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The Indian e-Commerce Euphoria- A bubble about to burst?

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Abstract: *The Indian e-commerce is making news every day- from festive season sales, deep discounts to another round of VC funding. The sector is gaining momentum more than ever. Even the government is supportive of the increased pace of startups. Prime Minister NarendraModi announced a new campaign "Start-up India, Stand up India" to promote bank financing for start-ups and offer incentives to boost entrepreneurship and job creation. The big techies of the world such as Google, Microsoft, Facebook, and Qualcomm have offered support to India in its transformation into a digitally empowered society, knowledge economy & a very high penetration of internet. This paper deals with the pattern of VC funding in Indian e-commerce sphere& brings to light the problems in operational areas in e-commerce companies. The mad rush in VC funding, mounting losses & increased valuations of e commerce giants raises possibilities of an e-commerce bubble in India, similar to the dot-com bubble abroad.*
Keywords:*e-commerce bubble, Venture capitalists, Startups, Entrepreneurship*

I. Introduction

Indian internet user base is about 354 million people as of June, 2015, with about 6 million people being added to the user base every month. The vast potential in the online purchasing market can be gauged from the fact that it went up to $12.6 billion in 2013 from $3.8 billion in 2009. In the Q1 of 2014, there were about 35 million online shoppers in India.According to Google India,this figure is expected to cross the 100 million mark by the end of 2016. [1]These statistics give a clear idea of the massive outreach e-commerce has in India. Increased internet penetration, explosive growth in the user base of smartphones, widening of the aspirational classes andimproved standards of living are some of the principal reasons for this colossal success of the e-commerce sector in India. Six Indian e-commerce companies have been able to achieve a billion dollar valuation, as of Q1 of 2015, namely- Flipkart, Snapdeal, InMobi, Quikr, Ola Cabs and Paytm.

A seemingly unending market and greater and greater acceptance of online purchasing among the buyers have resulted in soaring valuations for the e-commerce companies. This euphoria has led to proliferation of startups in the e-commerce industry, all desirous of becoming world's next Amazons and Alibabas. But this startup dream has to be fueled with funds and this capital comes from Venture Capitalists and Private Equities.

Venture Capital- Funding the e-Commerce Dream

"Venture capital (VC) is the money provided to seed, early-stage, emerging and emerging growth companies. The venture capital funds invested in companies in exchange for equity in the companies it invests in, having a novel concept or in high technology industries, such as bio technology and IT. The typical venture capital investment occurs after the seed round as the first round of institutional capital to fund growth in the interest of generating a return through an eventual exit event, such as an IPO or trade sale of the company. Venture capital is a type of private equity."[2]

VC funding happens in different stages starting from seed funding, start up, growth (series A), second round, expansion(mezannine) and exit of VC.

Naturally with the swelling e-commerce industry in the country and the burgeoning startups,the Venture Capital industry in India has also grown recently and shows signs of promising future. The figure of VC funding in India has quadrupled in the last decade. It is because of this reason that this area becomes important for research. Venture economics data shows that during the 1990-99 decade, India's ranking was 25/64 countries and raised about 945 million dollars of investment. Interestingly, in the decade 2000-2009, India's ranking improved to 13/90 countries and raised about 16,684 million dollars. This shows a growth of 1664% over the previous decade. The trend is even more positive for the years in between 2005-2009, in which India ranked 10/77 countries and attracted VCPE funding of 15,073 million dollars. This, itself was a growth rate of about 837% over the previous years. The growth rate in investments made by various VCPE funds has been equally strong. During five year period 2004-2008, the industry growth rate in India was the fastest globally and it rose to occupy the No. 3 slot worldwide in terms of quantum of investments. [2] The amount invested by VCPE funds grew from US$ 1.8 billion in 2004 to US$ 22 billion in 2007 before tapering off to US$ 8.1 billion in 2008[3]. During the five year period ending 2008, VCPE investments in India grew from 0.4% of GDP in 2004 to more than 1.5% of GDP in 2008. [4]

Indian markets have a huge growth potential for e-commerce in future because of increasing efforts by the present day government to increase the internet penetration through programs like Digital India. Due to this it is seen that both Indian and foreign venture capitalists are taking keen interest in this area. Indian online start ups system has shown alarming boom in the past few years, fuelled by foreign capital. Not only this, some of the e-commerce business of India made it to the list of top ten start ups in terms of their valuation. It is seen that the major venture capitalists in these firms were more or less the same. It included Tiger Global, Softbank, nexus venture partners, SAP ventures, sequoia capital, info edge, matrix partners and QUALCOMM ventures, to name a few.

