Internet: Consumer e-Commerce
United States

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Crossing the chasm into holiday 2000 and cash update. We provide our thoughts on post-2Q results, the e-Commerce adoption life cycle and why holiday 2000 could be a decisive turning point as e-Commerce should cross the chasm to the mass market. We also provide updated cash positions.

Post-second-quarter sector summary—strong EPS despite soft revenue

The e-Commerce sector reported EPS results that on average beat street consensus estimates by 3¢ or 11%. In contrast, the sector reported a shortfall in revenue relative to consensus estimates for the second quarter of approximately $1.4 million, or 2%. We believe revenue shortfalls were driven by lower marketing, the negative media environment, less aggregate marketing spending across the sector, and a slower consumer spending environment overall.

Crossing the chasm rather than reaching maturation

We believe that slower growth is due to unfavorable conditions, in addition to the natural lull that follows initial hyper-growth in the adoption life cycle of a new innovation. The current trends reflect an early stage in the adoption life cycle as online shopping is caught in the chasm. Accordingly, the 2000 holiday season will be important in improving the customer experience and beginning to reach the mass market.

Updated cash positions and cash burn rates entering holiday 2000

Based on second-quarter results and estimated cash burn rates, 27 of the 28 e-Commerce companies have sufficient cash to fund operations through the 2000 holiday season. We have focused on cash positions through the holiday season, because it will be a key gating factor in determining which companies will continue to get access to capital in 2001. Therefore, in this holiday season we are unlikely to see “hype" or exuberant spending to drive top-line results at any cost, as we did last year; instead, the themes will be execution, displaying progress toward achieving scale, and profitably meeting the needs of customers.

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The prices in this report are based on the market close of September 8, 2000.

Overview: Crossing the chasm in holiday 2000 and cash update

We provide our thoughts on post-2Q results, the e-Commerce adoption life cycle and why holiday 2000 could be a decisive turning point as e-Commerce should cross the chasm to the mass market. We also provide updated cash positions.

- Post-second-quarter sector summary—strong EPS despite soft revenue
- Crossing the chasm rather than reaching maturation
- Updated cash positions and cash burn rates entering holiday 2000

Post-second-quarter review

For the first half of 2000, the e-Commerce sector shifted from growth by any means to driving towards profitability. For the second quarter, the e-Commerce sector reported EPS results that on average beat street consensus EPS estimates by 3¢ or 11%. In contrast, the sector reported a shortfall in revenue relative to consensus estimates for the second quarter of approximately $1.4 million, or 2% below estimates as a result of lower marketing spend, negative media environment, less aggregate marketing spending across the sector, and a slower consumer spending environment overall.

Online adoption — crossing the chasm to the mass market

There are concerns that the slower growth that the sector has experienced this past spring and summer is a result of maturation of online e-Commerce adoption. It is our thesis that this modest trend is a result of a typical sales lull experience at the end of early stage adoption of evangelists and that holiday 2000 will be critical in terms of execution to cross the chasm to the mass market.

Sufficient cash through the holidays

Based on second-quarter results and estimated cash burn rates, 27 of the 28 e-Commerce companies have sufficient cash to fund operations through the 2000 holiday season. We have focused on cash positions through the holiday season because it will be a key gating factor in determining which companies will continue to get access to capital in 2001, based on holiday performance. Therefore, in this holiday season we are unlikely to see “hype" or exuberant spending to drive top-line results at any cost, as we did last year; instead, the themes will be execution, displaying progress toward achieving scale, and profitably meeting the needs of customers.

Why own consumer e-Commerce stocks?

In our view, Consumer e-Commerce stocks are attractive because they can provide both superior earnings power—measured by ROIC—and less volatile, more consistent earnings growth. In theory, e-Commerce companies have comparably minimal need for physical assets but leverage the Internet to maximize virtual commerce. Therefore, operating assets as a percentage of revenue are low, but operating margins are high. Rarely do companies exhibit both traits.

Post second-quarter review of results

The consumer e-Commerce sector reported strong EPS results with soft second-quarter revenue relative to consensus estimates. We were pleased by the companies that could effectively manage expenses in a cash-constrained environment, meeting EPS estimates despite a slight revenue shortfall. We believe revenue shortfalls were driven by lower marketing spending, the negative media environment, less aggregate marketing spending across the sector, and a slower consumer spending environment overall.

Better than expected earnings despite revenue softness in the second quarter

On average, the e-Commerce sector reported earnings results that beat Street consensus EPS estimates by 3¢ or 11%. In contrast, on average the sector reported a shortfall in revenue relative to consensus estimates for the second-quarter by approximately $1.4 million, or 2% (Exhibit 1). Fourteen of the twenty-six consumer e-Commerce companies fell short of revenue expectations, but, importantly, managed pricing and discretionary spending such as marketing and web design costs to achieve EPS results that were ahead of expectations.

A few select companies have built out infrastructure and entered into fixed-cost contracts that resulted in a high fixed cost base relative to the low level of revenue scale. This caused a significant net income shortfall as revenue fell short of expectations. Barnes & Noble.com was the only company of the twenty-six that fell into this category. Barnes & Noble.com reported $67.4 million in revenue with EPS of (27¢) versus our estimate of $80 million (a 16% difference) with EPS of (17¢) for a 63% shortfall.

Exhibit 1: Actual second-quarter revenue and EPS results versus Street and GS consensus
$ millions, except per-share data

