Connecting the Dots

The Invisible Hand of the "Start-Up" Economy

A one-tonner compact truck slowly makes its way into a quiet residential neighborhood at 7am on a Sunday morning. The "it's too good to be true" expression of the Bollywood star promoting the upcoming online grocer, printed on either side of the body of the truck, reveals what might be inside. A delivery boy carrying a few crates steps out. A quick search on my smartphone with key words "delivery boys for e-commerce companies" on a popular job hunting website yields 55,000[1] plus vacancies!

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Bypassing big-box retail

Not so long ago the retail sector gurus presciently told us that the local "kirana" store would make way for big-box retail outlets. The lure of "everyday low prices" (Walmart's popular tag-line), we thought, would entail a drive to the outskirts of the city every weekend. The story played out quite differently, thanks to government policies ostensibly meant to protect the small retailer. More importantly the battleground had already begun to shift online, as India seemed to by-pass big-box retail in favor of online e-commerce.

This was not the first time India leapfrogged Western trends. The lead-lag between trends in the developed and emerging countries has been crunched, if not eliminated entirely, or even reversed. Looking at trends a decade or two ago in the Western world may not be instructive for predicting the future in the emerging world. The telecommunications sector is one oft-quoted example. Land-line penetration in India never crossed 19 percent[2] as inefficiently run state-owned enterprises could not keep pace with demand. Mobile subscribers, on the other hand, stand at 988 million,[3] with the majority of subscribers,

[1] Source: Shine.com

[2] Source: TRAI, Telegeography, Kotak Institutional Equities. Data as of March 31, 2005.

[3] Source: TRAI, Kotak Institutional Equities. Data as of August 31, 2015.

particularly in rural India, having never owned a land line connection. Or consider internet access. It is estimated that there are 302 million[4] internet users in India, of which almost 283 million access the internet solely on mobile phones. Many of these internet users may never have used a desktop computer. And, in the not so distant future, many mobile internet users may leapfrog 3G networks and move directly to 4G.

The invisible hand

The "invisible hand" is a phrase coined by Adam Smith[5] in his book, *An Inquiry into the Nature and Causes of the Wealth of Nations,* to describe the unintended social benefits resulting from individual actions. According to Smith, by pursuing self-interest, an individual promotes the interest of the society more effectively than if it was done intentionally. The invisible hand is the underlying foundation that guides free markets and capitalism.

In this essay, we attempt to touch upon how start-ups are creating novel and disruptive business models that could have far reaching implications on society. From the churn in India's billionaires list to the way the middle class saves and consumes, and from encouraging a "start-up" culture to creating employment opportunities in new ancillary services, the "invisible hand" is creating new paradigms.

Dreaming big

The new generation entrepreneurs dream big, pitch investment cases to global venture capitalists, challenge old-economy business models and seek to change ingrained customer behavior. They are in no hurry to list their companies in the public markets so long as both valuations and the flow of funds in the private markets continue to be attractive. As Farhad Manjoo recently put it in the *New York Times*,[6] unlike the dot-com boom of the 1990's when the holy grail for a technology company was to go public with an initial public offering (IPO), this time around all efforts are being made to remain private.

Unlike the old economy players, these entrepreneurs realize that they are in a business with high mortality rates, and hence they need adequate funding. They do not mind diluting their stake to minority levels if the business needs capital. When we quizzed the founder of one of India's largest e-commerce companies if he does not worry that his stake, after factoring in all the convertible preferential shares issued to various private equity funds in multiple rounds of funding, might be less than 10 percent, pat came the reply "a small piece of a big pie is better than a large piece of a small pie."

This is in sharp contrast to many family-run infrastructure and real estate companies which are currently experiencing a crisis in their over-leveraged balance sheets, but had shied away from raising equity in better times because the family patriarch did not want to see the family's ownership stake fall below 50 percent. As the head of one of the prominent investment banks in India recently told us, many Indian promoters in the 1990's faced a crisis because they lacked globally competitive technology and scale. In the next decade they tried to set that right, but failed to get the capital structure right. They attempted exotic structured financing to avert the promoter stake from falling below 50 percent, but in the process found it difficult to face a downturn. Many of these today are languishing as non-performing assets for banks, with promoter equity almost eroded after factoring in the pledged assets and exotic structured financing deals. It does appear that the new generation e-commerce entrepreneurs recognize the imperative to raise risk capital and stay away from debt.

