

India's Startup Ecosystem

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Edoardo Comazzi

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Introduction

It is undeniable that India was strongly hit by the pandemic during the first quarter of 2020, when the nation's economic growth was severely affected by national closures. Whereas this situation was problematic for the operations of both the more established corporations as well as the country's ever-increasing startups, the effect was magnified for the latter due to their rather new and un-solidified business bases (Joshi, 2021a). Nevertheless, the Indian Startups were able to rise once again, with 2021 being an extremely positive year thanks to various IPOs as well as major investments from PE and VC firms (Choudhury, 2021). Still, investors are doubtful regarding the future outlook of many of such ventures, especially considering a great deal of Unicorns which are still lacking a solid revenue base and cash flows.

Apart from company level considerations, there are also macroeconomic developments that investors are currently concerned about when discussing what the outlook for Indian startups will be in 2022. Amongst others, such concerns include inflationary pressures, which have been severely aggravated by the latest Omicron variant. Nevertheless, Investors remain bullish on Indian Startups when taking a long-term perspective, thanks to ever-growing rates of tech adoption, fundamentals-driven investments from VCs (and, hence, incentives for startups to focus on profitability rather than mere revenues), as well as customers seeking value-driven businesses (Joshi, 2021a; Choudhury, 2021).

As such, to provide an overview of the overall Indian Startup Scenario, this report will be divided into three main sections. First of all, the positive trends that Indian startups have been experiencing throughout 2021 will be discussed, mentioning the major IPOs that occurred during the year as well as the global investments that entered the country. Secondly, the concerns going forward will be discussed, with a particular focus on the increasing inflationary pressures and the lack of profitable startups. Lastly, the two sections will be brought together to discuss what the final outlook in 2022 for Indian Startups looks like, mentioning how it appears that Startups will be able to be deal with the concerns and be successful also in 2022 thanks to a variety of trends in the country, going from value-centred customers to profit-driven investments (Joshi, 2021a; Choudhury, 2021).

India's Ever-Increasing Startup Presence: A positive trend that is here to stay?

A Positive 2021 for Indian Startups

2021 was an extremely positive year for India in terms of its startups, as the country was able to attract significant sums of investments that helped a variety of novel firms, especially in the technology sectors, to flourish throughout the year.

In terms of public markets, major IPOs took place involving Indian startups, involving firms of the calibre of Zomato and Paytm, valued at \$12B and \$19.9B at their IPOs, respectively. Apart from these groundbreaking IPOs, the country was also extremely attractive for private market investors, with over 779 tech deals coming from VC and PE firms, gauging total investments in tech startups of over \$38B, significantly higher than the \$11.1B received the previous year (Choudhury, 2021). The image below offers a schematic overview of the sources underlying the significant investments that Indian Startups experienced throughout 2021:

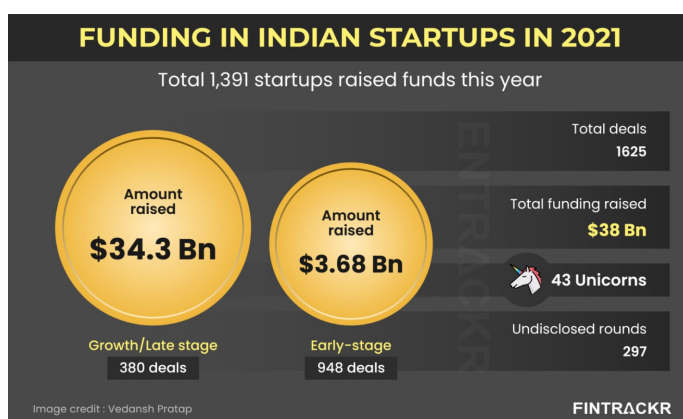


Figure 1: Funding Raised by the Indian Startup Ecosystem (Upadhyay & Pathak, 2022)

As it can be noticed from the picture on the left, the majority of deals involved early-stage startups. Nevertheless, deals that involved late-stage startups were significantly bigger, which explains the rather big difference between the amounts raised by the two segments. It should be noted, however, that about 300 deals involving either late or early-stage startups were not possible to include in the previous picture, entailing that the total amounts raised could be significantly higher. Another point of focus from the picture should be the rather astonishing data regarding Unicorns.