	Ticker	2Q00 Rev Consensus	2Q00 Rev Actual	% Chg from Consensus	Abs. Chg from Consensus	2Q00 EPS Consensus	2Q00 EPS Actuals	% Chg from Consensus	Abs. Chg from Consensus
Amazon	**AMZN**	**$600.0**	**$577.9**	**-4%**	**-$22.1**	**($0.34)**	**($0.33)**	**4%**	**$0.01**
Ashford	**ASFD**	**$14.3**	**$13.1**	**-8%**	**-$1.2**	**($0.29)**	**($0.23)**	**20%**	**$0.06**
Autobytel.com	ABTL	$16.6	$17.1	3%	$0.5	($0.48)	($0.46)	4%	$0.02
Autoweb.com	AWEB	$16.8	$15.2	-10%	-$1.6	($0.17)	($0.13)	24%	$0.04
Barnes & Noble.com	**BNBN**	**$80.0**	**$67.4**	**-16%**	**-$12.6**	**($0.17)**	**($0.27)**	**-63%**	**($0.11)**
Buy.com	BUYX	$207.0	$193.2	-7%	-$13.8	($0.24)	($0.18)	25%	$0.06
Cyberian Outpost [1]	COOL	$70.5	$64.8	-8%	-$5.7	($0.31)	($0.26)	16%	$0.05
Drugstore.com	DSCM	$25.8	$24.6	-5%	-$1.2	($0.97)	($0.83)	14%	$0.14
Egghead.com	EGGS	$144.4	$126.0	-13%	-$18.4	($0.50)	($0.44)	12%	$0.06
eBay	**EBAY**	**$94.5**	**$97.4**	**3%**	**$2.9**	**$0.03**	**$0.05**	**54%**	**$0.02**
eToys	**ETYS**	**$25.8**	**$24.9**	**-4%**	**-$0.9**	**($0.39)**	**($0.37)**	**5%**	**$0.02**
1-800-flowers.com	**FLWS**	**$111.5**	**$123.3**	**11%**	**$11.8**	**($0.24)**	**($0.20)**	**14%**	**$0.03**
Fogdog.com	FOGD	$6.1	$5.8	-4%	-$0.3	($0.36)	($0.33)	8%	$0.03
Garden.com	GDEN	$7.3	$7.3	0%	$0.0	($0.78)	($0.77)	1%	$0.01
Global Sports	GSPT	$7.5	$7.8	4%	$0.3	($0.58)	($0.54)	7%	$0.04
HomeGrocer	HOMG	$25.5	$29.8	17%	$4.3	($0.44)	($0.43)	3%	$0.01
MotherNature.com	MTHR	$4.1	$3.4	-16%	-$0.7	($0.70)	($0.59)	16%	$0.11
Onvia	ONVI	$23.5	$29.3	24%	$5.8	($0.59)	($0.48)	19%	$0.11
Pets	IPET	$8.5	$8.8	4%	$0.3	($1.08)	($0.89)	18%	$0.19
PlanetRx	**PLRX**	**$11.2**	**$9.4**	**-16%**	**-$1.8**	**($0.67)**	**($0.55)**	**18%**	**$0.12**
Priceline.com	**PCLN**	**$332.6**	**$352.1**	**6%**	**$19.5**	**($0.03)**	**($0.01)**	**75%**	**$0.02**
SmarterKids.com	SKDS	$1.2	$1.5	24%	$0.3	($0.42)	($0.39)	6%	$0.03
Streamline.com	SLNE	$10.2	$8.1	-21%	-$2.1	($0.52)	($0.51)	2%	$0.01
TheKnot.com	KNOT	$4.4	$6.9	58%	$2.5	($0.27)	($0.26)	4%	$0.01
Vitaminshoppe.com	VSHP	$9.5	$8.6	-10%	-$0.9	($0.42)	($0.39)	7%	$0.03
Webvan	**WBVN**	**$24.0**	**$28.3**	**18%**	**$4.3**	**($0.17)**	**($0.17)**	**0%**	**$0.00**
			Average	**-2%**	**-$1.4**		**Average**	**11%**	**$0.03**

Source: GS Research, FactSet, I/B/E/S.

Explaining revenue softness

As stated in our note dated June 22, *Comments on e-Commerce Trends Through the Summer*, we had anticipated that quarterly results could exhibit limited revenue upside, selected shortfalls and limited upward revisions due to the unfavorable macro environment for e-Commerce stocks during the summer months, driven by the following factors:

- **Many companies have reduced their marketing spending** as a percentage of revenue compared to a year ago as well as sequentially. These companies may not have enough history to accurately project the counter-effects that lower spending might have on revenue growth.
- The general media environment to consumers was vastly different today than it was a year ago, a trend that could reverse itself as we approach the holidays. The media could start to focus more on the likely winners as opposed to the broader exuberance of a year ago followed by the wholesale write-off of the sector over the past eight months. Generally, a year ago companies benefited from a significant level of positive press, centered around the enthusiasm for IPOs and e-Commerce in general. The free incremental impressions helped to drive awareness and traffic above and beyond the companies' efforts. **Today's media environment is extremely different and has been characterized by six months of negative press** to consumers

on issues ranging from poor customer service and security to companies going out of business.

- There is less marketing spending in aggregate from the entire universe of e-Commerce companies (both public and private). This reflects both lower spending as a percentage of sales for individual companies as well as fewer companies that can spend, given the ongoing shakeout. Ultimately, the lower aggregate noise generated by e-Commerce companies results in less of a synergistic effect or buzz that would have benefited the category in general.

- We believe that companies that have achieved significant scale were vulnerable to a slower consumer spending environment. We do not think this would have been a concern for many companies in the absence of the three aforementioned factors and thus the effects would probably not have been noticeable. We continue to believe that companies with lower levels of revenue scale are insulated from a slower consumer spending environment because their growth is driven more by increased penetration than by the overall buying rates of consumers.

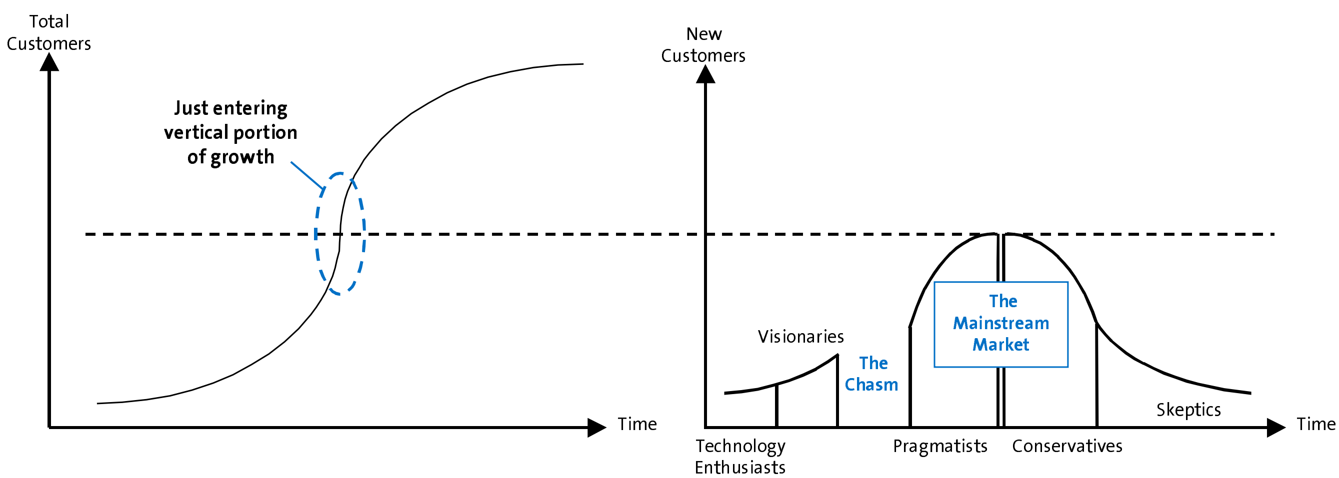
Crossing the chasm rather than reaching maturation

