PETS.COM INC.: RISE AND DECLINE OF A PET SUPPLY RETAILER[1]

Dr. Omar Merlo wrote this case solely to provide material for class discussion. The author does not intend to illustrate either effective or ineffective handling of a managerial situation. The author may have disguised certain names and other identifying information to protect confidentiality.

THE BIRTH OF PETS.COM

In 1994, Pasadena-based entrepreneur Greg McLemore registered the Pets.com name.[2] Although McLemore's commercial intentions for the Pets.com address were not clear from the start,[3] they became apparent in 1998, when he set up an online pet shop with colleague Eva Woodsmall and relocated to San Francisco shortly afterward.[4] In February 1999, Pets.com, Inc. was incorporated as an online retailer of pet products, and the Pets.com website was also launched.[5] Greg McLemore, aged 31, was best known for his prior start-up, Toys.com, which had recently been sold to eToys. McLemore still owned approximately 750,000 shares of eToys, which had filed for an initial public offering (IPO).[6]

By January 1999, the world was on the threshold of a new era in which companies would increasingly interact with customers through the virtual space of the Internet, and businesses would undergo a transformation on the scale of the Industrial Revolution.[7] This was the "information revolution," and it had captured the imagination of investors and entrepreneurs who wanted a piece of the cake. Although the Internet had created the opportunity of a new distribution channel for established companies, it also opened the possibility for new companies to enter into established industries without a huge capital investment in a retail distribution channel.

---

[1] *This case has been written on the basis of published sources only. Consequently, the interpretation and perspectives presented in this case are not necessarily those of Pets.com or any of it employees.*
[2] *Brad Stone, "Amazon's Pet Projects," Newsweek, June 21, 1999.*
[3] *Note that during this time, people often registered domain names with no intention of using them for business purposes, but simply to sell them to interested parties at a later date. This practice was particularly true for "generic" names, such as Pets.com. See Matt Haig, Brand Failures: The Truth about the 100 Biggest Branding Mistakes of All Times, Kogan Page, London, 2003.*
[4] *Tim Clark, "Amazon Invests in Online Pet Store," CNET News, March 29, 1999, available at http://news.cnet.com/Amazon-invests-in-online-pet-store/2100-1017_3-223621.html, accessed June 20, 2009.*
[5] *John M. Coulter and Thomas J. Vogel, "Pets.com, Inc.: Assessing Financial Performance and Risks in the e-Commerce Industry," Issues in Accounting Education, November 2004.*
[6] *Clark, "Amazon Invests in Online Pet Store," March 29, 1999.*
[7] *Barua et al., Measuring the Internet Economy, June 1999.*

The company leading the dot-com race was Amazon.com. Despite initial skepticism by some industry observers, the company's stock performance was outstanding: by February 1, 1999, its share price had increased to $58 per share from its IPO offer price of $18 per share in May 1997. Moreover, Amazon.com had successfully defined the business model of the dot-com age. According to an observer:

> Amazon.com has been a darling of Wall Street, albeit a rather unusual one. In five quarters as a public company, Amazon.com has not come close to posting a profit. But the company that makes it easy to order books and music online has seen its stock soar astoundingly as investors see Amazon.com as a leader in Internet commerce.[8]

Amazon.com's growth strategy had become an example for all subsequent companies to follow: when choosing between profits and growth, a start-up should opt for growth because substantial growth in revenue and subscribers ensures investor confidence and portrays market leadership.

After the success of Amazon.com, the case for selling pet supplies online mirrored that of online bookstores. If Amazon.com could successfully sell books online within the $12 billion U.S. retail book industry, surely a portion of pet supplies be sold online, given a total domestic industry size almost twice as large.[9]

Pets.com was an exciting business concept that was guaranteed to be a success.[10] By 2004, Forrester Research had forecast online pet product sales to be more than $4.5 billion,[11] and Pets.com was positioning itself to capture a large part of that market. Pets.com's prospects looked so favorable that even outsiders became fans of the company.[12]

In March 1999, McLemore succeeded in his first-round attempts to secure funding for Pets.com, receiving $2 million from a premier venture capital fund, Hummer Winblad Venture Partners (Hummer Winblad).[13] The Silicon Valley-based Hummer Winblad, which focused exclusively on software and Internet investing, had more than $500 million under management. Hummer Winblad's investments included PowerSoft Corporation and Arbor Software, as well as Internet companies Net Perceptions, AdForce, HomeGrocer and Employease.[14]

Pets.com named Julie Wainwright as chief executive officer (CEO), a post she took over in March 1999.[15] Her previous job had been CEO of the online video store Reel.com, which Amazon.com had recently surpassed as the Internet's top video outlet for non-adult titles.[16] When Wainwright was approached to be the top executive for Pets.com, she didn't even read the proposal:

> I did research instead and found the market for pet products is extremely fragmented. . . . Sales go through multiple stores — mass merchants, independent pet stores, supermarkets.

---

[8] Greg Heberlein, "Amazon.Com Loss Is Less than Forecast: Though Red Ink Grows, Sales Skyrocket, New Accounts Rise," Seattle Times Business Reporter, July 23, 1998.
[9] "Pet Quarters, Inc.," SECinfo, December 22, 1999, available at www.secinfo.com/dsvrp.6B38.htm, accessed June 17, 2009.
[10] Matt Haig, Brand Failures: The Truth about the 100 Biggest Branding Mistakes of All Times, Kogan Page, London, 2003.
[11] Dana Blankenhorn, "Pet Sites Prove It's a Dog-Eat-Dog World," Interactive Week from ZDWire, August 27, 2000.
[12] "Death of a Spokespup," Adweek, New England Edition, December 2000.
[13] Stone, "Amazon's Pet Projects," June 21, 1999.
[14] "Pets.com Raises $35 Million Third Round of Funding; Most Recent Round of Funding Raises Online Pet Site's Total Capital to Nearly $100 Million," Business Wire, November 3, 1999.
[15] "Reading List," BusinessWeek, 2000, available at www.businessweek.com/bschools/books/recommenders/wainwright.htm, accessed June 19, 2009.
[16] Clark, "Amazon Invests in Online Pet Store," March 29, 1999.