Mentioned below are some of the highly popular and successful e-commerce businesses in India and their VC/PE flows-

1. FLIPKART: It is one of the largest e-commerce sites in India founded in 2007 by SachinBansal and BinnyBansal. It is presently valued at 11 billion dollars. Though its parent company operates in Singapore, all of its operations are mainly in India. Till date, Flipkart has received 25 billion dollars of investment in 11 rounds through 16 investors. Some of them being; Tiger Global,Naspers, DST global, BailieGiggord and others.

2. SNAPDEAL: It was founded by KunalBahl and RohitBansal in 2010, valued at 2 billion dollars. Snapdeal has received funding of 1.1 billion dollars in 8 rounds by 16 investors. Some of them are: -Indus ventures, Nexus venture partners, Bessemer ventures. It received 627 million dollars of investment from Japanese Telecom and Internet Corporation, Softbank in October'2014.

3. OLA CABS: It was founded by AnkitBhati and BhavishAggarwal in 2010. Currently valued at 1.1 billion dollars. Ola has received funding of 276 million in 5 rounds by 9 investors including Tiger Global, Softbank, Sequoia capital, matrix partners. It raised 210 million dollars from Softbank in Oct '2014.

4. PAY TM: Pay tm is a mobile platform for digital payments. It was founded by Vijay Shekhar Sharma in 2010 and has raised funding of 610 million dollars from investors like ANT investors, Intel capital, SAP ventures and Silicon Valley bank.

5. IN MOBI: It is an advertising company founded eight years back by MohitSaxena, AbhaySinghal, Naveen Tiwari and Amit Gupta. Currently, valued at 2.5 billion dollars. The firm has raised 220 million dollars in 5 rounds through 4 investors namely Softbank, Sherpalo ventures, Kleinerperkins, Caufield and Byers. Like others, it also received 5 million dollars from Softbank.

6. GIRNAR SOFT: Co founded by Amit Jain and Anurag Jain in 2007, Girnar soft is an offshore software development company. It has raised 75 million dollars in 2 rounds by 4 investors like Sequoia capital, Tybourne and hillhouse capital firm. It has other online subsidiaries such as Cardekho.com, gaadi.com.

7. ZOMATO: Founded by PankajChaddha and DeepinderGoyal, Zomato is an online restaurant search portal and is expanding worldwide. It is still not a billion dollar company but is growing at a fast pace and is valued at 660 million dollars. It has received a funding of 113 million dollars from 3 investors namely Sequoia capital, Infoedge and VY capital.

8. JABONG: A part of Rocket internet big foot retail, Jabong is a Gurgaon based online portal for clothing. It is valued at 500 million dollars. It has raised around 27 million dollars in its latest round of funding and is planning to go for an IPO.

9. QUIKR: Now a billion dollar company, Quikr is an online classified site meant for sale and purchase of almost all products ranging from furniture to real estate. It was founded in 2008 by Jiby Thomas and PrannayChulet. The company is a billion dollar company. Not only this, it has raised 346 million dollars in 6 rounds by 9 investors. They are Matrix partners, Omidyar partners, warbergpincus, Nokia growth partners etc. Quikr in its series H round of funding has raised 150 million dollars from Tiger Global, hongkong based steadview and Sweden based AB kinnevik.

10. HOUSING.COM: It is an online buy and sell real estate portal. The company was recently found in 2012 and has now grown to 250 million dollars company. It has raised 140 million dollars from 4 investors namely Hellion Venture partners, Qualcomm ventures, nexus venture partners and others. The firm received 90 million dollars from Softbank in December'2014.