E-commerce is a new driver of foreign direct investment

Private equity funding from global funds gets classified as foreign direct investment (FDI). While the term FDI conjures up images of large dollops of capital from multinationals with deep pockets investing in long gestation projects in India, the fact is that many of the grand announcements such as a Korean steel major proposing a US$12 billion[7] steel plant have remained a pipe dream. The FDI in retailing from the likes of a furniture retailer company too has taken much longer to bear fruit owing to regulatory challenges.

It is the relatively smaller ticket investments from private equity funds that have made their way into India as FDI investments in start-ups that have now grown to meaningful amounts when added up. Official aggregate numbers are difficult to get because the FDI in internet and e-commerce companies get diffused under different sector heads. However, a bottom up analysis of deal sizes over US$ 5 million announced last year adds up to almost US$ 5 billion,[8] contributing more than one-sixth of overall gross equity FDI inflows. Considering that India's FDI this year might exceed its current account deficit, thus reducing its external vulnerability meaningfully, the role of start-ups in improving India's macro-economic situation should not be under-appreciated.

Winner takes it all

Entrepreneurs in the e-commerce and technology space are executing business plans at break-neck speed. It is considered to be a winner takes all market, and being number two is as good as being

[4] Source: TRAI, Kotak Institutional Equities. Data as of March 2015.

[5] Adam Smith (1776). *An Inquiry into the Nature and Causes of the Wealth of Nations.* London: W. Strahan and T. Cadell.

[6] Farhad Manjoo. July 1, 2015. As More Tech Start-Ups Stay Private, So Does the Money. *The New York Times.*

[7] Posco puts on hold $12 billion India plant, delayed since 2005. July 16, 2015. Bloomberg.

[8] Source: VCcircle, Crunchbase, Jefferies. Data as of March 2015.

irrelevant. Take the case of the smartphone industry. According to a recent article in *The Wall Street Journal*[9], the top player makes 92 percent of worldwide smartphone industry profits. The next player makes 15 percent, implying more than 100 percent share of profits for the top two players. Effectively this highlights some important facts. The number one player makes almost all the profits, the number two gets some share and the rest of the players are bleeding. This explains the cut-throat competition amongst e-commerce players to reach the top spot.

Contrast that with the Small Scale Industries (SSI) policies of yore. There the entrepreneur took shelter in items reserved for the SSIs. The perverse incentive was to remain small and keep investments below the threshold level rather than improve technology and build scale. Funding came from institutions such as the Small Industries Development Bank of India (SIDBI) or banks that lent more to meet priority sector norms, and not because they believed in the business viability. Over time, as the items progressively came off the reserved list, the SSIs found it difficult to survive.

The new billionaires

The churn in the *Forbes* list of billionaires is instructive. In the late 1990s, IT czars like Azim Premji and Narayana Murthy featured in the billionaires list and were the role models for young aspiring entrepreneurs. The *Forbes* billionaires list saw new entrants in the forms of real estate, mining and "infrastructure" barons after the tech bust in 2000 eroded wealth of the technology and media entrepreneurs. Now with the crash in commodity prices and slowing demand in real estate, these mining and real estate barons are again yielding, this time to entrepreneurs from the healthcare and knowledge sectors. With the co-founders of an e-commerce company each making it to the 2015 *Forbes*[10] list of Indian billionaires (ranked at #86, net worth at US$1.3 billion each), it motivates every start-up founder to aspire for more, just like the IT services sector did in the 1990s.

Sociological impact across income strata

Most of what we have discussed so far has already been well documented. The young entrepreneurs ready to take on the world have been in the media limelight. However, what is often missed out are the changes that are happening across multiple income strata in society, beyond the billionaires and the entrepreneurs.

