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India’s e-commerce frenzy

Investors pumped $4 bn into Internet businesses last year and are set to more than match that amount in 2015, bringing back memories of the dot-com boom-and-bust

Asia’s third largest economy is widely considered as the last big Internet market as the explosive sales of smartphones have made the Internet accessible to hundreds of millions of as-yet untapped shoppers. Illustration: Yatish Asthana/Mint

New Delhi/Bengaluru: The party came to an end in March 2000. Between 10 March (when it touched a peak not seen again for 15 years) and 6 April, the NASDAQ lost a little over $1 trillion of market value. Dot-coms began going belly up—Pets.com, WebVan.com, eToys.com and, most famously, Go.com.

Last month, the NASDAQ climbed above 5,000 again—for the first time in 15 years.

Internet businesses have again cemented their status as investor darlings, not just in the US, but even in India, prompting comparisons with the dot-com bubble.

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Tech investors in the US, Europe and Asia, which either missed out on the record initial public offering (IPO) of China’s Alibaba Group or were enriched by it, are queuing up to invest in India’s e-commerce companies.

Just last year, investors ploughed in more than $4 billion in Internet businesses, and that amount is expected to be significantly higher in 2015.

E-commerce is evidently here to stay as the convenience of shopping online, home delivery and low prices are real benefits that traditional retail can’t offer.

It helps that modern retail is a non-starter in India.

A Nielsen study last month pointed out that modern retailers were losing out just a bit more than traditional retailers (or corner stores) as online retailers continued to march ahead.

Still, a broad comparison between the current funding boom and the dot-com bubble highlights striking similarities: high rates of cash burn, massive losses, ambitious promises of future growth and weak due diligence by investors worried about being left out.

There is one big difference that makes an analysis of the current scenario hazardous: this time, it’s the private companies rather than the listed firms which are attracting eye-popping valuations.

So while the stock prices of **Just Dial Ltd** and **MakeMyTrip Ltd** have declined slightly over the past year, the valuations of privately held e-commerce firms in India, including **Flipkart**, **Snapdeal**, **Ola** and **Zomato**, have jumped four to five times, maybe more. Some of these firms are clear market leaders, particularly e-commerce platform Flipkart and taxi-hailing firm Ola, and they are reaping a premium for being so.

Flipkart has a market share of 44% of online retail, much ahead of Snapdeal, whose share stands at 32%, according to a March report by Morgan Stanley. Given its leadership position and fast revenue growth, investors have pushed up Flipkart’s valuation to nearly $15 billion in its next round of fund-raising from less than $3 billion at the beginning of 2014. Ola has an even bigger market share lead over US-based rival **Uber**, and its valuation is likely to increase to $2.5 billion from less than $300 million last year.

Though neither Flipkart nor Ola is anywhere close to profitability, investors are giving them high valuations based on the expectation of strong revenue growth.

Earlier this month, online classifieds site Quikr raised $150 million, taking the company's valuation close to $1 billion. The company has raised close to $350 million since the start from Tiger Global, Investment AB Kinnevik and Steadview Capital.

The rising valuations, however, aren't restricted to market leaders. Those of early-stage start-ups have also soared, while new start-ups are now demanding twice or thrice the value, compared with 2013, according to several venture capital firms. These include start-ups in real estate, classifieds and logistics that haven't even demonstrated reliable revenue models.

As new investors such as Steadview Capital, Qatar Investment Authority and **SoftBank Corp.** are putting cash into the larger e-commerce firms, the existing investors led by Tiger Global Management are doing several early-stage deals to spot the next big thing.

True, the valuations are crazy, but no one wants to miss the party.

"Valuations are out of whack, both among early-stage and late-stage start-ups," said **Tarun Davda**, director, Matrix Partners. "For most companies, valuations are one, sometimes two rounds, ahead because there's too much money chasing e-commerce firms as new investors, in particular, don't want to miss out."

Technology firms have typically received high valuations relative to companies in other sectors because investors are betting on future growth, said **Praveen Sinha**, co-founder at online fashion retailer Jabong.com.

"On the one hand, this creates many disruptive companies and, on the other, companies that fail miserably. (Today), money is coming in too early and, hence, valuations are rising too fast," Sinha said.

Valuation metrics

Traditionally, companies are valued based on metrics such as profit after tax (PAT), earnings before interest, taxes, depreciation and amortization, or Ebitda (a measure of operating profit), and cash flow. These methods of valuation don't apply to Internet companies, given that they generate massive losses.

Hence, investors have devised a valuation measure called annualized gross merchandising value (GMV), or cost of goods sold. GMV is an opaque metric as it does not account for the deep discounts most e-commerce firms offer. Nor does it factor in product returns. So, if a firm says its annualized GMV is $100 million, it can actually be booking sales of anywhere between $20 million and $70 million. About 2-2.5 times a firm's GMV is considered a reasonable number, while market leaders fetch valuations of up to four times their GMV.

Still, the current numbers are not excessive, one venture capitalist said.

"2000 was a market created largely by investors than the market reality itself," said **Sanjeev Aggarwal**, co-founder and senior managing director of venture capital firm Helion Venture Partners. "Today, companies are building business with real GMV. The entire ecosystem, too, has changed; the number of smartphones and Internet subscribers point to a very different scenario."