> There isn't one monopolistic figure out there that owns the pet world. . . . I knew it was an opportunity to aggregate products.[17]

Wainwright's team consisted of a handful of well-regarded, experienced managers, including a former Procter & Gamble marketing executive, John Hommeyer, who was Pets.com's new vice-president of marketing.[18]

THE PET INDUSTRY

In 1998, the pet industry was large and growing, consisting of a US$53-billion-a-year global marketplace.[19] Americans spent nearly $23 billion on their pets annually, according to the Pet Industry Joint Advisory Council,[20] and this number was growing at a rate of $1 billion per year.[21] To put this industry in context, each year Americans spent approximately $21 billion on toys, $13 billion on music recordings and $12 billion on retail books.[22] Some experts predicted that, by 2001, the pet product and services industry would total more than $28 billion.[23]

Pet Ownership in the United States

Pets were an integral part of American family life, evidenced by the 60 per cent of all U.S. households that owned a pet[24] and the 40 per cent of all households that owned more than one pet.[25] In particular, dogs and cats drove pet industry sales.[26] As of 1996, Americans reportedly owned 53 million dogs and 59 million cats, with four million more households owning dogs than cats.[27] Pet ownership break-down in 1999 is set out in Exhibit 1.[28]

Americans simply loved to spend money spoiling their pets. According to a 1999 American Animal Hospital Association survey, 30 per cent of pet owners admitted to cooking special meals for their pets, 25 per cent of pet owners bought their pets gifts and five per cent gave their pets greeting cards.[29]

Favorable demographic trends indicated continued growth of the already recession-resistant industry of pet products and services. Families with children between the ages of five and 15 were most likely to own pets. Meanwhile, projections suggested the number of families with children younger than 18 years of age would grow steadily over the next several years.[30]

---

[17] *Connie Guglielmo, "Category Killer: Pets.com," Interactive Week from ZDWire, May, 31 1999.*
[18] *Ibid.*
[19] *Barry Janoff, "Reigning Cats and Dogs," Progressive Grocer, June 2000.*
[20] *"Amazon.com Announces Investment in Pets.com," PR Newswire, March 29, 1999.*
[21] *Pet Products Manufacturers Association (APPMA), Greenwich, CT.*
[22] *"Pet Quarters, Inc.," December 22, 1999.*
[23] *Ibid.*
[24] *Joanna Sabatini, "Best of Breed," Adweek, Eastern Edition, November 22, 1999, p. 56.*
[25] *John Fetto and Jennifer Lach, "Pets Can Drive," American Demographics, March 2000, p. 10.*
[26] *"Pet Quarters, Inc.," December 22, 1999.*
[27] *"U.S. Pet Ownership & Demographics Sourcebook," Center for Information Management, American Veterinary Medical Association, Schaumburg, IL, 1997.*
[28] *"Pet Quarters, Inc.," December 22, 1999.*
[29] *John Fetto and Jennifer Lach, "Pets Can Drive," American Demographics, March 2000, p. 10.*
[30] *"Pet Quarters, Inc.," December 22, 1999.*

Furthermore, pet-owning households tended to be wealthier than average and, thus, were able to afford to spend more on pet products. According to the American Veterinarian Medical Association, nearly 65 per cent of households earning $60,000 or more were pet owners (see Exhibit 2).[31]

Consumer Spending on Pets

Of the total pet products and services industry, approximately half was accounted for by the pet food category.[32] This category could be divided into non-premium supermarket brands and premium brands. Historically, non-premium supermarket brands, such as Alpo, Kal Kan and Purina, dominated sales, comprising nearly 55 per cent of all pet food supplies. These non-premium brands, which were primarily sold though grocery and convenience stores, as well as through other mass merchant outlets, featured slow annual growth rates, small gross margins and low nutrient-levels compared with their premium counterparts.[33]

After the pet food industry became accustomed to the low competition that characterized the 1980s, by the mid-1990s, supermarket pet food brands began losing market share amid growing concern for animal welfare and nutrition. Healthy diet recommendations from veterinarians and breeders increased the popularity of premium brands, such as Iams, Nutro and Science Diet. These and other premium pet food brands became increasingly available and offered wider varieties, despite typically restricted distribution, which led to only few supermarkets or mass merchants carrying these premium lines. From 1994 to 1999, premium brand sales grew at an annual growth rate of approximately 18 per cent, until capturing approximately 25 per cent of the total pet food market in 1999.[34]

Consumers bought many pet products on impulse during their regular shopping trips to purchase pet food, cat litter or items for flea control. Typically, consumer demand was less price-sensitive for such impulse buys compared with staples such as pet food and other bulk products. Thus, non-bulk, non-food pet products required fewer discounts and yielded higher gross margins, attracting strong interest from supermarkets that were looking to stock their shelves with profitable goods. However, because of space constraints, supermarkets could carry only limited basic pet supplies, such as collars, dog chews, leashes, flea collars and toys. Conversely, pet supply stores could stock a wider variety of items, including grooming products, pet carriers, cat furniture, doghouses, vitamins, treats and veterinary products.[35] Despite the higher margins on non-bulk items, pet product profit margins on the whole were still low: in the bricks-and-mortar world, they ranged between two per cent and four per cent.[36]

The pet services category — i.e., veterinary, boarding, grooming and training services — yielded higher margins, though typically only large, experienced specialty retailers had the both the skill and insurance to offer these services. Most pet owners sought veterinary care at least once a year, including approximately 92 per cent of households with dogs and 78 per cent of households with cats. From 1991 to 1999, U.S. veterinary expenditures grew 9.5 per cent annually.[37]

---

[31] Ibid.
[32] Barry Janoff, "Reigning Cats and Dogs," June 2000.
[33] "Pet Quarters, Inc.," December 22, 1999.
[34] Ibid.
[35] Ibid.
[36] Pui-Wing Tam and Mylene Mangalindan, "Pets.com's Demise: Too Much Litter, Too Few Funds — Pet-Supply Site Sought Money but Couldn't Find Backers; 'It's Sad,' Says the Founder," The Wall Street Journal, November 8, 2000.
[37] "Pet Quarters, Inc.," December 22, 1999.

