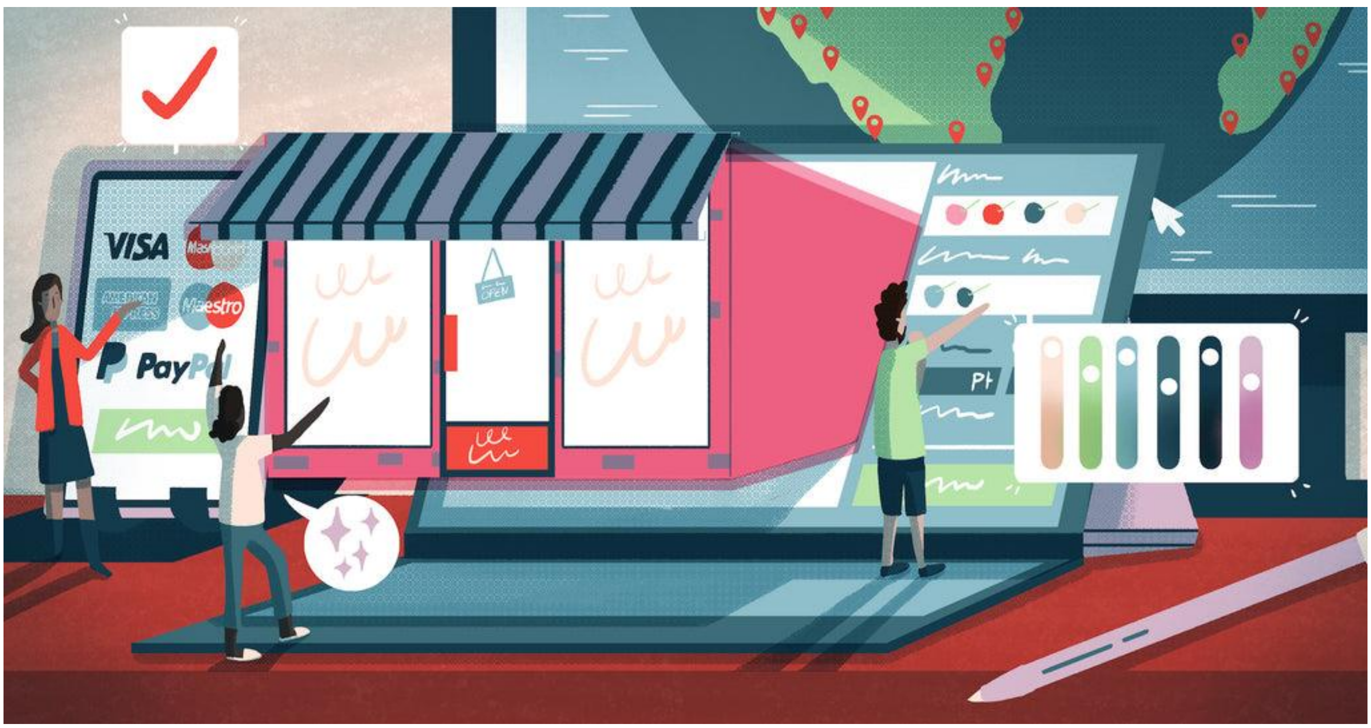
CREDENCE CAPITAL

(Investment Club of IIM Lucknow)



SECTOR REPORT

PLATFORM/INTERNET BUSINESSES

JANUARY 2023

INDEX

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Internet /Platform Sector

Indian internet platform sector is poised for big leap forward. Platform companies with their asset light business model and disruptive tech have helped businesses unleash growth and unlock value across industries. These companies generally have little debt on the balance sheet as the business model is asset light with limited fixed assets and strong cashflow generation. Given India's low online per capita spend ($224 compared to China's $1,862) and still growing online shopper base (30% subscribers compared to 80% in China), there is huge potential to grow. India's Internet economy at ~$250bn (FY21), has doubled over last 3 years, and is expected to grow 5x over the next decade.

Internet companies- Steep correction in valuation as euphoria wanes: Long Term Story Intact

Unicorns in India which got listed in 2021 have seen significant fall in value over last 1 year as investors focus has shifted towards profitability, viable unit economics and long-term sustainability. Also, the concerns regarding likely slowdown in global GDP growth has led to correction in the valuation of technology stocks worldwide. Platform companies with profitable unit economics or well-defined path to profitability are getting more interest from investors than other platform companies, where there is still less clarity over path ahead.

Actual monetizable market is smaller than perceived market potential size

India, with population of 1.4bn, has around 70-100mn individuals at the top of pyramid that offer real monetization potential. It has become difficult to monetize the existing users by most internet companies as the propensity to pay is extremely low for most Indian users and thus resulting in low conversion of free to paid users. The free to paid ratio for Indian Internet companies with Freemium model has been in the range of 2-4%.

