INFERENTIAL FOCUS BRIEFING

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INTERNET REASSESSMENT: DOES AN INTERNET "FLU" MEAN A CRISIS OR WHAT?

Obsession with Internet opportunity and growth has started to look like the addiction to growth that overtook world economies and created the Asian "flu" financial crisis. The ultimate trigger for the Asian crisis was overcapacity, which led to a surplus of manufactured goods, margin squeezes and, eventually, lower profits. Matched with elevated expectations among workers and managers, this led to extensive social and economic dislocation. We are seeing issues related to excess capacity and excessive expectations surface in Internet enterprises, and the resulting pressures are starting to push Internet pricing toward zero.

These realities are forcing a reassessment of the value that Internet enterprises offer, and as a result, we are seeing the beginning of the end of everyone's addiction to Internet opportunity and growth – or directly, the breaking of the enthrallment with anything.com. Stand-alone Internet enterprises may face more competitive pressures ahead, and the stand-alone store system may face additional pressures from Internet enterprises. "Multi-channel" operations – all channels with all services – that envelop customers in a complete system of offerings, services and products can count on return customers.

The Asian "flu" that became a global financial crisis may not be completely analogous to the Internet "flu," which should not lead to a collapse of Internet businesses. But a crisis of identity and value has hit the Internet.

A Different Category of Addiction

Research released at the recent American Psychological Association conference revealed that roughly 6 percent of all Internet users are "addicted" to being online. David Greenfield, a therapist and researcher, contacted more than 17,000 users to ask about their online habits, and he learned that those habits were more like addictions, becoming obsessions to the point of displacing real-world responsibilities. "Marriages are being disrupted," Greenfield noted, "kids are getting into trouble, people are committing illegal acts, people are spending too much money. As someone who treats patients, I see it." This research, according to another therapist, "adds a layer of legitimacy to the concern that Internet addiction is real." Indeed, new online games, like Ultima Online (or "UO," as players call it), have become so successful and their users so engaged that when an August issue of *Fortune* magazine covered the subject, the editors titled the article "The Newest Addiction." (*Atlanta Journal & Constitution*, 8/23/99; *Fortune*, 8/2/99)

The focus on users as addicted may be of interest to therapists who must deal with these problems in their clinics, but a different kind of addiction related to the Internet has caught our attention: an addiction to Internet opportunity – typically of the financial kind.

In October 1996, we outlined the ways in which Asian economies, their leaders and their workers were so addicted to substantial growth that it was causing social, economic and even political dislocations. Eventually, those early signs of trouble in a region of the world, which, to many, seemed to have created a new model for continuous, unending economic growth, erupted into a global financial crisis.

We are seeing signals that the addiction to opportunity in Internet enterprises, which, to many, seem to have created a new way to build and sustain growth, is creating some of the same problems that surfaced early in the Asian crisis: excess capacity, marketshare battles and desperate quests for new markets, all approached with hyper-extended expectations. In the Asian situation, these realities led to asset and price deflation (margin squeezes), market protection and heated legal (or political) conflicts, realities that are also starting to appear in the Internet arena.

An Addiction Thing, Again

The fundamental cause of the Asian and global financial crisis was the excessive dependence on and then the necessity of growth to sustain social stability and political power. Leaders seemed to have no choice but to use any and all means available to them to keep the overheated growth going, because heightened expectations of continued growth and steadily increasing wealth had become endemic. Vulnerability in the hyper-growth charade, however, first surfaced in excess capacity. To drive growth, business leaders developed new facilities and expanded capabilities until the system produced more stuff than even the entire world market could consume – especially a world market filled with other companies that were also overproducing everything.

In the Internet arena, infrastructure bandwidth offers a telling example of what is taking place. As telephone companies have expanded their line capacity, long-distance prices have steadily fallen, already dropping from the 10 cents per minute that drove the market just last year to 5 cents per minute now. That reality led Sprint to cease using its "dime lady" (Candice Bergen), and it inspired one pundit to suggest that the company might want to plan for the near future by signing endorser contracts with pro-basketball star "Penny" Hardaway and actress Penny Marshal.

The capacity issue, however, goes beyond this single piece of telephone business. New competitors like Qwest, Global Crossing, IXC Communications, Williams Companies and Enron (the last two, energy companies), worked to expand bandwidth to facilitate Internet traffic at ever-greater speeds. With these companies rapidly laying fiber-optic systems and with technological research in that area increasing fiber-optic capacity by factors of 16 to 32 times (with experiments pushing that to 160 times), capacity has exploded. Telegeography, Inc., looked closely at this reality and discovered that in 1997, the world's public-telephone networks carried 81.8 billion minutes of international calls – equal to 155,623 years of constant contact. Yet despite this amazing stage of development, **new optical systems coming online can transmit that entire 1997 load on a single line in 11 days**. (*New York Times*, 7/11/99)

Essentially, the scarcity of capacity that drove the financial plans to expand the systems has led to excess capacity that undermines the credibility of the original financial plans, a reality that matches closely the rapid expansion of capacity among Asian manufacturers during the years preceding their crisis. As a result of the communications capacity issue, industry players have engaged in market share battles, which, in turn, have led to margin squeezes.