In 1999, the pet industry appeared to potential online retailers as an attractive and growing sector. Analysts were optimistic because the Internet had already been proven to be a successful distribution channel for software, music and books.

Internet and Retail e-Commerce Trends

At the end of 1998, International Data Corporation (IDC) estimated 97 million people were using the Internet worldwide, with projections of 320 million users by the end of 2002.[38] Moreover, in 1998, nearly 60 per cent of all Internet-connected households went online at least once a day, compared with only 35 per cent the previous year. Not only was the number of users increasing but also the frequency and duration of users' online time. Experts predicted this trend would only strengthen, as more people sourced information and conducted market transactions online.[39]

Internet usage boomed among a wide range of age groups and demographic profiles, as a result of email, online information and virtual commerce becoming a part of daily American life.[40] The majority of Internet access occurred through personal computers (PCs). However, IntelliQuest (which measured the media habits and purchase behavior of people involved in technology-related purchasing decisions and usage) predicted alternative technologies, such as handheld computers and webTV, would further drive Internet growth by 2000.[41]

In 1998, according to the Texas Centre for Research in Electronic Commerce, the Internet economy generated U.S. revenues of $301.4 billion. Internet commerce accounted for approximately one-third of total revenues, or $101.9 billion. Growth nearly doubled between 1995 and 1998, with the Internet economy increasing by 174.5 per cent, compared with a global average economic growth rate of 3.8 per cent during the same period. Moreover, transfer of existing economic activity to the Internet, rather than newly created Internet activities, drove a significant proportion of Internet growth.[42] Finally, the globalization of e-commerce brought further opportunities for e-retailers prepared to transact beyond U.S. borders. The International Data Corporation predicted that, by 2001, international shoppers would outspend their U.S. counterparts $277 billion to $248 billion.[43]

Other factors influencing the growing Internet usage and e-commerce included a growing base of home and workplace computers; improved network security, infrastructure and bandwidth; faster modems and PCs; cheaper, more reliable Internet access and increased consumer adoption of online commerce.[44]

Pets Products Online

NPD Online Research's October 1999 online pet store survey, which was based on 2,009 individual responses, suggested the Internet had yet to capture the attention of most Internet-using pet owners.

---

[38] *"Drilling Down into Computer and Web Trends," LearnFrame, 2001, available at www.learnframe.com/aboutelearning/page16.asp, accessed June 19, 2009.*
[39] *"New IDC Study Predicts 23 Percent of All Households Online by 1998; Reveals Increasing Popularity of Business-to-Business Commerce Solutions," PR Newswire, March 30, 1998.*
[40] *"Drilling Down into Computer and Web Trends," 2001.*
[41] *Michael Pastore, "More People Online Without PCs," ClickZ, April 20, 1999, available at www.clickz.com/150271, accessed June 18, 2009.*
[42] *Barua et al., Measuring the Internet Economy, June 1999.*
[43] *Ann Sullivan, "E-comm's Biggest Mistakes," Network World, February 26, 2001, available at www.networkworld.com/ecomm2001/mistakes/mistakes.html, accessed June 17, 2009.*
[44] *"Drilling Down into Computer and Web Trends," 2001.*

However, present online pet store shoppers reported high levels of satisfaction. Of the nearly 30 per cent of Internet users who had purchased from an online pet store, more than half reported being very satisfied with their buying experience, and many intended to shop online again. The survey also revealed that females were the majority of buyers of online pet supplies. Women comprised 68 per cent of all online sales and spent nearly double the online pet supply purchases of men. The study also found that most pet owners discovered online pet stores by browsing the Internet.[45]

Toys were the most popular Internet pet store purchase, despite wide-ranging available items. Forty per cent of polled consumers bought toys for their pets online, compared with approximately 30 per cent of consumers who bought food or treats online; 26 per cent who purchased non-food accessories online and 17 per cent who bought health products online. Nearly half of all buyers spent up to $25 during an average visit, whereas 37 per cent spent between $25 and $50.[46]

According to NPD, convenience was the top reason for making an online pet supplies purchase. Other rationale reflected the time savings, flexible hours and reduced effort of Internet purchasing (see Exhibit 3).[47] However, some experts believed such benefits were limited to a small market and, in the long run, would be outweighed by higher costs and longer waits. For example, Matt Stamski of Gomez Advisors, an e-commerce consultancy, claimed that pet supplies were not a natural e-tail market; and, instead, believed that pet owners were less likely than others to shop online. Thus, one of the key challenges of online pet shops was to convince the public of the superior value of online shopping compared with regular shopping trips. The online competitors needed to be quick to establish a clear identity in the market and to communicate their unique value proposition.[48]

THE COMPETITION: READY FOR A CAT FIGHT

Wainwright acknowledged the attractiveness of the pet industry, which was appealing to a large number of competitors:

> I've never seen so many companies in a category, and they may all get funded. I don't think there's room for two. It'll be a bloodbath with huge cash outlays and low margins. It's a tough business.[49]

In 1999, a *Fortune* magazine article observed:

> In the beginning there were books. Then came CDs and videos. Travel vacations, toys, and prescription drugs followed. The latest e-commerce market to hit the Net? Pets. Until now pet owners haven't had a Website that will answer questions, quell concerns, and sell chewy toys for Fido and Fluffie. Now get ready for the pet portal wars.[50]

With at least six major online pet competitors, Silicon Valley venture capitalists studied the largest pet portals to determine the next lucrative "Amazon or eBay of the animal kingdom.[51]

---

[45] *"Online Pet Stores Poised for Success, Reports NPD Online Research," Business Wire, October 12, 1999.*
[46] *Ibid.*
[47] *Ibid.*
[48] *Troy Wolverton, "Pets.com Latest High-Profile Dot-com Disaster," CNET News, November 7, 2000, available at http://news.cnet.com/2100-1017-248230.html, accessed June 20, 2009.*
[49] *Clark, "Amazon Invests in Online Pet Store," March 29, 1999.*
[50] *Melanie Warner, "The Latest Fad in Portals: Your Pet," Fortune, May, 10 1999.*
[51] *Ibid.*

