

## INDIAN UNICORN VALUATION



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“Beauty lies in the eyes of the beholder. Value lies in the hold of the acquirer”

The above statement holds apt for the new age businesses which are comparatively newly formed cutting-edge technology businesses. Most of these businesses are burning cash and eroding capital yet in the eyes of their Investors they are valuable investments. Valuing such start-up businesses in the present complex and dynamic world is not an easy task. Although many a times, profit is a misfit for valuing a startup, cashflows often end up in doing little justice to the task they were employed to undertake in the first place. Valuing a startup is similar to connecting the dots and sometimes ought to follow or attempt unconventional methods.

Since the advent of technology and internet such businesses have evolved and augmented from merely a start-up to a graduated start-up and the successful ones are now known as “**Unicorns**”. This article is a humble attempt to understand what goes behind those funding deals and how the unicorns have achieved the valuations they are enjoying. Only time will tell whether these valuations will sustain, whether the new age tech business itself will sustain or whether they will replace the current top 50 blue chips.

### Concept and History of Unicorns

In the start-up ecosystem, a unicorn is a term used for privately held start-up company valued at over USD 1 billion (approximately Rs.7,500 crore) and is generally Venture Capital (VC) funded.

Aileen Lee, U.S. based venture capitalist, first wrote about unicorns in the venture capital world in her article, "*Welcome to the Unicorn Club: Learning from Billion-Dollar Start-ups (2013)*". Here, she looked at software start-ups founded in the U.S.A. in the 2000s and estimated that only 0.07% of them ever reach a USD 1 billion valuation. Start-ups that managed to reach the USD 1 billion mark, she noted, are so rare that finding one is as difficult as finding a mythical unicorn and thus the term “**Unicorn**”. As for “**Decacorn**”, it is a term for a company valued at more than USD 10 billion, while “**Hectocorn**” is used for a company valued over USD 100 billion.

As per data maintained by an information platform website<sup>1</sup>, there have been a total of 79 start-ups in India which have achieved the unicorn status till December 2021. Some of the start-ups at the helm of the valuations are widely known to the markets and media. There are some underdogs in the field of Saas, Fintech, E-commerce, Logistics which have performed well as far as their valuations are concerned but are not so widely known like:

<sup>1</sup><https://www.ventureintelligence.com/Indian-Unicorn-Tracker.php>

- Postman – Application Programming Interface (API) development and testing (Valuation ~USD 5.6 billion)
- Digit – General Insurer with tech-enabled processes (Valuation ~USD 3.5 billion)
- Unacademy – Online education like language, programming, job preparation web portal (Valuation ~USD 3.4 billion)

### Valuing a Start-up Business

Basic premise for a valuation of any company is going concern assumption and fair value concept. Cost approach of valuation cannot be effectively utilized for valuing a start-up company since it is difficult to estimate how much money will be spent in future. Market comparable approach is a worthy replacement but measuring a start-up's projections against historical performance of established companies would not lead to a realistic comparison because projecting earnings for a start-up company involves making a definitive judgment on the probabilities of success of a new business. Thus, income approach is the appropriate approach which will take into account the forecasted income from business.

While using Income approach in Valuation, more so Discounted Cashflow (DCF) method, valuing a company means discounting the future cashflows to present value at an appropriate rate. The value of start-ups is generally based on how investors and venture capitalists feel they will grow and develop, so it all comes down to longer-term forecasting. Like for instance in case of Zomato, in the span of ten years there were more than ten rounds of funding, starting from Series A to Series J. This means that such disruptive businesses should not be fragile and should have a higher success rate of growth. Thus, more often than not, their valuations have nothing to do with the way they perform financially. In fact, many of these businesses rarely generate any profits when they first get running. Therefore, most of the startup funding deals are not based on DCF method.

