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E-COMMERCE FUNDING IN INDIA: A BUBBLE WAITING TO BURST?

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Introduction

The theory of reflexivity is the centerpiece of billionaire Hedge Fund manager and philanthropist, George Soros's investment philosophy. The theory seeks to explain the interplay between a rational individual's cognition and his environment, in a mutually-influencing relationship. According to the theory, an individual's perception of his environment governs his actions, and the outcomes of his actions, in turn, augment his perception of the environment. In other words, an individual also influences his environment, instead of just being influenced by it.

Initially proposed as a general theory on human behavior and psychology, reflexivity has found its best application in investment finance. Soros has used his theory to explain the occurrence of boom-bust cycles in financial markets and explained how understanding these cycles can, not only save investors from huge losses, but also help them make large profits. Soros's most noted use of the theory was to explain the bursting of the housing bubble in the US that led to the Subprime Crisis of 2009. Soros has presented reflexivity as a theory on the working of financial markets in his book – *The Alchemy of Finance.*

In this paper, we have used Soros's ideas on reflexivity to examine whether the current funding boom in the Indian e-commerce industry is sustainable or, as is widely believed, is just a bubble that is waiting to burst.

The Reflexivity Theory

The reflexivity theory suggests that investors share a mutually-influencing relationship (i.e. a reflexive relationship) with financial markets. They try to analyze market fundamentals, develop their conclusions, and utilize those conclusions for making investment decisions. Unfortunately, their conclusions are never accurate because financial markets are complex and an individual's ability to understand them is limited. This creates a discrepancy

between market realities and investors' perception of market realities, and always produces market prices that are different from the equilibrium price.

When investors earn profits using inaccurate perceptions of market realities (what Soros's calls positive feedback), their faith in their false conclusions grows. Investors keep reapplying those false conclusions until they keep receiving positive feedbacks from the market. Soros calls this process a positive feedback loop. Positive feedback loops take prices away from equilibrium and create asset bubbles.

Once an asset bubble becomes too big, investors become jittery and start speculating that a sharp correction is imminent. This speculation triggers a positive feedback loop in the downward direction – with each fall in the market prices, investors feel that prices will fall further, and sell more assets, which leads to another steep fall in prices. This is when an asset bubble bursts. Prices keep falling until equilibrium is restored. The fall in prices during a bust, is much sharper than the rise during a boom.

According to Soros, booms and busts occur rarely. This is because an upward positive feedback loop is intermittently broken by small corrections that prevent prices from straying too far from the equilibrium. If the upward momentum survives these minor corrections, the bubble continues to grow and investors end up with big losses when it eventually bursts.

E-Commerce Funding Environment in India

The Indian e-commerce boom started in 2007-08. Ever since, the Indian e-commerce industry has made giant leaps and reached a value of approximately $20 billion. Between 2009 and 2013, the industry grew at a CAGR of 37.2% and reached $14.9 billion (including e tailing) from $4.2 billion[1]. TechSci Research[2] expects the Indian e-commerce space to grow at a CAGR of 36% between 2015 and 2020.

The potential market strength of over 250 million consumers and the multi-billion dollar valuations of e-commerce companies in other markets have created enormous investors interest in the Indian e-commerce space. Put together, Venture funds, PE funds, and others, have invested a record amount of $3.5 billion in Indian e-commerce so far this year[3]. The number of e-commerce funding deals in just the first half of this year crossed the number of deals in full year 2014. The top 15 e-commerce deals in 2015 involved a total funding of more than $2.7 billion, which translates to 43% of the $6.4 billion that all Indian startups received in funding during the year.

E-commerce funding in India has rising sharply since 2014, after a slump in 2012 and 2013. Today, e-commerce companies in India are valued higher than they were even during the peak in 2011. Valuations and funding activity in the industry have surged, even though most

of the challenges that confronted Indian e-commerce in 2011 continue to haunt it. We are a decade into the e-commerce boom in India, and even the torch bearers of India's e-commerce renaissance are incurring deep losses. It is hardly surprising that not one Indian e-commerce company is listed[4] yet. This disconnect between valuations and fundamentals of e-commerce companies has sparked fears the there is a funding bubble in India's e-commerce industry.