Of the dozens of competitors that were being set up at the same time as Pets.com, or shortly after, the most noteworthy were Petopia.com, PetSmart.com and PetStore.com.[52] Each claimed superior advantages, predicting that other sites were likely to fold first; yet, at various times, all had also talked about merging with competitors. In the meantime, predicting which company would emerge as top dog was nearly impossible.[53]

Petopia.com

The bricks-and-mortar pet chain Petco, with 465 stores nationwide and 100 international stores, hired banker Morgan Stanley to create its own online strategy.[54] Petopia.com, a San Francisco-based company, caught Petco's attention because it had just secured $9 million from Technology Crossover, a high-profile venture capital firm that believed in the pet market's online potential.[55] The name Petopia was the brainchild of Catchword, a brand-development firm. Burt Alper, Catchword's co-founder and strategy director, commented on the name:

> When we evaluated the competitive landscape, it became clear that we needed a name that would stand out from the crowd without distancing the consumer. Petopia, coined from the words "pet" and "utopia," meaning "an ideally perfect place," communicates a terrific shopping experience for pet owners, in a playful, yet sophisticated way.[56]

In 1999, Petco decided to back Petopia.com. Petco's brand name was well known for its quality products and its commitment to animal care.[57] Andrea Reisman, Petopia.com's co-founder and CEO commented:

> We're changing the way pet owners think about shopping for pet supplies. By extending the "bricks-and-mortar" pet business to the online marketplace, Petopia.com is able to create a place to go, a virtual park of sorts, where owners can research information about their pet's needs, shop for pet food and supplies, and interact in a warm community with other owners who share the same interests.[58]

The Petco portion of the deal involved a strategic partnership in which the two companies could cross-promote each other and leverage both their assets.[59] For example, with Petco as a partner, Petopia.com had access to world-class purchasing and distribution capabilities.[60]

A further source of funding for Petopia was found in Groupe Arnault, a new venture capital arm of the European consumer products giant LVMH Moet Hennessey Louis Vuitton. The deal opened the door to potential international expansion at a later stage.[61]

---

[52] Joelle Tessler, "San Francisco-Based Online Pet Store Will Close," Knight Ridder Tribune Business News, November 8, 2000.
[53] Kara Swisher, "E-Commerce (A Special Report): The Industries — A Web Surfer's Best Friend? Sites Battle to Be the Online Store for Pet Owners; A Guide to Their Strategies — and Their Chances of Success," The Wall Street Journal, July 12, 1999.
[54] Stone, "Amazon's Pet Projects," June 21, 1999.
[55] Guglielmo, "Category Killer: Pets.com," May, 31 1999.
[56] "Catchword Names Petopia.com, New Online Pet Supply and Service Firm," Business Wire, May 26, 1999.
[57] "PETCO Announces Strategic Partnership with Petopia.com to Launch the Premier Online Pet Commerce Site," Business Wire, July 13, 1999.
[58] "Petopia.com Announces $9 Million Equity Investment from Technology Crossover Ventures; Company Changes Name From paw.net to Petopia.com," PR Newswire, May 10, 1999.
[59] Andrea Orr, "Online Pet Store Raises $66 Million in Funding," Reuters News, July 14, 1999.
[60] "Petopia.com Unleashes the Internet Pet Paradise; The Virtual Animal Park Blending Commerce, Content and Community with Individual Customization," Business Wire, August 2, 1999.

In total, Petopia.com had managed to secure $66 million in investment, one of the largest sums ever for an Internet start-up; however, Petopia joined Pets.com in an already crowded market. When asked how Petopia differentiated itself from the competition, chair and co-founder Andrea Reisman responded with an answer that foreshadowed the spending spree the industry was just about to witness: "We're the best funded."[62]

PetSmart.com

One of Petco's main bricks-and-mortar competitors, PetSmart, also wanted a piece of the action. PetSmart launched its online presence, PetSmart.com, in 1999. PetSmart, a Phoenix-based discounter of pet products, with nearly 500 stores nationwide and 100 international stores, generated $2 billion a year in sales. In 1999, PetSmart entered into a joint venture with e-commerce entrepreneur Bill Gross of Idealab.[63] A July 1999 article in the *Wall Street Journal* reported: "PetSmart.com presents to Pets.com the same kind of challenge that Amazon.com has been fighting off from Barnesandnoble.com."[64]

According to PetSmart officials, the two partners invested $5 million each in the PetSmart.com venture based in Pasadena, California. PetSmart CEO Phil Francis said PetSmart's strong brand name, marketing clout, close vendor relationships and efficient catalog order fulfillment systems would greatly benefit the website. Referring to bricks-and-mortar stores that had seen intense competition from Web competitors, Francis commented:

> Usually, the story is how the online retailer attacks the big box. Now it's big box and e-commerce retailers combining . . . this is a template for the future.[65]

Tom McGovern, CEO of the joint venture, thought a fast-moving traditional retailer with a substantial Internet presence could dominate the nascent online pet market. According to McGovern, PetSmart.com's advantages included a strong back-end warehouse and delivery systems, purchasing power, vendor relationships, national advertising and brand name.[66] Many analysts agreed that PetSmart was ahead of the pack because it had already developed brand recognition. Indeed, McGovern did not expect to lose to Pets.com when the new website went online in 1999:

> They are not the Goliath in this situation. I don't discount any of the [competitors], but each one is going to have to struggle through the basic blocking and tackling that we have done already.[67]

Petstore.com

Pets.com's third main competitor was another California-based start-up, Petstore.com. This company's initial round of funding yielded $10.5 million, mainly supplied by Battery Ventures, a national venture