Thus, in practice there are some other methods which are used for start-up funding deals which are as follows:

#### Gross Merchandise Value method

For many e-commerce entities gross merchandise value (GMV) is used to value e-commerce business, where the focus is only on top-line of the entity and profitability is ignored. In layman's terms, GMV is the value of the merchandise sold over a period of time, without taking into account the discounts offered, the cashbacks granted or any other expense in connection to the sale. Thus, to quote a simple example, a commodity worth Rs.1000 was offered at 50% discount, that is, at Rs.500. Furthermore, the customer was offered a 10% cashback, and thus he paid an amount of Rs.450 for the product. Though the cash inflow is Rs.450, the GMV is Rs.1000.

GMV is often used to determine the health of an e-commerce site's business because its revenue will be a function of gross merchandise sold and fees charged. It is most useful as a comparative measure over time, such as current quarter value versus previous quarter value. There is also the flip side of this method. Just to attain higher valuation based on the gross value, cheap selling techniques like huge discounts and cashbacks become a trade practice which results into operating loss for the transaction. Another

noteworthy point to be carried home is the fact that GMV nowhere considers 'profitability' of the transaction from the e-commerce website's perspective. Thus, many venture capitalists no longer consider GMV as the sole substratum for valuing e-commerce businesses.

### Venture Capital Method

It is most common approach to value young companies. It is a valuation based on expectation of venture capital investor. Investor will try to obtain return on its investment commensurate with the risk it perceives. This method starts by defining return on investment (ROI). Objective of investor is pre-determined exit date & pre-determined ROI. It generally focuses on revenue and earnings and ignore intermediate items like working capital requirements, capex requirements, etc. It also tends to ignore cash flows.

In this method, the earnings of the private firm are forecasted in a future year, when the company can be expected to go public. These earnings, in conjunction with a price-earnings multiple, estimated by looking at publicly traded firms in the same business, is used to assess the value of the firm at the time of the initial public offering; this is called the exit or terminal value. Discounting the terminal value arrived with ROI to arrive at the present value. Value arrived as above is 'post-money' value.

Post Money Value = Pre-money value + New Capital infusion by Venture Capital investor

For Instance:

Particulars	Scenario 1	Scenario 2
Annual Earning as on date	1,00,00,000	1,00,00,000
Growth in Earnings	20%	15%
No. of Years to Exit	10	15
P/E Multiple	12	10
Initial Investment by Founders	20,00,000	20,00,000
Required Rate of Return	35%	25%
Equity Stake of VC Investor	10%	15%
Current No. of Shares	10,00,000	10,00,000
Annual Earning as on Exit	6,19,17,364	8,13,70,616
Future Value of Startup	74,30,08,371	81,37,06,163
<b>Value of Startup (Post Money Valuation)</b>	<b>3,69,53,538</b>	<b>2,86,29,740</b>
Number of Shares owned by VC Investor	1,11,111	1,76,471
Total Outstanding Shares	11,11,111	11,76,471
<b>Price per Share</b>	<b>33.26</b>	<b>24.34</b>
Pre Money Valuation	3,32,58,184	2,43,35,279
<b>New Capital Infusion by VC Investor</b>	<b>36,95,354</b>	<b>42,94,461</b>

### Unit based Economics in case of Start-ups<sup>2</sup>

There is a certain user-based economics. In the start-up language it is generally referred to as customer cohort. At the outset, it is important to differentiate between a user and a customer. A user may be a paying user or a free user, whereas a customer is generally a paying customer. Accordingly, it is important to note that as a term, user is much wider than the term customer, in the start-up discussion. Accordingly, for valuing a start-up based on the user base, it is critical to work out how much money is the start-up expecting to generate from its users? Hence, it is a factor of three things that come into picture:

<sup>2</sup>From article "Understanding the Valuation drivers of new-age modern technology enabled businesses" in Valuation: Professionals' Insight Series – 6 of ICAI

- (i) Existing users (Already achieved – stage of the start-up to see if it has a value proposition)
- (ii) Future users (Growth potential coupled with scalability)
- (iii) The above two inflows would be adjusted for Costs involved (User acquisition costs as well as business costs)

For valuing the existing users, factors like revenue per user, renewal rate, life of user with the start-up and associated costs of existing users are considered. For new users, in addition to the associated costs, the user acquisition costs are to be adjusted to identify the profit potential of the business.