II. Key Takeaway

The important thing to note here is that there are only seven VCs who are shaping the Indian e-commerce industry. These VCs have virtually become the kingmaker in the e-commerce economy, being a part of 54% of the deals in the e-commerce space since 2007. These VCs are engaging with companies in multiple ways, even funding their operational requirements. “Ironically, Tiger Global, one of the most active investors, doesn't even have an office in India. It is a guy sitting in New York who is flying in and out, who is doing the deals,says a person associated with industry, referring to Lee Fixel, partner and co-head of Tiger Global's private equity and venture capital investing. Fixel reportedly also led later-stage investments in Facebook and LinkedIn, making a return of about $1 billion and $400 million, respectively, on them.”[5] Not only this, the correct valuation of these E-commerce venture capital firms is hardly known.

The Problem with the e-Commerce Sector

The business models of these e-commerce websites are currently focused on acquiring more and more customers, increasing their Gross Merchandise Value (GMV). Dedicated to earning more customers and top line growth, companies’ profitability is suffering. With the motive of multiplying the user base these companies are offering an avalanche of discounts, free shipping, cash-on-delivery, which eats into the profits. These firms have waged price wars between themselves by offering deep discounts to the consumers and selling way below the cost. They have enlarged the consumer appetite to such an extent that even their survival in the long run is questionable, leave alone making profits. The cost of customer acquisition is so high that these companies are spending Rs. 1000-2000 on advertising on TV, newspapers etc to acquire a customer order worth rs.400-500. [6]

A website Trak.in,tracking business and tech startups, claims that Flipkart has a loss to revenue ratio of 2.23 while Snapdeal has a ratio of 1.72.[7]Flipkart’slosses rose from Rs 344.6 crore in FY13 to Rs 719.5 crore in FY14, while Snapdeal’s losses mounted from Rs 120.1 crore in FY13 to Rs 270.7 crore in FY14. Most other e-commerce websites are also in red, with their losses widening. [8]

NO regulation of Indian e-commerce

In spite of showing exponential growth in the past years, it is surprising to note that no e-commerce specific regulations have been set up. The reason given for the same is that e-commerce as a sector is new to India and has its origin in foreign developed nations. It is said these nations have adequate infrastructure to serve the needs of e commerce stakeholders. Legal provisions pertaining to FDI, FEMA, cyber law due diligence are openly flouted in India by some e-commerce giants. Repeatedly claims of predatory pricing and unfair trade practices have been raised against these firms. In some instance, enforcement directorate (ED) has also initiated investigation against big e-commerce players like Myntra,Flipkart and many more e-commerce websites operating in India.[9]Flipkart’s “big billion day” sale was under scanner by the Enforcement directorate. They were accused of predatory pricing, problems in placing orders, fake products and other dubious practices. Since Amazon entered India in 2013, it has restricted its operations to the marketplace model because Indian laws do not currently permit online retailers with foreign funding to sell directly to consumers. Yet companies like Flipkart seem to sell a range of products to customers while successfully having procured hundreds of millions of dollars in foreign funds over the past few years. [10] Consumers are wary of using their debit/ credit cards due to problems of theft etc. and rely heavily on cash on delivery mode which is a pricy affair for the company in the long run. The Indian government must take this issue into notice and amend and enact dedicated laws under Information technology act (2000). This will bring more trust and the industry will operate in a healthy ecosystem.

III. Is It A Bubble About To Burst?

Nevertheless, investors are pushing in more and more capital and the e-commerce market is swelling. According to Grant Thornton, Private Equityand Venture Capital investments rose from $363 million in 2011 to nearly $5 billion in 2014. The excessive funding by these venture capitalists, in spite of running in losses, creates a suspicion of an e-commerce bubble. These VC firms are completely fine with the e-commerce companies running into losses as long as the revenues are multiplying. The simple model of return on equity exceeding the cost on equity doesn’t apply to the startup e-commerce companies, because in majority of these companies there is no return on equity.