---

[61] *Orr, "Online Pet Store Raises $66 million in Funding," July 14, 1999.*
[62] *Ibid.*
[63] *"Discounter PetSmart, Entrepreneur to Merge Pet-Products Web Sites," Dow Jones Business News, May 13, 1999.*
[64] *Swisher, "E-Commerce (A Special Report): The Industries — A Web Surfer's Best Friend? Sites Battle to Be the Online Store for Pet Owners; A Guide to Their Strategies — and Their Chances of Success," July 12, 1999.*
[65] *Kara Swisher, "Discounter PetSmart Scampers Online in Venture with E-Commerce Incubator," The Wall Street Journal, May 13, 1999.*
[66] *Swisher, "E-Commerce (A Special Report): The Industries — A Web Surfer's Best Friend? Sites Battle to Be the Online Store for Pet Owners; A Guide to Their Strategies — and Their Chances of Success," July 12, 1999.*
[67] *Ibid.*

capital firm.[68] As Petstore.com co-founder and vice-president of Marketing, Bruce Gallaher, put it, "In e-commerce, a leadership position can quickly be established with 'the category killer' domain name, innovative marketing and a superior customer experience." Joshua Newman, co-founder and CEO of Petstore.com, agreed:

> Amazon's recent purchase of a major stake in Drugstore.com validates the strength of names like Petstore.com. Both Drugstore.com and Petstore.com will spend millions promoting their brands, and both are sure to benefit.[69]

Newman was also not put off by PetSmart's effort, considering the combination of an old-line retailer with a new media company problematic: "I think there will be a lot of marriage counseling there," he said.[70]

Petstore.com was the first to have a warehouse in operation. The company focused heavily on advertising (for example, it signed an advertising agreement with Yahoo), capitalized on both its name and its exclusive relationship with 12,000 veterinarians with membership in the American Animal Hospital Association and targeted its marketing efforts to drawing users to the site's content.[71] Late in 1999, Petstore.com secured a further investment of $97 million from Discovery Communications Inc., the parent company of the Animal Planet cable network.[72]

PETS.COM'S STRATEGY

Wainwright had been hired by the board of Pets.com Inc. to lead the company and establish it as the market leader of the online pet supplies category. Soon after joining, she wondered whether Amazon.com, which had established itself as the leader in selling books and music online, would also be looking to enter the pet supplies category. Consequently, she decided to offer shares of Pets.com to Amazon.com. Indeed, despite all the competitive activity, the competitor Wainwright had feared most was Amazon.com. "The opportunity just got significantly less risky with Amazon in as a partner, not a competitor," she noted.[73]

In June 1999, $50 million was invested in Pets.com. Jeff Bezos, CEO and founder of Amazon.com, purchased 54 per cent of the shares, and a second round of funding came from Hummer Winblad Venture Partners.[74] The investment by Amazon.com in Pets.com followed its recent similar deal with Drugstore.com, a newly launched online pharmacy of which Amazon.com now owned 46 per cent.[75] Bezos said:

> We invest only in companies that share our passion for customers. [Pets.com's] proven management team is dedicated to a great customer experience, whether it's making a product like a ferret hammock easy to find, or help in locating a pet-friendly hotel.[76]

---

[68] "Petstore.com Announces $10.5 Million Financing Round; Petstore.com Rapidly Dominating the Online Market for Pet Supplies," Business Wire, April 13, 1999.
[69] "Petstore.com Acquired by Truepet, Inc.: Petstore.com Brand to Dominate the Online Market for Pet Supplies and Services," Business Wire, March 29, 1999.
[70] Swisher, "E-Commerce (A Special Report): The Industries — A Web Surfer's Best Friend? Sites Battle to Be the Online Store for Pet Owners; A Guide to Their Strategies — And Their Chances of Success," July 12, 1999.
[71] Ibid.
[72] "Petstore.com, Discovery Communications in Financing, Marketing Pact," Dow Jones News Service, November 3, 1999.
[73] Clark, "Amazon Invests in Online Pet Store," March 29, 1999.
[74] Laurie Freeman, "Pets.com Socks It to Competitors," Advertising Age, November 29, 1999.
[75] Stone, "Amazon's Pet Projects," June 21, 1999.
[76] Clark, "Amazon Invests in Online Pet Store," March 29, 1999.

In addition to receiving cash, Pets.com obtained a link on Amazon.com's home page, and Amazon.com took a seat on Pets.com's board. Behind the scenes, Amazon also offered a buddy system, whereby every Pets.com employee could turn to his or her counterpart at Amazon for guidance on any kind of business issue. The investment would also help Pets.com recruit top talent and, crucially, raise more money.[77]

Wainwright commented on the Amazon.com/Pets.com deal:

> This is a marriage made in heaven and clearly positions us as the online category leader. The successful track record represented by Amazon.com and Hummer Winblad really makes this a CEO's dream team.[78]

The partnership with Amazon.com was an early success for Wainwright because it had eliminated a strong potential competitor and enabled Pets.com to use the experience and strategic assets of Amazon.com to build a competitive advantage. Wainwright's strategy was to partner with the industry leader, hire the best people, bring in the best advertising talent and focus on a business model that had worked for Amazon.com. The following is an extract from an interview with FDCH Nightly Business Report:

REPORTER:	Can the market support four major players in this particular marketplace? Wall Street is skeptical of that. Can the market support it?
WAINWRIGHT:	Absolutely not. Absolutely not.
REPORTER:	So you have to drive one of your competitors out of business?
WAINWRIGHT:	Oh, actually, you know, I have to tell you. They will, the business to consumer market right now as we speak is not exactly the hottest market. Therefore, it will translate into a shortage of venture capital. Every one of our competitors actually is backed by venture capitalists. I would have believed around now they're probably running out of money. So, you know, I don't have to drive them out. The market dynamics will drive them out.
REPORTER:	So it was very important for you to be first to market with your idea?
WAINWRIGHT:	Absolutely, absolutely. But, you know, I've got to tell you, we wouldn't have done it. It was important. It was a really strategy but we wouldn't have done it if we hadn't had the people, the infrastructure and the brand that we thought was saleable.[79]

Wainwright clearly wanted Pets.com to build market share as quickly as possible: "We're simply going to be able to pull out of the pack faster, because there is no room for four of us," she said in another interview.[80] "Pulling out of the pack faster" was as much a strategy decision as a survival guide for Pets.com. According to Wainwright, an aggressive marketing strategy was crucial, or the company would not have had enough money to sustain it through the launch phase. For investors to have confidence in the company, Pets.com needed to be seen as the leader of the online pet supplies industry, in the same way as Amazon.com was seen as the leader of the online books industry. Investors had confidence in Amazon.com because of consecutive quarters of high revenue and subscriber growth despite losses that exceeded the expectations of Wall Street.