User acquisition costs are the costs that are incurred by the start-up in acquiring a user. These are in the form of marketing spends, as well as the significant spending in the form of lucrative deals that are offered to the first-time users or to all users in the initial phase of the life-cycle of the start-up. Business costs are the operational costs of the start-ups that are required to be incurred by the start-up for the purpose of running its business.

A depiction of the above discussion, in context of a start-up, in a tabular format for comparing the Good and the Bad, in a relative sense, can typically be as under:

Point	The Good	The Bad
Losing money	Where money is being lost for user acquisition. Such type of cash burns is funded by VC only at the pretext of super normal growth.	Where money is being lost for business expenses.
High costs	Where higher costs are attributable to fixed expenses, which have the potential to grow revenue in the future, without corresponding increase in costs.	Where higher costs are attributable to variable expenses, which will increase with the increase in scale of operations.
Growth	Increase in the number of users backed with growth in per user revenue, backed by cross-selling and upselling.	Growth only supported by increase in number of users with low per user revenue
Life Cycle Relevance	A start-up that focuses the relevant attribute from either of user growth, revenue growth or revenue sustainability, in tandem with the life cycle where it is.	A start-up that focuses the relevant attribute from either of user growth, revenue growth or revenue sustainability, not in tandem with the life cycle where it is. For example, a young start-up focusing on revenue growth from existing users, rather than focusing on user growth, would potentially lose more users which would hamper its growth.

Point	The Good	The Bad
Surviving through uncertainty	Businesses which have serious users i.e., users that repeat/renew as well as come back to the business more often are less susceptible to adjustments on account of uncertainty. This kind of business creates a benefit of exclusivity or the choice of first preference for the users, which commands a premium in valuation.	Businesses which have casual users i.e., users who are not repetitive as well as those which do not transact but look at the business as an option, are more susceptible to adjustments on account of uncertainty.

### Some Indian Unicorns:

In India, till December 2021 there are two start-up giants which have attained a valuation of decacorn viz., Flipkart and Byju's. Both of these companies are not listed on any stock exchange. Also, very few data points are available in public domain. So, it is difficult to gauge their valuations. As far as listed start-ups are concerned, there are three such companies as of now viz., Zomato, Paytm and Nykaa which have attained a valuation of decacorn. Thus, one can analyse valuation of unicorns through these three companies.

Before we gauge the data points of valuation of these unicorns, a question might arise that how Indian bourses or regulator are allowing such loss-making companies to get listed on stock exchange? Some of the conditions for raising funds through IPO for Startups under National Stock Exchange areas follows<sup>3</sup>:

- Proven track record of atleast 3 years of either the applicant company, promoters or the erstwhile enterprise
- Networth should be positive
- Capitalisation of the applicant's equity shall not be less than Rs.25 crore (Capitalisation will be the product of the issue price and the post issue number of equity shares)

As can be seen from above, profit is not the criteria for raising funds through IPO. The Networth of the company should be positive although this criterion shall not be applicable to companies whose proposed issue size is more than Rs.500 crore

Also, as per the Issue of Capital and Disclosure Requirements (ICDR) Regulations of SEBI, if a start-up can get Qualified Institutional Buyers (Mutual Funds, AIFs, etc.) to back at least 75% of the issue then they can go public even if they are making losses. Hence, this comparatively new phenomenon of 'trading of loss business' is now allowed by the regulator in India.

<sup>3</sup><https://www.nseindia.com/companies-listing/raising-capital-public-issues-eligibility-equity-debt>

## Zomato (Zomato Ltd.)

Zomato started in 2008 as an online platform providing food guide and restaurant directory. It eventually ventured into food delivery business. It has a network of more than 3.5 lakh restaurant partners and 4.4 lakh delivery partners which mitigates concentration risk of business. It has raised funds around Rs.1.43 lakh crore through VC funding before its IPO. Much of the funds have gone into acquisition of companies like Runnr, TechEagle, Uber Eats India, etc. which has strengthened the network and supply chain of Zomato. It has an impeccable commitment of 13 years and is also recognised as one of the best Indian brands.

