

## FINANCING AND RISKS OF INTERNET START-UPS<sup>1</sup> A PRELIMINARY ASSESSMENT

The recent emergence of the Internet sector has sparked a macroeconomic debate concerning the sector's impact on the global economy. This applies both to the “real” sphere, with the surge in productivity gains accompanying the advent of the “New Economy”, and to the financial sphere, with the development of a speculative bubble on Internet stocks. However, we have still a limited knowledge of Internet start-ups, even though these firms are often referred to as the development model for this sector. One reason for this limited knowledge is the rapidly changing nature of start-ups, which makes it difficult to draw up a stable profile. In addition, because these companies were set up recently, it is often practically impossible to conduct analyses based on historical – and especially financial – data.

**This paper seeks to shed some initial light on the Internet sector from a microeconomic perspective by defining the main financial characteristics of Internet start-ups.** To do this, we studied specific aspects of their balance sheets on the basis of an empirical analysis and a statistical examination of a sample of annual financial statements<sup>2</sup>. In addition, we interviewed a selection of analysts and investment managers from commercial banks and investment funds<sup>3</sup>.

Two key themes emerged from our research:

- **The sources of funding for Internet firms have dried up since the tech-stock correction in March-April 2000.** This has forced start-ups to turn prematurely to bank credit and to offer the markets innovative and attractive equity products.
- **A trend towards business failures is likely to occur in the months ahead.** This should accelerate the process of consolidation in the sector and eliminate a significant number of market players.

---

<sup>1</sup> This is a slightly revised version of a paper elaborated in the course of September 2000, based on data available at end-1999. An updated paper is likely to be available in June 2001.

<sup>2</sup> A sample comprising 85 companies recorded in the Banque de France's FIBEN data base. Each company either reports sales of over FRF 5 million or has banking commitments in excess of FRF 2.5 million. Forty-six companies in the sample companies are listed on the Paris stock market.

<sup>3</sup> We met with Apax-Partners, Arthur Andersen, Ernst and Young, Cap Gemini Consulting, Innovacom, Natexis Capital, Netscapital, Société Générale Asset Management, Sorgem Evaluation, and Viventures

## 1. RECURRING FINANCING NEEDS FORCE START-UPS TO SEEK NEW FUNDING SOURCES

### 1.1. Bank loans

One of the most striking findings of the statistical examination of the sample is the extent to which Internet start-ups rely on traditional bank loans. Of the sample's 85 firms, 38 already had credit lines totalling FRF 650 million (recorded in June 2000 as loans granted by French credit institutions only). The sums involved remain small, but **these credit lines have swelled by a massive 282% over 12 months**. This can be attributed to the combination of two factors: first, efforts by commercial banks to invest in a sector with promising business prospects; second, the immediate and significant financing needs of Internet companies, whose sources of financing have dried up since the stock-market correction of March-April 2000. Owing to a more selective approach by venture capital firms and waning investor appetite, the initial financing forecasts for start-ups have been skewed, and bank financing has become a forced alternative.

**Bank loans recorded for the 85 firms in the sample**  
(Source: Central Risk Register, Banque de France)

	June 1999	December 1999	June 2000
<b>Total (FRF bn)</b>	<b>0.23</b>	<b>0.41</b>	<b>0.65</b>
<b>o/w % short term</b>	61	46	53
<b>o/w % long term</b>	21	28	13
<b>o/w % leasing</b>	4	4	3
<b>o/w % off-balance sheet commitments</b>	14	22	31

One significant development is that commercial banks, pursuing their traditional lending business, have taken over from venture capital firms as a source of funding. The statistics show an expansion of bank credit. This appears to confirm that the financing cycle in the Internet sector - from which venture capitalists are disengaging faster than other sectors - has indeed accelerated, notably through IPOs. By investing in the Internet, bank lenders are exposing their traditional lending business to a new kind of risk given the nature of the start-ups, i.e. recently created and with reduced visibility on future earnings. Apparently, some credit institutions initially restricted their lending to leasing commitments for hardware and to bridging loans to IPOs. However, these restrictions limit only partially the significant risks connected with start-ups and do not show up in the overall risk statistics, which reveal the diversity of the commitments recorded over the last 12 months.

### 1.2. Start-up's financing needs as a source of financial innovation

Several factors - including the need for Internet start-ups' historical managers and shareholders to retain a significant share of the company's capital, the scarcity of funding from venture capitalists, and recurring funding needs - could give a fillip to financial innovation. For example, Alcatel Optronics, an Alcatel subsidiary specialised in the manufacture of fibre optics for data transportation, issued Europe's first-ever tracking stock, based on comparable issues in the USA. The principle behind tracking stocks is to offer the markets a share that is representative of the subsidiary's activities and that is issued legally by the parent company but that entitles the holder to dividends based on the subsidiary's earnings. This solution offers two key advantages. First, it places a value on assets that are keenly sought after by the markets with a view to acquiring complementary businesses through share swaps. Second, it is a legal expedient that does not expose the parent company to the risk of losing control of its subsidiary in the event of a hostile bid from a competitor.