Yet, the valuations of the biggest of e-commerce companies in the country run into billions of dollars. This incongruity between loss making businesses attracting stratospheric levels of valuations has resulted in the call for a bubble in e-commerce and startups, just like the dot com bubble of the 2000s. [11] Stock market investors are questioning the viability of the business model of the e-commerce companies. They are concerned about how and when they will turn profitable and not about their sky-high valuations. These companies have been burning capital at the same rate at which they are raising them.

Valuations of some of the Indian e-commerce firms are currently 2-3 times higher than they should be. For instance, in October, 2013 Flipkart was valued at 1 billion dollars and as of March, 2015 it has shot up to $12.5 billion. Similarly, Snapdeal's valuation rose from $1 billion to $5 billion in just a year.

Comparing the valuations of e-commerce firms and traditional brick and mortar retailers, we get a clear sense of the widening gap between the two segments. On the one hand, Flipkart is valued at $11 billion;on the other hand Trent, Future Retail and Pantaloons are valued at $800 million, $600 million and $200 million respectively. The total market capitalization of India's major brick and mortar retailers is less in comparison to the value of Flipkart and Snapdeal alone. Jack Ma promoted Alibaba Group Holding backed off from buying a stake in Snapdeal, because Snapdeal sought a valuation of $6-7 billion while Alibaba was seeking to value the firm under $5 billion. [12]

This conundrum has led to the fears that VCs might pull out their investment sooner or later due to huge losses they are incurring, which are unjustified with the soaring market valuations of the e-commerce companies. The big question that arises now is that will the Indian virtual economy be able to sustain such a rally. If yes, for how long?

IV. The Other View

There are others who believe in the euphoria that the e-commerce sector is selling, thinking that the fears of the impending bubble burst are unfounded. According to a recent report by the UBS, "Is India in an e-commerce bubble? A framework for assessing emerging markets' e-commerce" such fears are misplaced. After analyzing the supply chain of offline retail by category in the Indian market, they found that there is enough margin for e-tail in the coming years, which they believe would grow to $50 billion by 2020 from the current $16 billion.

The study says that this growth in the sector would come from the increased internet penetration by mobile (3G and 4G), higher acceptance of technology, and breathtaking rate of adoption of smartphones, growing middle class and availability of sufficient capital to fund the initial phase. The key driver of e-commerce, the study says, would be the young population of the country (below 35 years) with higher preference for online purchasing.

It is generally believed that India will mirror China in the case of growth of e-commerce. According to UBS, internet penetration in India in the year 2019-2020 would be similar to China's in 2012. Since India's population would be commensurate with China's only in size and not in income levels, and given India's smaller middle-income population, a similar trend in India like China's wouldn't be too obvious. UBS claims India's middle income population would be around 66 million in 2020, smaller than China's 75 million in 2008, which is when China's e-commerce story began. Also, Chinese companies benefited from a relatively closed economy, Indian companies would benefit from technological advances and powerful analytical tools.

V. Conclusion

E-commerce in India is at a nascent stage and its growth is being aided by ample capital provided for by VCs, leading to aggressive discounting that is driving up the Gross Merchandise Values. UBS is of the view that though this has clouded an objective analysis of the sectorand has led to speculations of it being a bubble that will burst shortly; it is highly likely that this won't happen.Still, the stock market investors may still have to wait till 2020 to invest in profitable e-commerce ventures. But we assert that this rat race for securing skyrocketing valuations and ever expanding GMVs shouldn't continue as it is. The possibility of e commerce bubble cannot be negated in entirety, the specialized firms who follow a balanced approach may survive and others showing reckless behavior may perish. Former MD of Network18 RaghavBahl said. "The bubble is going to burst. History has been witness to this time and again. For the past 100 years, these bubbles have been created from the Tulips, to the dotcoms and now e-commerce. Ultimately, businesses run on cash flows and profits and not on ideas that can be valued at astronomical figures", he said at the India Retail Forum (IRF) in Mumbai [16]. The e-commerce companies must introspect and strategically use the discounting offers and the like for widening the customer base. Improving customer experience and providing high quality products with smartly used discount offers should soon become the norm for the industry, so that most of them come out of the red-ink in their profitability statements. Also, it is high time to start charting a profitability plan, albeit for the long term, and not keep it on the back-burner.

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