The shortfall in second-quarter revenue, in our view, is not an indication of slower growth due to e-Commerce hitting maturity in several categories, but merely a result of unfavorable conditions, plus the natural lull that follows initial hyper-growth in the adoption life cycle of a new innovation. We think the summer and fall of 2000 reflects the typical early stage in this life cycle. Online shopping is caught in a chasm of faltering sales, as the industry transitions naturally from early adopters and evangelists to the mass market.

We think the summer of 2000 for consumer e-Commerce reflects a typical early phase in the adoption cycle of a new innovation. We do not see the slowdown as a sign that the market has already matured. **In fact, we see holiday 2000 as the decisive period when e-Commerce will begin to cross the chasm to the mass market.**

After studying adoption (S-curves) and diffusion curves, we have ascertained that most leading companies are just entering the vertical portion of their growth S-curve, which reflects hitting critical mass and entering mass market adoption and the beginning of re-accelerated growth (Exhibit 2).

Exhibit 2: Adoption of the mass market – crossing the chasm



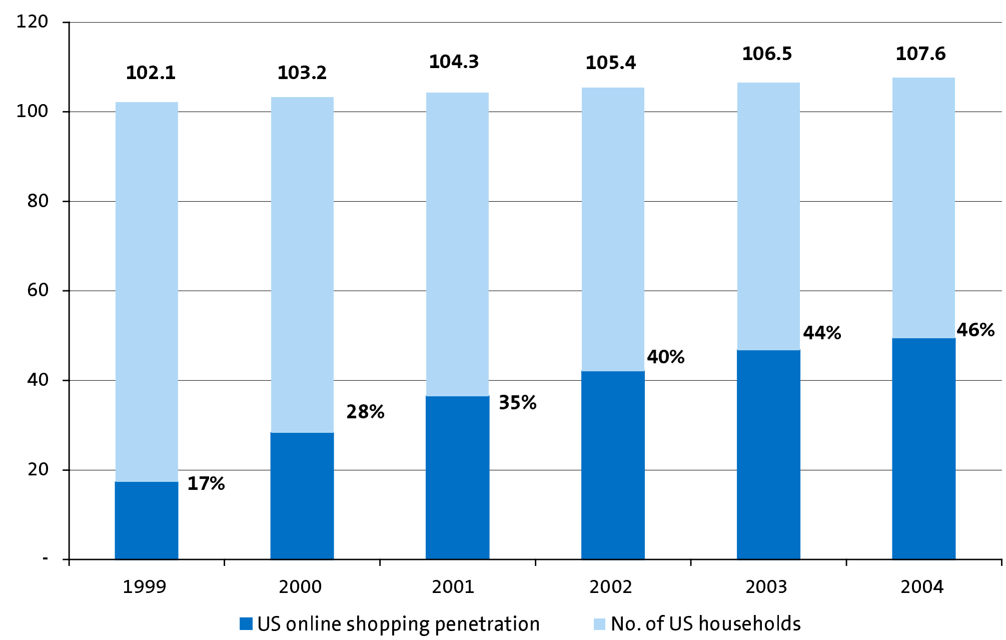
Source: GS Research, Crossing the Chasm, Into the Tornado by Geoffrey Moore.

e-Commerce in the context of the adoption life cycle

It is commonly held by noteworthy strategists and researchers that mass market or critical mass adoption begins to be achieved at 20%-25% household penetration. Contrary to what is widely believed, we have not hit mass-market adoption for online commerce, at just 17% household penetration at the end of 1999. In contrast, Internet usage has achieved mass market adoption with 40% of households online, which is above the 20%-25% level indicated by Geoffrey Moore, author of *Crossing the Chasm* and *Inside the Tornado*. We think the mass market adoption rate for Internet usage is often misconstrued, leaving people to believe that online commerce has also achieved the sweet spot of acceptance from the mass market. But e-Commerce in 1999 only had

17% household penetration, which is below the 25% mass market level. Current forecasts for penetration levels call for approximately 28% of US household by the end of 2000, indicating the beginning of mass market acceptance (Exhibit 3). Thus, we believe the summer/fall months for e-Commerce growth represents the lull and that the holiday season represents an important time to begin to cross the chasm and exit this period of faltering sales. The holiday season, which is typically when the largest percentage of new customers shop, will be a critical test in whether e-Commerce companies can satisfy the 100% service requirements of the mass market. It will not be enough that one or two leading customer centric companies, such as Amazon and eToys, provide a 100% solution; the majority must provide a 100% solution in order for e-Commerce to become adopted by the mass market.

Exhibit 3: US on-line shopping household penetration
millions



Source: Forrester Research.

There is a significant level of research published by the likes of Geoffrey Moore, Theodore Modis (*Predictions*) and Everett Rogers (*Diffusion of Innovation)*, that illustrate the timing and requirements for new technology adoption as well as the S-growth curve rates that are replicated. Specifically, Geoffrey Moore, in *Crossing the Chasm* and *Inside the Tornado,* describes mass-market adoption as requiring a 100% solution for customers. The early market consisting of technology enthusiasts or early adopters and visionaries (the majority of the current 17% penetration rate of online shoppers) are willing to accept an 85% solution. An 85% solution (or less) is what consumers have experienced in consumer e-Commerce in that they get strong service in some areas of buying but not in all areas. For example, some companies are great at selection, and easy navigation, but poor at fulfillment. Ultimately, a 100% solution for a consumer means the ability to go online and buy at a fast, easy to use web site with great navigation and selection, efficient information, convenient order features, good security, etc. and then receive a product and be able to return it with ease. We would argue that we have not achieved this 100% solution broadly for consumer e-Commerce companies. Thus, the online shopping proposition, while acceptable to early adopters and evangelists, has not widely penetrated the sweet spot of the opportunity of the mass market.

