E-RETAIL VALUATION : MYTH OR REALITY

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ABSTRACT

Indian E-tailer Flipkart has been valued at whopping $ 17 billion in March 2015 and Snapdeal is valued at by private equity investors. Asronomical valuations of e-retaliers in India form apprehension in the critical minds. Researchers and analysts suspect whether these valuations are realistic on the ground of India's leading e-retailers are booking losses since their inception few years ago.

Losses of the e-retailers are funded by the fresh infusion of capital by foreign private equity investors and venture capital funds. The losses are due to various reasons one being 'the spree of discounts' strategy adopted by most e-retailing sites and also other investments in new product lines, technology up gradation, talent acquisition which will reap benefits over the next few years.

Despite the losses their total sales turnover, Gross Merchandise Value (GMV) is multiplying riding on rising number of netizens across the country primarily due to widening reach of internet services, both broadband and mobile and favorable demographic factors. Additional investments in vital business fronts are also instrumental in GMV growth.

Business valuation is as per conducted using income based method for profit-making companies. This article investigates the truth behind the escalating valuations of non-profitable e-tailing business. It reports investments by the e-retailer Flipkart. The valuation perplexity is resolved based on the analysis of projected GMVs, estimated revenue, operating costs and profits. Financial analysis reveals that for an internet scale company there is trade of between profitability and growth. For such companies, estimation of cumulative cash-flow during specific future period may be reliable measure of valuation. This article reports investments by the e-retailer Flipkart and its possible revenue & profits in future

E-retail Valuation : Myth or reality

In March 2015, leading international daily 'International business times' reported in March 2015 'Flipkart Seeking $15 Billion Valuation In New $800 Million Private Funding: Report'. Around the same time, 'The Huffingston post' reported 'Flipkart's Valuation Zooms To $12.5 Billion after Helion, IDG Stake Sale'. Earlier in December 2014, Indian business newspaper 'Business Standard' had quoted 'Flipkart now valued at $11 bn after raising another $700 mn.' These news articles imply the sky-high valuation figures for Indian e-retailing firm Flipkart. Not just Flipkart, even other e-retailers in India are making headlines about higher investments and soaring valuations. In February 2014 Business Standard carried an article quoting Indian e-retailing portal Snapdeal being valued at $5 billion.

In simpler words, if someone has to buy the company "Flipkart" today he has to shell out whopping Rs 96,000 cr (@ Rs 64 per dollar). This value is abysmally high when compared with market value of India's largest brick and mortal retailer Future group which has a total market value at only 3000 cr. Trade pundits find these valuations ridiculous and few analysts predict that e-retail in India is one big bubble that will burst, just like the major crashes of the recent past - dot com bubble of 2000 and global recession of 2008. During the dotcom crisis in 2000 the stock-prices of Tech companies crashed world-wide causing Dow Jones Index to fall by 37% in 2000 and wiping out the wealth of enormous number of investors. Global recession in 2008 was led by collapse of the investment bank Lehman Brothers subsequent to defaults by US housing mortgage borrowers.

Valuation news about the e-retailers in India forms an apprehension in the critical minds. Researchers and analysts suspect whether such valuations are realistic for the companies that have a suffered losses during the past three years. According to the USB report, three largest e-retailers in India Flipkart, Amazon India and Snapdeal reported a combined revenue of $85 million and a loss of $163 million in FY14. It can be inferred that these companies spent nearly $3 to earn revenue of $1. In FY 2014 Flipkart reported a loss of Rs 400 cr on a revenue of Rs 179 cr in FY 2014 (Data : Tech Circle). As detailed financial data is unavailable as the Indian e-retailers being privately held companies till date, we have extracted relevant financial data from bits and pieces of published information.

Since the losses are so huge, it needs to be examined how is the money spent by these companies? Citing the most commonly known 'spree of discounts' strategy adopted by most e-retailing sites it seems the discount have made a big hole in the pockets of the e-retailers. E-retailers reason it as customer acquisition costs in the form of discounts and free home delivery as means to attract more customers and enhance its scale of operations.

