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Author : Jwalit Vyas & Ranjit Shinde
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DOT BOMB: Ecommerce companies are fast burning through their funding money to gain customers and garner market share but more factors than one will ensure the long-term viability of online retailing. As valuations balloon, ETIG explores sustainability
ET Intelligence Group: With every round of funding, valuations of some ecommerce companies keep surging exponentially to blockbuster levels. Is this realistic or just one big bubble? There's no one answer to that as yet but a recent arbitrage opportunity serves to illustrate the intriguing possibilities that arise in such a situation.

A bullion supplier to a large online retail player recently found a way to make some extra money .Having first sold gold coins to his client, he bought them back in the name of another buyer when the company offered a discount. For the website, this was a means of winning new customers and increasing market share. Similar exercises abound across the market as ecommerce firms burn through funding money to gain customers but will this ensure the long-term viability of online retailing?
The factors cited in support of high valuations include improving internet access, greater affordability due to rising incomes, wider choice and the expected long-term profitability of ecommerce. According to a recent report by UBS Securities India, the nation's ecommerce market will grow 10 times by 2020 to $50 billion from current levels.

According to news reports, Flipkart's valuation touched $12.5 billion in March 2015 from $1.6 billion in October 2013, an eightfold jump in just 18 months. Snapdeal's implied valuation has risen from about $1 billion to $5 billion in a year.

While industry trackers agree about the potential of the sector, there's no unanimity on the fairness of valuations. “Evaluating ecommerce companies requires a change in the traditional valuation mind set,“ said Rachna Nath, leader, retail and consumers, PwC India. “Digital assets can create value just like physical assets and therefore may attract valuations that may look high at present.“

Valuations appear to be aspira tional, said GT Thomas Phillippe, associate partner at law firm Khaitan & Co. “I am not surprised with the comparisons being made with s being made with the dotcom bub ble,“ he said.

“Both involve unclear profit ability models, though the dot com bubble was characterized by highly questiona ble revenue mod els as well. Cur rently, revenue is being ramped up rapidly in e-retailing largely on the back of discounts funded by abundant venture capital. However, the roadmap to profitability remains unclear as ever on account of dis counting as well as core operational reasons.“

Some believe valuations reflect potential. “Current valuations appear to be high but they reflect upbeat sentiments about potential of ecommerce based on expected economic growth, improving lifestyle, increasing internet connectivity and expanding consumer base,“ said Hemant Joshi, partner, Deloitte Haskins & Sells.

According to the USB report, Flipkart, Amazon India and Snapdeal reported a combined revenue of $85 million and a loss of $163 million in FY14. At the risk of over simplification, this means these companies spent nearly $3 to earn revenue of $1. Rising operational charges and discounts are the main reasons for costs spiralling.At some point, such incentives may be rolled back.

“Discounts are offered as a means to acquire customers on hopes that they will continue to shop online and at some point there will not be a need to offer discounts to retain customers,“ said PWC's Nath.

Meanwhile, ecommerce adoption is spreading rapidly , said Rajat Wahi, partner and head of retail sector, KPMG India.

“It is being driven by factors such as positive sentiment for India, increased valuations for ecommerce across the world, including the US and China, and the opportunity investors see in India to tap 350 million middle and upper class consumers,“ he said.

It will be recalled that a similar buoyancy accompanied the initial public offer of Just Dial, a telephone and online information service provider, which was oversubscribed 12 times in June 2013. Stock trebled within six months to ` . 1,650.But with sales growth slowing from 40% in the three years prior to the IPO to less than 30% in the first nine months of FY15, stock has fallen 29% in the past six months.

Amazon.com, the world's biggest online retailer, has not shown sustained earnings growth after nearly two decades of operations. It became profitable in 2007 but since then earnings have been dwindling. It reported a net loss of $241 million in 2014. However, sales have grown from $34 billion in 2010 to $89 billion in 2014.

“Retail is a long-gestation game and even many offlinebrick and mortar retailers are not making profits after many years of operations in India and other markets,“ said KPMG's Wahi.

Mehul Savla, executive director at Ripple Wave Equity , a boutique investment bank, feels these businesses will easily sail through with some consolidation along the way .

“If you observe, none of the top Indian corporate groups have invested much in this space, probably because there is the fear of unknown,“ he said. “They are comfortable taking ` . 30,000 crore worth debt to set up power plants, which also has a long gestation period and enough risks but no one wants to explore the ecommerce space because there is fear of the unknown.In that sense, the good part is ecommerce is growing on equity and the fear of the unknown may not be for the investors, who have more skin in the game than the promoters and know where they are headed.“

Figuring out the correct valuation of such companies is tricky , with higher valuations lead to a corresponding bump up in the next fund-raising round.

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