Updated cash positions and outlook entering holiday 2000

Based on second-quarter results and estimated cash burn rates, 27 of the 28 e-Commerce companies have sufficient cash to fund operations through the 2000 holiday season. We believe this holiday season will likely not be one of "hype" or exuberant spending to drive top-line results at any cost, as was the case last year, but will be about execution, displaying progress toward achieving scale, and profitably meeting the needs of customers.

We have updated our cash burn rates based on second-quarter results. As initially outlined in our *Issues & Outlook 2000* report dated December 29, 1999, we stated that approximately 16 of the publicly traded consumer e-Commerce companies would need to access the capital markets in 2000 or the first half of 2001. Since the fourth quarter 1999, 7 of the 28 publicly traded companies have accessed the markets and many have cut discretionary spending to conserve cash positions based on current capital market conditions. Based on our revised cash estimates, 27 of the 28 companies will have sufficient cash through the holiday season while at least 15 companies will still likely need to raise capital by holiday 2001, which could prove challenging for those companies that do not deliver a solid holiday season consisting of both solid growth, scalability of the business model, exceptional customer service, and controlled discretionary spending. As shown in Exhibit 4, we approximate each company's cash position by the end of 2000 by subtracting the operating losses in each quarter (the cash burn rate) from the previous quarter's cash position, adjusting for any financing in the interim.

Exhibit 4: Historical cash burn positions and current forecast

		First Calendar Quarter 2000			Second Calendar Quarter 2000			Third Calendar Quarter 2000E			Fourth Calendar Quarter 2000E		
Company	Ticker	Revenue	Net Income (1)	Cash	Revenue	Net Income (1)	Cash	Revenue	Net Income (1)	Cash	Revenue	Net Income (1)	Cash
Amazon	**AMZN**	**$573.9**	**($121.5)**	**$1,008.9**	**$577.9**	**($115.7)**	**$907.6**	**$605.0**	**($114.8)**	**$874.4**	**$1,000.0**	**($90.5)**	**$1,081.0**
Ashford	**ASFD**	**$11.8**	**($13.3)**	**$46.5**	**$13.1**	**($10.6)**	**$63.1**	**$12.9**	**($13.3)**	**$49.8**	**$42.0**	**($11.2)**	**$38.6**
Autobytel.com	ABTL	$15.1	($8.1)	$106.6	NA	($9.3)	$100.3	NA	($6.3)	$94.0	NA	($5.2)	$88.8
Autoweb.com	AWEB	$15.8	($5.1)	$25.3	$15.2	($3.9)	$41.2	$16.8	($3.4)	$37.9	$18.9	($2.1)	$35.8
Barnes & Noble.com	**BNBN**	**$78.2**	**($27.1)**	**$432.8**	**$67.4**	**($40.0)**	**$356.0**	**$70.0**	**($36.6)**	**$319.4**	**$130.0**	**($35.1)**	**$284.3**
Buy.com	BUYX	$207.6	($25.0)	$144.5	$193.2	($23.1)	$140.5	$191.7	($20.8)	$119.7	$237.4	($22.0)	$97.7
Cyberian Outpost (2)	COOL	$76.1	($9.8)	$58.0	$64.8	($7.9)	$48.1	$70.1	($7.4)	$40.6	$85.8	($7.4)	$33.2
Drugstore.com	DSCM	$22.7	($38.9)	$174.7	$26.4	($33.7)	$88.6	$26.4	($33.7)	$88.6	$30.2	($33.2)	$55.4
Egghead.com	EGGS	$147.8	($22.6)	$64.9	$126.0	($17.7)	$41.2	$106.5	($16.1)	$31.6	$119.2	($15.4)	$16.2
eBay	**EBAY**	**$85.8**	**$8.0**	**$819.6**	**$97.4**	**$13.2**	**$836.1**	**$107.7**	**$11.1**	**$847.2**	**$124.5**	**$19.6**	**$866.8**
eToys	**ETYS**	**$23.0**	**($36.6)**	**$193.6**	**$24.9**	**($45.4)**	**$211.1**	**$27.0**	**($41.0)**	**$170.1**	**$251.5**	**($50.9)**	**$119.2**
1-800-flowers.com	**FLWS**	**$85.0**	**($14.8)**	**$128.6**	**$123.3**	**($12.9)**	**$111.6**	**$68.3**	**($18.6)**	**$93.0**	**$144.8**	**($15.6)**	**$77.3**
Fogdog.com	FOGD	$4.7	($13.1)	$60.2	$5.8	($15.4)	$52.1	$9.0	($8.2)	$43.9	$15.0	($9.9)	$34.0
Garden.com	GDEN	$3.2	($10.6)	$32.4	$7.3	($12.6)	$27.7	$3.4	($8.5)	$19.2	$10.7	($8.2)	$11.0
Global Sports	GSPT	$5.7	($11.6)	$51.5	$7.8	($11.2)	$40.3	$8.0	NA	NA	NA	NA	NA
HomeGrocer	HOMG	$21.2	($35.3)	$257.1	$29.8	($50.2)	$158.6	#N/A	($73.0)	$85.6	#N/A	($67.2)	$18.4
MotherNature.com	MTHR	$4.1	($16.5)	$34.7	$3.4	($8.9)	$29.7	$3.6	($8.2)	$21.5	$3.6	($8.2)	$13.3
Onvia	ONVI	$21.5	($24.6)	$243.5	$29.3	($31.5)	$209.2	$35.8	($44.8)	$164.4	$51.2	($46.8)	$117.6
Pets	IPET	$7.7	($38.0)	$70.1	NA	($23.0)	$40.2	NA	($15.1)	$25.1	NA	($16.0)	$9.1
PlanetRx	**PLRX**	**$8.8**	**($35.2)**	**$76.4**	**$9.4**	**($26.4)**	**$50.6**	**$10.5**	**($20.8)**	**$79.8**	**$13.1**	**($20.4)**	**$59.5**
Priceline.com	**PCLN**	**$313.8**	**($7.7)**	**$149.5**	**$352.1**	**($1.6)**	**$138.7**	**$380.7**	**($0.9)**	**$137.8**	**$395.6**	**$1.9**	**$139.6**
SmarterKids.com	SKDS	$1.5	($8.0)	$50.4	$1.5	($7.7)	$41.5	$1.6	($8.9)	$32.6	$5.7	($8.9)	$23.8
Streamline.com	SLNE	$8.5	($11.7)	$20.7	NA	($11.4)	$18.9	NA	($12.3)	$6.6	NA	($11.4)	($4.8)
TheKnot.com	KNOT	$3.7	($2.2)	$27.6	$6.9	($2.8)	$22.6	$7.0	($4.2)	$18.4	$8.4	($2.8)	$15.6
Vitaminshoppe.com	VSHP	$9.3	($10.1)	$25.2	$8.6	($8.0)	$14.5	$9.5	($2.6)	$11.9	$11.6	($2.3)	$9.6
Webvan	**WBVN**	**$16.3**	**($38.6)**	**$540.7**	**$28.3**	**($57.1)**	**$410.0**	**$46.3**	**($67.3)**	**$342.7**	**$75.0**	**($74.8)**	**$267.9**

