ISAS Insights
No. 738 – 27 September 2023

Indian Start-ups Face Headwinds

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Summary

The Indian start-up landscape has been acclaimed as a remarkable success story. The COVID-19 pandemic provided a boost to e-commerce as restrictions on physical movement helped boost online supply services. However, post the pandemic and with the tightening of liquidity in global markets, funding to start-ups has slowed down. There have also been reports of lapses in the governance standards of these start-ups, leading to scepticism among venture capital funds. However, with the re-engineering of governance fundamentals and with the Indian economy continuing to be resilient, it is expected that a turnaround will soon happen.

The Indian economy has overcome the debilitating effects of the COVID-19 pandemic and emerged stronger than ever before. Its fundamentals are strong, and it is expected that the government's emphasis on investment for the creation of infrastructure will soon provide a further stimulus to growth. However, in this uptick of the economic cycle, the news emerging on the start-up ecosystem is not encouraging. Start-ups, mainly unicorns, around which there was much expectation, seem to be facing headwinds. Funding has declined, reports of financial irregularities have appeared, and there have been news items of severe governance lapses on the part of some of the front runners in this space. The leader in the pack was the education technology giant, Byju's, which had been termed a decacorn (with a valuation over US$10 billion (S$13.6 billion), facing legal cases over disputes with its investors. The company has faced a substantial markdown in its valuation and has had to cut its workforce by about 10 per cent to cut costs. Swiggy, another popular start-up, has had to cut its valuation to half. Ola's valuation has also been reduced by 35 per cent. Healthcare start-ups such as PharmEasy and Mojocare; GoMechanic, a technology-enabled car repair and services setup; beauty products by Nykaa, which initially took the market by storm, Zomato, Paytm and Delhivery, have faced very sharp cutbacks in their market valuation. They lost heavily in their market capitalisation and share prices took a plunge.

It is reported that India had about 84,000 odd start-ups, among which 108 had joined the Unicorn club as of 31 May 2023.[1] These had generated about 860,000 new jobs. During the days of the pandemic, these start-ups had become a boon for the average citizen. It was due to their unique capability to provide services electronically they had become household names and the crutch for day-to-day chores. Post the pandemic, as physical services commenced and movement became easier, the unique selling proposition (USP) of these start-ups declined. It was then that desperation set in among the promoters who were unwilling to face the spectre of declining valuation and so they began to display ambitious revenues and sales figures in an attempt to ramp up valuations. However, actual sales and

1 Aroon Puri, "From the Editor in Chief", *India Today*, 31 July 2023, https://www.indiatoday.in/magazine/editor-s-note/story/20230731-from-the-editor-in-chief-2409304-2023-07-21.

revenue did not keep pace as a consequence of which the downturn commenced and became rapid.

It is worthwhile to ascertain the factors that led to the steep decline in valuations and subsequent drying up of funding for these unicorns and other start-ups in general. We proceed to examine some of the significant factors.

Salary

In the heady days of rising valuations and seeking to become unicorns, start-ups had made it their USP to splurge to attract new talent, offering, inter alia, large salary packages, food coupons, vacation allowances, vehicle loans and house rent allowances. Professionals had become the toast of the market and employers sought them out with large compensation packages and job responsibilities which were substantially above their experience levels. The tendency to be liberal in expenditure was a natural corollary of abundant money flowing into the start-up ecosystem.

Valuations

One of the reasons for the present predicament is that the fund flow into start-ups was based largely on mark-to-market valuations. These valuations many a time are not so accurate and tend to be unreal. As the pandemic tapered, the demand for online businesses declined as they were no longer an absolute necessity. Yet another factor was the surplus funds available in the western markets, largely the United States (US), due to the release of stimulus into the economy. Post the pandemic, as interest rates were hiked by the US Federal Reserve (Fed), surplus funds were absorbed, and venture capitalists did not have surpluses to deploy in Indian start-ups. The more ambitious of the start-ups, which drove valuations instead of firming up their fundamentals, have been put to hardship.