Reflexive Patterns in Indian E-Commerce Funding

The Indian e-commerce industry has a short history of just under a decade. We have witnessed two significant funding surges over this period. The first surge happened in 2011, and the second (which we are currently in) began in 2014. The two funding surges are clearly visible in the illustration below, which shows the estimated annual e-commerce funding in India from 2010 to 2015.

The Funding Boom of 2011

The surge of 2011 was largely inspired by the rapidly spreading e-commerce culture in the west. It was suspected that e-commerce would flourish in India too, given our rich 'demographic dividend,' most of all. Most stalwarts of India's e-commerce scene received their Series A and B funding during this period; and 2011 ended with a total funding of $800 million for the sector. This was an 8x jump over 2010, when funding deals worth $110 million were signed.

For all the fervor surrounding the potential of e-commerce in India, the e-commerce model was still very new and insufficiently tested. As with all new business models, early investors in Indian e-commerce scarcely understood the environmental factors that are necessary for the model to thrive, and were not sure of what they were getting into. In other words, early investments in the Indian e-commerce space were more speculative than fact-based. This situation closely resembles the founding tenet of Soros's theory of reflexivity – investors gather all the information that they can from their environment, and take the best possible decision. However, their understanding of their complex environment is incomplete, and the application of this incomplete understanding results in flawed decisions.

Investors didn't realize that the ground was not yet ready for e-commerce to prosper in India. Yes, the demographic dividend was there, but the governing laws, tax regulation, logistical support, secure internet servers, plastic card culture etc.; which are inseparable to a healthy e-commerce ecosystem, were not in place.

For starters, the country's internet penetration was too low and only a few urbanites could shop online. A large percentage of the 250 million internet users that e-commerce companies

use for their projections, were rural folk (as they still are). Back in the day, mobile internet was not so ubiquitous, and rural India had little access to the computer. So selling goods online to 250 million people was a distant dream. So, while e-commerce companies were spending aggressively to establish themselves in the market place, it just wasn't happening!

A lot of e-commerce companies had to spend over $3 to generate one dollar of sales! Despite this, investors kept investing in the space and boosting values of e-commerce companies to sky-high multiples. The consistently rising valuations of Indian e-commerce companies kept the positive feedback loop going and brought more money into a bloated-up Indian e-commerce space. The gap between ground realities and valuations just kept on growing.

Investors started getting nervous and the positive feedback loop was ultimately interrupted towards the end of 2011. E-commerce funding activity in India went into a slumber for the next two years, and 2013 ended with total investments of merely $224.85 million. This is about a fourth of its 2011 peak. The minor correction (or what George Soros refers to as a 'short circuit') brought some sanity to the funding activity and e-commerce valuations in India, and probably brought us somewhat closer to equilibrium.

2014: Return of the Funding Boom

The second positive feedback loop began in 2013-14, with the global e-commerce IPO boom. The positive feedback came externally even this time. Although many new-listees in the US and elsewhere, failed to receive much favor from investors, some came out with flying colors. The most celebrated of the favored lot was Alibaba, the Chinese e tailing giant that listed on the NASDAQ. The company got a whopping $231 billion valuation, and its stock surged 38% on the first day of trading. Other e-commerce companies that had rip-roaring IPOs included GrubHub, the US online food delivery and takeout company that went up 31% on the first day of listing.

The positive feedback in the form of high valuations of listed companies convinced investors that the e-commerce dream is for real, and not just a flash in the pan. It proved that e-commerce businesses can actually get listed and get multi-billion dollar valuations. Early investors in Alibaba, GrubHub and the like, made millions in profits, overnight when these companies listed. All of a sudden, venture funds and PEs again started clamoring for a piece of the e-commerce pie. Valuations of e-commerce startups into the galaxy!

Waves of funding came gushing into the e-commerce industry in India too. In 2014, investments in the Indian e-commerce space shot up to $805 million, or over 3.6x over 2013. Flipkart, perhaps the most celebrated India's e-commerce company, received $1 billion in funding in a deal that valued it at $11 billion dollar.