(1) Excludes non-cash items

(2) Third quarter ends August

Note: Companies highlighted covered by Goldman Sachs. Revenue estimates for non-GS covered companies from I/B/E/S. Net Income estimates for non-GS covered companies from First Call and Disclosure. Cash estimates are for Amazon in the third and fourth quarters are GS estimates.

Source: GS Research, FactSet, I/B/E/S, Company reports.

Pioneers with proven business models will continue to have access to capital

Amazon had $908 million in cash and marketable securities at the end of the second quarter. We expect Amazon to continue to generate positive free cash flow ahead of profitability. We estimate that, over the next two quarters, the business should generate enough cash flow to fund planned expenditures. Management stated that the company would spend less than $200 million total in capital expenditures for 2000, having spent $65 million in the first half. We estimate that the company will end the year with over $1 billion in cash on the balance sheet. Similarly, priceline.com has a strong balance sheet, with $139 million in cash and equivalents as of the second quarter. Priceline does not need to return to the capital markets for additional funding, and is on track to break even in the third quarter. eBay is currently the only e-Commerce company that is profitable. As opposed to most e-Commerce companies, eBay can uniquely reinvest its positive cash flow into key growth areas and marketing vehicles while still delivering increased profitability and expanding operating income. We are encouraged by management's decision to invest in driving additional growth through new broad marketing vehicles. Barnes & Noble.com continues to have a strong balance sheet, with $356 million in cash and equivalents, down from $432.8 million in the first quarter, with $40 million (62% greater than our estimate) in net losses. We note that 1-800-FLOWERS.COM ended its calendar second quarter with more than $111 million in cash and equivalents, which is sufficient cash to carry through EBITDA breakeven in June 2001.

Other leaders will focus on lowering costs and achieving operating leverage

Ashford had $63.1 million in cash and equivalents on the balance sheet at the end of the June quarter, including $25 million in secured credit against $21.9 million in inventory. Management stated that it could reach profitability by the December 2001 quarter without having to return to the capital markets for funding given its current cash burn rate. Ashford should be able to achieve this goal by reducing marketing expenses (70% of S&M is discretionary) and keeping G&A expenses low while meeting street estimates for revenue and EPS growth. However, we believe the ability to balance growth and available cash creates increased uncertainty and we will monitor the potential “doom loop” effect that could occur, which make Ashford's goals challenging. Ashford demonstrated its ability to reduce marketing expenses and keep G&A expenses low while exceeding street estimates for EPS, though revenue growth is slower as a result. While most e-Commerce companies face a multitude of challenges in achieving profitability, we believe Ashford’s primary challenge is straightforward: it must simply drive demand. We estimate that Ashford requires approximately 185,000 orders in December 2001 to achieve profitability; at a conservative $350 average order size assumption, this translates to revenues of $75-$80 million, with 60% of customers returning to Ashford.

eToys had an effective cash position of $211 million at the end of the second quarter, consisting of $162 million in cash and equivalents on the balance sheet plus $49 million of the $52.5 million of inventory fully paid for. In addition, the recent $100 million in capital raised in the second quarter empowers eToys with operating flexibility to fund initiatives through 2001, and the company believes it can reach breakeven for the full fiscal year 2002 (at $750 million to $900 million of sales). Additionally, management expects to sign leasing credits for additional financial flexibility. eToys is not only well capitalized into 2001, but is selling in a category in which we expect to see more rational competition relative to last year with the demise of various kids/toy sites such as ToySmart.com and RedRocket.com and, more recently the collaborative efforts of Amazon and Toysrus.com. We believe a continued shakeout will likely strengthen positions for leadership companies and decrease competitive clutter.

Several companies have sufficient cash providing flexibility

Cash remains king as those companies with access to capital continue to separate from competition. While a company may have a solid strategy, the inability to access the capital markets reduces the ability to execute such a strategy. Models that have high fixed costs due to early infrastructure build-out, but have only nascent revenues to cover their fixed costs, are the most vulnerable. Why? Taking several rounds of financing to achieve profitability is no longer acceptable in the public markets; therefore, while a strategy may be solid, the company will be starved for spending capacity and thus be unable to increase revenue enough to cover fixed costs.

We are seeing three different scenarios emerge:

- Companies with a sound model and strategy with a differentiated, scalable, profitable profile that executes on critical success factors will continue to get funding,
- Companies with a sound model and strategy, but with a high cash burn rate that cannot be reduced due to high fixed costs (possibly due to building out infrastructure early or simply the high cost nature of business), may require multiple rounds of financing that the capital markets do not currently have an appetite for, and
- Companies with poor business models that lack a sound strategy, or companies that have a plausible model but have failed to execute, will likely not receive funding.

