SPARK FUND

Greetings!

Unicorns under the lens

Unicorns are emerging from under the hood. The spotlight is on them. Our perspective on them is purely as secondary market investors. This is as it should be. That is our sole business. It is important for investors to absorb this. Excitement in the start-up ecosystem and the private markets should not influence the judgement on their prospects in the listed world. Life for them starts at the opening price and not even the offer price as the high-profile IPOs list at prices way above the offer price. This is a point well worth belabouring.

Secondary markets are a huge cauldron of views, often divergent and always evolving with data. The churn and the flux in the same leads to price discovery. We are about to witness a lot of action in that process and the news is not very good for investors in the listed space at this point. Unicorns are here to be a major driver of secondary markets and could one day create a lot of value for us. As we have stated before, unicorns are probably the best thing that happened to India after IT services. At the moment, there is possibly a huge chasm emerging at the space where the pre-IPO market hands over the baton to listed investors. We are not concerned about the causes but have to worry about the consequences.

Most of the Unicorns are disruptors of sorts. With some exceptions, what this means is that they are seeking to alter how the cookie crumbles in the pie chart. Of course, this not a zero-sum game. Eventually, this paves the way for new markets. That takes time. In the interim, this will likely look every bit like a massive zero-sum game. In the most recent example of the new large listing that tanked right on day one, it could be argued that the profits of a few investors ended up being the losses of many. The markets don't usually take kindly to that. The bad news is that this may just be a trailer.

Unicorns typically disrupt the client acquisition ecosystem, supply chain or delivery. They are seeking to bring scale. The concept of unit economics is being brought in to possibly magnify the potential upside from scale benefits when the same comes about. The jargon apart, unit economics is old wine in new bottle. Ask any good old cost accountant. We always had contribution margins. Everything below that counts too. Unlike in the boring business of manufacturing, the fixed costs in the Unicorn ecosystem appear more open-ended. A lot of that seems to be in client acquisition. In B2C businesses, the assumption that aggressive customer acquisitions automatically lead to customer stickiness could be fallacious. The disruption that many of the Unicorns are engineering need not end when they seek to. The jury is still out on that one.

The other challenge in India is about the size of the end markets. This is where the comparison with the US or China becomes very problematic. We are still a poor country desperately searching for disposable income.

Some key metrics in the food delivery space

In US$ terms	units	Zomato	Swiggy	DoorDash	Meituan	Just Eat Takeaway	Delivery Hero	Deliveroo
		FY21	FY20	CY20	CY20	CY20	CY20	CY20
Country		India	India	US	China	Netherlands	Germany	UK
Market Cap	US$mn	16,000	NA	62,782	1,87,674	13,977	30,000	7,644
Market Cap/Revenue	(x)	79.6	NA	21.8	19.5	6	9.3	5
Total orders	millions	239	500	816	10147	588	1304	178
Gross Order Value (GOV)	US$mn	1,270	1800e	24,664	70,869	14,708	14,093	5,233
AOV (GOV/orders)	US$	5.3	5.0e	30.2	7	25.1	10.8	29.4
Total revenue	US$mn	201	380	2,886	9,606	2,328	3,234	1,526
Take rate (revenue/GOV)	%	16%	21%	12%	14%	16%	23%	29%
Number of restaurants	Units	1,48,384	1,40,000	4,50,000	NA	2,44,000	NA	1,15,000
EBIT margins	%	-30%	-152%	-15%	4%	-5%	-36%	-19%

Note: Spark Capital Research; Spark Fund Research

1. The relatively small size of the Indian market is quite apparent
2. This may point to future potential. However, the per capita income level and experience in other areas does not evoke confidence in terms of the ability to attain scale within reasonable timeframes
3. Margins are a function of revenues and the order values. Indian companies need to do a lot of heavy lifting before becoming profitable

Revenues of a few giants from the new age businesses

Company	Revenue (US$ Mn)	
	2020	2015
Google Inc	1,82,527	74,989
Amazon.com Inc	3,86,064	1,07,006
Facebook Inc	85,965	17,928
Baidu Inc	15,534	10,564
Twitter Inc	3,716	2,218
Tencent Holdings	69,938	16,370

Note: Bloomberg; Spark Fund Research

Note that even in 2015, these companies were pretty big and then they have grown. The Indian companies in contrast have not even started. While that is being touted as an opportunity, the valuations already factor in perfect execution. This is very reminiscent of the Dot Com era.

Timelines for the dash to attain scale assume significance for Indian businesses. Way back in the mid-1990s, India was supposed to become a market for a million cars by the year 2000. The forecast came from one of the blue-blooded consultancies. While the report was floated with much fanfare, the target was off by four long years. As a country, we have managed to miss almost every single macro-target in terms of the timelines. The per capital income for India has been stagnant at around US$ 2000 for a while and going by expectations raised a few years back, we should have been higher than US$ 3000 by now. Similar slippage is evident in the case of power demand, steel demand, broadband penetration and even many social indicators. Indian growth has been playing out in slow motion for most part.

We know India is adept at offering explanations for all these delays. We have to calibrate investor returns by time and not by other factors as the clock does not stop ticking once money is put to work. Time, tide and excuses wait for no stock.