Following a behavior path much like that taken by Asian manufacturers, telephone companies – both regional operating companies and long-distance providers – have started to search for ways to enter new markets hoping to sustain growth via revenue streams outside their overbuilt traditional markets. One way of reaching new markets has been through mergers and acquisitions. For example, AT&T acquired cable giants Telecommunications Inc (TCI) and MediaOne and made an alliance with a content provider (Warner Communications) in an effort to move beyond the margin-squeezed long-distance telephone service and become a content service provider into the home.

Another technique for gaining access to new markets has been to form partnerships. To take just a single example, Qwest, one of the players responsible for the excess capacity issue in telecommunications infrastructure, announced partnerships with KPMG, BellSouth, Siebel Systems, SAP American, Hewlett-Packard, Oracle and Automatic Data Processing Brokerage Services, all intended to move the company into a market area with higher margins.

Growth resulting from a movement into new markets eventually faltered for Asian manufacturers, leading to efforts to protect their markets, often using domestic politics as a weapon. In the Internet battle, AT&T faces challenges to the local service monopoly it purchased when it bought TCI and MediaOne, cable companies with monopoly distribution authority in areas they serve. But other suppliers of online services have challenged that monopoly in court and are lobbying the Federal Trade Commission (FTC) to create "open access" systems. Such an FTC ruling would force cable companies to "open" (*i.e.,* lease) their infrastructure to companies interested in linking local customers to the Internet or in offering other to-the-home services. Already, the Canadian Radio and Telecommuni-cations Commission has ruled that cable operators in that country must maintain open systems. In south Florida, Miami-Dade commissioners voted to require the local cable company (MediaOne) to make its system available to any and all Internet service providers (ISPs). AT&T promises to appeal that decision as it already has a similar decision in Portland (OR). (*Miami Herald*, 7/11/99; *Electronic Media*, 7/12/99)

The telephone example highlights the larger issue facing Internet enterprises. The focus on growth has led to excess capacity, which has created margin squeezes and marketshare battles. These uncomfortable realities have inspired major players to move outside their traditional business arenas in search of larger margins – that is, in search of a way to satisfy their growth addiction. In turn, many companies have had to protect their own markets against new competitors, which eventually has returned them to another margin-squeeze problem.

It's Not Just Infrastructure

Excess capacity has hit many areas of Internet-related business. New competitors offering similar services at lower price points, more efficient connections or better service continue to surface in every area from e-business to games, all forcing prior leaders into the same situation that the telephone companies face – tighter margins. Some still hope that techniques that have lost their effectiveness in the physical marketplace will somehow work in the online marketplace. For instance, E*trade is trying to defend its marketshare with advertising. "We have 100 competitors," admitted Jerry Gramaglia, the online broker's senior vice president for marketing. Spending significant sums on advertising, according to these companies, gets them "noticed" in the increasingly crowded marketplace. Just in case that traditional tactic failed to increase business, however, E*trade spent an additional $1.6 billion to buy Telebanc Financial, hedging their situation by entering a new market, online banking. (*AP Online*, 7/22/99; *Wall Street Journal*, 7/12/99)

Other companies continue to spread themselves into new markets, believing that the traditional tactic of brand and line extensions will work in the ephemeral and volatile online market. Amazon.com keeps adding new products to its line of offerings – most recently, toys and electronics – hoping, perhaps, to secure some market share in those areas before a capacity-busting Wal-Mart, with its high-volume buying power, enters the e-business fray this year. (*Miami Herald*, 7/14/99; *Business Week*, 7/26/99)

Based on the Asian experience, new markets eventually lose their ability to generate new growth, leading to the merger-and-acquisition phase. As in the telephone example, the entire Internet enterprise has moved aggressively into this phase of growth addiction. In the first six months of this year, information-technology, communications and media companies announced 2,900 mergers and acquisitions valued at $545 billion, far exceeding the $283 billion announced in the same period in 1998. (*Wall Street Journal*, 7/25/99)

The merger-and-acquisition activities lead to market protection – that is, trying to protect existing markets from encroachment on every front. For example, the music industry consortium seeking to preserve the sanctity of copyrighted music recently completed its Secure Digital Music Initiative, which seeks to stop the online "theft" of the industry's recorded music. However, that plan does not stop once-contracted artists from leaving the industry's structure altogether and creating direct online connections to customers. The appearance of a heretofore-nonexistent competitor (artists bypassing the industry system) will, in turn, put pressure back on industry pricing. (*New York Times*, 7/14/99)

