Journal of Management & Public Policy
Vol. 4, No. 1, December 2012, pp. 4-16
ISSN (Print): 0976-013X ISSN (Online): 0976-0148

Pathways to Failure of New Ventures: Markers of Failed Internet Ventures

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Abstract

In this paper, we examine the most frequent pathways that are followed by failed non-failed Internet ventures. Based on an examination of several Internet ventures that completed initial public offering during 1995-2000 we found that pathways of failed ventures and non-failed ventures were different: pathways of failed venture were relatively complex, and both pace of events and level of activity along the pathways were relatively high. In contrast to the failed-ventures, the non-failed ventures seemed to maintain a very simple agenda, attend to one change at a time, and keep the change activity level low. We also examine managerial implications of the pathways.

Keywords: Internet Ventures, IPO, Bankruptcy

Prior to the market shakeout in year 2000, market value of Internet companies was estimated to exceed $1 trillion according to Barron's Online 2000, and it fell to $572 billion in December 2000 (Morgan Stanley Dean Witter, 2000). Destruction in value following an initial public offering (IPO) may not be as high in other industries, such as packaged software ventures, that completed IPOs during the same period. However, Clark (2002), based on a study of 1234 firms in 14 industries that completed IPOs during 1991-1997, reported that 3.9 per cent of the newly-minted public firms – in technology and non-technology industries alike – experienced financial distress and their stocks were de-listed within three years. Life after IPO can be rocky!

While cross-sectional analyses of large data point to several reasons for the failures, e.g., high levels of non-investment expenses and shift in investor sentiment toward using more conservative valuations, one question that persists is: What are the most frequent pathways, i.e., series of linked decisions, actions, and events, to failure of new Internet ventures? And, what are the differences in pathways, if any, between failed and non-failed

Internet ventures? In this paper, we have examined these and related questions by studying the case histories of several Internet ventures that have completed IPO during 1995-2000. The pathways to failure and their implications have been discussed in the paper.

Background

Failure rates are generally high for new ventures: According to Timmons and Spinelli (2004), roughly one in five new ventures fail. Earlier studies of new venture failures show that two out of three new ventures die within seven years. From a broader perspective, Stinchombe (1965) indicated that the risk of failure of new ventures is extremely high due to the "liability of newness." New ventures require the development of new roles, standard social and operational routines for running the business, relationships with stakeholders (e.g., suppliers, buyers) in an effort to gain trust, and a dependable customer base to utilize its products or services. Since Stinchcombe's (1965) writing, multiple factors, some from the external environment and some from international environment have been identified as causes of new venture failure.

With external factors, according to a study reported by Wall Street Journal (Otober 16, 19992) on overall new business failure rates , about 47 per cent of the failures were due to "economic factors," Also, performance tends to be lower (Covin & Slevin, 1990; Kunkel, 1991; Miller & Dess, 1996) for ventures operating in the introductory stage of an industry. With internal factors, new ventures are reported to have failed due to a lack of management skills, inappropriate strategy, poor vision, and poor management of capital (Zacharakis, Meyer & DeCastro, 1999). According to Meyer and Dean (1990), when new ventures reach 'executive limits' of the entrepreneurial team, that is, when the top management team can no longer cope with the demands placed on the venture and the team members are not replaced, the ventures are likely to die.

Transition from privately held venture to publicly held firm presents additional risks: At the juncture of IPO, there are risks associated with strategic initiatives that new public ventures initiate, e.g., acquisitions, mergers, and alliances, and strategic adaptations that new ventures attempt to undertake. New ventures contemplating IPO or ventures that have just completed IPO face rather unique challenges. A traditional approach to understanding new venture failure is to identify the relative importance of various factors associated with failure, and manage the risks appropriately. The assumption underlying this approach is that a few factors are deemed as pivotal to venture survival and that focusing on the factors would be fruitful. Also, these factors, acting independently, cause a new venture to fail. For example, Wilbon (2002) reported that enhancing core technology resources, e.g., R&D spending and recruiting executives with technology experience, early in the life of the venture raise the odds of survival of the venture after IPO.

An alternative perspective that we present in this paper is: a "combination" of factors causes failure. Process of failure is akin to the process by which accidents occur. According to Perrow (1999), failures are "normal" events. Cook and O'Connor (2005), in a review paper on "thinking about accidents and systems" reviewed several accidents in settings ranging from nuclear power plants, space agency, and hospitals. Cook & O'Connor's review and the stream of literature on accidents (Perrow, 1999) offer several useful leads for understanding new venture failures.

