



# Pets.com, Inc

**Case study**  
**Reference no 201-009-1**

This case was written by John D Sullivan, Boston University. It is intended to be used as the basis for class discussion rather than to illustrate either effective or ineffective handling of a management situation. The case was compiled from published sources and generalised experience.

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## Pets.com, Inc.

In February 1999, the web store Pets.com, Inc. was formed to catch the niche of limited product availability carried by large regional pet superstores, specialty stores, and grocery stores. Following the wave of Internet businesses opening across the globe, Pets.com's sold its company shares in the open market hoping for a favorable initial public offering. In March of 2000, the stock price reached a 52 week high of \$9.25, but just nine months later had fallen to \$.063 on January 2, 2001 with earnings per share falling to (\$33.03). If the company was to continue to survive, a restructuring plan would need to be set in place to provide Pets.com with enough capital to ensure enough time to increase revenues to support the fixed costs associated with running a large internet distribution business.

### The Pet Industry

Driven by a large and emotional customer base, the pet industry in the United States grew at a rate of approximately 9% per year between 1993 and 1997 translating into \$23 billion in sales at the end of 1997. According to one study, more than 60% of United States households owned a pet and 40% of those households owned more than one pet in 1998.<sup>1</sup> The pets products market has traditionally been served by a combination of store based retailers, including superstores, independent specialty stores, and grocery stores.

### Background

Pets.com, known for its use of a dog sock puppet in its television advertisements, is one of the online retailers of pet products, integrating product sales with expert information and professional resources. The company provides a wide array of products with a selection of approximately 15,000 SKUs outpacing the

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This case was written to stimulate class discussion and analysis and is not a critique of an effective or ineffective management situation.

<sup>1</sup> Pets.com, Inc. Securities and Exchange Form 10-Q May 15, 2000

product line distributed by larger superstores, specialty stores, and grocery stores. The company does not, however, sell live animals such as cats, dogs, fish or reptiles, but has not ruled out the possibility of entering this market segment in the future.

The company was formed in February 1999 and the web store was updated with a second version by July 1999. Operations during this time were concentrated on building sales momentum, expanding products offered, establishing vendor contracts and relationships, and streamlining order and shipping operations. To support the web store, a distribution center was opened in San Francisco, California.

Since inception, the company generates its revenue, almost entirely, from online sales. Each sale is either billed directly to a customer's credit card or paid via personal check. Under a credit card transaction, the company typically received payment within two to five days from the date of the transaction. If a customer chooses to use a check, the shipment is not sent until the check has been received and the funds are available. If, for any reason, the customer is unhappy with the order, the merchandise may be returned within thirty days of the purchase for either a full or partial refund. For the ten months ended December 31, 1999, Pets.com reported revenues of \$5.8 million. Revenues for the three months ending March, June, and September 2000 were \$7.7 million, \$8.7 million, and \$9.3 million, respectively. (Exhibit 3)

Pets.com has pulled together a strong merchandise team with extensive experience in product design, purchasing, distribution, and retail. By offering a wide array of products, the company believes it can leverage its vendor relationships to buy direct and thus realize better pricing. Currently, the company offers a majority of well-known pet brands such as Science Diet, IAMS, Pedigree, Eukanuba, Alpo, Fresh Step, Friskies, and Hartz.

In 2000, the company plans to launch its own line of private label dog and cat food and cat litter products. As of the end of 1999, the company had completed several of the necessary steps to launch these product lines such as the development of a marketing plan, the development of several products, the selection of key vendors, consumer research, product packaging development, and the necessary trademark and registration steps with regards to each product. With regards to these products, the first half of 2000 will be spent purchasing and stocking of the products and expenditures for promotional materials associated with the implementation of the marketing plan. If these products are successful, Pets.com may also include apparel, bowls, rawhide, toys, and other pet accessories later in 2000.