Consider the long-term implications when retail shops located in high street malls shut down because customers are buying online. The online store does not need to rent expensive property at premium locations. Instead, all it needs is a warehouse on the outskirts of the city with an army of "delivery boys" on motorcycles fulfilling the last mile.

The young entrepreneurs of start-ups want to focus on their expertise and are willing to outsource activities that are peripheral to the core. Logistics, accounting services, and a host of other ancillary services which are getting outsourced in turn create an ecosystem of new start-ups. This ignites a virtuous cycle of entrepreneurship. Within our own circle of friends, we hear of young professionals who are giving up salaried jobs to start up their own ventures. Hitherto happy with a cushy job, they are willing to explore life in a start-up. Beyond the entrepreneurs, this also throws open many interesting opportunities for employment, such as the vacancies for delivery boys mentioned earlier.

How will Indians consume, save and invest?

From entry-level jobs to the most successful entrepreneurs in the country, there is a shift from "old wealth" to "new wealth." The "old wealth" represents wealthy individuals or families that were well positioned to disproportionately benefit from asset inflation in the last decade or more, with the bulk of their wealth primarily invested in non-financial assets like gold and property. The "invisible hand" in the new economy is redistributing wealth, "from the mining baron to the e-commerce entrepreneur" and "from the landlord to the delivery boy."

We would like to believe that recent trends in "financialization" of savings represent a new and different way the youth in India will save and invest. The lure for saving in physical assets like property and gold will make way for financial assets—equities or fixed income. The youth will look at physical assets as too cumbersome to buy and manage, as having limited productive use and yielding lower returns. Over the last seventeen months, equity mutual funds have seen consecutive net inflows, the longest streak of inflows since data is available from the year 2000.[11] While it may not be wrong to assume that bulk of these inflows came from a bunch of high net worth individuals, what is more interesting is the trend of increasing registrations for Systematic Investment Plans (SIPs) among mutual fund investors. SIP registrations are up almost 40 percent from a year ago, to about 7.6 million accounts.[12] A SIP is defined as an option offered to mutual fund investors allowing them to invest small amounts periodically, usually on a fixed day every month, instead of lump sums. This is a plan ideally suited for retail investors wanting to create long-term wealth in the equity markets without trying to time entry and exit.

As investors in public markets, a simple barometer we use to predict trends is to look at the line-up of companies that are raising money from the capital markets through IPOs. After all these usually represent companies from sectors that are witnessing above-average growth rates and need funding.

[9] Apple's Share of Smartphone Industry's Profits Soars to 92%. July 12, 2015. *The Wall Street Journal*.

[10] India's 100 Richest People. September 2015.

[11] Source: SEBI, BSE, Morgan Stanley Research. Data as of October 30, 2015.

[12] Source: CAMS, Morgan Stanley Research. Data as of June 30, 2015.

Retail logistics, healthcare services, airlines and coffee retailing represent the current line-up. A decade ago this would have been dominated by real estate and road builders. Almost two decades ago it was information technology and media companies. The current line-up of IPOs highlight that India is witnessing a changing pattern of consumption.

The largest consumer staples company in India struggled to grow volumes despite price cuts and higher spending on advertising, as per the latest reported quarterly numbers. In contrast, one of the largest online marketplaces in India is reported to have quadrupled their sales during the festive Diwali season. So it seems consumers are stepping out to have coffee, flying out for vacations, buying smart phones or watching more movies. Hindi and English movies box office collections in India last quarter were the highest on record.[13]

To conclude, the invisible hand of the start-up economy is at work. This will have far reaching implications to society at large, beyond just the entrepreneurs. To use a quote from the American philosopher and writer Alan Watts, "the only way to make sense out of change is to plunge into it, move with it, and join the dance."

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[13] Source: boxofficeindia.co.in.

[14] Source: Assets under management as of September 30, 2015. Morgan Stanley Investment Management ("MSIM") is the asset management business of Morgan Stanley. Assets are managed by teams representing different MSIM legal entities; portfolio management teams are primarily located in New York, Philadelphia, London, Amsterdam, Hong Kong, Singapore, Tokyo and Mumbai offices. Figure represents Morgan Stanley Investment Management's total assets under management/supervision.

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