---

[77] Stone, "Amazon's Pet Projects," June 21, 1999.
[78] Haig, Brand Failures: The Truth about the 100 Biggest Branding Mistakes of All Times, 2003.
[79] Paul Kangas and Susie Gharib, "Pets.com: Chairman and CEO," Nightly Business Report, March 20, 2000.
[80] Swisher, "E-Commerce (A Special Report): The Industries — A Web Surfer's Best Friend? Sites Battle to Be the Online Store for Pet Owners; A Guide to Their Strategies — And Their Chances of Success," July 12, 1999.

Being seen as the number-one company in the online pet products category espoused among investors a confidence that was critical for providing the funding required for survival. Wainwright seemed to believe that such funding could only come through rapid growth in revenues, by adopting an aggressive marketing strategy. Typically, such an aggressive growth strategy presupposed that the market was large enough, or would grow quickly enough that revenue would provide a profit before the seed money ran out. Such a strategy also assumed that the company would be able to retain the customers that it had acquired profitably through a unique selling proposition and meaningful sources of differentiation. As Jupiter analyst Ken Cessar pointed out, Pets.com's cost model would have worked if the company had achieved a very high level of sales, and if it had accessed sufficient resources to sustain itself until the requisite level of sales could be reached.[81] Such an aggressive strategy was often risky, but if well thought-out and well executed, it could be very successful.

Pets.com's significant investments in building market share through promotion and infrastructure development resulted in the company needing a very large critical mass of customers to be profitable. On the basis of optimistic estimations of Internet shopping trends, pet owners' online shopping behavior and projected demand curves, management believed that a revenue target of nearly $300 million would be needed to break even, and this target would take a minimum of five years to attain.[82]

THE MARKETING MIX

According to the Pets.com website:

> Pets.com is committed to serving pets and their owners with the best care possible through, products, information, and service. Pets.com is an online retailer of pet products, information, and resources. Offering a broad product selection and expert advice from a staff of pet-industry experts and veterinarians, Pets.com believes that it gives consumers the confidence that they are providing their pets with the best possible care.[83]

The selection of products at Pets.com was indeed fairly broad, offering many different pet products for cats, dogs and fish, in more stock keeping units (SKUs) than any other supplier. Pets.com went a step further in 2000, when it launched its private label of cat and dog food, dog biscuits and cat litter, marketed under the Petsplete and Pets brand names.[84]

Pets.com was "designed to become a pet portal," said co-founder Eva Woodsmall. It relied heavily on chat areas for pet owners, editorial content on pets, a monthly "Pet Lawyer" column, pet health-related information and searchable databases that provided listings on hotels that welcomed animals and access to other topics, such as veterinarians, dog breeders and boarding facilities.[85]

Additionally, several strategic alliances allowed Pets.com to offer animal health insurance and to also become the featured pet store on Yahoo![86]

---

[81] Pui-Wing Tam and Mylene Mangalindan, "Scarcity of Backers Forces Pets.com to Close Its Doors: Company Will Sell the Majority of Its Assets," The Asian Wall Street Journal, November 9, 2000.
[82] Nate Lanxon, "The Greatest Defunct Web Sites and Dotcom Disasters," CNET UK, June 5, 2008, available at http://crave.cnet.co.uk/gadgets/0,39029552,49296926-8,00.htm, accessed June 25, 2009.
[83] Erika Matulich and Karen Squires, "What a Dog Fight! TKO: Pets.com," Journal of Business Case Studies, May 2008.
[84] Ibid.
[85] Clark, "Amazon Invests in Online Pet Store," March 29, 1999.
[86] Matulich and Squires, "What a Dog Fight! TKO: Pets.com," May 2008.

Pets.com relied on two critical elements of the marketing mix to achieve its strategic objectives: an unprecedentedly aggressive communication strategy and a penetration pricing policy.

A large amount of resources was devoted to marketing communication (see Exhibit 4). The huge budget was immediately put to work, and the Pets.com site design was well received, garnering several advertising awards.[87] The company also launched an advertising campaign that relied mainly on TV, print, radio and, eventually, a Pets.com magazine.[88] The five-city advertising campaign expanded rapidly, reaching 10 cities by December 1999. In January 2000, Pets.com showed its first national commercial, a $1.2 million Super Bowl advertisement,[89] which introduced the country to Pets.com's tongue-in-cheek advertising slogan: "Because pets can't drive."[90]

John Hommeyer, the vice-president of marketing at Pets.com, was known for his sharp relationship marketing skills honed during his former position as director of baby care products at Procter and Gamble. In developing an early marketing strategy for the pet retailer, Hommeyer ensured that thorough research was conducted in homes and at dog parks to discern the likes and dislikes of pet owners. Working with leading advertising agency, TBWA\Chiat\Day, Hommeyer created a sock puppet that would serve as a brand icon for the company. This character would be the central feature in promotional campaigns, akin to Kellogg's Tony the Tiger and the pink Energizer bunny.[91] The sock puppet was launched in the autumn of 1999 in an impressive promotional campaign, which, within a few months, was successful at both ingraining the sock puppet in the public consciousness and making consumers more aware of the availability of online pet products.[92]

In the coming months, the marketing team worked hard to promote the sock puppet, which quickly became a celebrity. It appeared in 13 TV spots, on "Nightline," "Good Morning America" and "Access Hollywood." It received exposure in such magazines as *Entertainment Weekly*, *Time* and *People*. It was also featured in Macy's Thanksgiving Day Parade in New York and was the star of its own line of merchandise.[93] Wainwright was clearly impressed with the success of the sock puppet and observed: "People love the sock puppet. We have gotten over 10,000 letters of love, professing love for the sock puppet."[94] Naturally, all of these promotional efforts did come at a high cost, and eventually the cost per customer acquisition grew from approximately $80 per customer[95] to $400 per customer.[96]