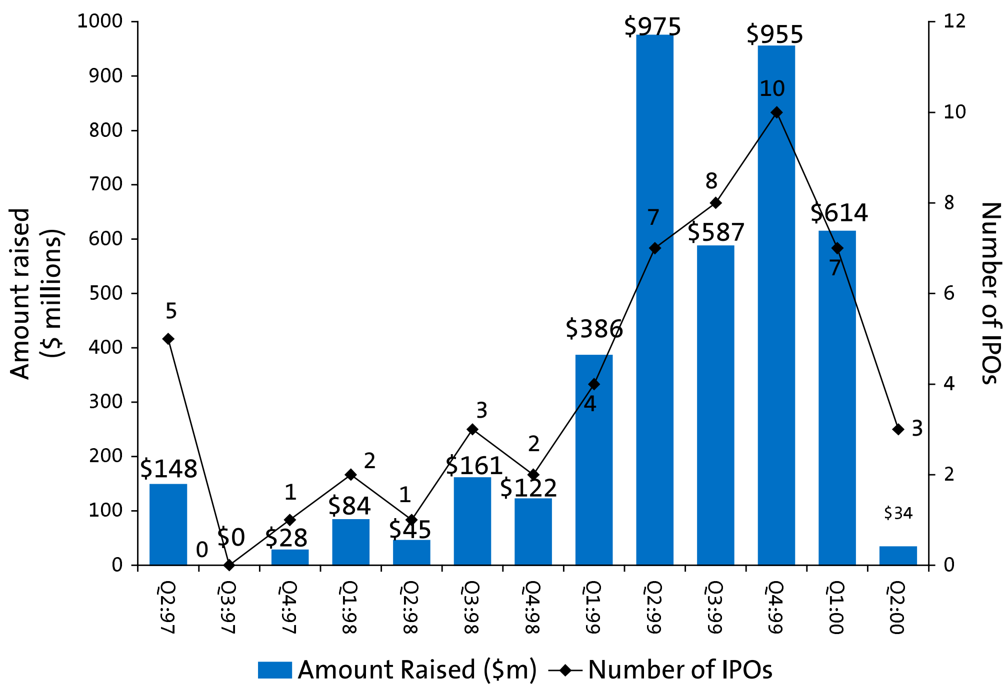
Our **critical success factors** include a large addressable market, visible path to profitability, development of a high touch end-to-end fulfillment system, differentiated and integrated marketing, effective on-line merchandising, customization/customer service, leverage points that position a company to be among the top three or four in a sector, scalability potential, and strength of management team (we acknowledge this is not an exhaustive list, but provide it as a framework to apply in the absence of in-depth historical results). We believe that companies with unproven business models, high fixed costs and lack of a sound strategy will have greater difficulty raising capital than leading companies. As such, the leaders in each category that have gained significant scale, brand awareness, and other critical operational factors will face decreased competition as well and should be able to gain access to capital.

IPO activity on hold

The decline in deal flow in the first quarter will give investors an opportunity to revisit or refocus on the emerging leaders in the Consumer e-Commerce sector, given that many Consumer e-Commerce stocks are more than 75% off their 52-week highs. The IPO window for this sector has essentially closed following last year's indiscriminate funding of both good and questionable business plans. Only four Consumer e-

Commerce stocks were able to go public in the first quarter and none were able to go public during the second quarter, in stark contrast to the 10 IPOs during the fourth quarter and 29 that went public during 1999 (see Exhibit 5). Additionally, numerous companies in registration have since withdrawn their IPO filing. We continue to believe that the slowdown in IPOs will give investors more time to revisit existing public companies in order to determine which companies will emerge as leaders, reversing the indiscriminate selling of e-Tailers in 2000 that has followed the indiscriminate buying of the sector in 1998 and 1999.

Exhibit 5: Slowdown of IPOs following a frothy 1999



Source: SEC Filings, Edgar Online's IPO Express, IPO Central, IPOHome.com, press articles, GS Research.

Why own Consumer e-Commerce stocks?

During the past year, one of the key themes for the Consumer e-Commerce sector has been evaluating companies based on their ability to satisfy the following question: What's in it for the customer? Now it's time to answer another important question about Consumer e-Commerce and e-Tailing stocks: What's in it for the shareholder?

What will bring investor interest back into the sector? . . . and when?

We disagree with the perception that all e-Commerce models are flawed. We think the sector is in the similar phase to what online media companies faced in 1996-1997 when investors questioned the viability of these new media models. Online shopping is still only in its infancy, with currently only 1% of US retail sales conducted online, and we think the of evolution e-Commerce models and broader technology innovation has only just begun. Pinpointing when the sector rebounds is extremely difficult, as it depends in large part on market sentiment. We think we could see enthusiasm for the group return by late summer or early fall as several events converge:

- Amazon.com is positioned to have delivered three consecutive quarters of consistently driving down operating losses as a percentage of revenue, with increased visibility on its ability to deliver single-digit losses by the fourth quarter.
- eBay will have grown its operating income from just $0.5 million in the first quarter of 2000 to our estimated $21 million-plus by the fourth-quarter—illustrating the ability of the company to diversify its business model beyond collectible auctions and deliver superior ROIC.
- We expect priceline.com to break even as soon as the third quarter with profitability in the holiday quarter.
- The media frenzy surrounding the approaching holiday season will heighten.

We think there are three companies (eBay, priceline.com, and Amazon) that can appreciate in price without a sector catalyst, owing to the fact that each company has emerged as an e-Commerce model or platform that transcends multiple Internet sectors and each has attracted a broad investor base. Not all stocks will rebound, as the market will continue to recognize and discriminate between the winners and losers.

That said, we believe that Amazon, as a bellwether e-Tailer, can have the greatest impact on the performance of the sector. **If Amazon achieves its goals of reducing fulfillment expenses as outlined and begins to demonstrate operating leverage as it moves toward profitability, this could serve as a catalyst for the whole sector. It would demonstrate that (contrary to today's belief) e-Tailing models are not inherently flawed.**

Ultimately, we believe investors will come back to this forgotten sector, but invest only in the leaders once the value proposition of owning e-Commerce stocks becomes as clear as the value proposition to consumers of buying from e-Commerce companies.

Investing in companies that meet our critical success factors

It is obvious from the amount of negative press during the past eight to ten months and the performance of the Internet e-Commerce index that the enthusiasm for the Consumer e-Commerce sector has waned significantly from the levels of just a year ago. Given the level of negative sentiment, we thought it might be refreshing to remind readers why Consumer e-Commerce can be attractive investment vehicles. First, we want to be clear, that we are bullish only on the leading companies that meet our list of critical success factors, not the whole sector.

