New Economy Learns Lessons of Old from Recent Tech Wrecks

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Strategic development, meeting market demands, healthy business models and generating revenue. Once upon a time, meeting such criteria was essential for launching a start-up company. Unless of course that start-up was a dotcom. In that case, a myriad of deep-pocketed investors infused the market with the concept that none of the above needed to apply.

After a blistering first quarter, the second quarter of 2000 has produced a sobering reality for investors and venture capitalists infatuated with the technology sector. The Nasdaq, down 5.7% this year, took a nosedive and hovered around the 3,000-point level at May's end. In addition to the multitude of IPOs that were pulled in recent weeks due to suddenly unpredictable market conditions, cloudy skies further darkened as the downturn unleashed its first wave of tech wrecks.

"Basically, this is the shakeout people were talking about," said Ray Beier, Leader of Structuring Services at PricewaterhouseCoopers. "These were new ideas coming into new business models and several of them overlooked the unpredictable nature of the market."

Although companies had backing from considerable sources, several Internet companies have logged off, permanently, leaving investors uneasy in a market once flirting with bear territory. Several analysts, however, see the liquidation as part of an inevitable digital Darwinism'.

ePatients, a patient community backed in part by Saratoga Ventures and Morgenthaler Ventures, became the first flop of the year in January. Its closure, however, generated little attention from a bull market still dizzy from a stellar 1999 performance that saw an 86% climb on Nasdaq.

April showers brought with it the washout of specialty retailer Violet.com. Backed by 21st Century Internet Venture Partners, the company pulled the plug on its operations as funding dried up.

The forecast only became gloomier in May, as Disney closed its online toy retailer Toysmart. Its short-lived competitor RedRocket.com, owned by

Viacom Inc., was also canned. In the same month, Craftshop.com, which had enlisted backing from CMGI @Ventures, Andinger Capital VII, Brand Equity Ventures I and Primedia Ventures, filed for bankruptcy protection. Brandwise.com, a joint venture between Hearst and Whirpool, also announced it was liquidating. But the real boohoo that captured Wall Street's attention was the failure of Boo.com, a British apparel retailer and Europe's first major (failed) Internet retailer.

Backed by French entrepreneur Bernard Arnault, Italy's Benetton family and J.P. Morgan, Boo.com raked in an estimated $135 million in funding in just seven months, created one of the most sophisticated e-commerce Web sites, (complete with 3-D photography and a talking saleswoman) and generated nothing. $25 million is owed to creditors, most of which are advertising firms. Poor marketing strategy fueled by an excessive advertising splash eventually bled the flow of capital dry.

Whether placing blame on poorly timed launches, marketing strategies executed with little acumen or timetables cut too short before profitability could be demonstrated, some analysts believe the first wave of tech wrecks is nothing more than the natural progression of the market itself.

"It's healthy and it's a little overdue. From our side, this is actually refreshing, as poorly planned business models are flushed out," said John Zappettini, managing partner at private equity firm Plantagenet Capital.

"A natural evolution is beginning to show," PricewaterhouseCooper's Beier said. The flow of capital into Internet-related business start-ups will continue, he said, "[But] there will be more discipline put into their thinking. The access to capital will be restrictive compared to where it was."

In the last three weeks Zappettini's phone has all but overheated from the volume of calls generated from companies in early stage deals, unable to make it to the next level of financing rounds. The combination of circumstances has proven itself to be favorable to some degree for VCs.

"This shakeout has created the opportunity for acquisition of companies at huge discounts. It's allowing us to be much more creative with the structuring of these deals," Zappettini said. Consolidation of tech start-ups with others in the firm's portfolio has become more of an angle taken in recent weeks, he said.

The failure of Boo.com led to a sale for other companies eager to pick through its remnants.

Just three days after the company's closure, Bright Station, a London technology firm, purchased Boo.com's tecnology backbone for just $372,500. Addition-nally, five-year-old Fashionmall.com, [NNM: FASH] a low-profile online retailer, acquired Boo.com's domain name, trademarks and content, such as the site's interactive shopping assistant, Miss Boo.

Though Fashionmall.com's CEO Ben Narsin would not release details of the acquisition price, he stated that Boo is a well-known brand name in Europe. And while Fashionmall.com is among the lowest-valued publicly traded dot.coms, with a market cap of about $19 million, Narasin noted the acquisition created a very rapid shortcut for his company to enter the European marketplace.

With so many start-ups vying for capital, companies with weak balance sheets and those rushing to the IPO market too quickly are finally being weeded out.

"The IPO as a source of capital, that's been lost to a certain extent," said one e-commerce analyst at Goldman Sachs. "Too many companies have gone out way too early, and we're seeing the results of that strategy."

In fact, the washout may even prove helpful for the overall market, driving development into gaps much more visible now that the rose-colored glasses have been taken off. **For instance, Zappettini pointed out that in the B-to-C and B-to-B markets, the Internet may make it easier to buy products, but it has not driven down overall selling costs. "Right now the Web is only getting a broader audience. Solutions are needed for payment and distribution," he said.**

The logging off of such sites as Boo.com and Toysmart have exemplified the fact that instant global access is far from equated with instant success. And established business models can't be skirted so easily in the New Economy.

"The lesson to be learned from all of this is, keep it simple'. Make sure the business works and that it is one you can scale up. Otherwise, you're going to have a hard time attracting capital," Zappettini said.