1. Though new ventures are formed with growth and value creation in view, a number of features put in place, e.g., financing, corporate and business strategy, organizational structure, management systems and processes, in themselves may have "holes" or develop holes over time. The holes are markers of impending failure of new venture.
2. The holes serve as latent conditions and "conspire" with other conditions, e.g., economic conditions, to result in a perfect failure. The latent conditions come to exist for a variety of reasons:
   Executives in new Internet ventures often deal with new and emerging technologies and markets. In early stages of industry, it is rather difficult to see the holes and assess their potential impact. In early stages of industry evolution, e.g., Internet technology-based industries back in late 1990s, executives face the question: what might work in this industry? Therefore, executives tend to engage in experimentation to identify strategies that might work. It is often difficult to distinguish "holes" from strategies that might work.

   As industry evolves, strategies that work become clearer but a different question comes to the front: what will work for my venture? And, strategies that worked for other ventures in the industry or a different industry might prove to be "holes" for certain ventures. Transition from private venture to public firm involves experimentation and selection of a winning strategy. But the presence of certain latent conditions, e.g., founding team characteristics, ownership structure, and alliances, technological resources, of the venture may render experimentation and subsequent selection of strategy ineffectual.

   Successful transition of private ventures in to publicly held firms involves a series of restructurings (Bowman & Singh, 1993; Matens, 2004). Those include:

- Financial restructuring – it involves converting venture capital, private placement, preferred stock, debt, and other forms of financing in to publicly held stock
- Portfolio restructuring – it involves acquisitions, mergers, forming alliances, and selling-off certain business lines to sustain the growth and value of the venture
- Organization restructuring – it involves redesigning systems and processes so that venture strategies are executed effectively and efficiently
- Management restructuring – it involves restructuring the board of directors, top management team, changing the form of organization to reflect the restructured portfolio of businesses of the venture

Navigating these restructurings can be risky and can raise the odds of failure of the newly minted public ventures. In this paper we have examined the following questions: What were the most frequent pathways that lead to the new venture failures during the 2000 Internet bubble? And, what were the differences, if any, between failed and non-failed Internet ventures?

Study Design

For the purposes of the study reported in this paper, we identified Internet ventures as ventures that use "…Internet technology in their business to re-form markets for known products and services as well as those that use the Internet to pursue breakthrough market opportunities" (adapted from Chaganti, Watts, Chaganti, Zimmerman-Treichel, 2008). Also, we defined failed ventures as ventures that exited their businesses and closed doors permanently. The exit might have occurred via bankruptcy or voluntary liquidation of business by selling some or all parts of their assets to meet financial obligations of the ventures.

Internet technology space is comprised of a wide array of ventures using a variety of business models – portals and search engines, at one end, and on-line banks, pharmacies and retailers, at the other end, and combinations of the two ends in between. Day, Fein, and Ruppersberger (2003), in their study on shakeouts in digital markets, reported that odds of failure of Internet ventures depend on the business model of the ventures. Accordingly, to identify the pathways of failed and non-failed new ventures, we followed the following steps in the study design:

Step 1. From a list of 227 new Internet ventures that were tracked by Pegasus Research International, an independent investment research firm, and reported by Willoughby in Barron's magazine (Willoughby, 2000), we identified 28 ventures that have failed during 1995-2003.

Step 2. Each failed venture identified in Step 1 above, was paired with a non-failed Internet venture in such a way that both failed and non-failed ventures have same business model.

For each venture identified in Steps 1 and 2, we tracked the developments – IPO-related events, changes in performance, management responses – that occurred and time line of the developments. Data for the study were extracted from FACTIVA – a news archival source that continuously tracks news items and reports from major print media, including Wall Street Journal, New York Times. It includes archives of public and private ventures. For each venture, we tracked developments from the date on which venture announced its IPO to the date on which the failed venture declared its liquidation or bankruptcy. The grid that we used to trace the developments in each venture is presented in Table 1.

For the purposes of this paper, we analyzed case histories of the following failed ventures:

1. Garden.com – B2C retailer of garden related information and merchandise
2. Furniture.com – B2C retailer of furniture-related information, advice, and merchandise
3. Value America.com – B2C retailer of computer related products, grew to electronics and general merchandise.