Corporate Governance

Any sound enterprise must be premised on the fundamentals of good corporate governance. Unless there is an emphasis on transparency and accurate financial reporting, any commercial entity will face challenges for long-term viability. In the attempt to blindly pursue growth by unrealistically hiking sales and revenue expectations, some enterprises gave good corporate governance factors the go by. In the post-pandemic era, sales did not materialise, leading to credibility issues around the promoters of the start-ups. Venture capitalists started seeking forensic auditing to ascertain accurate financial details. There have been requests for forensic auditing in start-ups such as 4B Networks[2] and the healthcare start-up Mojocare, as they found that the business model was not sustainable, due to changed market and operational factors. GoMechanic, another hugely appreciated start-up, which claimed to be opening shop in tier two towns and revolutionising car repair business, met with the same fate and had to be finally sold off.

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[2] Rajiv Singh, Nasrin Sultana, Hoopla and Hubris: Why Indian Startups are coming undone, *Forbes India*, 21 June 2023, https://www.forbesindia.com/article/take-one-big-story-of-the-day/hoopla-and-hubris-why-indian-startups-are-coming-undone/85971/1.

The issue was about compromising on fundamental values that must underline every business venture. While venture capitalists will attempt to drive valuations, it was primarily the role of the founders to ensure that the business was premised on firm credentials. Such basic criteria were given the go-by in seeking enhanced market capitalisation during the heady days of growth. The business became a spiral of pushing growth which the business model could not sustain and ultimately the need to balance shareholder, promoter, employee and client interests became the casualty.

Slowdown in Funding

The funding environment in India experienced a sharp downward last year, following a bumper year for fundraising by start-ups in 2021. However, the breakout of Russia-Ukraine hostilities in 2022 led to global macro-economic and geo-political headwinds. Accompanied by the US Fed tightening the interest rates, angel investors, private equity companies and venture capital funds faced the drying up of funds. A stage has reached wherein even those venture capitalists who possess un-invested funds are seeking to exercise caution in their deployment.

There has been course correction among the more cautious enterprises, with investment strategies being based on promoter-driven strategies with a focus on profitability and strong fundamentals. No longer is cash burn on new hires or perks for employees being permitted with the emphasis being on scalability and growth potential.

Optimism

The entire start-up narrative will ultimately have to be viewed in the context of the fundamentals of India's economic growth journey. Industry experts and analysts feel there is a likelihood of a possible turnaround by the end of the current calendar year. Considering India's large consumer base, the technology sector remains upbeat that venture capital funds are seeing positive investor sentiment despite the difficulties that have been experienced in the post-pandemic period.[3]

With a huge population base, where the middle class has more disposable income and expanding internet use, start-ups in India will continue to attract local and foreign investors. A course correction seeking a re-engineering of the business model with emphasis on fundamentals such as reporting realistic revenue streams and good governance practices with all the parameters, viz transparency, accountability and long-term commercial viability, being built in. To remain healthy in the long run, start-ups need to manage environmental, social and governance risks and opportunities. Towards this end, the responsibilities will have to be shared amongst founders, investors and the Board of Directors.

Some of India's major start-ups have helped overcome the challenges of e-commerce by innovating in areas such as agri-tech, health-tech and edu-tech. The impetus provided by

[3] Rebecca Bundhun, "Why India's Start-Up Sector is Likely to Face a Funding Crunch in 2023", *The National*, 25 September 2023, https://www.thenationalnews.com/business/2023/03/13/why-indias-start-up-sector-is-likely-to-face-a-funding-crunch-in-2023/.

the JAM trinity (JanDhan-Aadhar-Mobile) has helped most households in the country to afford basic banking services in accessing fast payment through mobiles. The Unified Payment Interface has gained wide acceptance not only in India but also in about 20 other countries. The important factor is that start-ups with good governance business models have continued to progress and attract capital. So, start-ups such as PhonePe, Google Pay, Paytm and Amazon Pay continue to facilitate payments. Others such as LendingKart, Pine Labs and Mobikwik have managed to perform well in their spaces and have continued to gain investor and client interest.

It needs to be recognised that the bulk of the resource flow into Indian start-ups continues to be from foreign sources. Estimates put this flow at about 75 per cent.[4] This trend must be reversed and, considering the liquidity and investible capital available within the country, more domestic capital flows into this sector. Besides private family funds, private equity, pension funds, insurance companies and corporate entities need to support Indian start-ups. India has become a leading start-up nation and, subject to these enterprises developing robust business models, greater domestic resources need to flow into them. There is potential even to create a fund of funds which would deploy resources into alternate investment funds that could invest in credible start-up enterprises. The sector offers huge potential, and the country needs to seize this opportunity.