But in addition to products, Pets.com also offers customers access to extensive veterinary care information. This goal is primarily conducted through a wide variety of articles written by veterinarians, by allowing customers to participate in its "Ask the Vet" column, and by entering into relationships with accredited veterinary care organizations that offer in-depth information on pet illness and wellness.

## Further Developments

In February 2000, Pets.com announced the sale of 7.5 million shares at a price of \$11 per share, thus completing the company's initial public offering. In connection with the closing of this offering, all the outstanding convertible preferred stock was converted into approximately 17,400,000 shares of common stock.

Following this announcement, in March, the company opened a new 300,000 square foot distribution center in Greenwood, Indiana and announced an agreement with Yahoo as the only pet retailer to appear on the Yahoo Shopping main page.

Following the company's marketing plan, in April 2000, Pets.com introduced a complete line of premium private label products (pets.com/pets.complete). Under the Pets.complete name brand, the product line includes dry dog and cat food, dog biscuits, and cat litter.

In September 2000, Pets.com relocated its customer service call center from San Francisco, California to Greenwood, Indiana. The primary reason for the relocation was to significantly lower the company's operating costs associated with a large distribution company.

## Competition

While the online market or electronic commerce is relatively new, the competition in the new economy is rapidly developing and intensely competitive. Pets.com's competition comes from several areas including other online retailers such as Petopia.com (partially owned by Petco Animal Supplies, Inc.) and PetsMart.com (partially owned by PetsMart, Inc.). The combined force behind these two online retailers could pose a problem to Pets.com in the near future. By the pure size of these stores, the online companies and their respective corporate investors could achieve a better brand recognition and may also enable the online stores to negotiate better pricing and other terms from suppliers through volume discounts.

Other competition outside the online retailers includes large superstores that specialize in pets such as Petco Animal Supplies and PetsMart. But outside even the large specialty superstores, Pets.com also faces competition from large mass-market retailers such as WalMart Stores, Kmart Corporation, and Target Stores.

In addition, further competition, while the product line may be significantly less than the superstores or Pets.com, may come from warehouse clubs such as Costco Companies and supermarkets.

Many of these companies, which include national, regional, and local chains, have a longer history than Pets.com, and thus, greater financial resources, established marketing relationships with advertisers and manufacturers, and a brand recognition among customers.

Pets.com believes that they possess an advantage over the competition that can be broken down into four attributes<sup>2</sup>:

*Extensive Product Selection* – The company’s 15,000 SKUs are approximately twice that of the largest pet superstores.

*Expert Information and Professional Resources* – Throughout the Web Store, customers have access to a wide array of pet and pet care information, as well as through the in-house staff of pet experts and outside counsel from Pets.com strategic alliances.

*Superior Shopping Experience* – The use of the Web Store is considered by the company to be easy to use and organized in such a way that customers have a quick and streamlined exit with the products being delivered within a short time period.

*Quality Customer Service* – Pets.com has invested a significant amount of time and resources to create a state of the art distribution, fulfillment, online assistance, and personal customer service to ensure a pleasurable shopping experience for all of the Web Store’s customers.

Pets.com believes that there may be a significant advantage in establishing a large customer base before the competition. If the company fails to attract and retain a large customer base before the competition, Pets.com may have difficulties continuing to grow. The company believes the principle factors that will impact growth and customer base include: brand recognition, product selection, quality of the Web Store, reliability in ordering and shipping, customer service, convenience, and price.<sup>3</sup>

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<sup>2</sup> Pets.com, Inc. Securities and Exchange Form 10-Q June 30, 2000

<sup>3</sup> Pets.com, Inc. Securities and Exchange Form 10-Q March 31, 2000

## Conclusions

The options available to the Board of Directors range from filing Chapter 7<sup>4</sup>, a liquidation under the United States Bankruptcy Code, to the implementation of a restructuring plan and avoiding the problems associated with filing for bankruptcy protection including filing for Chapter 11<sup>5</sup> reorganization. Other possible options include the possibility of finding a partner to merge with. But as time passed with dismal financial results, the company's ability to negotiate a favorable purchase price would diminish.