Also, the following matched-pairs of failed and non-failed ventures:

1. Applied Theory and BizLine
2. Breakaway and Be Free
3. Calico and Critical Path

4. Acclaim and Backweb

Study Findings

It is generally acknowledged that failure is not an event; instead, it is a process. Failure of firms, most notably relatively old firms, seems to follow a downward spiraling process. According to Hambrick & D'Aveni (1990), who studied the process by which relatively established firms end up in bankruptcy, the seeds of bankruptcy may be laid as far back as ten years prior to actual bankruptcy. Following a shock – environmental or internal shock, firm's slack is impacted and depletes the ability to withstand further shocks. The downward spiral may be set off by top management's misperceptions of events and erratic choices in adverse conditions that then further speed the failure process.

Along the same lines as above, new venture failure is often preceded by a series of events and responses on the part of the founding team. Studying the events and founding team's responses to the events along the way to failure can pinpoint the "markers" of failure; and potentially the markers help entrepreneurs avoid the pathways to failures.

Overall, the failed ventures that we examined were founded in 1995 and 1996, announced IPO around 1999, and completed multiple rounds of private funding prior to IPO. Since the announcement of IPO, failed ventures received awards and recognitions, formed alliances with technical, marketing and promotional partners, and made top management changes. According to the statements of the founders and the founding team members of the failed ventures, scale of operations is viewed as key to profitability.

Further, our examination of failed ventures suggests two specific markers:

1. Founders and founding team members expressed a strong sense of optimism and confidence in their business models and odds of their success. Here are a few examples of this sense of confidence:
   Value America.com

   "We're in here to change the world. We're literally in business to change the way people buy and sell products."

   "…Hire the best management talent and driving revenues through its innovative advertising campaigns. The Company believes such expenditures, as well as continued growth in the breadth and depth of brand name products sold in its online store at Valueamerica.com, are critical to achieving scale and customer satisfaction."

   Furniture.com
   "Unlike a bunch of gear heads who may just put up a site that's technology or functionality-driven, ours is grounded in an understanding of why and how people buy furniture," he said.

   "Combined with our $27 million in financing, this sends a strong message that we're here to weather the storm"
   Garden.com

"We don't have serious competitors at this stage, and it's because of our supply chain. It's a virtual warehouse, and it's hard to build".

2. Another marker of failed ventures was: vacillation around the IPO decision. The series of events surrounding IPO in the three failed ventures, presented in Figure 1, show that there was back and forth on the decision to go public and its timing.

It is noteworthy that both markers that we have identified are behavioral in nature.

Pathways to Failure

Turning to the pathways that distinguish failed and non-failed ventures, trace of events that occurred in the failed and non-failed ventures over twelve consecutive quarters are presented in Figure 2.

Based on an examination of the events, the pathway to failure of new ventures is as follows:

1. Complexity. Pathways of new ventures that filed included a complete suite of events, viz., finance related, organization-related, and portfolio-related activities, followed by management-related activities. In contrast to the above, pathways of non-failed ventures were relatively simple. They included primarily portfolio-related events and, to a lesser extent, organization-related events. As such, pathways to failure were more complex than the pathways of non-failed ventures.

2. Pace of events. Along the pathways to failure entrepreneurs were engaged in a wide array of events all at the same time. There was much too much "traffic" on the pathways. Managing a wide array of events in a concurrent fashion stresses the founding teams of the newly minted public ventures and seems to risk the very survival of the ventures. In contrast to the above, traffic on the pathways of non-failing ventures was relatively light: entrepreneurs in non-failing teams were dealing with one set of events at a time, e.g., portfolio-related events followed by organization-related events.

3. Level of activity. Failed new ventures, according to Figure 2, were engaged in relatively high number of events whereas non-failed ventures were engaged in relatively low number of events.

We are unable to make any comments on statistical significance of the differences between the pathways of failed and non-failed ventures, as the number of cases examined in the paper is rather low. Nor do we claim her generalizability of the findings to a larger population of ventures.

Concluding Remarks

Going public involves major strategic changes. It involves a series of changes – finance-related, portfolio-related, organization-related, and management-related. Some of the changes may prepare the venture to successfully complete its IPO. Some other changes made after the IPO may be aimed at maintaining or enhancing the performance of the new venture as a public entity. In this paper we focused on the changes that entrepreneurs make shortly after completing IPO. Specifically, we explored the markers of failed ventures and differences between the pathways of failed and non-failed ventures.

