PETS.COM CASE STUDY DISCUSSION

Pets.com was founded at time when Amazon.com was the inspiration of all dot-com companies. Whereas Amazon.com was the leader in the online books category, Pets.com set out to become the leader in the online pet supplies category. The Amazon.com prescription for success was to grow revenues at a breathtaking pace to sustain investor confidence and eventually grow large enough to be able to generate profits for investors. Because 54 per cent of the shares of Pets.com were owned by Amazon.com, Chief Executive Officer (CEO) Julie Wainwright and her team had access to valuable strategic resources and expertise. The challenge was to replicate the success of Amazon.com and position Pets.com as the leader in the online pet supplies industry. The strategy decisions taken by Wainwright were aimed at the achieving this objective.

The use of the marketing mix to drive revenue was aligned with the growth strategy of the company. Heavy investment in market communication and brand building and an aggressive pricing strategy were part of the marketing strategy to grow revenue rapidly. Wainwright chose not to be overly concerned with profits initially, and the company relied on funding from investors to survive. The company needed to signal to the market that Pets.com was the leader in the online pet supplies category. In Wainwright's view, this approach was Pets.com's best chance of success.

The challenges faced by Wainwright can be broadly categorized into three types:

1. To establish an Internet-based company in an environment in which the Internet was very new and the Internet's impact on consumer behavior was not completely established.
2. To use venture capital money effectively before the company could sustain itself.
3. To develop the organizational structure and strategy for the company to support its growth objectives.

Despite tremendous encouragement in the media predicting the success of Pets.com, Wainwright knew the challenges she faced to make the company successful. In particular, she was aware that Amazon.com would use its strategic assets and experience to enter the online pet supplies industry, and that competing with Amazon.com would be extremely tough given its proven success. Because the market was too small for Amazon.com, Pets.com and three other large players (all backed by venture capital), Pets.com would need to differentiate itself from its competitors.

Thus, the key decisions that Wainwright had to make included the following:

- Whether to compete with Amazon.com or to join hands.
- How to ensure that investors would continue to back Pets.com when other players in the market were competing for the same pool of funds.
- How to develop a marketing strategy to differentiate Pets.com from its competitors and to provide the growth necessary to be profitable in the long term.
- How to build a company identity associated with reliability, affordability and creativity.

Wainwright had the option of either accepting Amazon.com as a competitor or developing a strategic alliance with Amazon.com to prevent it from entering the category. Wainwright convinced Amazon.com to purchase shares in Pets.com, thereby preventing it from entering the market. The mere exit of Amazon.com from the market was as beneficial to Pets.com as it was to the competition (i.e., Amazon.com's exit translated into less competition in the market for all players). The main benefit of the deal with Amazon.com, however, was to build competitive advantage by leveraging the strategic assets of Amazon.com, such as its existing customer base, warehousing facilities and reputation.

Wainwright believed that investors would only continue to back a company that was seen as the market leader in the online pet supplies category. The rationale may be seen as sound because investors want, in exchange for their investment, the guarantee of safe returns, such as that provided by the Amazon.com deal. Indeed, it is difficult to ignore the fact that by July 1999, Amazon.com had demonstrated that, despite heavy operating losses, investors would continue backing an Internet company that was viewed as a category leader on the assumption that the company would eventually generate significant returns. Amazon.com had a presence on the board of Pets.com; but the extent to which Amazon.com influenced the development of the growth strategy is unknown. However, Wainwright was clearly impressed with Amazon's growth model, and, when deciding on a growth strategy, she chose to imitate Amazon.

But some of you may be critical of the Amazon.com deal. For example, often the underdog or a later player receives more investor confidence and eventually generates more profits. Look for example at Yahoo versus Google!

The partnership choice eventually boils down to three options: (1) partner with no one, (2) partner with Amazon.com or (3) partner with someone else. One might argue that a partnership with a bricks-and-mortar pet supplier would have been more desirable, particularly because of the logistic advantages. Indeed, some of Pets.com's main competitors already benefitted from the synergy between the online world and a bricks-and-mortar operation. Another discussion point could revolve around whether Pets.com should have joined hands with some of its key competitors. Given the competitiveness of the market and the risks associated with an attractive market, some of you may believe this approach would have provided a sustainable advantage. Also, in the end, and with the benefit of hindsight, many of the biggest e- commerce success stories have come from companies that were already selling to customers through traditional channels (e.g., Dell, Ryanair and Tesco.com).

Now let's assess Pets.com's strategic approach.