The recurring losses of the e-retailers are funded by the fresh infusion of capital by foreign private equity investors and venture capital funds. Since its inception in year 2007, Flipkart has raised a total of $2.1 billion from investors out of which $1.2 billion (Rs 6800 cr) was received in 2014 and further $210 million received this year. Snapdeal has raised $600 million from investors ado the $233.7 million it raised earlier this year. (source : livemint which ifrom)

E-retailing, also termed as online retail is a relatively new business in India. Most widely used business models are inventory-led model and marketplace-driven model. Both Flipkart and Snapdeal are operating under market-place driven model. In marketplace-driven model the e-retailing company does not hold any stocks, but various decentralized sellers trade their products on the portal (Flipkart.com). The portal merely serves as a platform where buyers and sellers come together and transact. E-retailers earns through certain commission charged on the respective transaction.

Gross Merchandise Value (GMV)

For an e-retailer, the Gross Merchandise Value (GMV) represents the aggregate of total value transactions or products sold on the portal. In marketplace-driven model, term used is GTV or Gross Transaction value. For leading e-retailer the value of GMV has soured to the skies in the FY 2014-15. Flipkart's GMV was $4 bn (Rs 25,600 cr) in 2014-15, four times higher than $1 bn (Rs 6400 cr) in 2013-14. During the previous year, too Flipkart's GMV had risen more than 3 times from Rs 2000 cr in the year 2012-13. (source : Business Standard -Feb 2015). Even Snapdeal reported 3.5 times growth in its GMV up from yearly $1 bn in August 2014 to $3.5 bn in May 2015 (Source : Business Insider' June 2015). Compounding GMVs are indicators fast-growing volumes and surging scale of operation.
Rising number of netizens across the country primarily due to widening reach of internet services, both broadband and mobile is the prime reason behind the growth in E-business. Flipkart, Snapdeal and Amazon are the leading e-retailers in the highest growth era of digital India and are able to capture the initial euphoria of this new business segment .

Growth of the Indian Online retail industry

Indian retail industry is estimated to grow at a CAGR of 10% till 2020 riding on projections of GDP growth rate and increasing purchasing power parity of consumers. At this growth rate, the retail industry will touch a value of $1 trillion in 2020 from the current $ 600 bn in 2015. As per the report from Assochem & PWC, average online spend per consumer will rise sharply from Rs 6,000 in 2014 to Rs 10,000 in 2015 riding on the rising purchasing power of middle class and growth in the wealthy class.

- Currently, internet penetration in India is only 20% of the population much lower than 45% penetration in China and 86% in the US. Digital India initiative for the growth of broadband internet and the growth of mobile internet due to cheaper data-services & declining smartphones prices are indicative of bright future for the internet in India.
- Number of internet subscribers are estimated to grow from 354 mn in 2015 to 500 mn in 2017, which is whopping 45 % growth in just two years. This is a large consumer base for the e-retailers (Source : PwC report E-commerce 2014)
- India's E-retail in 2015 has grown more than 5 times since 2011. Online retail will grow at a higher rate on expectations of more customers from across the country as broadband and mobile internet expands. Other favourable demographic factors for in terms of …..
- Currently, online retail market of $8 bn is just 1.3% of the total retail of $ 600 bn in FY 2014. Worldwide, online retail constitutes 8 to 10% of total retail whereas thus clearly indicating a huge growth potential.

The point worth mention is that actual data about total number of net-users in India, market size, growth rate have outshined their estimated numbers, clearly boosting expectations for the future as well.

Future GMV Growth of Flipkart

Though e-retail is vastly growing industry in India, one also needs to know the prospective GMV of a website. Web-analytics provide data about key performance indicators of an e-commerce site . Web-analytics site WOW (worth of web) has recorded a number of 837 million visitors per month to the Flipkart website in May 2015, indicating astronomical 30 times jump from 26 million visitors in July 2014. The number of unique visitors to the Flipkart site has been consistently rising and it has gone up 3 times from 20 million in March 2014 to 60 million in March 2015. Also, marketing specialists have observed that while measuring revenue it is important to examine the nature of the sales, i.e if 80% of your revenues come from just 3 customers or from 20% of the customers.