Pricing pressure resulting from an Internet growth addiction continues to mount. For example, America Online (AOL) has had to cut subscription fees by up to 50 percent in the United States because of multiplying competitors, all with special pricing plans and unique or innovative capabilities. Moreover, just to become competitive in the United Kingdom, the American ISP has had to offer its service for free. (*International Herald Tribune*, 7/20/99)

In fact, "free" is becoming the ultimate margin squeeze price. Fax, voice mail, long-distance calls, recorded music, copyrighted documents and other types of resources that once brought a price online and off are currently available free through some Internet service. NetZero has attracted 1.2 million customers to its no-fee Internet connection. Yahoo does not charge for its Internet directory service, Netscape gives away its browser, and some Hallmark cards are available free at its Internet site. The Egreeting experience illustrates the developmental pattern of the no-charge business model – an Internet exclusive.

❖ One year ago, Egreeting Network was selling e-mail greeting cards for prices ranging from 50 cents to $2.50. With this pay model, the company managed to get 300,000 users to register on its site, but actual sales lagged. With sales slumping, the company turned to the ultimate margin squeeze: free cards. Now its site has 7 million registered consumers, which the company hopes to leverage into advertising revenues. (*Wall Street Journal*, 7/28/99)

The no-charge business model depends on selling advertising, something Egreeting thinks will ultimately replace revenues once generated by selling its products. In the *Briefing* "…And Money Comes from Everywhere: Advertising – A Favorite Financial Tool – Faces a Tougher Reality on the Internet" (**IF 2015**, 6/4/99), we described the troubles facing any Internet site that relies on advertising as its primary source of revenue. The anomaly in the situation, we noted, was that as the number of Internet users was steadily rising, the price of advertising was steadily declining. In short, advertising on the Internet, like other businesses on the Internet, is confronting a margin squeeze.

Thus, the financial model emerging from the Internet enterprise tends toward zero margins. That, in turn, leads to advertising as the primary source of growth, a risky bet in the best of times. Based on the Asian example, this model of diminishing revenues runs headlong into the addiction to growth, which has until now been the source of the "money [that] comes from everywhere," which we discussed in the just cited *Briefing*. But so far, Internet companies have managed to avoid what happened to Asian companies because of their ability to exploit novelty (whether enhanced capabilities, new products or new services) and expand into new market areas (the latest being "broadband"). The Asian example, however, suggests a limited reach to such responses.

Reassessment and Its Implications

This year, we have written three *Briefings* related to the Internet, and taken together, they begin to sketch an image of a developing Internet business environment. First, in "Selling Is the Easy Part: The Learning Curve Steepens for Internet Marketing" (**IF 2002**, 2/2/99), we noted that companies selling products online were discovering that customer service was not simply a technological gimmick and that sustaining customers in order to create a real business involved much more than merely filling orders from an attractive Web page. In our next *Briefing* on this subject, "…And Money Comes from Everywhere: Advertising – A Favorite Financial Tool – Faces A Tougher Reality on the Internet" (**IF 2015**, 6/4/99), we added that Internet realities were pushing businesses to depend increasingly on advertising as an essential part of their business model. However, Internet capabilities make measuring advertising effectiveness very easy and consequently are forcing advertising prices to decline. Now, with this *Briefing*, we add that overcapacity in infrastructure and competitors is putting downward pressure on pricing, that unlimited competition has altered the marketplace and that traditional marketing tools are less and less effective in the online environment.

Together, these *Briefings* point toward a change: We are seeing the beginning of the end of everyone's addiction to Internet opportunity and growth – or said more baldly, the breaking of the enthrallment with anything.com. We are also seeing the start of a reassessment process as to what is the most effective aspect of online enterprises.

Users have already started reassessing the value of online buying:

❖ After four straight quarters of spectacular growth, the percent of people with Internet access actually making an online purchase declined in the second quarter of this year. The figure dropped only from 74 percent to 71 percent, but after shooting upward for four quarters, an actual decline seemed rather abrupt and hinted that market penetration limits and weaknesses in the buying processes are affecting buyers. (*New York Times*, 8/2/99)