Business Model of Zomato broadly includes:

- Transaction fees – Transaction fees charged from food ordering and delivery ranges from 20% to 25% of the gross order value
- Advertising – Restaurants listing on Zomato pay a fixed fee to get listed on the platform
- Subscriptions – Subscriptions to Zomato Gold Pro from customers to get discount on food and delivery

India's food service industry is approximately USD 65 billion, out of which online food delivery business is hardly 7-10% as per one management consulting firm, which tantamount to USD 4.5 billion. Market share of Zomato in online food service business is approximately 42%. China's online food service industry is approximately USD 90 billion. Although it is not a proper comparison considering the per capita GDP and internet usage for food service between both the countries but overall, it emphasises that India's market of online food service is not so matured and has ample scope to grow.

Let's look at some of the data points of Zomato to understand the journey of recent past

(Rs. In crore)

Particulars	March 2019	March 2020	March 2021
Sales	1,313	2,605	1,994
Operating Profit	(2,287)	(2,388)	(480)
Profit after Tax	(965)	(2,367)	(813)
Gross Order Value	5,387	11,221	9,483
Investment of Venture Capitalist	~34,599	~10,644	~83,274
Enterprise Value	15,480	24,750	40,500
EV/Sales	11.79	9.5	20.3

As can be seen from the above exhibit till March 2021, Zomato had operating loss. Per unit cost economics was also negative owing to high selling and administration expense. Thus, in such cases free cashflows will not do justice. Use of different multiples like EV/Revenues, EV/Gross Income, EV/User are more appropriate to value such companies. Also, one interesting fact to note is that the Enterprise Value has been steadily increasing due to VC funding rounds. Post IPO, Zomato is valued at nearly double the Enterprise value as on March 2021.

*“The biggest reason why Zomato is losing money is because it is comparatively a young company that is trying to take advantage of a market with immense growth potential, not because it cannot make money. In fact, if Zomato cut back on customer acquisitions and platform investments, my guess is that it could show an accounting profit, but if it did so, it would be worth a fraction of what it is today.”*

– Aswath Damodaran

### **Paytm (One97 Communications Ltd.)**

Paytm started in 2010 as an Indian multinational fintech company that specialises in digital payments. It has a user base of nearly 450 million and has also tied up with 17 million merchants, most of which are QR code-based small merchants. From a payment and wallet service company, it has now expanded its business segments into e-commerce, investing, broking, consumer internet and payment bank. In short, over time it has used its platform of users to launch itself into almost every online activity. In case of Person-to-Merchant market of digital payments, Paytm's market share is 52%. Paytm also has plans to convert its payment bank into a small finance bank. As far as offline payment system is concerned, Paytm accounts for nearly 10-15% of total Person-to-Merchant POS Machines installed in the country.

Telecommunication and data usage have increased in India by leaps and bounds in last decade due to various reasons like cheaper data price, cheaper smart phones and high tele density in rural areas. Thus, the interface between business to consumer had a paradigm shift from physical to digital which has compelled many new age tech businesses to get their payment mechanism on mobile phones too. Unified Payment Interface (UPI) is a pathbreaking application layer devised by National Payments Corporation of India for cashless transactions which allows B-to-B or even merchant payments. UPI transactions have crossed around Rs.1 trillion daily in 2021. As a consequence, wallet operators already have more merchants signed up than the POS machines set up by all banks cumulatively in the last two decades. Digital payments have increased at a staggering rate of ~10.5x in last five years which now constitutes nearly 30% of the retail transactions.

Retail digital lending has reached around USD 110 billion due to many fintech companies who have ventured into specialized as well as short-term lending through faster disbursements, although average ticket size of fintech loan is quite small.