Our list of leaders contains only a handful of names, implying that the remaining companies will struggle to continue as stand-alone businesses. We arrived at a list of leading companies by picking one or two companies within each vertical segment of the Consumer e-Commerce sector that compared well against our success factors.

Potential for high ROIC with consistency and predictability of earnings

In our view, Consumer e-Commerce stocks are attractive because they can provide both superior earnings power—measured by ROIC—and low volatility or consistency of earnings growth. Other securities typically have only one of these two characteristics, but rarely both.

For example, technology companies typically have high earnings power (ROIC greater than 70%) but high volatility because of lower consistency of earnings. Traditional retailers or consumer products companies, however, provide consistent or little volatility in earnings growth (relative to technology companies) but low earnings power (ROIC less than 35%).

To support our assertion, it is important to understand why Consumer e-Commerce companies have greater predictability in earnings and how Consumer e-Commerce companies can achieve levels of earnings power that their land-based brethren have long envied.

Consistency and predictability of earnings

Historically, consumer businesses have had greater consistency of earnings because the drivers of growth are more stable and predictable. At the macro level, growth is driven by the number of consumers and how much they spend.

The first variable, the growth in the number of consumers, has become stable and is highly correlated with the growth of the population. The second variable, the amount consumers spend, has greater variability, but the changes are not sudden and are driven by slow-changing indicators such as wage growth, debt capacity and consumer confidence. Therefore, the consumer sector is relatively more predictable than most technology sectors, where earnings growth is driven by less-predictable and much faster-changing variables.

For example, a new, more advanced software application can deplete the sales of the incumbent leader in less than one quarter. The demand side of technology companies can change based on the evolution of business models and the change in a widely accepted platform. In consumer businesses, there is less of a risk of a bubble, because consumers are always there, and behavior changes slowly.

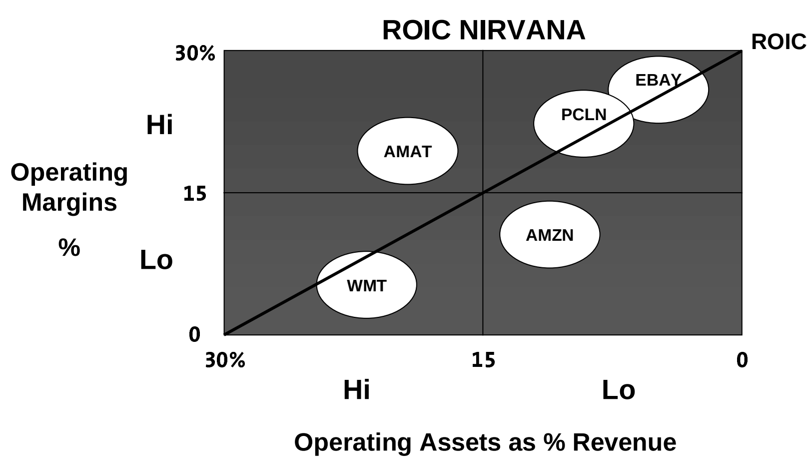
Superior earnings power

Of course, earnings power for Consumer e-Commerce is still theoretical because these companies have not reached the scale to measure actual ROIC. Thus, we are left with evaluating potential ROIC. The potential levels of ROIC are quite believable as we evaluate the conditions required to achieve them.

As seen in Exhibit 6, we have laid out examples of different types of companies and the two factors that drive ROIC: operating margins and operating assets (the physical assets of the company, plus inventory, and networking capital) as a percent of revenue.

Historically, consumer businesses or retailers have fallen into the bottom left-hand quadrant with low operating margins and high assets as a percent of revenue, as with Wal-Mart (20%-25% ROIC with 5%-6% operating margins and 20%-25% operating assets as percent of revenue). Some technology companies, such as Applied Materials, are characterized by high operating margins (20%) but also by high assets as a percent of revenue (25%), resulting in strong ROIC of 80%.

Exhibit 6: The path to ROIC nirvana
How operating margins and operating assets drive companies' ROIC



ROIC = return on invested capital

Source: GS Research.

Low operating assets, high operating margins

First let's look at companies such as eBay and priceline.com. Both companies are forecast to have operating margins in the 10%-30% range, combined with less than 1% of operating assets as a percentage of revenue. These companies will be very prosperous. They have no need for physical assets and they leverage the Internet to maximize on virtual commerce.

Amazon, meanwhile, has the potential to migrate from the bottom right-hand quadrant to the top right-hand quadrant if it achieves operating margins of 10%—higher than those of traditional retailers, such as Wal-Mart.

Let us assume that Amazon achieves operating margins of only 5%—the same as Wal-Mart. In that case (which is unlikely as Amazon adds high-margin revenue from services and advertising), Amazon is still positioned to have superior earnings power relative to consumer companies with ROIC in the 80%-100%-plus range. Why? Because it will drive its operating income with substantially less operating assets as a percent of revenue at 3%-9% than Wal-Mart at 20%-25%.

So, the logical question to ask is this: When can these companies achieve triple-digit ROIC? We believe it is sooner rather than later. eBay and priceline.com are poised to be the first two companies to reach triple-digit ROIC. Though both companies will likely do that in 2001, eBay is poised have significant ROIC in 2000 north of 60%.

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Stock ratings:

RL: Recommended List	**LL:** Latin America Recommended List	**TB:** Trading Buy
MO: Market Outperformer	**MP:** Market Performer	**MU:** Market Underperformer