Concerns regarding economic slowdown

The risk of slowdown in the global economy on account of supply side constraints and the rise in interest rates across the globe, is likely to result in muted economic growth in near term. This has impacted the valuation for equity markets globally.

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PLATFORM BUSINESS OVERVIEW

TYPES OF BUSINESS MODEL

B2C: Platforms that connect businesses to consumers, ex: Amazon, Flipkart,

B2B: Platforms that facilitate interaction between two or more businesses, ex: Udaan, IndiaMART, etc.

B2B2C: Acquires customers through other business intermediaries, ex: company onboarding private doctors to acquire new patients

C2C: Connects consumers among themselves, ex: OLX, eBay; enlist lots of buyers and sellers, but may face quality issues

C2B: Enables sale by individuals to businesses; consumers can also post jobs, businesses bid for them; eg: Upwork

CHARACTERISTIC OF PLATFORM/INTERNET BUSINESSES

Internet/Platform companies, led by their scalability and the unmatched convenience they bring to transactions, have helped businesses unleash growth and unlock value across diverse spheres including finance, professional services, healthcare, consumer goods, transportation, and entertainment. They use AI/ML tools for better matching between sellers and buyers and that helps to improve overall customer satisfaction. The proliferation and popularity of subsegments like e-learning, online gaming, food delivery, e-pharmacy, video streaming, and ride sharing apps have paved the way for the creation of a mega consumer internet economy in India.

A	Network effect	Leads to phenomenal value creation in quick time
B	Access to markets across geographies	Results in companies with global presence leading to more choices to customers
C	High initial cash burn	Followed by quick monetization in line with the scale-up
D	High operating leverage	Characterized by minimum capex requirement
E	High degree of disruption	Primarily led by the judicious use of disruptive technology and appropriate business models and growth strategies
F	Critical parameters linked to customers	Level of Engagement, Acquisition Cost, Lifetime value

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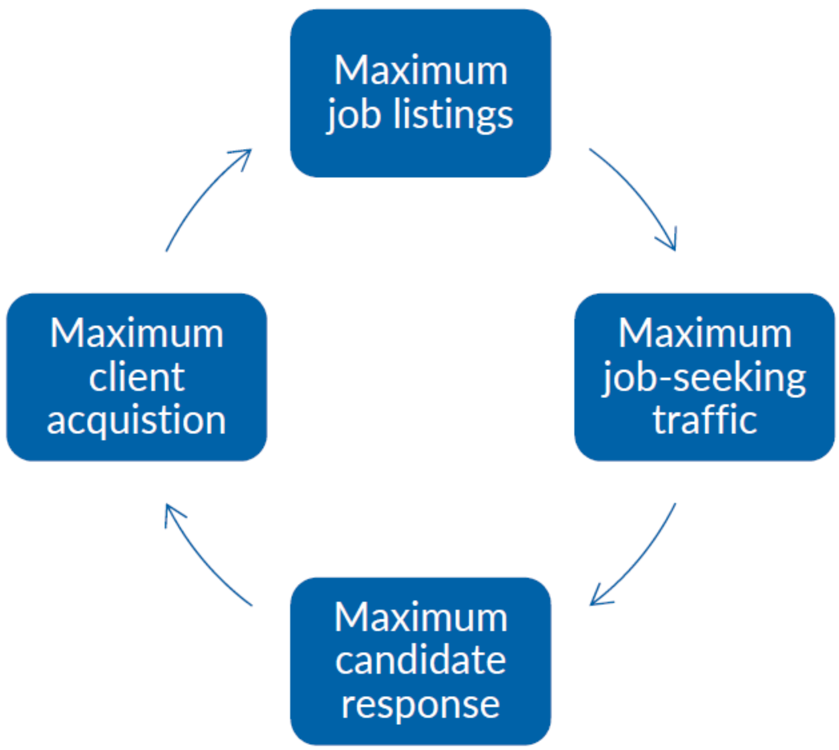
Network effect: Platform businesses have huge network effect, the strength of which is strongly linked to the market share of companies. The presence of large number of sellers makes a platform more valuable to a new buyer. Similarly, a platform with higher internet traffic is more valuable to a new seller. Platform companies with dominant market share such as Naukri.com, Indiamart, Amazon, have strong network leading to better customer experience compared to players with low market share. Consequently, most such business segments in the internet space are dominated by just 3-4 players, while other players are often subscale with insignificant share in profit pool. These 3-4 companies control bulk of the market share and are monopolistic in nature; Facebook in Social Media, Google in Search, Uber in cab aggregation and AirBnB in vacation rentals, etc.

Thus, a platform company that provides better customer experience and keeps on innovating has the potential to become a dominant player in its category. These network effects act like entry barrier and provide long term revenue visibility for a platform company. Thus, the size of consumer internet company offers visibility about its longevity and its long-term earning potential.