Online retailers are realizing that Internet selling cannot stand alone as easily as they thought just a few months ago, and this reality is forcing a change in strategy. Alloy.com, which sells clothes online, saw its sales skyrocket when it opened a catalogue division and mailed its teenage market the first issue. Similarly, Soma.com, which sells drugs online, became part of CVS, a huge bricks-and-mortar drug retailer. That prompted a competitor, Drugstore.com, to sell a 25 percent stake in its operations to Rite-Aid, also a huge physical outlet operation. Meanwhile, Tiffany, which swore it would forever remain a store-based operation, announced it would add an online component, something that department store giant Nordstrom just did as well. Also, Charles Schwab, which originally shifted from a low-cost provider of brokerage services to an online (but not low-cost) provider of brokerage services, has now moved past the Internet and is building more and more physical outlets. Of course, the biggest of the emerging "multi-channel" retailers will be Wal-Mart, once it goes online later this year. The power to buy in huge quantities – for stores and online sites at the same time – has Internet-only retailers worried. (*Economist*, 8/21/99)

The reassessment of Internet effectiveness is lowering the value of online-only selling. But the added dynamism that having more than one retail channel at the same time brings is also lowering the value of store-only retailers. In response, BancOne launched WingspanBank.com, an online banking operation that can compete for the same retail customers that the original bricks-and-mortar BancOne outlets now have or would like to have. Similarly, Toys R Us, Petsmart and Barnes & Noble Bookstores have created separate online businesses that can compete with the original stores.

Having these channels, of course, is not the same thing as doing these channels well. Online retailers who fail to provide satisfactory customer service, as we noted in the first of our three *Briefing*s, will not benefit from being online. Schwab is adding bricks-and-mortar outlets to increase business strength, but they have intertwined their functions and involved customers in an elaborate and expanded web of relationships. As we mentioned in "The New Mainstream, Part III" (**IF 2020**, 6/30/99), this model of "web thinking" is most effective in the new business environment.

Three other past *Briefing*s expand upon the possibilities of this changing Internet business environment. First, "From Selling to Buying: A Shift in the Customer-Retailer Relationship" (**IF 1929**, 9/30/98) described how the customer was taking control of the retail relationship and how selling techniques no longer worked. As Scott Eckert, director of Dell Online, explained, "Our job is to put people in charge of the buying process."

Another *Briefing*, "A Higher Threshold: Connecting with the New Consumer" (**IF 1908**, 3/20/98), identified attributes that seemed to please consumers: They were looking for resources that were extremely useful and highly entertaining, and that left them alone (this being part of the "customer is in control" approach).

The third *Briefing* focused on the online retailers. "Internet Retailing: What Works; What Doesn't; What's Missing" (**IF 1911**, 4/13/98) anticipated the current state of affairs and suggested a few additional ideas to interest buyers, some of which have come to pass: give it away (free access); customize it (customer-created products); get a proprietary product (uniqueness holds interest); engage the customer (expand the relationship); and create a community (develop a connection to transcend the transaction).

These parts of a new business strategy can overcome the vulnerabilities of e-commerce. The Internet reassessment and revaluation should encourage business participants to use a web thinking approach to develop these new relationships with customers.

Is It a Crisis or What?

The Asian crisis that became the global crisis started with an addiction to growth. The scope of the damage that resulted certainly exceeded the expectations of those who originally dubbed the situation the Asian "flu." As we have mentioned in recent *Briefings*, the positive blips seen in Asian economies in the past few months have much to do with those countries reverting to the same growth techniques that got them in trouble in the first place.

What we see developing in the Internet arena bears a structural or formal relation to the Asian crisis – that is, the form, not the substance, of the situations are much alike. Participants in the boom that has been Internet business have created hyper expectations that have fueled a feeling that growth, indeed super growth, can go on endlessly. Moreover, they have progressed through phased responses to the shortcomings resulting from these expectations in a manner similar to what Asian companies did.

A close look at the Asian crisis reveals a pattern of efforts that moved the trouble toward a crisis. That pattern is being repeated in Internet business: excess capacity leading to marketshare battles leading to new market quests all taken within the context of hyper-extended expectations of growth and financial return. Already, Internet companies are facing margin squeezes, many are trying to defend and protect their markets and some legal battles have already broken through the Internet delirium.

This does not mean that an Internet business collapse is imminent or that a global financial crisis is at hand. Rather, events unfolding suggest a new Internet business environment, aspects of which are:

- An unlimited breadth of operations that makes excess capacity and expanding competition inevitable;
- Market vulnerability – to new competition, new technologies, new markets, and new consumer attitudes – that can overwhelm traditional market techniques;
- Devolutionary financial models that push pricing toward zero;
- Volatility that converts business alliances and consumer connections into survival techniques;
- A competitive environment that favors openness even as that openness undermines market-share stability.

Is this a crisis? Yes, but not of the type that spread from the Asian "flu." Rather, it is a crisis of identity and values that is leading to a category of changes that is shifting thinking, attitudes and operations. For now, we might just call this expanding Internet reassessment the Internet "flu."