Positive feedbacks are a bit like potation – the more you get, the better you feel, and the more you want to indulge! But less do you realize that as the tipples increase, you keep drifting further from reality. The funding boom of 2013 was perhaps the first tipple of the second e-commerce funding wave. It received a positive feedback in the form of soaring e-commerce valuations in India. This positive feedback reinforced investors' faith in the e-commerce industry and gave them a proverbial high.

Investors got tempted, and imbibed the second round of potions by pumping in a whopping $3.5 billion in fresh investments in Indian e-commerce companies in 2015. The number of deals in the first half of 2015 itself crossed the number of deals in full year 2014. 380 deals have been completed in the year so far, and the valuations are much higher than they were in 2011. Flipkart's valuation went up to $15 billion at the end of FY 2014-15, despite the Company's losses triplicating from Rs.715 crore in 2013-14, to Rs.1932.9 crore in 2014-15.

The Departure of Valuation from Equilibrium

While e-commerce valuations in India are constantly increasing, little has changed fundamentally. Low internet penetration, inadequate hard infrastructure, weak cyber law compliance, ambiguous tax laws, and slow pace of reforms, such as GST and FDI; continue to impede the creation of a flourishing e-commerce ecosystem in the country. A United Nations survey[5] conducted in April, 2015, ranked India 83rd on e-commerce congeniality, out of 130 countries; and echoed some of these concerns.

Although the revenues of Indian e-commerce companies have displayed strong growth in recent years, growth has come at a high cost. High cash burn rates and mounting losses for even top e-commerce players, attest to this. Companies have had to offer steep discounts and spend heavily on Sales & Marketing due to an increase in market competition. In fact, leading e-commerce players have been selling products at as high as 40% discounts to the market, just to repel competition.

India's three largest e-tailers – Snapdeal, Flipkart and Amazon; earned a combined Revenue of $85 million in 2014, whereas their combined loss for the year amounted to $160 million. In other words, they lost $1.88 per dollar of Revenue earned during year. Despite this, all these companies were valued in the billions during the year. The graph and the table below show how three of the top Indian e-commerce companies are valued at very high multiples, despite running deep losses for the last three years.

A high cash burn rate has directly affected the longevity of e-commerce companies. Companies have had to pivot, sell out, downsize or, in many cases, shut shop to survive. According to a study by Allegro Capital Advisory[6], 25% of Indian e-commerce companies that were funded in 2011-12 have pivoted since. The ones that have pivoted are performing much better than the rest. As illustrated below, out of the 53 companies that received Series A venture funding in 2013, only 11 survived to receive series B funding, and only 10 to receive Series C,D funding.

Given the disparity between the lofty valuations and harsh ground realities of Indian e-commerce companies, the suspicion of a bubble in Indian e-commerce is hard to dismiss. Bloated up valuations may only be a product of a reflexive, self-reinforcing positive feedback cycle that is present since 2013. The funding spree of 2014 made valuations of e-commerce companies rise steeply, and drift away from equilibrium. The increase in valuations generated a positive feedback for investors, and inspired them to pump in more money into the Indian e-commerce space. This surge in funding spawned the rally of 2015, which appears to have inflated values further, and may culminate in a short term fall in valuations and funding activity.

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Notes:

[1] Source: "Evolution of E-Commerce in India: Creating the Bricks Behind the Clicks," ASSOCHAM and PWC India

[2] Source: "India E-Commerce Market Forecast and Opportunities," 2020, TechSci Research, September 2015

[3] Till Q3,2015

[4] October, 2015, Infibeam received SEBI's approval to raise Rs.450 crore through an IPO. It became the first Indian e-commerce company to file it herring prospectus for listing on the NSE and the BSE.

[5] Source: Bloomberg View: http://www.bloombergview.com/articles/2015-05-08/india-s-e-commerce-boom-may-turn-to-bust

[6] Source: "E-Commerce: Investment and M&A Activity," Allegro Financial Advisors Pvt Ltd

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