Exhibit 1 – Network effect lead value creation for online platforms as seen in case of Naukri.com



Source: Yes Sec Research

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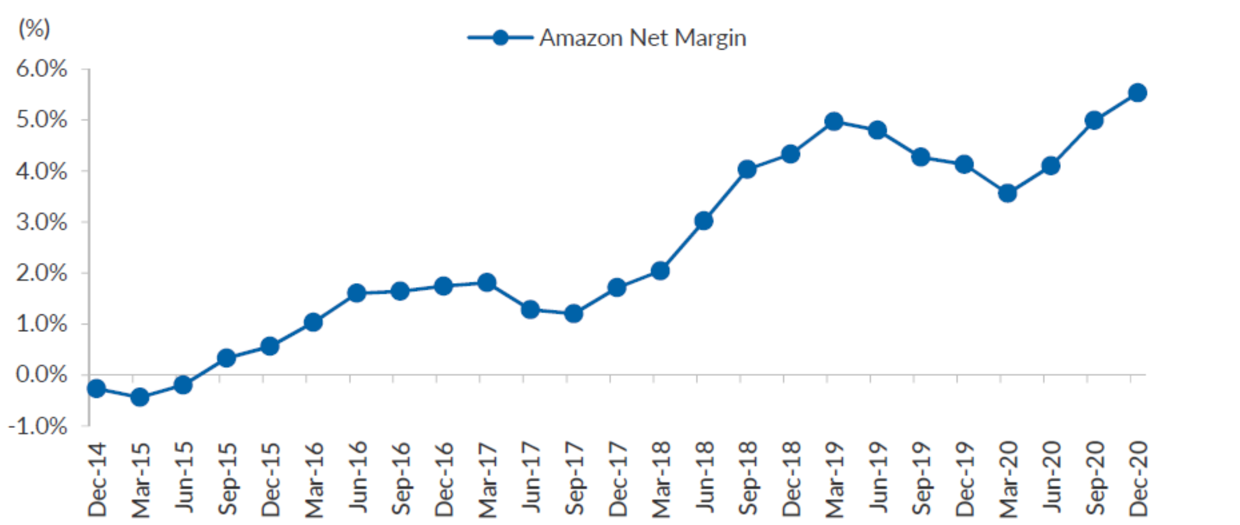
High cash burn initially; followed by monetization phase: Initially, these companies generally suffer huge cash burns, primarily on account of high advertisement cost and negative unit economics due to their small sizes. This continues till they reach a certain critical size when the unit economics become favourable and the company turns profitable. The advertisement expense as % of sales come down as the company grows. Monetization can take different shapes such as subscription fees, advertisement-based revenue and higher convenience fees. However, Internet companies generally start with monetization through advertising, followed by monetization through transactions as they reach a certain scale

High degree of operating leverage: The profitability improves with scale as the platform can be easily scaled up with minimum requirement of incremental capital. This enables the company to serve large number of customers at reasonable average cost, leading to improving profit margin with scale. Example: Amazon, which was loss making for many years since inception has turned profitable on account of economies of scale. Moreover, the presence of large number of buyers/sellers on the internet platform help in better price discovery.

These companies generally have little debt on the balance sheet as the business model is asset light and generally have strong cashflow generation upon reaching a certain scale. This helps them to manage sudden disruptions like Covid19 which can otherwise seriously impact revenue streams

Exhibit 2 – Improved profitability led by positive operating leverage in case of Amazon



Source: Company, YES Sec – Research

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High degree of disruption: Before expanding the firm, it is crucial to have the correct business model. Instead, than paying money to duplicate something that already exists, the goal should be to use open source resources that are currently available to create new applications. There are numerous instances of players who made a respectable start but eventually failed because they were unable to keep up with their colleagues.

CHALLENGES FACED BY PLATFORM/INTERNET BUSINESSES

- In spite of being a huge market in terms of number of potential customers, the ARPU remains low due to mix of factors like low purchasing power and high competitive intensity in that segments. The low ARPU leads to cash flow falling well short of operating expenses and thus requiring frequent cash infusion to fund operating losses. This often results in significant equity dilution.

- The focus of many of these companies remains on driving volume growth through freemium model, where value added services are offered to drive free to paid conversion. The free to paid conversion factor remains low. Despite, India being a huge market for mobile applications, the number of paid customers of these app companies as percent of total users remains quite low and is generally in the range of 2-4%.

- Churn rate for such companies can range from around 10-35%. Churn rate is directly related to intensity of competition in the segment. Certain segments like online food delivery, Online cab booking has lower churn compared to segments like online payments. Lower churn rate leads to higher Lifetime value and vice versa. It requires careful balance between Customer acquisition cost(CAC) and Lifetime value(LTV) to generate value. There is often need to spend significant fraction of revenue on advertising to add new customers and this adversely affects LTV/CAC ratio.