<u>Heavy Spending on Communication</u>

Wainwright's strategic decision was to pull out of the pack faster to be seen as the number-one company in the online pet supplies category. To do this, she wanted Pets.com to become the Amazon.com of the online pet supplies industry and to grow to a critical size before worrying about profits. In the meantime, investors would keep funding Pets.com in the same way they were funding Amazon.com, because of the company's leadership position in the category. The key issues for Pets.com in this regard were the following:

- How to effectively use the marketing mix to execute the overall growth strategy of the company.
- Whether to focus on overall revenue at this stage or on product margins.
- The market communication strategies to employ to drive Internet users to the site and how to convert visitors into customers.
- How to stimulate repeat purchases.

Do you think that the company spent too much on advertising? Or perhaps the company had no choice?

Arguments against the heavy spending on promotion would include the following. First, the heavy spending meant that Pets.com spent an average of $400 to acquire each customer, and then sold a product mix that included low-margin commodities, such as dog food. This approach may be an unsustainable strategy, even in a growth context. Second, Pets.com's strategy is a good example of a "shotgun" versus a "sharp-shooter" approach to promotion. Pets.com used of much of its capital to reinforce its brand. By creating its sock puppet mascot and advertising more heavily than any other online retailer, Pets.com did not succeed in branding itself so much as succeeded in building awareness about the entire online pet category. Pets.com's competitors, all with similar names, benefited as much from the campaign as did Pets.com. In fact, the expensive campaign may have channeled more revenue in the direction of all online e-tailers, and perhaps did little to establish Pets.com as the leader. Third, "unlimited advertising" was a philosophy shared by many failed dot-coms. This philosophy was based on the assumption that the more money spent on advertising, the more successful the company will be. This situation is not always the case, however, because most advertising typically reaches a point of diminishing returns, at which further spending on advertising will no longer be associated with increased sales and profits.

The case study also opens a very interesting debate about the benefits of Super Bowl–type advertising (we touched on this issue in the lecture). In the United States, advertisers love the Super Bowl because it has reached an average television audience of more 120 million American viewers over approximately the last 20 years (the Super Bowl is the single most-watched television event each year). To reach this large audience, companies are prepared to spend $2 million or more to air 30-second commercials, which usually equates to a cost of less than $0.01 per person. The advantage of the Super Bowl is not only access to a large audience but also access to two key demographics: a concentrated male viewership (which is typically difficult to target during prime-time viewing) and adults under the age of 35. The Super Bowl has also been seen as a very successful vehicle to launch new products, since the historic success of Apple's "1984" advertisement (the Super Bowl slot was the only instance in which that advertisement ever appeared as a commercial spot on network television, and yet it resulted in Macintosh's sales skyrocketing to 44 per cent above projections). Also, research has shown that big spending on advertising, such as in the Super Bowl, is associated with improved perceptions of the advertiser, and a positive correlation may also exist between Super Bowl commercials and stock returns.

In light of these benefits, and given a situation where the key driving factor for Wainwright was the short- run objective of growing revenue, some of you might believe that spending heavily on marketing was Pets.com's only option to drive sales. This argument also suggests that the company could not focus on generating profits at this stage because it was relying on additional funding from investors to survive. In fact, the objective of rapidly growing revenues in the first place was to sustain investor confidence.

Those who are critical of the Super Bowl commercial cite the arguments discussed above against unnecessarily large promotional investments and point to the inefficiency of such a method. One might question the effectiveness of the company in actually converting their marketing spending into sales (i.e., marketing efficiency). Given the target demographic of Pets.com, and the need for repeated and more targeted communication to develop interest in the company, some of you may believe that the money spent on the Super Bowl commercial was wasted.

What can the customer behaviour data tell us? For example, because females were more likely than men to shop in this category, the Super Bowl commercial was not very well targeted. Also, research has suggested that the Super Bowl is not always the best vehicle for introducing new companies or products to the marketplace. In fact, evidence suggests that younger companies may affect purchase decisions more effectively and efficiently by advertising more frequently during less expensive programming slots that are targeted more toward early adopter groups.

Another interesting issue pertains to the differences between Pets.com and Amazon.com. Amazon.com became the leader in its category, but how did it achieve this standing? Amazon.com could have easily afforded to advertise more than it did in the beginning and more than it currently does. Instead, the company chose to channel its investment into improvements, such as free shipping, service enhancements and customer relationship management. Amazon.com believed that if you build a great experience, customers tell each other about it and will come to you. Thus, in many ways, Amazon.com built its growth organically, through the positive word of mouth of its growing customer base; it did not set out to "buy growth" aggressively, as big advertisers often do. It may also be argued that Amazon.com succeeded because it was outstanding at distribution and logistics, an area that Pets.com did not seem concerned about.