Many disagree with Aggarwal. Partly because of this relatively new, and vague, valuation metric, only a few large institutional investors such as Qatar Investment Authority and GIC, Singapore's sovereign wealth fund, have put money in e-commerce. Many, including Barings, Blackstone and KKR as well as the world's most famous investor, **Warren Buffet**, have largely avoided e-commerce firms.

"A lot of investors try and stay away from this sector due to the risks involved. Traditional private equity (PE) firms stay away and only the early-stage VCs or hedge funds get excited about the sector," said **Raghubir Menon**, partner at Amarchand and Mangaldas, a legal advisory firm.

Most of the "serious big money" in the world has avoided e-commerce companies and Indian firms, in general, said **Santosh Kanekar**, an independent consultant who advises financial firms on investing in Indian companies. "Over the past two years, many PE investors in India have been selling stakes through private deals rather than taking their portfolio companies public. And some of the new investors in e-commerce companies, especially hedge funds, are hoping for exits through secondary sales rather than IPOs, necessarily. This investment thesis depends almost entirely on new investors coming in, and when that stops, the secondary market will collapse," Kanekar said.

Analysts and experts have an unkind term for the strategy Kanekar is describing: the greater fool theory.

Pullback scenario

While nearly all VC firms and investment advisers agree that e-commerce valuations have run much ahead of reality, there is no real clarity on what could cause a bust.

The majority view is that there will be one.

The two biggest technology crashes of the past 15 years have had different triggers. The 2009 one was a broader, global recession, triggered by the collapse of the US investment bank **Lehman Brothers Holdings Inc.** The 2000 dot-com bust was more specific to technology stocks although there was an accompanying telecom crash (catalysed by auctions in 1999 in the US and early 2000 in Europe that saw telcos shelling out big bucks for spectrum).

This time, experts say, since the so-called bubble is prevalent in privately held Indian e-commerce companies and that the valuations here are also closely linked to the soaring valuation of US tech start-ups, three kinds of events may lead to an investor pullback. One, a macroeconomic event; two, declining valuations of US-based private companies such as Uber and Dropbox; three, if a large Indian Internet company struggles to raise cash.

“I don’t think investors in e-commerce, particularly late-stage investors, have factored in some key macro-economic risks such as a US rate hike. When a US rate hike happens, money will flow back to the US, and no one really knows how that will impact the flow of capital around the world,” said Kanekar, the independent consultant, referring to an expected increase in US interest rates over the coming years.

Apart from macroeconomic events, one trigger for a downturn could be a market leader or a large e-commerce company failing to get an increase in valuation in its next round of funding, according to **Manik Arora**, managing director at VC firm IDG Ventures India, which owns shares in Flipkart, Yatra and Lenskart, among others.

“Or worse, if the valuation declines in the next round (from the previous round).”

Winners and losers

In the 2000 dot-com bust, several Internet companies failed. Companies such as Pets.com and Boo.com went bankrupt; stocks of most online retailers and tech firms crashed; some such as **Lycos** were fortunate to be acquired at the start of the bust but were later sold again for a fraction of their purchase prices.

However, some survivors such as **Google Inc.** and **Amazon.com Inc.** grew stronger over time and have gone on to become among the most valuable tech companies globally.

This time around, rather than a broad tech bubble, it’s mostly privately held e-commerce companies and Internet businesses that are suspected of having unsustainable valuations.

Some 73 private firms worldwide are valued at $1 billion or more, according to a February report by *The Wall Street Journal*. The number of billion-dollar companies was 35, adjusted for inflation, at the peak of the tech bubble in 2000, the report said.

“During irrational periods, you will see two things happen. Firstly, while many companies will fail, there will emerge certain winners. Secondly, these irrational periods help build infrastructure in any economy,” said **Ajit Balakrishnan**, founder of **rediff.com**.

Consolidation is also inevitable and early signs of it are already visible.

In April, online marketplace Snapdeal said it was buying mobile recharge service Freecharge in the biggest-ever deal in India’s start-up domain. The deal is estimated to have valued Freecharge at roughly $450 million; Snapdeal believes it can sell products and services to millions of users who currently use the Internet only to recharge their mobile phones. Apart from potential business benefits, the deal was done to boost Snapdeal’s valuation. The acquisition of Freecharge, which has about 20 million users, makes Snapdeal the company with the highest daily transactions and the highest user base, two key metrics that investors use in valuing money losing e-commerce businesses

In 2012-2013, when investors refused to back most e-commerce firms, several shut shop and some were gobbled up by survivors such as Flipkart.

This time, too, the survivors will become significantly stronger and will increase their dominance when capital stops flowing easily, investors said.

“Those firms that are well capitalized and have raised money just 3-4 months prior to such a downturn will be in a position to consolidate the market cheaply. In a downturn, a lot of firms will get merged into bigger players, and you may also see companies raising capital at falling valuations,” IDG’s Arora said.

Experts said shareholders agreements have largely remained similar over the past decade, meaning that if companies fail, shareholders stand to lose a majority of their investments.

Unlike manufacturing or industrial firms, for instance, e-commerce ones don’t own sizeable physical assets.

“There are two broad sets of shareholder rights that become important in case of companies that are struggling,” said **Vaibhav Parikh**, partner at law firm Nishith Desai Associates. “One is rights relating to operation of the firm—these rights allow shareholders to control some aspects of management in case the management is doing a very bad job of execution. The second set of rights are exit rights: these rights determine which shareholders will get how much and in what order of preference. These are the key rights that would help protect shareholders and they have stayed standard.”