FLOW OF P&L

Particulars	
Gross Orders	Number of orders placed on platform including cancellations
Gross Merchandise Value (GMV)	Gross orders X average order value (AOV)
Less: Cancellations & Discounts	Orders cancelled; returned & discount provided by company
Net Merchandise Value (GMV)	GMV net of cancelled orders and discounts
COGS and direct expense	Defined as commission, customer delivery and other costs
Discounts by fulfilment vendors	Includes discounts by all other third-party vendors
Contribution Margin (CM)	NMV less COGS, direct expenses, and other discounts
Other Expenses	Marketing, branding, and other fixed operating costs
EBITDA	
Other non-recurring expenses	Other expenses including consulting charges and audit fees
Net Burn	

ANALYZING FINANCIALS (UNIT ECONOMICS)

Particulars		
Revenue Per Customer Per Month (A)	200	Avg Monthly Rev. /No of Acquired Customer
Gross Margin % (B)	50%	Average Gross Margin
GM Per Customer Per Month (C)	100	A x B
GM Per Customer Per Year (D)	1200	C x 12
Lifetime (In Years) (E)	5.0	1/(1-Retention Ratio)
Lifetime Value (F)	6000	D x E
Customer Acq. Cost (CAC) (G)	500	Includes advertising & mkt costs for new cust.
LTV/CAC	12x	F/G

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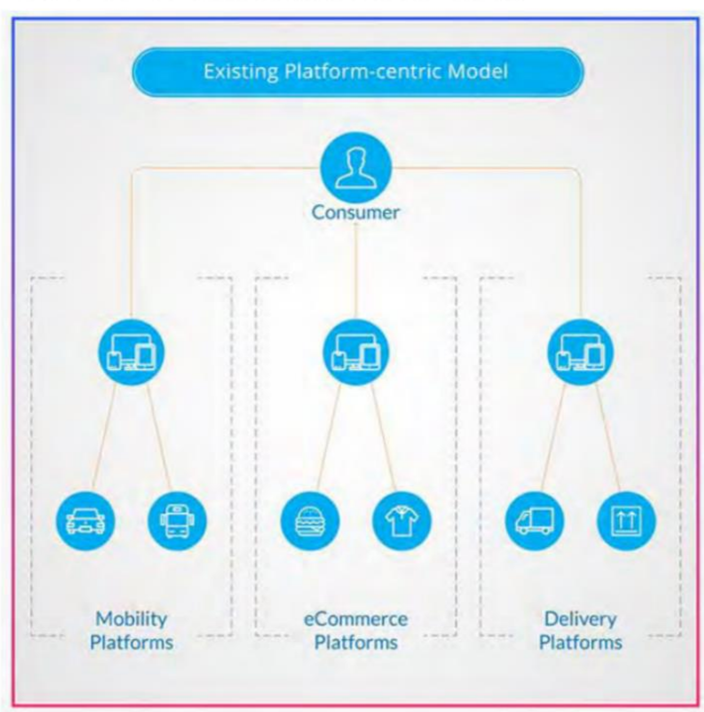
RECENT DEVELOPMENTS

Open Network for Digital Commerce

ONDC is network based open protocol which will have buyer side apps wherein consumers can search for products or services and seller side apps which will onboard sellers. Network aims to generate new opportunities, reduce digital monopolies and support MSMEs to get on online platforms

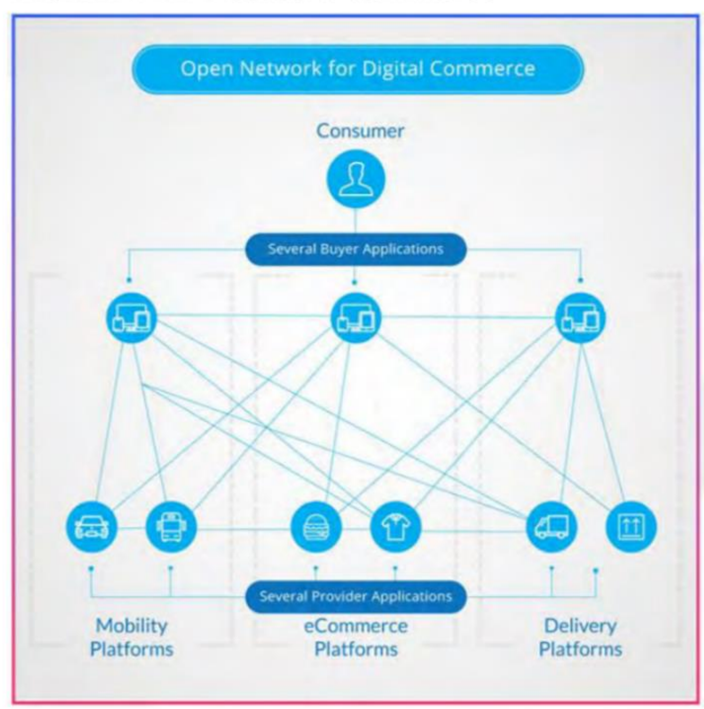
As per the ICICI Securities report, "ONDC is likely to be a creative disruptor in the e-commerce space in India over the medium term; however, the ramping up of the network to cover different aspects of the e-commerce ecosystem is likely to take 2-3 years. As of now, ONDC is creating a hyperlocal marketplace focused on food delivery and grocery retail. Food delivery could help scale ONDC in the initial phase (CY23) as the business model is more amenable to hyperlocal delivery. Also, transactions on food delivery apps are driven by restaurant brands and not just the platform. This, increases the likelihood of a customer ordering food through an ONDC buyer app compared to that for a customer trying to buy a branded smartphone. Grocery retail could also scale up, but it would be contingent on driving retailer and customer density beyond a certain threshold to make it feasible for retailer to directly deliver items to customer's home."