Based on the case studies examined in the paper, we found two markers that distinguish failed and non-failed ventures:

1. Degree of optimism and confidence in the business model. The exaggerated sense of optimism as a marker of failed ventures is consistent with earlier research writings: Kahneman & Lavallo (1994), writing on timid choices and bold forecasts, suggest that entrepreneurs tend to have "cognitive blind spot" and overestimate their prospects based on their own ambitious plans rather than on their own or others' past experience. A possible result of such exaggerated sense of optimism and self-confidence is that the founders and their ventures land in trouble. In a similar vein, Krueger and Dickson (1994), writing on the risks of "believing in ourselves", showed that executives who are led to believe that they are "competent" tend to engage in risk behavior and vice versa. Awards and recognitions that newly minted IPOs receive can have perverse effects.

2. Degree hesitancy on the decision to go public and timing of the decision to go public. This finding was consistent with the Hambrick & DeAveni's (1988) findings that firms that are under stress, e.g., new ventures and ventures that are about to go public, vacillate between action versus no action, and even engage in certain initiatives that may be rather extreme. Such vacillation is a marker of stress and likely impending failure.

With respect to the pathways to failure, we found that pathways of failed ventures and non-failed ventures were different: pathways of failed venture were relatively complex, and both pace of events and level of activity along the pathways were relatively high. In contrast to the failed-ventures, the non-failed ventures seemed to maintain a very simple agenda, attend to one change at a time, and keep the change activity level low.

What might explain the differences in the pathways of failed and non-failed ventures? One plausible explanation is: entrepreneurs who are contemplating the IPO engage in a wide array of changes – finance-related, portfolio-related, organization-related, and management-related changes. However, in a rush to seize the opportunities presented by the capital markets and to be the first to go public the entrepreneurs may choose to just do the minimal preparation for an IPO event and hold-off on the other changes until after the IPO is completed. The pathways of failed ventures, compared to the pathways of the non-failed ventures, indicate that failed ventures had more unfinished business; and their preparations were still "work in progress."

Even with strategic changes initiated prior to the IPO event, entrepreneurs may find it necessary to engage in a series of post-IPO rounds of changes for a variety of reasons: the changes made prior to IPO were not appropriate to the post-IPO situation or the changes were executed rather poorly. Based on the case studies examined in this paper we cannot pinpoint as to whether the failed ventures were not ready in first place, i.e., the preparations were not complete, the initiatives were not appropriate, or the situation warranted a second round of initiatives.

However, finance-, portfolio-, organization-, and management-related events faced by the newly minted public ventures were rather risky: Relatively high complexity along the pathways gives entrepreneurs opportunities to engage in initiatives that may risky and raise the odds of failure. The high pace of events along the pathways impacts on the allocation of attention of entrepreneurs and tends to have an effect on the survival of the ventures. And, elevated level of activities along the pathways suggests that the ventures are under stress. As reported by Hambrick & DeAveni (1988) firms that are under "stress" tend to launch many more initiatives than their counterparts that are under less stress. Elevated levels of activity among failed ventures suggest that hyperactivity comes at a cost.

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Table 1
Name of the Venture
Start Date _____ ____ End Date _____ _____

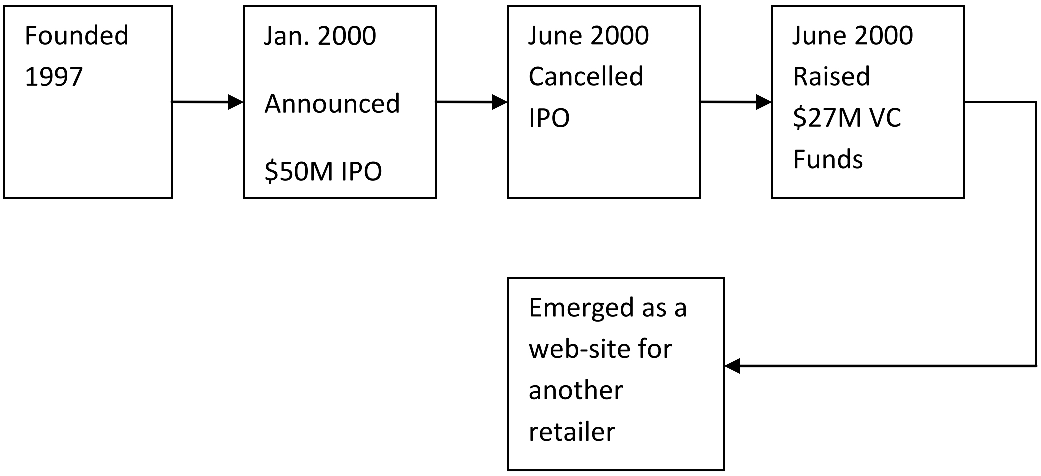
Events & Decisions		Time Line		1	2	3	4	5	6	7	8	9	10	11
Financial	1	Cash Crisis												
	2	Cut Costs												
	3	Raise Capital												
	4	Raise Debt												
	5													
	6													
Portfolio Related	1	Geo Diversification												
	2	Merged or Acquired												
	3	Vertical Diversification												
	4	Horizontal Diversification												
	5	International Diversification												
	6	R&D, Technology												
Organization Related	1	Structure												
	2	Systems												
	3	Ownership												
	4	Alliances												
	5													
	6													
Management Related	1	New CEO												
	2	Top Management												
	3													
	4													
	5													
	6													