This was a critical time for the new company. While it had enjoyed the recognition of its brand logo Sock Puppet, revenues had not grown as quickly as management had anticipated. Given the high cost structure of running a large Internet distribution business, a large customer base may be required to secure a future for the company. The remaining question was whether or not the company had the necessary time to implement any of their options.

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<sup>4</sup> Under Chapter 7, a company or the United States Bankruptcy Court may elect to cease operations and liquidate the company's assets. In some cases, the process may take several months to complete.

<sup>5</sup> Under Chapter 11, a company, as approved by the United States Bankruptcy Court, elects protection from its creditors and is allowed to reorganize and restructure its financial obligations. The advantages of protection range from the ability to negotiate or break union contracts to the temporary elimination of debt payments. However, before a company may emerge from bankruptcy protection, the creditors and Bankruptcy Judge must approve the restructuring plan with the Judge having the ultimate approval or disapproval of the plan.

## Exhibit 1

Pets.com  
Balance Sheets  
Assets  
(in thousands)

	30-Sep-00	30-Jun-00	31-Mar-00
Current Assets			
Cash	\$23,065	\$37,227	\$70,114
Inventories	\$7,766	\$9,356	\$8,116
Prepaid Advertising	\$18,268	\$10,499	\$11,782
Other Prepaid	\$2,147	\$2,645	\$1,735
Total Current Assets	\$51,246	\$59,727	\$91,747
Certificates of Deposit	\$1,007	\$914	\$889
Fixed Assets, net	\$19,630	\$19,875	\$17,010
Intangible Assets	\$305	\$339	\$372
Other Assets	\$5,858	\$6,270	\$4,774
Total Assets	\$78,046	\$87,125	\$114,792

## Exhibit 2

Pets.com  
Balance Sheets  
Liabilities & Stockholder's Equity  
(in thousands)

	30-Sep-00	30-Jun-00	31-Mar-00
Current Liabilities			
Accounts Payable	4,738	4,960	8,199
Accrued Expenses	3,004	4,164	4,877
Payable to Related Parties	1,210	631	416
Capital Lease	82	176	176
Total Current Liabilities	9,034	9,931	13,668
Long Term Capital Lease	719	761	812
Shareholders Equity			
Convertible Preferred Stock	1	0	0
Common Stock	43	37	37
Additional Paid In Capital	225,461	213,278	214,893
Accumulated Deficit	(146,648)	(124,925)	(100,866)
Stockholder Note Rec	0	0	0
Deferred Stock Based Compensation	(10,564)	(11,957)	(13,752)
Total Stockholders Equity	68,293	76,433	100,312
Total Stockholder's Equity & Liabilities	78,046	87,125	114,792



## Exhibit 3

Pets.com  
Statement of Income  
(in thousands, except per share data)

	30-Sep-00	30-Jun-00	31-Mar-00
Net Sales	\$9,365	\$8,764	\$7,651
Cost of Goods Sold	\$9,642	\$10,513	\$12,515
Gross Margin	(\$277)	(\$1,749)	(\$4,864)
Operating Expenses			
Marketing & Sales	\$14,709	\$17,091	\$28,855
Product Development	\$2,268	\$2,257	\$2,686
General & Administration	\$3,843	\$2,681	\$2,331
Amortization	\$1,040	\$1,022	\$1,075
Total Operating Expenses	\$21,860	\$23,051	\$34,947
Operating Income	(\$22,137)	(\$24,800)	(\$39,811)
Interest Income	\$412	\$741	\$723
Net Income	(\$21,725)	(\$24,059)	(\$39,088)
Basic & Diluted Income Per Share	(\$0.68)	(\$0.89)	(\$2.54)
Average Number of Shares	31,985	26,945	15,408