Chart 1: Platform based e-commerce



Source: ONDC.org

Chart 2: ONDC based e-commerce



Source: ONDC.org

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B2B e-commerce likely to be the next big thing

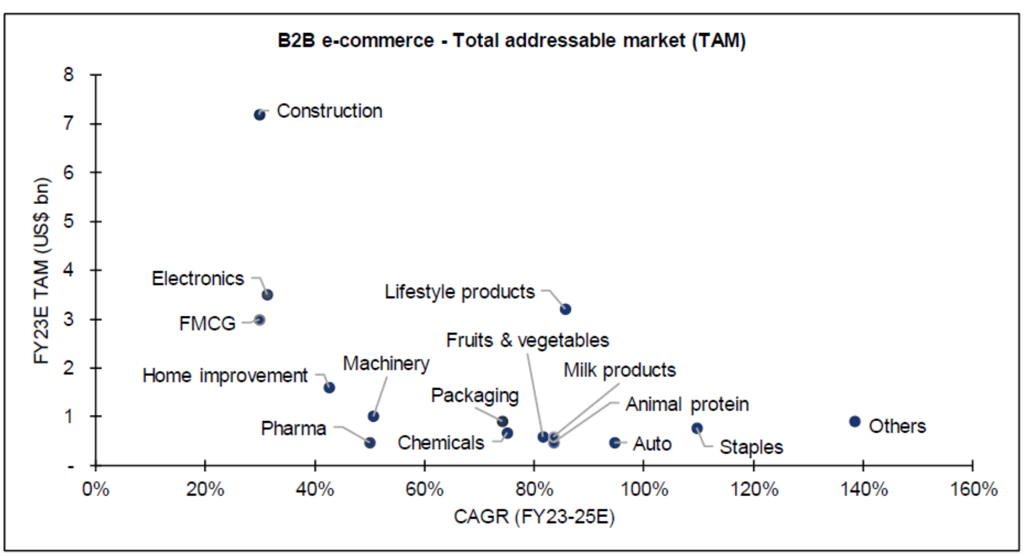
B2B e-commerce has high potential growth story over the next 5 years. B2B e-commerce could grow GMV 5x over the next 5 years led by growth in upstream B2B e-commerce.

As per ICICI Securities Report, B2B e-commerce's total addressable market (TAM) is expected to grow at a CAGR of ~55.8% over FY23E-FY25E. However, IndiaMART and Just Dial, the two listed stocks in the space, have corrected meaningfully over the past one year. On the other hand, strategic investors and private financial investors have turned bullish on the space. As per ICICI, this divergence is unlikely to last longer. Both IndiaMart and JustDial are expected to outperform broader markets over the next year given their large exposure to the fast growing B2B e-commerce space.

Exhibit 3 – B2B e-commerce – total addressable market (TAM)

	FY23E		FY25E					
			Downside (GDP growth 2%)		Base (GDP growth 6%)		Upside (GDP growth 9%)	
US$ bn	**Digital penetration**	**TAM**	**Digital penetration**	**TAM**	**Digital penetration**	**TAM**	**Digital penetration**	**TAM**
Milk and milk products	0.5%	0.60	1.0%	1.25	1.5%	2.02	2.0%	2.85
Fruits and vegetables	0.5%	0.60	1.0%	1.24	1.5%	1.98	2.0%	2.76
Animal protein	0.5%	0.48	1.0%	1.00	1.5%	1.62	2.0%	2.28
Staples	0.5%	0.78	1.0%	1.61	2.0%	3.43	3.0%	5.38
FMCG	2.0%	3.00	2.5%	3.90	3.0%	5.06	3.5%	6.24
Lifestyle products (apparel, footwear etc.)	1.0%	3.20	2.0%	6.71	3.0%	11.03	4.0%	15.71
Electronics (smartphones, TVs, appliances etc.)	1.0%	3.50	1.0%	3.67	1.5%	6.03	2.0%	8.59
Pharma	1.0%	0.48	1.5%	0.75	2.0%	1.08	3.0%	1.71
Construction materials and equipment	3.0%	7.20	4.0%	9.99	4.5%	12.13	5.0%	14.26
Home improvement and décor	2.0%	1.60	2.5%	2.11	3.5%	3.25	4.5%	4.49
Auto and components	0.6%	0.48	1.0%	0.84	2.0%	1.82	3.0%	2.90
Machinery and spares	1.0%	1.00	1.5%	1.57	2.0%	2.27	3.0%	3.62
Packaging	1.0%	0.90	1.5%	1.88	2.0%	2.73	3.0%	4.35
Chemicals	1.0%	0.68	1.5%	1.42	2.0%	2.07	3.0%	3.31
Others	0.5%	0.90	1.0%	3.13	1.5%	5.11	2.0%	7.25
Total	**1.2%**	**25**	**1.7%**	**41**	**2.3%**	**62**	**3.0%**	**86**