In fact, throughout the previous year, a total of 43 private startups were able to achieve the 'unicorn' status (i.e. a valuation exceeding \$1B) and were able to gauge massive investments totalling \$12.46B, which is about a third of the total investments raised in the country (Upadhyay & Pathak, 2022). Some of the Unicorns realized during the year are represented below, next to their valuation, funds raised, and their contribution to the abovementioned \$38B:

Unicorns of 2021 and their contribution in overall funding in the year						
Total funds raised by 43 unicorns in 2021: \$12.46 Bn [32.82% of the total funding in the year]						
Startup	Headquarter	Month	Current valuation (\$ Bn)	Fund raised (\$ Mn)	No. of deals	Contribution
Digit Insurance	Bengaluru	Jan	3.47	34.5	2	0.09%
Innovaccer	Noida	Feb	3.5	265	1	0.70%
Infra.Market	Mumbai	Feb	2.5	272	5	0.72%
Five Star	Chennai	Mar	1.4	234	1	0.62%
Meesho	Bengaluru	Apr	4.9	870	2	2.29%

Figure 2: Examples of 'Unicorns' (Upadhyay & Pathak, 2022)

Of course, such astonishing amounts of investments, paired with the variety of success stories coming from the country's startups, does not go unnoticed, with India's popularity amongst international investors growing more and more, making the country one of the most followed and ambitious Startup Hubs in the world (Choudhury, 2021). For example, the Global Startup Ecosystem Report 2021 by Startups Genome ranks Mumbai as the best emerging startup ecosystem in the world in terms of performance, funding, market reach and talent, entailing interesting future promises (Joshi, 2021b). The data by the Hurun Research Institute is even more impressive, ranking India as the world's #3 startup ecosystem, just after China and the U.S. (Sarkar, 2021).

There are various reasons that can be identified behind the success of India, but, for the sake of the report, only two of the major ones will be discussed:

Firstly, India has an ever-increasing, and relatively young, population. Whilst being one of the most populated countries in the world (second, only after China), the average age in India is of 29 years old. This has positive implications for the country as it leads to the creation of so-called demographic dividend (i.e. economic growth caused by structural changes in the age composition). This, paired with job opportunities thanks to higher literacy rates and technological advancements, creates a stronger customer base thanks to younger people having disposable income without dependents, which can explain the success of startups (Indbiz, 2021).

Secondly, the government is certainly proactive in these regards, as shown by the various initiatives that been started to favor the growth of the startup ecosystem: notable examples are the Startup India Initiative and the Atal Innovation Mission (AIM), both launched in 2016, which, in the case of the former, aim to provide encompassing support to startups in terms of founding, incubation and taxation and, in the case of the latter, aim to foster an entrepreneurial mentality in the country thanks to cooperative schemes between schools, NGOs, research centres and MSMEs (PBNS, 2021)

Nevertheless, whereas the overall situation might seem extremely promising, there are still some considerations to take into account: firstly, such a positive trend might increase the likelihood of overvaluation of companies simply based on the hype of the ecosystems they are part of, which perhaps can explain Paytm's subpar performance on its first trading day on the market, seeing its value drop by over 27% (Ray, 2021); secondly, the rise of Unicorns in 2021 might need to be taken with a grain of salt, considering that many of such ventures still do not have a solid revenue base, which might prove problematic given the recent surge of Omicron (Joshi, 2021a); lastly, Omicron has also worsened the situation of the Country's inflationary pressures, which is a crucial make or break factor of the startup ecosystem's success (TNN, 2021; Choudhury, 2021). These issues will be discussed in the following section.

Overvaluation and inflation

To get a clear picture of the problems that will need to be addressed by India's startup ecosystem, it is necessary to categorize them in two main sections, one of them related to firm-level concerns, the other linked to macroeconomic, country level predicaments:

Starting off with the micro-level, investors have expressed their concerns about the lack of solid fundamentals of the companies that have gained significant amounts of investments in the past year. These concerns are clearly expressed by Nikhil Kamath, co-founder of Zerodha, an award-winning Indian brokerage startup: "Majority of these [companies] are not profitable and they don't look like they will be in the next four or five years, so, it's a bit hard to justify the valuation" (Choudhury, 2021).

These are long-term concerns are investors are wondering whether such seemingly over-valued firms, which include both (now) public firms as well as some of the abovementioned Unicorns, will be able to create sustainable value for their shareholders in the future.

This problematic situation is due to a variety of factors: firstly, it is clear that last year's success of the country's startup ecosystem has led to more and more investors, both domestic and international, financing all sorts of ventures.

This has hence created a slippery slope scenario where companies are more likely financed due to their overlying popular status rather than their underlying fundamentals; secondly, the ecosystem's enormous inflows of capital in the past year has increased competitive pressure among startups, which are then forced, despite lacking a solid base, to burn as much cash as possible to earn market share and surpass their competition.

