. economy experienced the dot-com boom or dot-com bubble in the late 1990s. The height of the boom was characterized by an enormous increase in stock prices, especially in the prices of Internet-related stocks. Starting in January 1997, the dot-com industry stimulated NASDAQ and thus surpassed expectations with record high after record high. In the period of just one year (1997-1998), America Online's stock rose by 593%, and Yahoo!'s by 584%. Amazing growth occurred in Amazon.com, with a 970% increase. The NASDAQ also showed inflation. Within only six months (September 1999 to March 2000) it showed an 83% increase (Callahan & Garrison, 2003).

However, in early 2000 the stock market witnessed a bubble ready to burst. This burst led to the rapid decline in the value of Internet-related stocks. In the weeks and days that followed the burst, the stock market bounced up and down randomly. For instance, on March 10, 2000 NASDAQ closed above 5,000, but dropped three days later by almost 500 points. On March 22, NASDAQ jumped to 4,864.75 with a 3% increase and was back to almost 5,000 points at the end of week. However, the overall cycle of NASDAQ during March 10 to April 14 showed a 34.2% decline. More importantly, though, the stock prices for all the 20 leading Internet stocks fell (Cassidy, 2002). For instance, Amazon.com dropped by 29.9%, eBay by 27.9%, Yahoo! by 34.8%, and TheStreet.com by 54.3%.

The first factor contributing to the dot-com collapse was the frenzied buying of Internet-related stocks without serious consideration of whether the companies were actually fiscally sound with strong management plans. This impulsive buying sent the main U.S. market indices (especially the tech-heavy NASDAQ) soaring from a low 1541.80 in late 1998 to a high of 5000 in early 2000.

With this inflation in NASDAQ and in the Dow, many believed that the dot-coms constituted a prime investment opportunity and that technology itself was a good business plan. This idea led to significant growth of the Internet-related sector of the stock market through the overvaluing of stock prices.

The second factor was that investment firms involved in launching IPOs undervalued the initial stock offering, depriving the startups of vital capital resources. For example, Priceline.com went public on March 31, 1999 and initially had an IPO of \$16, with an initial public offering of 10 million shares. However, Priceline.com opened the first day of trading at \$81.00 with a high of \$95.94 and achieved market value of \$9.8 billion, the highest first-day ever achieved by an Internet company (Business Magazines & Media Inc., 1999). If the firm had priced the IPO at \$30.00, it could have made \$300 million instead of \$160 million (which it made at the initial IPO). One reason for such undervaluation was the lack of know-how in decid-

ing the true value of dot-coms with complicated situations. Given that Priceline.com had profit and revenues of only \$35 million, and there was no justification for predicting the potential market value: "One person who took part in the Priceline.com pricing meeting likened the process of valuing Internet companies to throwing darts" (Cassidy, 2002, p. 216). This scenario was repeated throughout the dot-com industry as billions of dollars were lost in IPOs by the undervaluation of these stocks.

Although the stock market's bounce resulted in many dot-com meltdowns, there are a number of other reasons why many dot-com companies have been unsuccessful at making a profit. One of these reasons is that most dot-com companies did not have a sound business strategy that provided a clear plan.

DOT-COM FAILURES

In some cases, failure was due to financial problems. Most of the so-called B2C (Business to Consumer) companies had spent far too much money marketing themselves to consumers, but had not yet turned a profit. Many dot-coms failed because they spent too much when the company was founded and then simply ran out of money. For instance, Boo.com, founded in 1999, targeted women under 30 who are interested in trendy clothing. The site promised that it would be "working diligently over the next few weeks to position Boo as the ultimate global fashion portal—to deliver all the great things you loved about Boo." But that portal never reached its target audience.

Boo.com's attempt to reach a global community of online "fashion-conscious consumers" made them the first victim in the NASDAQ crash. On May 17, 2000, five months after its Web site launched, Boo.com shut down and filed for bankruptcy. Boo.com's failure was generally credited to its expensive marketing budgets, high technology costs and ambitious Web site. When Boo's Web site launched in November 1999, it was slow because it was graphic heavy as well as inaccessible to some Apple users.

However, one crucial factor leading to Boo's bankruptcy was its failure to make a profit. Boo.com spent \$185 million in 18 months to create brand value, but total sales were only \$1.1 million in the three months, between February and April 2000 (Cassidy, 2002). In the "old" economy, stock performance correlates with earnings—the more money a company makes, the higher its stock price should increase. But in the "new" economy of the dot-com bubble, investors assumed that market share comes first and profits follow. Boo.com relied heavily on venture capital but revenue did not follow, its failure was inevi-

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