<u>Low Pricing</u>

Pets.com operated under the assumption that selling products below cost is an effective strategy for gaining customers. Although this approach may be successful in building demand, if the strategy of selling below cost is maintained for too long, failure is inevitable. For Pets.com, delivery costs were a primary problem. Shipping products such as an 18-pound bag of cat food was expensive. Management at Pets.com believed that patience was required and eventually the strategy would allow them to reach the breakeven point and eventually profits. This belief, of course, assumed that funding would not run out before then. However, getting beyond the damage caused by selling below cost proved to be too much of an obstacle to overcome.

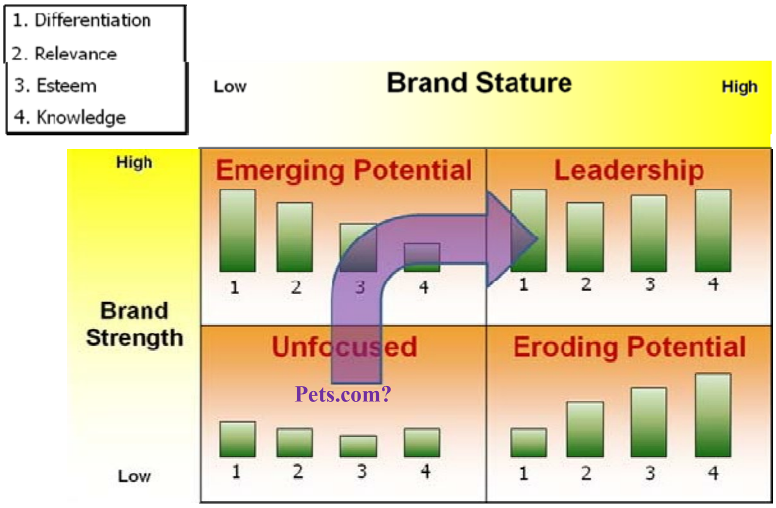
Profit margins on pet products were already notoriously low, and in the bricks-and-mortar world, they ranged between 2 per cent and 4 per cent. Even if the company had achieved the level of sales it required to be profitable, it would still have faced a difficult future. Many Internet ventures were based on the premise they could sell merchandise at unbeatable prices because of their low overhead and superior efficiency. According to this approach, profits would then come from incidentals. Actual customer behaviour, however, often negates these plans.

Again, perhaps Pets.com had no choice: given its growth strategy, Pets.com had to bet everything on the fact that a penetration pricing approach would eventually yield returns, despite losses in the short term. Yet some of you may think that Pets.com was not a sustainable business proposition, particularly in a product category that is not known to be price-sensitive. According to the case study, low prices were not among the main reasons for online shopping. The price elasticity of consumers in this segment appears to be relatively low; testament to this price inelasticity is the growth in popularity of premium brands. A further argument against the low-pricing strategy is that, in the online world, an aggressive price strategy is typically justified on the basis of low overhead expenses and efficiency. It is questionable, however, whether Pets.com benefited from such advantages.

These issues also allow for an interesting discussion of the value of doing business online from the point of view of the customer. The value of the Internet to consumers has been often explained in terms of lower prices. And indeed, consumers often seek out products and services online at lower prices than on the high streets. Yet, evidence suggests that benefits from access to increased product variety in online stores are much more important than price benefits. Thus, the key value of Internet retail to consumers emerges primarily from the provision of products in the so-called "long tail"; that is, in a business model without the constraints of physical shelf space and other bottlenecks of distribution, narrowly targeted products and services can be as economically attractive as mainstream products. An Amazon.com employee once described the long tail as follows: "We sold more books today that didn't sell at all yesterday than we sold today of all the books that did sell yesterday." This description might suggest that instead of being overly concerned with prices, Pets.com should have perhaps placed more emphasis on product variety and convenience. The consumer behavior data in the case suggest that price is only the third most common reason for purchasing pet products online; the most popular reasons are 24-hour shopping and home delivery.

By creating its sock puppet mascot and by advertising much more heavily than any other pet e-tailer, Pets.com arguably did not succeed so much in branding itself as it did in raising awareness about the entire online pet space. Its competitors, all with similar names, benefited as much from Pets.com's campaign as did Pets.com. Thus, the campaign may have pumped more revenue toward all the pet e-tailers, but accomplished little to establish Pets.com as a leader.