This is clearly a suboptimal decision, especially considering the importance of having solid revenues bases and cash flows to survive in a Omicron-aggravated economy (Joshi, 2021a). This problematic situation is especially pressing for Unicorns, as the example of Cred, an Indian fintech company who has acquired the Unicorn status in 2021 thanks to a valuation of \$2.2B, despite rather worrying fundamentals due to constant cash burns (e.g. its EBIDTA margin in FY20 was -1979.5%)(Kumar, 2021). For a graphical representation of the company's situation, see below:

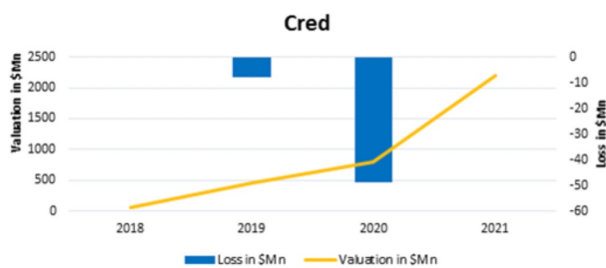


Figure 3: Cred's Overvaluation (Kumar, 2021)

Secondly, on a country-level, there is a severe concern that startups might have to face: inflationary pressures. Considering the heavy reliance of startups on a strong customer base, contractions in customer's purchasing power due to inflation is certainly something to consider. 2021 was a tumultuous year for consumers, whose pockets were badly hit by the second COVID-wave, causing job losses and declines in incomes. Rising costs of raw materials in fact reached the end consumers in the form of more expensive commodities.

Nevertheless, whereas the economy was showing recovery towards the end of 2021, the occurrence of Omicron raises further concerns regarding the country's ability to reduce inflationary pressures, at least in the short-term. This, according to the Reserve Bank of India (RBI), is especially problematic due to further aggravations of supply shocks (which were already pressing pre-Omicron) as well as drastic cuts in FPIs (the country went from the astonishing amounts of inflows above mentioned H1:2021-22, to net outflows Q3:2021-22), which are necessary for the India's economic recovery (PTI, 2021; TNN, 2021). A representation of this problematic situation is shown below:

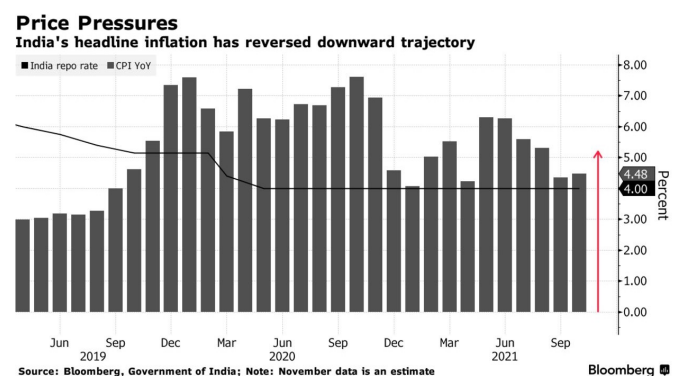


Figure 4: Price Pressure in India (Benival & Sircar, 2021)

Future Outlook

In conclusion, taking into consideration both the explosion of India's Startups in 2021 as well as the challenges that remain going forward, the outlooks seems to be positive. In fact, regarding the problem of Indian companies lacking a solid revenue base and being overvalued, it is expected that investors will change their strategy from FOMO (fear of missing out) to one that is rather based on fundamentals (Joshi, 2021a; Go, 2020). Setting clear milestones and having different stages of investments will likely help startups focus on their core businesses and their bottom-line profitability, rather than merely burning cash to beat the competition. This expected shift of focus of investors going from mere hype to proper and sustainable business model will likely ensure that funding will only be attained by those firms which are able to guarantee creation of long term value.

In addition, the population is becoming more and more dominated by Gen Z and Millennials customers, entailing that firms will have to put value first (rather than discount) to sustain a solid customer base (Joshi, 2021a)

Additionally, Omicron seems to represent a problem for the country's inflation only in the near-term, as inflation is expected to find some ease throughout this year. Thanks to both domestic (e.g. VAT reduction) as well as global (e.g. supply chain improvements) developments, India's inflationary outlook appears to be positive, with the RBI expecting decreases down to 5% in CPI inflation by the second half of the year (PTI, 2021; TNN, 2021)

Hence, it can be expected that the startup ecosystem of India will continue to flourish throughout 2022 and even beyond, favouring economic growth not only on a domestic but also global level.

Conclusion

To conclude, in order to fully assess the future promise of India's Startup Ecosystem it is necessary to look at both the positive past year as well as the present issues.

On the one hand, 2021 has been exceptional for the country's startup ecosystem, with massive inflows coming both from domestic as well as global investors. This has given rise to major IPOs as well as Unicorns 'being born' throughout the year. Reasons for this could be not only the rather young population of the country, but also the multitude of initiatives implemented by the government.

At the same time, this raises issues in terms of long-term value creation for the investors. This is especially the case because of the variety of startups in the country which lack a solid business base and profitability, and that engage in cash burning strategies to enlarge their market share. Apart from issues of possible overvaluation, there are also concerns brought about by the rising inflationary pressures, which have been aggravated due to the recent Omicron surge.

Nevertheless, both of these problems seem not to be here to stay, thanks to investors and customers focusing on value rather than discounts, and governmental actions aimed to reduce inflation (Joshi, 2021a; Choudhury, 2021).

To conclude, the outlook for India's ecosystem of startups remains positive, and it appears the ecosystem's role in domestic and global economic growth will be more prominent than ever in the future.



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