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# Crisis.com

-The 2000 “dot-com crisis” and its relation with demand, supply, network externalities and the objectives pursued by companies-

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## **Crisis.com**

The 2000 “dot-com crisis” and its relation with demand, supply, network externalities and the objectives pursued by companies

### **Overview of the dot-com crisis**

Dot-com companies are the collection of start-up businesses that sell products or simply services by means of, or related somehow to, the Internet. In the late 1990s a stock-market bubble took place, this means that there was a big rise (or boom) in the share value of stock of the Internet Industry, which crashed after the difficult year of 2000. These dot-com companies were stereotyped as having really young and inexperienced managers who had to work for extremely long hours and at high pressure. But the problems came along, not so much with the Internet Industry at large, but how these companies were being operated. They would advertise themselves giving away all types of freebies from pens to t-shirts and stress balls, in parties and other venues, that had the company’s logo on them. They mainly wasted budgets on this advertising or in rapid development assuming that in a year’s time the company would increase one hundred times its original size. What they did not foresee is that society (and humans themselves) needs to adapt to changes, and they do so slowly. This did not mean that they were all going to fail (in fact, we can see already that the Internet Industry is growing promisingly) but that it was going to take more time and maturity than the first wave of investors comprehended. So when, metaphorically speaking, this bubble burst, all the shares became just a small fraction of their value at the height of the boom and many of

these companies went out of business completely. The crash also had to do with the fact that in that period it was relatively easy to get money for new businesses, even for those without well prepared plans. Quite often companies were funded based on nothing else than an idea. Under these conditions it was natural that many companies that were founded, had very small chances of survival.

### **Demand, supply, network externalities and objectives pursued by companies**

There are some important terms to be considered here, but a definition of them must be given first:

- The “demand” is the quantity of a service wanted at a specified price and time.
- The “supply” is the quantity of a service offered or available at a specified price and time. For example, someone needs to supply a restaurant with its raw materials (that is, the food) or even the heating.
- The “network effect” (or “network externalities”) causes the service to have a value to a potential customer dependent on the amount of customers already using this service. For instance, by purchasing a telephone you make other telephones more useful.
- Finally, the “objectives” of a company are the goals or aspirations it wants to achieve, and was created for.

## **The 2000 dot-com crisis and demand, supply, network externalities and objectives pursued by companies**

It has only been 20 years since Internet started, but it is already present everywhere. Its easy, instant access to a vast amount and diversity of information, data, products, and even people, has allowed the possibility for companies to target not only the hundreds, thousands or even millions of people they have in their village, city or country but thousands of millions all around the world, without having to leave their offices. This assumption combined with the easiness with which one can set up a web page (basic html –hypertext mark-up language– knowledge can be acquired within a few days) lead to the belief that all you needed was some investor supplying an initial economic input to create an Internet-based company that would have millions of clients and, consequently, would make the owners of the companies instantly rich. All you had to do was to choose a product to sell, and as the clientele was so large, any product was bound to have its audience.

Based on all these assumptions, starting in the 90s many young people (more familiar with the computer-based society developing, and ready to try new things) started Internet-related companies (hence their “.com” nicknames) with the objectives of reaching success and becoming rich with little effort. Once they had an idea or a product like, for example, telephones (to continue with the initial example), and the idea to sell say, small, nice and, most importantly, cheap and easily accessed (no need to move from home to order or pick up the product, with an assured quick delivery) fixed telephones for every household to have, and substitute the larger and already antiquated ones present in those houses, all they had to do was go public (this is, to disclose the financial situation

and prospects of the company to the prospective investors, and sell the common shares). Then the stock price would increase instantly as investors would want a share in the profits the new companies would make (and become instant millionaires).

Now, these companies had the money to start-up and get the basic requirements for the business to work: a place to work from and make the product, staff (from the hands-on workers to the administration or advertisement personnel, the quantity depending on the type of enterprise), the raw materials to make the product, etc. Things like the rent of the buildings the company is based on, the company's infrastructure (PCs, telephones, ...), will make up the fixed costs, which will be independent of the size of the production (also known as indirect costs). On the other hand, they will have the costs related to the amount of production, this being, for instance, the amount of raw material (this will make the variable cost or direct cost). The price of the products then will have to cover the direct cost of each product at least. To break even, you will also have to charge for each product the total fixed cost divided by the number of products to be sold. The larger the number of products, the lower this added "price" for the product will be. But this price will be approximately the same for all the companies with the same products, so to gain the clientele, the company will have to lower its price per product, by charging less than the amount needed to cover its indirect costs. And so the idea to offer products at very low prices, even knowing that they will have losses at the beginning, in the hope that in a year of business there will be enough "faithful" clientele to increase the money income and finally, recover the losses and eventually start making profits.

So, suddenly, there was a large supply of countless products, for example, books online, from similar dot-com companies. Many companies starting at the same time with

the same target audience and similar products. To be able to attract the public, they had to do aggressive advertisement: free products in expensive parties, lower prices for their products than all the other companies of the same characteristics, etc. As for the sources of demand, it could be divided into two groups: the first, more advanced, group was formed by an increasing number of people everywhere in the world, who searched and found the cheapest offers and “over-subscribed” to the more successful companies (those offering the best products, prices, delivery conditions, ...); the second group, which was still not familiar with the idea of online shopping. This latter group was presumed to become interested in online shopping slowly but steadily. The speed, though, was not enough to produce the necessary clientele to contribute to the demand in such a short time. Hence, only the “best” companies in each area would have enough clientele to survive. They had the first group of customers. But the same interest in their companies that these people provided, which would have been the source of profits to the best companies, exceeded the clientele they were able to handle. Finally, these companies were not able to fulfil their initial promises (for instance, delivery speed), and were unable to deliver. Therefore, with huge losses and no profits, ended up bankruptcy. The companies for which advertising was a success had their number of clients increased. Following the network effect, the increase in the buyers of the product, increased the value of the products themselves, and this would in turn increase the interest in the products and, closing the circle, the number of buyers would continue increasing. But the number of people interested can be above the capabilities of the company, specially if it has not done extended and careful planning. Once the clients saturate the capabilities of the company, the company’s services lose value as it stops being able to supply enough

products to cover the demand and losses and from then on, it goes down-hill until it collapses.

## Summary

The dot-com companies that raised and collapsed during the twentieth century, with their young entrepreneurs which managed their companies assuming Web-based businesses were a bottomless well of increasing orders, even though still losing money, lacked a plan to make sure they could cope with the demand that companies of their characteristics would require, and were not able to cope with growth nor competition, finally running out of money and customers.

Internet companies realized that they could not change the world in a matter of months and that unless profits are made soon enough, the money dries out and the business collapses.

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