The sock puppet raises some interesting questions about the importance given to building awareness by many emerging companies, not only in the online world. Building awareness is an important element of the marketing strategy of any new business; however, the question is whether a new company should perhaps first strive to build a distinctive meaning and appeal and, only after this step has been successfully completed, focus on building awareness. The Brand Asset Valuator model is a useful tool to communicate this point. As discussed in class, the model argues that brand value consists of two dimensions: brand strength (i.e., the brand's differentiation and relevance) and brand stature (i.e., customers' esteem for and knowledge of the brand). The model suggests that new brands start with low strength and stature (i.e., they are unfocused), and that the best path to leadership is to first develop relevant differentiation and establish a reason for being (brands that follow this model display emerging potential). If these paths are well executed, awareness and favorability will follow, which will ensure that the brand achieves a leadership position (the brand then needs to be managed over time to ensure it maintains that position). Thus, the development of differentiation and relevance should take place before the brand has acquired esteem or is widely known.



After the Pets.com sock puppet became a celebrity, a number of marketing experts and observers provided their view on Pets.com's use of the brand icon to build its brand. Here are some interesting quotes:

- *Kevin L. Keller, professor of Marketing, Tuck School of Business Administration, Dartmouth College*: "Although, frankly, the Sock Puppet did absolutely nothing for me, it did give the brand some personality. What is not clear at all is whether such an association would be compelling and relevant enough in this category. I think [Pets.com needs] to get a really clear, detailed snapshot of the market and make sure they understand exactly what type of positioning is sustainable in the marketplace and what type of business model will make that positioning work, assuming such a positioning can be found."
- *Al Ries, chairman of branding consultancy Ries & Ries*: "I consider the job to be getting attention and communicating a message. And I think this only gets attention. Why should I go to Pets.com? The only reason they've left me is to buy a sock puppet. Maybe they'll sell a lot of Sock Puppets, but that's not going to keep the company alive. You cannot win today just by getting a character famous. The character has to communicate a motivating message. Otherwise you've wasted all your money."
- *Peter Sealey, of Haas School of Business at the University of California, Berkeley*: "[Pets.com] should forget brand building and look at direct marketing to acquire customers. You don't build a brand and have consumers flock to it. You build a customer base and create a brand on top of that."
- *Michael Dunn, CEO of consultancy Prophet Brand Strategy*: "[Pets.com needs] to figure out how [to get] interaction with these customers that turns them into repeat customers and profitable relationships. They need to figure out what they need to invest in, change in the product assortment, change in the pricing strategy, that allows them to demonstrate to their investors and the market . . . that they can translate those brand associations into a profitable business model. Until you've been able to demonstrate that customers want to interact with you in a profitable way, I think all the brand building is for naught."
- *Matt Haigh, marketing & branding consultant and author*: "As with many other ill-fated dot-coms, Pets.com spent too much money on building awareness, and too little time questioning whether its Web site was a viable business in the long term. As a result, the company was spending over US$3.50 on marketing and sales expenses for every dollar it made in sales. . . . Sock puppets may be popular, but they can't single-handedly support a brand."

WHAT HAPPENED NEXT

Pets.com had enough money to continue operations for a while, but needed another $20 million to $30 million in funding if it were to become profitable within the desired timeframe. When, by the end of 2000, the Pets.com management and board realized that they would not be able to raise further capital, they aggressively undertook actions to sell the company. The company hired bank Merrill Lynch & Co. to help initiate sale or merger discussions with potential interested parties. However, of the 50 domestic and international prospects contacted, fewer than eight even visited the company. Competitor PetSmart offered less than the net cash value of the company, and Pets.com's board turned down the offer; they would return more money to shareholders by simply shutting down the company while it still had a positive net worth.

On the afternoon of November 6, 2000, Pets.com announced that it was closing its doors, thus becoming one of the first publicly traded Internet companies to fall. Pets.com stock had fallen to $0.19 per share the day of its liquidation announcement. Although the offer from PetSmart.com was declined, some assets, including notably its domain, were sold to PetSmart.com. Of the company's 320 employees, 255 were laid off immediately. The Pets.com management stayed on to provide an orderly wind down of operations and liquidation of assets. During this period, top executives were paid $1.4 million in retention bonuses. In a Securities and Exchange Commission filing, Pets.com disclosed it had paid 10 executives bonuses ranging from $75,000 to $225,000, and CEO Julie Wainwright received $235,000 in severance pay on top of her $225,000 retention payment.