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# The Risk Associated with Private Equity Funding in Indian e-Commerce Sector

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**Introduction**

In India, most of the investments in the service sector are made in the form of private equity (PE), with the e-commerce segment being the largest receiver. Altough this has allowed the sector to grow, it does not favour the interests of young start-ups, as PE investors merely seek for short-term profit opportunities.

After acquiring stakes in newly established companies, PE firms re-sell them after short time with premium rates. Despite being harmful, this remains the easiest option available for start-ups to access funds: receiving loans from banks is difficult, especially due to their lack of collaterals. In this situation, the Indian Government is taking steps forward to protect and encourage entrepreneurship by providing funds to allow the growth of start-ups. Yet, there is still room for new policies to allow the sustainable growth of newly-established companies without the need of turning to private equity financing.

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**Background**

Along with other segments in the services sector, the e-commerce industry in India was opened for up to 100 per cent ownership through Foreign Direct Investment (FDI) in 2000, with the condition that companies only engage in business-to-business (B2B) activities.[2] Currently, the service sector attracts the highest proportion of foreign inflows, and the e-commerce industry is a major recipient (Choudhury, 2018). As the new FDI policy does not allow companies with foreign funding to sell goods and services directly to the consumers, foreign e-commerce ventures operate in the form of online marketplace in India. In the marketplace model, e-commerce portals provide a platform for business transactions between buyers and sellers and generate commissions for sellers of goods and services (Choudhury, 2015).

The e-commerce industry in India has reportedly grown at a rate of more than 34 per cent compound annual growth rate between 2009 and 2014. This remarkable growth has attracted a huge number of investors from across the globe. The expected return in this sector has also influenced some of the major industrial houses in India to invest in it. For instance, Reliance operates an e-commerce portal in the name of AJIO, the Mahindra group runs M2all, Tata runs Tatacliq, Ratan Tata has invested in Snapdeal.[3]

**Growing importance of private equity financing**

Although a few companies like Amazon have chosen to operate directly, the majority of the investments in this sector have come in the form of PE. It appears that almost all the companies operating in India have some amount of PE investment. The increasing focus of PE firms in Indian economy can be noticed from the fact that the value of PE investment, which stood at $7.1 billion with 296 deals in 2006, jumped to $22.7 billion with 1047 deals during 2015.[4]

Almost all sectors have received some amount of PE investment in the last few years. The IT and ITES sector (that includes e-commerce firms) is the highest recipient with 45 per cent of total PE investment in the country. The e-commerce sector has been a favourite for PE companies, and this can be demonstrated from the fact that the highest PE investment ever made globally in a technology based company is in the Indian online marketplace provider Flipkart. Other brands like Snapdeal, Paytm and Ola cabs (an app-based taxi service provider) were other major recipients of PE, while Tiger

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[2] B2B is a type of transaction that exists between businesses, such as one involving a manufacturer and wholesaler, or a wholesaler and a retailer. In this type of business transaction end user of the goods and services sold are not involved (Press Note No2, 2000 Series. DIPP, Ministry of Commerce and Industry, Government of India).

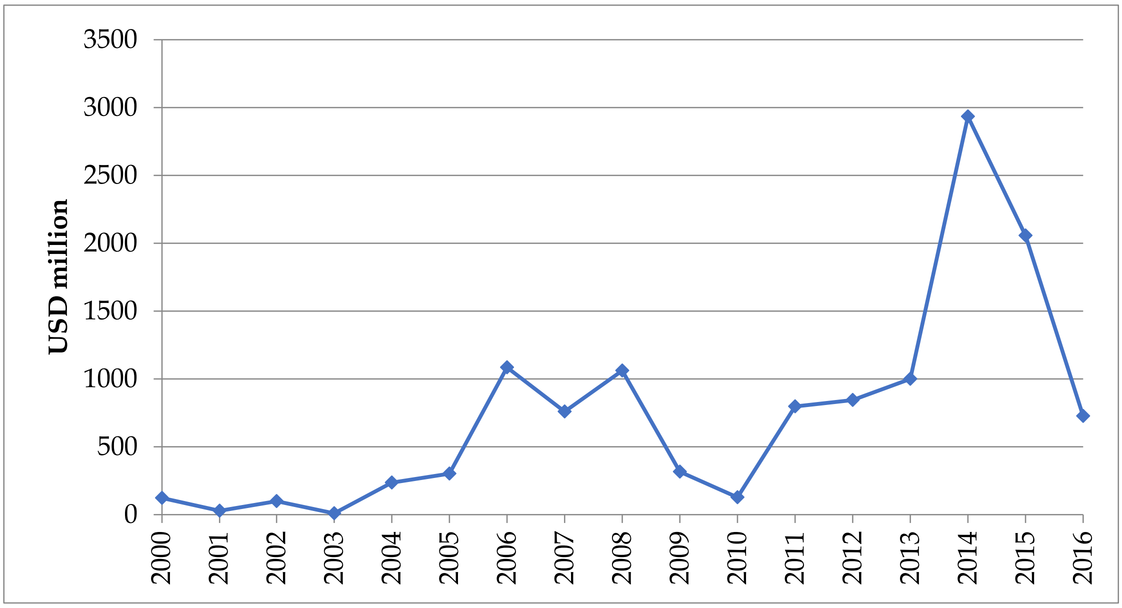
[3] See www.m2all.com, https://www.ajio.com/, https://www.tatacliq.com/.