Source: I-Sec research



Source: I-Sec research

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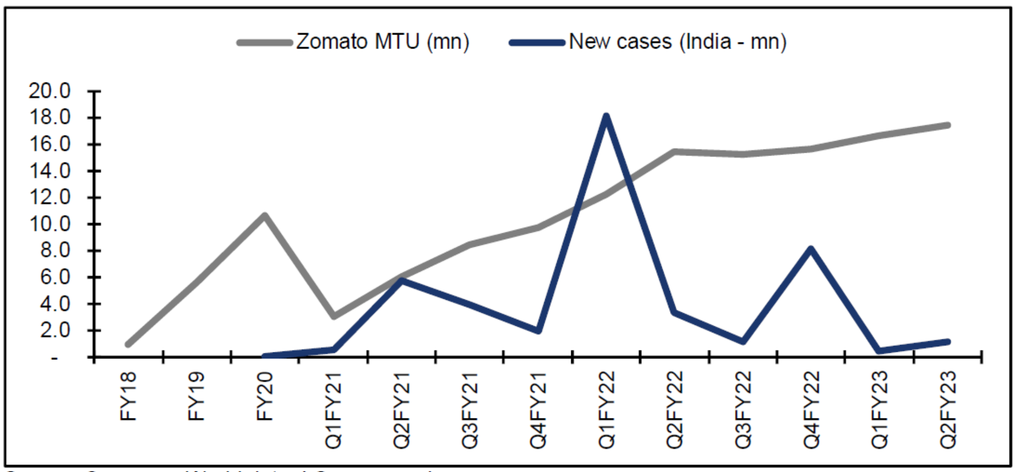
Resurgence of Covid

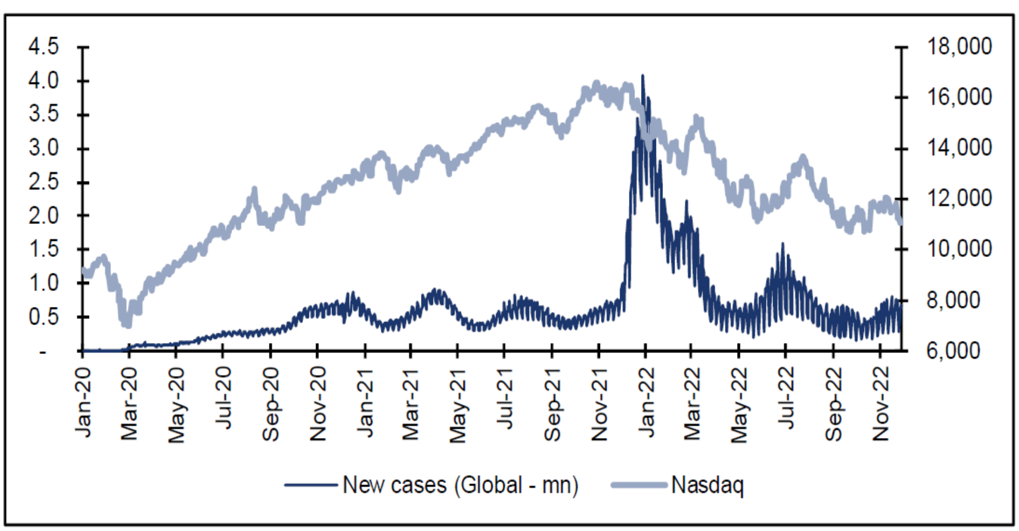
Strong rebound in brick and mortars retail led to cannibalization of e-commerce sales and large number of e-commerce companies experienced muted discretionary spends. This was majorly due to Indian consumers relishing the holiday season following the complete easing of COVID regulations. There is a strong potential that this trend will reverse given the increasing number of covid cases around the world. Most e-commerce companies saw a strong increase in adoption during the periods of covid restrictions. Zomato for example reported strong MTU growth during this period. This was also reflected in tech valuations. However, given high inflation, low growth environment seen over the last year, consumers could choose to curtail discretionary expenses across the board.