What Does the Future Portend?

India's growth trajectory has been steadily on the upward and the country has maintained a rate which is always three to four per cent above the global average. The emphasis and investible funds that the government has set apart on infrastructure development will have a positive leverage effect on generating economic activity. The supply side policy issues such as the goods and services tax implementation, improving corporate tax issues, privatising a large number of state-owned commercial enterprises, improving ease of doing business, deregulating barriers to entry of commercial enterprises and attempting more flexible labour markets, will provide greater confidence to investors and make firms more productive and profitable.

The policy of not releasing massive stimulus during the pandemic and instead providing incentives to growth-related activities has paid dividends and helped the recovery process. Though it is too early to conclusively predict, there are early signs of production-linked incentives bearing fruit and incentivising manufacturing activity to migrate to India. The US$10 billion (S$13.6 billion) assistance plan to provide uniform fiscal support of 50 per cent of project cost for semiconductor fabrication plants across technology nodes and display manufacturing, announced by the government for making India a semi-conductor and chip-making hub, has attracted some major companies such as Foxconn, Samsung and Broadcom. The government has planned for the country to become self-reliant in semiconductors not only to reduce reliance on imports and benefit from exports but increase strategic independence and lessen its vulnerability to supply chain disruptions.

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4 Amitabh Kant, "It is Spring Season for Startups in India", *The Week*, 2 April 2023, https://www.theweek.in/columns/amitabh-kant/2023/03/25/it-is-spring-season-for-startups-in-india.html.

Continued Resilience of the Indian Economy

The World Bank in its report, *Navigating the Storm*, continues to exude confidence in the strength of the Indian economy.[5] It recognises that the impact of the tightening of the global monetary cycle, slowing global growth and inflation in commodity prices may portend slower economic growth for the present but there is an uptick in most sectors which indicates that it will register strong gross domestic product growth and continue to remain one of the fastest growing economies in the world.

The report recognises that the Indian economy is relatively insulated from global spillovers compared to other emerging markets due to its large domestic market and relatively less exposure to international trade flows. India's external position has also improved considerably over the past decade. The current account deficit is adequately financed by improving foreign direct investment inflows and a cushion of foreign exchange reserves. Policy reforms and prudent regulatory measures have also played a key role in developing resilience in the economy. Increased reliance on market borrowings has improved the transparency and credibility of fiscal policy and the government has diversified the investor base for government securities. The adoption of several regulatory and policy measures such as the introduction of a new Insolvency and Bankruptcy Code and the creation of the new National Reconstruction Company Limited has facilitated an improvement in financial sector metrics over the past five years. These policy interventions are also expected to help alleviate pressures related to non-performing loans. The report also notes that both levers of macroeconomic policy – fiscal and monetary – have played a role in managing the challenges that have emerged over the past year. The Reserve Bank of India withdrew accommodative monetary policy settings in a measured approach as it balanced the need to rein in inflation while continuing to support economic growth. Fiscal policy supported the central bank's rate actions by cutting excise duty and other taxes on fuel to moderate the impact of higher global oil prices on inflation.

The World Bank's country director for India, Auguste Tano Kouame, stated, "India's economy has been remarkably resilient to the deteriorating external environment, and strong macroeconomic fundamentals have placed it in good stead compared to other emerging market economies".[6] He goes on to caution that continued vigilance is required as adverse global developments continue to persist. This statement pretty much sums up the state of the Indian economy.

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5 India Better Positioned to Navigate Global Headwinds than Other Major Emerging Economies: New World Bank Report, The World Bank, 5 December 2022, https://www.worldbank.org/en/news/press-release/2022/12/05/india-better-positioned-to-navigate-global-headwinds-than-other-major-emerging-economies-new-world-bank-report.

6 Murali Krishnan, "India Economy Growing Fast Amid Financial Gloom", *Deutsche Welle*, 21 February 2023, https://www.dw.com/en/india-economy-growing-fast-amid-financial-gloom/a-64774118#:~:text=%22India's%20economy%20has%20been%20remarkably,Bank's%20country%20director%20in%20India.