Investments and Acquisitions by Flipkart

Flipkart is in the huge growth phase, both organic and inorganic and has made numerous acquisitions and additions recently. Flipkart acquired India's leading fashion portal Myntra.com for Rs 2000 crore in May 2014. Flipkart employed 10,000 people in 2014 and plans to double the number of employees by recruiting 10,000 to 12, 000 more employees (source : livemint)

Few of the noteworthy achievements on the technological front include acquisition of mobile technology firm Appeiterate to operate and enhance its mobile app platform and acquisition of software development company Ezetap for credit and debit cards. Flipkart has stepped up its advertising on the Google and Facebook and other forms of media as well with an aim garner additional revenue from banner advertising on their site. Distribution and logistics network is a key parameter in the success of e-retail. The ability to deliver products especially to the hundreds of millions of Indians living in smaller towns who are unable to buy all their needs at local retailers is the prime area of focus of the E-retailers. The warehousing infrastructure, branding and team that flipkart has been able to create is a huge entry barrier for anyone trying to enter this space. Partnering with Mumbai dabbawala for last mile of delivery, exclusive tie-up with Indian postal services are milestone developments in the supply chain logistics of Flipkart It is win-win situation for both the parties. Recently They have recruited Mr Peeyush Ranjan as Senior Vice President and Head of Engineering and Mr Punit Soni who have served the brand 'Google'. Flipkart has wisely acquired the world's best human resource in technology to excel as world class technology company and maintain growth momentum.

Valuation of e-retailers

Business news has reported both Flipkart and Snapdeal to have incurred losses during the past three years. In the most commonly used, 'the income-based business valuation method (by the principle of going-concern) analysts at the valuation amount based on the net profit (PAT) number, operating profit or EBDTIA (Earnings before depreciation, taxes, interest and amortization) figure and cash-flow. Companies with high positive profits and cash-flows claim high valuations. However, the e-tailers, despite a record of huge losses in subsequent years and negative profitability ratio, are being valued at an astronomical figures.

Further, venture capitalists and foreign PE firms have made several investments in these e-retailers during the last five years till 2015 period. Surprisingly infusion of fresh capital is translated into upward revision in the valuation number, according to the published information. Mukesh Bansal of Flipkart had commented in the news daily Business Standard in August 2014 "We understand that multiplying growth in future GMVs can be achieved due to the greater investments made in the business". American author and venture capitalist Mark Suster, concluded in his research blog titled 'Should Start-ups forcus on profitability or not' (from the blog-post 'Both sides of the table' December 2011)," there is trade-off between profitability and growth and the internet-scale companies should focus on being cash-flow positive instead of the profitability". With a reference from Mark Suster's research, the valuation amount can be ascertained based on the financial projections of GMV, revenue and gross profits. In the present analysis we prepare financial projections for two hypothetical e-retailing firms P and Q which started at the same time with a seed capital of Rs 500 cr each in the year 2014, and are expected to achieve different rates of GMV growth.

In the unavailability of correct figures of published data Pls note the analysis cannot be carried out on the Flipkart

Assuming the e-retailers operate in market-place driven model, both the firms earn certain commission on the products sold on the portal. Presently portals charge different rates for commission ranging from 1% to 20 % of the value of transaction. Assuming that currently e-retailers P and Q generates an average of 10% commission on GMV, revenue p.a. will be the 10% of the GMV. Costs assumed here are total operational costs which include payment gateway charges, logistics and delivery costs, human capital and technological R&D are indirect costs. Company P grows at 50%, slightly aligned with the present industry growth 50-55% in Indian e-retail . (source : CRISIL Indian retail report 2014). Table A(1) indicate one year estimate for company P

Table A(1) –One year estimate for e-retailer 'P'

	2015	2016
GMV	**2000**	3000
Growth rate	**-**	50%
Commission (%)	**10**	10
Revenue	**200**	300
Operational Exp	**600**	**600**
Profit	**-400**	-300

GMV of Company Q is projected to grow 3 times due to marketing efforts and increased spend in delivery and logistics network in 2015-16. Financial estimate for yr 2016 for company Q is indicated in the table B(1)

Table B(1)- One year estimate for e-retailer Q

	2015	2016
GMV	**2000**	6000
Growth rate	**-**	300%
Commission (%)	10	10
Revenue	**200**	600
Operational Exp	**600**	1200
Profit	-400	-600