Exhibit 4 – Strong growth during periods of covid restrictions



Source: Company, World data, I-Sec research

Exhibit 5 – Valuations rose on the back of increased digital adoption



Source: Bloomberg, World data, I-Sec research

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Economic slowdown leading to funding winter

The risk of slowdown in the global economy on account of supply side constraints and the rise in interest rates across the globe, is likely to result in muted economic growth in near term. Amid tightening monetary conditions since March’22, the funding environment has bit dried up, as PE/VC firms have become more cautious while evaluating new investment proposals and consequently, the speed with which unicorns are being added has slowed down recently and has impacted the valuation for equity markets globally.

Exhibit 6 – India minted just 4 unicorns in Q2CY22 compared to 14 in Q1CY21

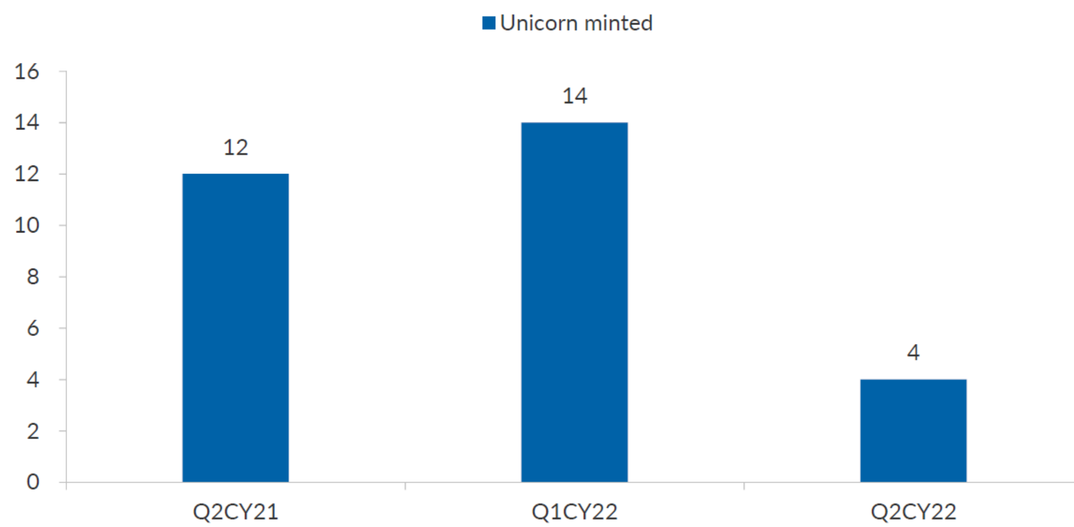
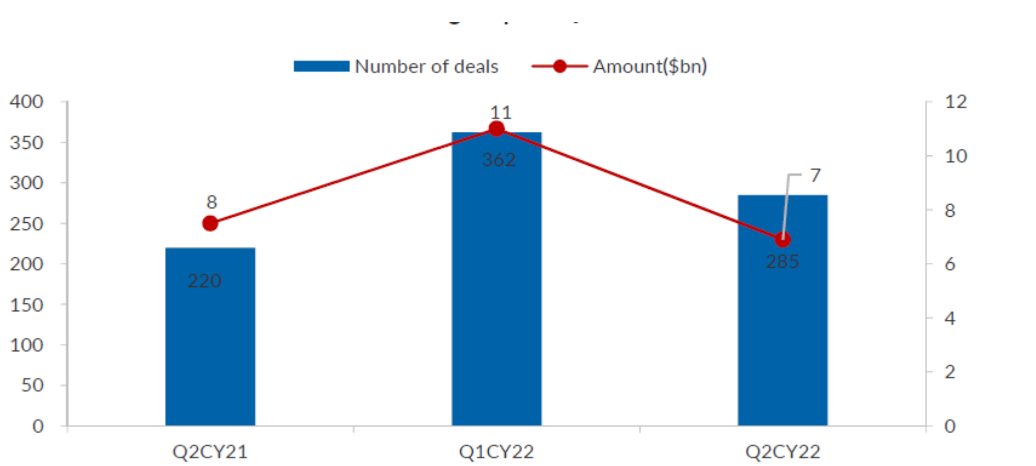


Exhibit 7 – VC funding drops in Q2CY22



Source: Company, Tracxn, YES Sec

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Profitability is the new focus area

Growing investor interest in tech startups with a solid business plan and a tighter focus on profitability is driving the rise in profitability attention. Over the past 1 year, the share prices of publicly traded online companies have declined by close to 30-50%, with valuation depreciation being substantially greater for businesses where profitability is still years away. A portion of it can also be attributed to increased capital costs on a worldwide scale in an environment of tighter financial conditions; nonetheless, profitable tech companies with good growth prospects and moats continue to command a premium over their peer group. Additionally, the digitalization trend that had accelerated during COVID19 has gradually slowed as offline channels resume operations following the lockdowns associated with COVID19. This is reflected in the growth projections of businesses such as Docusign/Netflix, which have cut down growth outlook compared to that seen in covid19 years.