Some of the data points of Paytm to understand the valuation it has reached

(Rs. In crore)

Particulars	March 2019	March 2020	March 2021
Sales	3,050	3,115	2,667
Operating Profit	(4,115)	(2,465)	(1,677)
Profit after Tax	(3,960)	(2,833)	(1,560)
Gross Order Value	2,29,200	3,03,200	4,03,300
Investment of Venture Capitalist	~2,500	~7,550	0
Enterprise Value	90,200	1,20,000	1,23,750
EV/Sales	29.57	39.34	46.40

As can be seen from the above exhibit, gross order value is increasing exponentially since Paytm has been expanding its business in all the walks of online transactions. Although the operating profit and PAT have been decreasing since last three years but the interesting fact is sales are stagnant. It gives an indication that the take rate (aggregator's charges) on gross order value is decreasing year on year. This is mainly because the company is more focused on the number of transactions rather than the value of those transactions. Although a company like Paytm which is in super normal growth phase can have a pretext of lower take rate but if the cash burnouts have to be reduced then the take rate has to increase over time. Again, in the case of Paytm, use of different multiples like EV/Revenues, EV/User are more appropriate to value such companies. EV/Sales have been increasing year on year which is too high as compared to some international peers like Paypal and Visa. Interestingly, Post IPO the valuation has decreased from Rs.150,000crores to Rs.90,000 crores.

### **Nykaa (FSN E-Commerce Ventures Ltd.)**

Nykaa is an Indian lifestyle marketplace for beauty, wellness, and fashion products, started in 2012. The company has expanded from online-only to an omnichannel model to sell the products. It has around 80 brick-and-mortar stores in India along with its online e-commerce website and mobile applications. It claims to have over 3 lakh products across 1500 brands. It has raised funds around Rs.1.1thousand crore through VC funding before its IPO.

In India, there are three modes of selling beauty and wellness products viz., unorganized retail, organized branded stores and online marketplace. The first two methods face a lot of accessibility issues whereas online marketplace has resolved this issue. The online market size for beauty and personal products is around USD 1.2 billion which is not more than 10% of the total market of beauty and personal products as per the Management & Discussion Analysis of Nykaa's Annual Report. E-commerce operators for such products work on two models either as an aggregator/ marketplace (for e.g: Amazon) or as an own platform/ holding inventory (for e.g: D-Mart). Aggregators are merely a mediator between buyers and sellers and earn some % of transactions whereas own platform model hoards the inventory in their own warehouses and then sell products using their bargaining power.

Some of the data points of Nykaa to understand the valuation it has reached

(Rs. In crore)

Particulars	March 2019	March 2020	March 2021
Sales	1,111	1,768	2,441
Operating Profit	21	83	163
Profit after Tax	(25)	(17)	62
Gross Order Value	1,650	2,685	4,046
Investment of Venture Capitalist	~108	~100	~86.5
Enterprise Value	5,430	9,000	33,750
EV/Sales	4.89	5.09	13.82

Most interesting fact which seldom occurs in start-up world is “profits”. Since last 3 years Nykaa has reported operating profits and in the last year bottom-line also became positive. This is mainly because Nykaa has opted for holding inventory model rather than aggregator model. This strategy has not only helped the company to sell products at their price but has also solved a problem of duplicate or obsolete products as the products that are sold are under the control of their own warehouses. Enterprise Value has increased at a rate faster than the increase in sales because of optimizing cost along with customer retention, which has helped the company to report profits. Post IPO, Nykaa has achieved a valuation of decacorn.

### Conclusion:

Principles of Valuation will remain same for any company in all the markets but conventional methods would need to be replaced by newer methods. Most of the unicorns are money-losing, cash burning enterprise now but they are in the early life cycle of the business. Most of them are on track to deliver a viable business model. For such companies, network is the biggest asset. Network carries an inherent value which is gauged by the potential investor and thus, they don't have second thoughts to pump in the money. When such companies grow through their network, it is easier from them to grow. Valuation isn't a one-dimensional game wherein a straight-jacketed formula can be conveniently laid down. It is not a uni-regressional model. And that is the reason why a loss-making company is traded at a unicorn valuation.