After heavy promotional efforts, aggressive pricing was the second key element of Pets.com's marketing mix. The company ran numerous product specials, and its prices were low across the board, particularly compared with bricks-and-mortar pet shops. In an attempt to grow revenue quickly, the company even decided to sell some of its merchandise at prices below cost.[97] In the online world, this strategy is often justified on the basis of low overheads and efficiency. In addition, profit were made from incidentals, such as inflated shipping charges, renting out customer lists, online advertising and other charges.[98] However,

---

[87] Jennifer Owens, "Pets.com," Adweek, June 5, 2000.
[88] Charlie Fletcher, "Pets.com Publishes Print Magazine," Catalog Age, June 2000.
[89] "The Sock Puppet," Tribble Ad Agency, March 26, 2007, available at www.tribbleagency.com/?p=195, accessed June 20, 2009.
[90] Matulich and Squires, "What a Dog Fight! TKO: Pets.com," May 2008.
[91] Adrienne Mand, "A Sock's Best Friend," Brandweek, June 5, 2000.
[92] Fletcher, "Pets.com Publishes Print Magazine," June 2000.
[93] "Death of a Spokespup," December 11, 2000.
[94] Kangas and Gharib, "Pets.com - Chairman & CEO," March 20, 2000.
[95] Haig, Brand Failures: The Truth about the 100 Biggest Branding Mistakes of All Times, 2003.
[96] Chris Bucholtz, "Poor Product Choices Doom E-tailer E-failures," VARBusiness, November 17, 2000.
[97] Arlene Weintraub and Robert D. Hof, "For Online Pet Stores, It's Dog-Eat-Dog," BusinessWeek, March 6, 2000.
[98] Jacques R. Chevron, "Name Least of Pets.com's Woes: Blame Poor Management, not Generic Moniker," Advertising Age, January 22, 2001.

low initial demand and fierce competition forced Pets.com to slash its shipping charges regularly, and on numerous occasions the company offered free shipping promotions to entice customers to place orders.[99] However, the lack of a warehouse on the east coast put pressure on Pets.com's margins because many orders had to be shipped by expensive air freight.[100]

Although some of Pets.com's competitors were eager to expand their market quickly (for example, by shipping internationally), Pets.com decided against shipping products even to Canada, choosing instead to concentrate on building market share in the United States.

EPILOGUE

By the middle of 2000, many observers believed that the online pet market needed to consolidate to deal with the razor-thin margins, increasing competition and company names that carried few differences.[101] In February 2000, Pets.com raised $82.5 million in an initial public offering and four months later bought its rival, Petstore.com.[102] Wainwright said, "By acquiring these key assets and strategic relationships, we expect to reap the benefits of consolidation and thus strengthen our position as the online pet category leader."[103] Retail analyst Matt Stamski wasn't surprised that Petstore.com was closing its business, especially given the company's failure to forge a retail partnership similar to its rivals.[104]

Nevertheless, some observers believed that the Petstore.com acquisition was not enough. As a June 2000 article in the *Wall Street Journal* noted:

> The pet-supply business is a $23 billion industry, much of which is food that is often discounted. Even with the demise of Petstore.com, Pets.com must compete against Petopia Inc., PetSmart.com and about 100 other online pet retailers.[105]

Faced with large outlays of money just to attract traffic to the website, Pets.com eventually had to pursue cost-cutting activities. In September 2000, it announced plans to move some of its staff and, notably, its customer service call center, to Indiana to cut costs. The company also sought new revenue sources. For example, in April 2000, the company attempted to diversify and capitalize on the popularity of its mascot by licensing sock puppet merchandise.[106]

Despite these moves, the company's stock price continued to drop (see Exhibit 5). After an $11 per share price at the time of the IPO, and a 52-week high of $14 per share on the same day, the share value steadily fell over the next 10 months, as investors demanded rapid returns. Suddenly, according to a former Pets.com employee, "spending millions on advertising and selling products at a loss merely to add to Pets.com's list of 475,000 customers became folly," and the company started a steep slide.[107] Pets.com's

---

[99] Bob Tedeschi, "The Pet Supply Business Is Finding That a Site May Serve Mostly to Guide Shoppers to Stores and Catalogs," The New York Times, October 28, 2002.
[100] Weintraub and Hof, "For Online Pet Stores, It's Dog-Eat-Dog," March 6, 2000.
[101] Stefanie Olsen, "Pets.com to Buy Assets of Rival Petstore.com," CNET News, June 13, 2000, available at http://news.cnet.com/Pets.com-to-buy-assets-of-rival-Petstore.com/2100-1017_3-241823.html, accessed June 22, 2009.
[102] Wolverton, "Pets.com Latest High-Profile Dot-com Disaster," November 7, 2000.
[103] Olsen, "Pets.com to Buy Assets of Rival Petstore.com," June 13, 2000.
[104] Khanh T.L. Tran, "Pets.com to Buy Petstore.com Assets," The Wall Street Journal Europe, June 15, 2000.
[105] Khanh T.L. Tran, "Pets.com Will Buy Assets of Online Rival Petstore.com: Consolidation of Web Retailers Continues," The Asian Wall Street Journal, June 15, 2000.
[106] Tam and Mangalindan, "Pets.com's Demise: Too Much Litter, Too Few Funds — Pet-Supply Site Sought Money but Couldn't Find Backers; `It's Sad,' Says the Founder," November 8, 2000.
[107] Carlotta Mast, "Living Through the Death of a Dot-Com," BusinessWeek, December 13, 2000, available at www.businessweek.com/careers/content/dec2000/ca20001213_830.htm, accessed June 18, 2009.

lowest stock price of 2000 valued the entire company at $6.4 million. A month before going public, Pets.com had spent nearly one-fifth of that on a 30-second Super Bowl commercial.[108]

Carlotta Mast, managing editor of the Pets.com magazine, said of these tough times:

> Managers accustomed to spending whatever was necessary to keep Pets.com growing were told to conserve cash while the CEO and CFO [chief financial officer] scrambled to refill the company's shrinking reserves. I knew Pets.com was one sick puppy at the end of October, when management pulled the plug on our print magazine.[109]

After only nine months as a public firm, it looked like Pets.com had come to the end of its nine lives.