Common stock comparison for the consumer e-Commerce sector

Company	Ticker	Rating	9/08/00 Price	Market Cap ($M)	% from 52-Week High	Price Performance 1999	YTD	Last Mo.	Last Wk	Price/Sales (X) 1999	2000E	2001E
Amazon.com	**AMZN**	**TB**	**$42.94**	**$15,023.2**	**-62.0%**	**42.2%**	**30.4%**	**30.4%**	**3.5%**	**9.2**	**5.4**	**3.6**
Ashford.com	**ASFD**	**MA**	**4.00**	**180.4**	**-88.6%**	**-15.4%**	**33.3%**	**33.3%**	**28.0%**	**5.9**	**2.3**	**-**
Autobytel.com	ABTL	—	4.63	94.0	-77.3%	-34.0%	12.1%	12.1%	-7.5%	2.3	1.3	1.0
Autoweb.com	AWEB	—	1.97	57.9	-86.1%	-22.3%	1.6%	1.6%	8.6%	1.8	0.9	0.6
Barnes & Noble.com	**BNBN**	**MP**	**4.94**	**719.8**	**-79.0%**	**-21.2%**	**0.6%**	**0.6%**	**21.5%**	**3.6**	**2.1**	**1.2**
Buy.com	BUYX	—	3.63	477.1	-89.0%	-	18.4%	18.4%	28.9%	0.8	0.6	0.4
Cheap Tickets	CTIX	—	10.50	254.1	-70.1%	54.9%	-3.4%	-3.4%	-1.2%	1.7	0.5	0.4
Cyberian Outpost	COOL	—	4.53	129.0	-71.6%	-63.9%	18.9%	18.9%	27.2%	0.9	0.4	-
Drugstore.com	DSCM	—	5.31	282.0	-90.7%	101.0%	-13.3%	-13.3%	-11.5%	8.1	2.7	1.2
eBay	**EBAY**	**RL**	**65.80**	**18,113.7**	**-48.4%**	**55.7%**	**30.9%**	**30.9%**	**4.6%**	**80.6**	**43.6**	**31.5**
eBay (Gross Merch Sales) [1]				**0.0**	**0.0%**	**0.0%**	**0.0%**	**#Calc**	**0.0%**	**6.5**	**3.4**	**2.5**
Egghead.com	EGGS	—	3.50	148.2	-87.4%	-59.6%	47.4%	47.4%	21.7%	0.3	0.3	0.3
eToys	**ETYS**	**MO**	**5.63**	**683.6**	**-93.5%**	**31.3%**	**38.5%**	**38.5%**	**20.8%**	**5.1**	**2.1**	**-**
Expedia	**EXPE**	**MO**	**17.38**	**748.9**	**-73.6%**	**150.0%**	**7.8%**	**7.8%**	**9.9%**	**12.9**	**2.7**	**1.9**
1-800-flowers.com	**FLWS**	**RL**	**5.63**	**361.0**	**-71.5%**	**-49.1%**	**4.7%**	**4.7%**	**-1.1%**	**1.1**	**0.9**	**-**
Fogdog.com	FOGD	—	1.09	40.1	-95.0%	-13.6%	2.9%	2.9%	9.4%	5.7	1.3	0.8
FTD.com	EFTD	—	2.28	107.8	-81.8%	-34.4%	4.3%	4.3%	-8.8%	2.2	-	-
Garden.com	GDEN	—	1.63	28.6	-93.3%	-27.6%	-20.0%	-20.0%	-10.3%	5.3	-	-
Global Sports Interactive	GSPT	—	8.00	173.6	-68.3%	59.5%	6.7%	6.7%	-6.6%	31.5	4.3	1.7
Hotel Reservations Network	ROOM	—	36.00	583.6	-7.1%	-48.2%	12.7%	12.7%	0.2%	3.6	2.0	1.4
Mothernature.com	MTHR	—	0.66	9.9	-95.5%	-43.8%	-12.5%	-12.5%	-8.7%	1.7	0.6	0.3
Onvia	ONVI	—	6.94	560.1	-91.1%	-	-3.5%	-3.5%	-0.9%	20.6	4.1	2.0
Peapod	PPOD	—	2.03	36.5	-87.6%	26.6%	1.6%	1.6%	1.6%	0.5	0.3	-
Pets.com	IPET	—	1.00	29.2	-92.9%	-	-27.3%	-27.3%	6.7%	5.0	0.7	0.3
PlanetRx	**PLRX**	**MO**	**0.63**	**30.1**	**-98.3%**	**-9.4%**	**-25.9%**	**-25.9%**	**-18.4%**	**3.3**	**0.7**	**0.5**
Priceline	**PCLN**	**RL**	**25.75**	**5,070.2**	**-75.3%**	**196.1%**	**-8.0%**	**-8.0%**	**-0.7%**	**10.5**	**3.5**	**2.5**
SmarterKids.com	SKDS	—	1.81	37.3	-89.4%	-48.2%	18.4%	18.4%	3.6%	6.9	3.9	0.4
Streamline.com	SLNE	—	0.75	16.8	-94.9%	-14.4%	-70.0%	-70.0%	20.0%	1.0	0.3	0.1
TheKnot.com	KNOT	—	3.13	45.7	-85.1%	-15.6%	-10.7%	-10.7%	-3.8%	8.9	1.8	1.4
TicketMaster.com	TMCS	—	22.25	879.7	-53.0%	-31.4%	-6.8%	-6.8%	-8.2%	8.4	3.9	3.1
Tickets.com	TIXX	—	1.63	96.1	-94.9%	14.5%	-27.8%	-27.8%	2.0%	2.1	1.6	0.9
Travelocity	**TVLY**	**MO**	**13.63**	**678.5**	**-77.6%**	**182.7%**	**-8.4%**	**-8.4%**	**-2.7%**	**7.5**	**3.3**	**1.8**
Vitaminshoppe.com	VSHP	—	1.34	9.8	-93.1%	-17.0%	19.4%	19.4%	26.5%	0.7	0.3	0.1
Webvan	**WBVN**	**RL**	**3.81**	**1,249.2**	**-88.8%**	**10.0%**	**-15.3%**	**-15.3%**	**-1.6%**	**93.9**	**7.5**	**1.6**
Leading e-Commerce Avg					-79.6%	39.0%	11.3%	11.3%	7.1%	16.0	3.3	2.1
Total Group Average					-80.4%	11.8%	1.7%	1.7%	4.6%	10.6	3.3	2.3
Total Group Median					-87.4%	-14.9%	1.6%	1.6%	1.6%	5.1	1.9	1.2
S&P 500			$1,494.5		-3.8%	19.5%	0.8%	0.8%	-1.7%			
Dow Jones Ind. Avg			11,220.7		-5.8%	25.2%	2.2%	2.2%	-0.2%			
GIN			456.8		-42.6%	110.3%	6.8%	6.8%	-4.3%			
NASDAQ Composite			3,978.4		-22.5%	85.6%	3.4%	3.4%	-6.0%			

Source: GS Research, FactSet, I/B/E/S.