Table 1 (continued)
Name of the Venture
Start Date _____ ____ End Date _____ _____

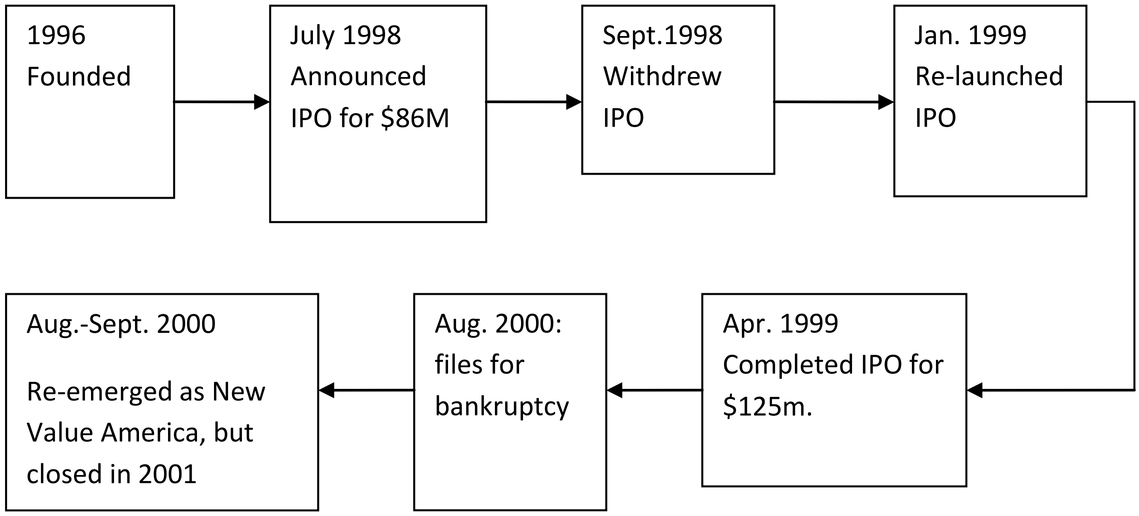
IPO & Outcome Related	1	Announce IPO													
	2	Delisted													
	3	Bought-out													
		Merged Out													
	4	Chapter 11													
		Chapter 7													

Figure 1
Vacillation Surrounding the IPO Event

Failed Venture – Furniture.com



Failed Venture – Value America.com



Failed Venture – Garden.com

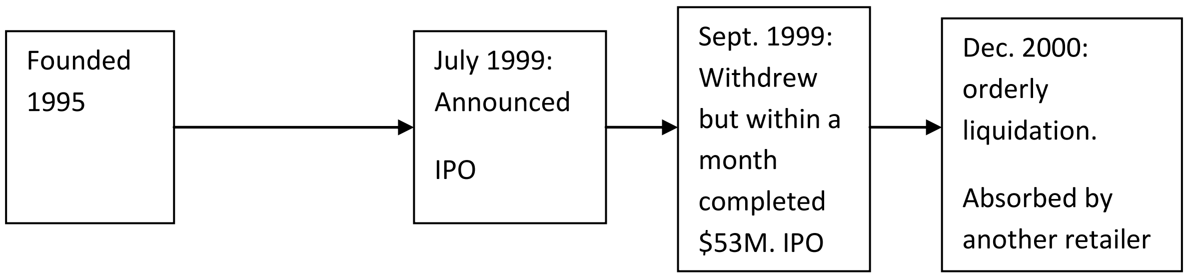


Figure 2
Types of Events that Occurred in Failed and Non-failed Ventures Over Twelve Consecutive Quarters