Dr. Omar Merlo is an assistant professor at the Judge Business School, University of Cambridge.

[108] *Wolverton, "Pets.com Latest High-Profile Dot-Com Disaster," November 7, 2000.*
[109] *Mast, "Living Through the Death of a Dot-Com," December 13, 2000.*

Exhibit 1

PET OWNERSHIP IN THE UNITED STATES BY PET TYPE, 1999

Pet Type	Total # of Pets (millions)	% of Total Number of Pets	# of Households (millions)	% of Total Number of Households
Cats	59	30	32	33
Dogs	53	27	36	37
Fish	56	28	6	6
Birds	14	7	5	5
Rabbits/Ferrets	6	3	2	2
Rodents	5	3	2	2
Reptiles	4	2	1	1

Source: American Veterinary Medical Association in "Pet Quarters, Inc.," SECinfo, December 22, 1999, available at www.secinfo.com/dsvrp.6B38.htm, accessed June 17, 2009.

Exhibit 2

PET OWNERSHIP IN THE UNITED STATES BY INCOME, 1999

Household Income	% Owning a Pet
Less than $12,500	47.8
$12,500 to $24,999	55.6
$25,000 to $39,000	60.7
$40,000 to $59,999	64.8
$60,000 or more	64.6

Source: American Veterinary Medical Association in "Pet Quarters, Inc.," SECinfo, December 22, 1999, available at www.secinfo.com/dsvrp.6B38.htm, accessed June 17, 2009.

Exhibit 3

MOST FREQUENT REASONS FOR BUYING FROM ONLINE PET STORES

Reason for Buying	% of Respondents
24-hour shopping	54
Orders delivered to front door	48
Low prices	47
Online discount promotions	35
No waiting or standing in line	34

Source: "Online Pet Stores Poised for Success, Reports NPD Online Research," Business Wire, October 12, 1999.

Exhibit 4

PETS.COM FINANCIAL DATA

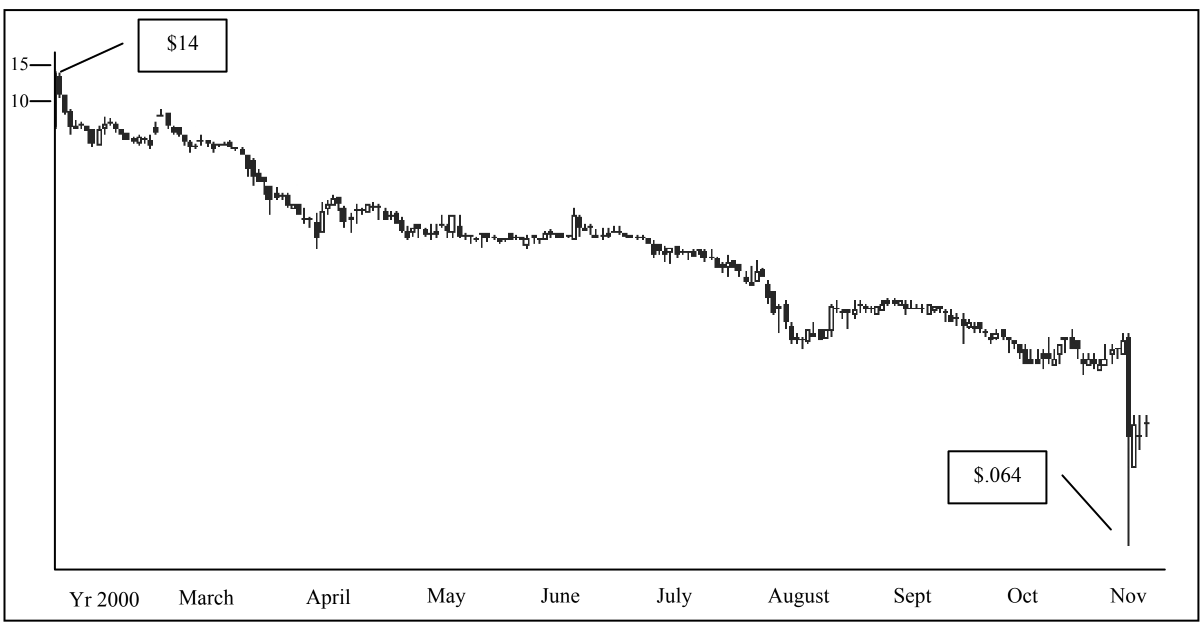
STATEMENT OF FINANCIAL OPERATIONS (in 000s)

	Quarter ended June 30, 1999	Quarter ended Sept 30, 1999	Quarter ended Dec 31, 1999	Feb 17, 1999* to Dec. 31, 1999
Net Sales	39	568	5,168	5,787
Cost of goods sold	76	1,766	11,570	13,412
Gross margin	(37)	(1,198)	(6,402)	(7,625)
Operating expenses				
Marketing and sales	1,122	10,693	30,676	42,491
Product development	1,624	2,194	2,646	6,481
General and administrative	838	1,205	2,211	4,254
Amort. of stock-based comp.	-	1,139	979	2,118
Total operating expenses	3,584	15,231	36,512	55,344
Operating loss	(3,621)	(16,429)	(42.914)	(62,969)
Interest income	123	577	491	1,191
Net loss	(3,498)	(15,852)	(42,423)	(61,778)

Source: John M. Coulter and Thomas J. Vogel, "Pets.com, Inc.: Assessing Financial Performance and Risks in the e-Commerce Industry," Issues in Accounting Education, November 2004. This data also available at http://ipoalerts.edgar-online.com/EFX_dll/EDGARpro.dll?FetchFilingHTML1?ID=in_1091153&SessionID=ohNCWAxkZ3O4H8Y, accessed June 29, 2009.

Exhibit 5

PETS.COM'S SHARE PRICE



Source: Compiled from NASDAQ data.