Therefore, we should examine the risks

Fallacy of execution invincibility

The pricing of several of the new listings seem to indicate that there will be perfect execution by these managements for many years to come. While all optimists in any growth stock assume that growth may be linear, the ask rate from these companies is very demanding. They use technology as a lever but don't drive innovation in tech. These business models have not been tested through cycles and by stiff competition. To assume flawless execution may be an assumption that will be put to test as we move forward.

Company	Consensus forecast	Price to Sales on FY30 forecast revenue
PAYTM	~26% Revenue CAGR over FY 21-30	7x
Nykaa	~30% Revenue CAGR over FY 21-30	4x
Zomato	~36% Revenue CAGR over FY 21-30	6x

Note: Bloomberg; Spark Fund Research

While growth assumptions are very aggressive and do not provide for even one year of miss, the valuation itself is on revenues being discounted for many years in advance. Don't even talk of profits. That aside, existential threats are considered as out of bounds for analysis. This honeymoon will not last long. We may witness high mortality in this ecosystem. At the least, execution gaps will test investor patience. When the going gets tough, the secondary markets have a habit of demanding too much and that is a big risk.

Fallacy of extrapolating too much into ever-expanding end markets

It could even be argued that some of the Unicorns could end up destroying sectoral toplines as they force disruption. However, when it comes to the financial models that lubricate their traction in the stock market, the end markets are expected to be ever expanding. On top of that, we see some 20-year projections now. We are left with the inescapable conclusion that these are products of compulsion rather than forecasting. Be that as it may, we should at least recognise that the margin of error in a long-term model is high. Investors should demand a discount when confronted with these and not pay a misplaced premium.

Growth rates on the revenue line have been robust for many of the Unicorns in recent times. Some have used the low base from the pandemic year to reveal high annual growth without any inhibition. It would be a mistake to extrapolate these growth rates over long periods. If Indian incomes expand fast, the markets for these companies can expand faster. Secondary market investors will have a choice and they have always exercised it in an opportunistic manner and why not. This is the same free market which has changed the value of Unicorns by a great deal in a short time with no change to the underlying fundamentals.

Fear of Missing Out (FOMO as the jargon proudly and stupidly proclaims)

Let us make no mistake. This is the single most important factor driving the Unicorn universe right now. A very small proportion of their float is available to investors at present. This is skewing the supply-demand equation. If index-makers rush to include these in major indices without enough free float, they will do some disservice to equity and fairness. But then, that is their call. All we wish to stress is that the price action has little to do with the fundamentals at this stage.

Company Name	Free Float (INR Cr)	Company Name	Free Float (INR Cr)
HDFC Bank	6,53,802	SBI Cards And Payment Services	25,124
HDFC	4,88,168	Britannia Industries	41,857
Asian Paints	1,41,756	ICICI PruLife Insurance Company	22,973
Titan Company	99,094	Havells India	34,154
Divi's Laboratories	62,192	Apollo Hospitals Enterprise	57,296
SBI Life Insurance Company	50,606	Bharat Petroleum Corporation	35,305
Pidilite Industries	33,613	Dr. Reddy's Laboratories	56,625
Dabur India	34,627	Zomato	19,218
Mahindra & Mahindra	80,002	Nykaa	9,329
Godrej Consumer Products	35,069	PAYTM	8,823

Note: Free Float as on 29th November 21, BSE; Spark Fund Research

As is easily seen, the available float is too small for institutions to change. The FOMO can get magnified a lot in this situation.

Let us look at some more questions.

Are we missing some exponential growth near term (1-3 years)?

Depends on what is exponential. If it is 30-40% growth or thereabouts, that is impressive but not exponential. Not to mention that 30-40% growth is no cakewalk. There are companies that listed with new age business models (retail for instance) who have struggled to grow at that pace even though such was the range of expectations. Then came the pandemic and everyone blamed the same. Market caps have expanded but the CAGR remains lower than the optimistic projections. Numbers are clear on that even though the best of these companies have done well in terms of execution. The limited point is that growth rates tend to taper down with size, competition and over time.

Are we missing something on the cost of capital?

The higher valuations everywhere are indeed an (unintended) consequence of the lower cost of capital. If anything, if we read the same numbers that everyone is able to see, the cost of capital is looking to inch up and not the other way. So, you can't expand the valuations using that as a reason

Are we missing some massive margin uptick or scale benefits?

Margins are not about to expand for most businesses. Why should they expand for an ecosystem for whom this has not even been a priority? On the latter, the pre-requisite for scale benefits is scale itself and we are nowhere close

Are we missing the point we have been told often – which is that this is beyond us to understand?

This has been a constant refrain. These are new businesses and there is a young, brave new world out there who is supposedly in the know. Profit based valuations should not be used and the younger and braver buyers of stocks know what they are doing. We also heard this that if many smart fund managers have bought into these names at the pre-IPO stage and in the IPOs at prices that are well documented, those prices have to be right. That is the train of thought.

History in India and other markets like the US, China and Japan is replete with instances of the stiff price that investors paid for following this kind of argument without asking inconvenient questions. However, we are waiting to be educated this time. **Until then, does it not make sense to be cautious?**

Warm regards,

P Krishnan (CIO) and Team Spark Fund