Which is the better-run company of the two? On the face of it company P is the better run company as it has achieved break-even in 2016 while losses of company Q went up to Rs 600 crore. Company Q's operational costs are higher due to certain investments made by it. It added a new product line by acquiring another e-retailer. It upgraded its technical team to roll out the new product line It invested to real estate and human capital to expand their delivery network in the form of additional delivery staff, fulfillment centers. They created a strong business development team to work on deals which will embed their products with other companies' products and augment their revenue. They acquired bigger office space and hired the best talent in the industry to build on technological expertise to stay ahead of its competitors. We now draw financial projections for next three years for company P and Q. Assumptions for GMV rate growth and commission (revenue) for company P and Q are indicated in table C below. Compnay P is estimated to grow at industry growth rate and Company Q is a estimated to grow faster due to various investments made. GMV of Company Q will triple every year during the first three years and will grow by 200% p.a. during the year 4 and 5. Commission rate was 10% during the first three years and it can have rose to 20% as GMV as companies gained a brand name and popularity the market during the advanced stage of growth

Table C –Assumptions for projections of P and Q

	GMV Growth rate		**Commission (%)**	
	Yr 1-3	**yr 4-5**	**Yr 1-3**	**Yr 4-5**
Company P	50% p.a	37% p.a	10%	20%
Company Q	3 times	2 times	10%	20%

During the first three years company P is estimated to grow at 50% and the last two years (4 and 5) growth rate will drop slightly to 37% as per the industry trend (Infact this is a conservative estimate in comparison with estimated CAGR 50% Indian e-retail industry). GMV of Company Q is estimated to grow by three times every year during yr 1-3 and at 200% p.a. during the year 4 and 5 as the industry matures. Commission rate was 10% during the first three years and it can rise to 20% as companies will gain a brand name and popularity the market during the advanced stage of growth.

Now a look at the 3-5 year financial projections

Table P (2) for company P- Financial projections

	2015	**2016**	**2017**	**2018**	**2019**
GMV	**2000**	3000	4500	6165	8446
Revenue	**200**	600	450	1233	1689
Operational Exp	**600**	**600**	**600**	**600**	**600**
Profit	**-400**	0	-150	633	1089
Cumulative Profit	**-400**	-400	50	683	1772

Table Q (2) for company Q – Financial Projections

	2015	2016	2017	2018	2019
GMV	**2000**	6000	18000	36000	72000
Revenue	**200**	600	1800	7200	14400
Operational Exp	**600**	1200	2400	4000	4000
Profit	-400	-600	-600	3200	10400
Cumulative profit	-400	-1000	-1600	1600	12000

So which company an investor should invest company P or Q? Certainly company Q, as it has earned higher cumulative profits. A point worth a mention is company Q has been able to sustain the losses and achieve growth primarily due to its access to the external funds. At the end of 5 years the company Q has earned Rs 12000 cr as against Rs 1772 cr earned by company P. It can be inferred that an internet scale company has to sacrifice profitability for growth . its always a trade of between profitability and growth.

Conclusion :

For a company which is growing at above average rate appropriate measure of valuation is being cash-flow positive instead of being profitable .

- In the current scenario E-tailers can afford being unprofitable since they do not have succumb to the pressure of the stock-market to report a positive profits
- Besides, venture capitalists who invest in these companies possess sound business acumen, they can plan specific investment duration with a pre-defined strategy for exit. In future when the investors wish to sell off the business, they can boost up the valuation by curtailing the operational costs, report outstanding profits and fetch handsome price for the business. This number can be in big multiples of their investment in the venture.
- In our financial projections company Q which has a access to private equity funding, can earn cumulative cash-flow of Rs 12000 crore while its avg GMV (equivalent of total sales value) is Rs 4000 crore (Rs 2000 in FY 2015 and Rs 6000 in FY2016), which implies that it can be fetch total of Rs 12000 cr in four years time, which is three times its GMV.

Flipkart aims to achieve a annual GMV of $8 bn (Rs 48000 cr) by December 2015 . Also going by the astonishing growth in the Indian e-commerce industry and company's multiplying GMVs , in the current situation Flipkart, is in comparable to the company Q. On the demand side, growth in the web-traffic to flipkart site is a favourable indicator. Strategic investments made by the e-retailing giant in acquisition of new product lines, technological upgrades, innovative marketing & cost-effective delivery methods, hiring best talent in the industry will shoot up its operating cost in the short-term, but in medium term it will reap huge benefis. So with annual GMV of $4 bn in April'14 and and estimated $8 bn in 2015, how much is Flipkart worth is anybody's guess?

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