**Just as Internet companies have quickened the spread of stock option schemes, their capital needs could spur development in segments of the financial markets that are geared to start-up**

**risks.** Until recently, for example, Paris’s equity warrant market was fairly sluggish, with only a handful of issues. In recent months, however, warrants have been used increasingly by companies seeking to expand their business in new technologies. By issuing a warrant, a start-up can “sweeten” a stock offering with an equity product that appeals to investors. The influx of Internet firms on the capital markets might also lead to the birth of a high-yield bond market, which is still embryonic in Europe. In France, only five bond issues can be considered as high-yield, and all of them relate to traditional (or “Old Economy”) companies. The development of Internet companies could act as the catalyst for the high-yield bond markets and significantly alter the profile of the main companies involved. Instead of being a market tapped chiefly by traditional companies strapped for cash, the high-yield bond market could turn into a new source of financing for high-tech start-ups that cannot - or do not wish to - raise new equity capital. However, this assumption means that, to attract investors, companies issuing these bonds must have a proven ability to generate business volume. This factor will postpone the take-off of a high-yield market until the medium term and will rule out the participation of fledgling start-ups or those with only a token sales record. That said, one high-yield bond issue has already been floated. In December 1999, Jazztel, a Spanish telephone operator and Internet access provider, became the first European company from the TMT sector to make an issue of this kind, worth US\$150 million.

**2. A TREND TOWARDS FAILURES IS LIKELY**

**2.1. Imbalanced financial structures**

**Of the 85 companies in the sample, a significant proportion have imbalanced financial structures.** Twelve of them have negative own funds — one of the best leading indicator of a business failure in the short term. This could be seen not only as the reason why venture capital firms have been more selective since the March/April 2000 correction, but also as the result of that policy. Furthermore, the median capitalisation of the other 73 companies is not higher than the median rate of IT-sector companies. This fact ought to be emphasised because the launch phase of a start-up usually requires more capital.

**An analysis of the assets of Internet start-ups further strengthens the evidence of stunted capitalisation.** A full 33% of the assets of these companies are in the form of securities, and in reality, start-ups' assets are probably totally insufficient to pay off creditors. In part, those securities are representative of worthless assets, since they consist of holdings in companies that are developing their business in the Internet sector and that suffer from the same weaknesses in terms of solvency. Furthermore, the value of securities carried as assets on companies' balance sheets corresponds to the price the company accepted in order to acquire an ownership interest, a price that might be markedly higher than the estimated value of the target company's capital. If, therefore, we recalculated shareholders' equity net of worthless securities, we would find financial structures exhibiting negative net assets. Consequently, in the event of a payment default, and assuming that banks had granted conventional loans to the aforementioned companies, start-ups would be not just illiquid, but also insolvent. Under such circumstances, the loss experience would be aggravated by a much lower debt-recovery rate than in the case of traditional firms.

Our analysis of the performances of start-ups in 1999 provides a more dynamic confirmation of insolvency risk by highlighting the fact that many of the companies fail to generate operating profits. **41% of the 85 companies analysed had negative profitability, before interest expense and non-recurring expenses.** This figure illustrates how the companies concerned cannot reinforce the already weak or negative capitalisation recorded on their balance sheet - and, hence, their solvency - unless they once again appeal to investors. On the contrary, the figure underscores the long-term need for external financing of start-ups, whose recurring losses entail a massive and rapid consumption of the funds they receive.

Ratio	Median of the	Percentage of companies with
-------	---------------	------------------------------

	<b>sample in %</b>	<b>negative ratio</b>
Value-added (VA) / Sales	47.7	VA<0 : 16%
Operating result (OR)/ Sales	2.9	OR<0: 41%
Equity holdings <sup>4</sup> / Total Assets	33.1	
Net shareholders' equity/ Balance-sheet Total	29.8	Net shdrs' equity <0 : 14%

## 2.2. Do the high-profile failures abroad herald a wave of bankruptcies?

**The initial difficulties of some Internet pioneers seem to bear out the conclusions drawn from our balance-sheet analysis; they also presage a possible model for future start-up failures.** For example, 18 months after its launch, Boo.com, a Swedish company set up by three people and specialised in on-line clothing sales, suspended payments after swallowing up FRF 900 million, employing up to 300 people and generating just FRF 10 million in sales. Amazon.com, the US leader in global e-commerce, has had to downsize several times since the beginning of the year (2000). Despite recording the biggest sales in the market for online sales of books, music and videos, Amazon has been unable to reach its breakeven point, which is revised upwards with each new half-yearly forecast.

Although we are not yet in a position to present an analysis of a typical Internet start-up bankruptcy, the three major companies in the sector that recently suspended payments - Boo.com, Dressmart.com and Adabra - share two similar characteristics. **In each case, it was impossible for the defaulting companies to be taken over, and there was almost no residual value to pay off creditors.** In the case of Boo.com, the only purchasable asset was the company's brand, which fetched US\$2.4 million. The conditions of Boo.com's failure are consistent with the above analysis of the financial statements, supporting the idea that the restated net worth of several Internet companies is near-zero or negative.

**More generally, the financial conditions in which Internet companies are developing suggest that the restructuring process will result in the exit from the market of a large number of companies in the short term.** The origin of this trend lies in the economic development model of start-ups. The size of marketing and advertising expenditures needed to boost market share, and the R&D spend required to keep pace with fast-breaking innovations, mean that these expenses are necessarily recurring. This specific feature means that expenses, which in traditional sectors are usually variable and reducible, become fixed expenses in the Internet sector. These are compounded by payroll costs, which are steep because of the high level of skills required and the scarcity of labour in the IT sector. As a result, the economic model of Internet start-ups is epitomised by a high breakeven point (as illustrated, for example, by the difficulties encountered by Amazon.com to break even). Consequently, sales volumes must be substantial.

**In theory, this constraint is likely to lead to a market configuration where the number of viable players is limited.** Financial analysts agree with this forecast. They estimate, for example, that on the segment of general Web portals such as like Yahoo, Altavista and Lycos, just three international portals will be profitable in the long-term, along with one or two national portals in each country. The vast array of portals currently on offer is thus likely to evaporate. Similar analyses can be made for other segments, including website hosting and Internet access provision.

---

<sup>4</sup> Gross data