Unicorns in India which got listed during July-Dec'21(Zomato, Paytm, Policy Bazaar, etc) have seen significant drop in valuation over last 1 year. Many of these companies, since listing, have focused on improving their cost structure, have cut down on discounts and tried to generate new revenue streams to demonstrate a predictable path to profitability.

Exhibit 8 – Price return of newly listed internet companies

India Internet price performance	1m	3m	6m	1y
Nifty 50	1.7	7.1	9.8	3.5
Paytm	(9.6)	13.7	(9.7)	NA
Zomato	9.2	(17.3)	(25.6)	(60.2)
CarTrade	(1.5)	4.3	18.0	(56.3)
Policybazaar	(13.3)	(24.9)	(24.4)	NA
Route Mobile	(2.0)	3.0	(5.8)	(27.5)
Tanla	0.3	(46.5)	(49.7)	(17.3)
Info edge	(1.2)	11.3	(1.8)	(31.0)
Nazara Technologies	(2.8)	7.1	(24.9)	(27.7)
matrimony	(13.0)	(15.5)	0.2	(30.4)
Just Dial	3.9	(4.6)	(16.2)	(37.4)
latent View Analytics	3.2	(2.0)	(6.8)	NA
Indiamart	2.0	3.4	5.8	(42.7)
Rate gain Travel	(2.1)	(3.0)	0.1	NA

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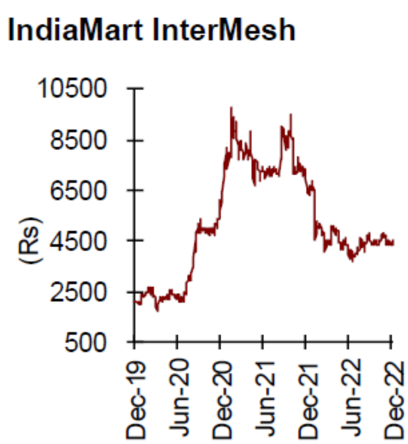
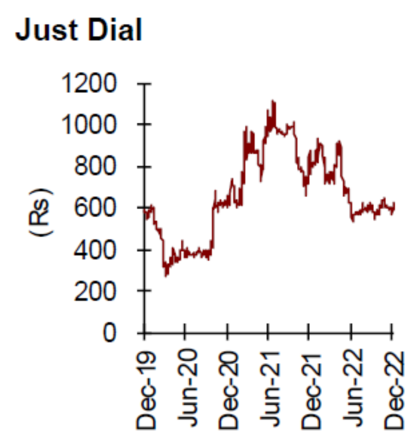
Exhibit 9 – Commentary around discretionary spends

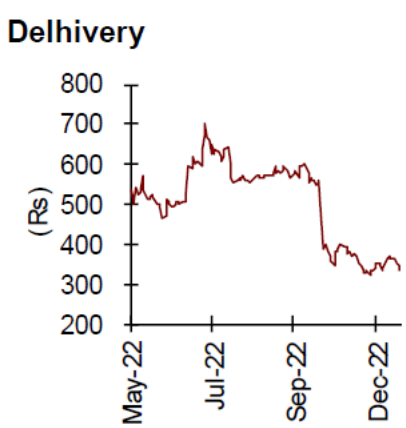
Company	Commentary
Nykaa	Witnessed a strong rebound in physical retail, but doesn't seem to be a cannibalising e-commerce business. The online penetration for beauty consumption in India today is so low (<10%) and the macro trend in India of shifting from offline to online continues to remain; unlike other metro markets where there is cannibalisation and demand shifts back from online to offline.
Zomato	Witnessed lower app opens in the quarter compared to the past, clearly demonstrating some low intent to spend by consumers
Shopify	Financial outlook of the company assumes that higher inflation and rising interest rates will continue to negatively affect the consumer's purchasing power of discretionary goods and services.
Alibaba	There's been an increased focus on non-discretionary consumption on daily essentials, food and groceries. Seeing a lot of demand for stocking up with people worried about potential supply disruptions, lack of access to necessities and essentials.

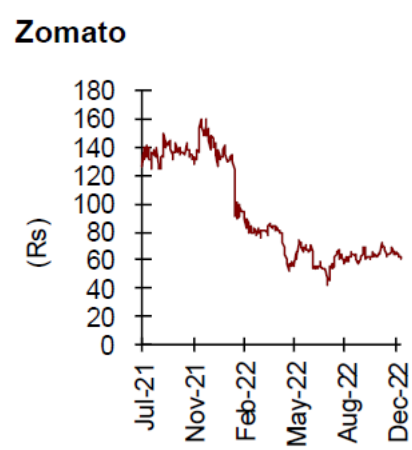
Source: Company, I-Sec research

Exhibit 10 – Price Charts









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