[4] Balakrishnan, Reghu (2016). 2015 sees highest-ever private equity investments in India Live Mint, Bangalore, 3 March. Accessed 3 May 2018. Available from: http://www.livemint.com/Industry/DZYKCErQomg1vBKjrCfBDO/Private-equity-investments-in-India-highest-in-2015-report.html

Global, SoftBank, Steadview Capital, and Alibaba group were amongst the top investors (Venture Intelligence, 2016).

Examples of large deals include Flipkart, which raised $4 billion in 2017, of which $2.5 billion was from a single PE investor, SoftBank. Subsequently, in May 2018, the American retail giant Walmart acquired 77 per cent stake in Flipkart for a total of $16 billion, entering the Indian market by buying shares from various PE investors. Other major global deals include Facebook's record $1.5 billion transaction[5] ahead of its IPO and Yahoo's $1 billion transaction to buy a stake in Alibaba. It is not only Flipkart and Snapdeal that have raised funds from PE firms. Almost all the players in the Indian e-commerce industry have raised some amount of funds from PE firms in some point of time. Figure 1 shows the trend in foreign PE investment in the Indian e-commerce sector.

**Figure 1: Trends in foreign private equity investment in Indian e-commerce sector, millions of United States dollars (2000-2016)**




*Source:* Author's calculation from Venture Intelligence Database.

PE investments have grown significantly since 2003, though experiencing significant volatility, as evident in steep increases and declines during the period. There was steep growth in 2013 followed by a sharp fall in 2016. The major reason for this unusual surge was the capital infusion in Flipkart. The extraordinary large volume of investment shook the entire trend. The fall during 2016 was predictable, as the market returned to

5 Includes secondary components as well. Here some of the existing shareholders sell their share in the company that issues the IPO. The money goes from one shareholder to another shareholder, not to the company.

normal and no such large investment was made. Table 1 shows the major investors and the funds raised by the major e-commerce players in India since 2014. A closer inspection of the data reveals the skewed nature of the investments made in the e-commerce sector. Despite the large huge infusion of capital, most of the money was directed to a small number of large companies, such as Big Flipkart, Snapdeal, Jabong, Paytm and Pepperfry.com.

**Table 1: Major Investors and Investee Firms in Indian E-commerce Sector**

| Year | Amount (Mil US$) | Major Investors | Major Investee |
|---|---|---|---|
| **2014** | 2,933 | Tiger global, Nasper, Accel Partners, DST Global, ICONIQ Capital, Morgan Stanley, Temasek | Pepperfry.com, Snapdeal.com, Jabong.com, FabFurnish.com |
| **2015** | 2,057 | Temasek, SoftBank, Kalaari Capital Goldman Sachs | Snapdeal, UrbanLadder.com Pepperfry.com |
| **2016** | 726 | Helion Ventures, Bessemer, Ascent Capital | Furlenco Snapdeal, Industrybuying.com, Big Basket |
| **2017** | 4,402 | Nasper, Tencent, SoftBank, Nexus | Just Buy, Flipkart, Snapdeal, Paytm, UrbanLadder |

*Source:* Dealcurry 2013, 2014 Venture Intelligence 2015 onwards. Data includes on e-commerce and mobile commerce under IT and ITES sector

### Shareholding patterns

The shareholding patterns reveal how the ownership of the total volume of shares (equity and preferential) of a company is divided and distributed among the various entities and individuals. This sub-section depicts and compares the shareholding pattern of the major players of the Indian e-commerce companies in recent period. The selected companies hold the majority share in the market.

Table 2 gives information on the shareholders or owners of the major companies in the

Indian e-commerce sector. Flipkart.com is controlled by the entity Flipkart Internet Private Limited. The website Amazon.in is managed by Amazon Sellers Services Private Limited, while Paytm is controlled by One97 Communications. New Delhi based firm Jasper Infotech manages the website Snapdeal.com.

**Table 2: Shareholding Patterns of Major Indian E-commerce Companies**

| Company/websites | Shareholders and theirs shares in % |
|---|---|
| **Flipkart** | Tiger Global (29.5), Accel partners (11.5) ,Binny Bansal (8.7), Sachin Bansal (8.7), Intervision Services (18.4), Others (23.2) |
| **Snapdeal** | Soft Bank (32.98) Kunal Behl (3.94), Kaalari Capital (7.81), Nexus (9.71), ebay (6.32), Rohit Bansal ( 2.44),Alibaba (2.93), Foxconn (4.03), Temasek (2.65), Others (27.19) |
| **Amazon** | Amazon Asia-Pacific Resources Private Limited, Singapore (99) Amazon Eurasia Holdings S.A.R.L, Luxembourg (1) |
| **Paytm** | Alipay Singapore E-Commerce P Ltd (32.41), Mr. Vijay Shekhar Sharma (21.33), SAIF III Mauritius Co Ltd (20.37), Alibaba.com Singapore E commerce Co P Ltd (8.53) , AIF Partners India P Ltd ( 8.31) |

*Source*: Ministry of Corporate Affairs, Government of India

The descriptive analysis reveals that the majority of shares in these companies are held by foreign PE investors. It is interesting to note that this shareholding pattern has changed drastically from the initial period of company formation. The companies raised funds by issuing equity shares to the listed investors and subsequently reached the current pattern. At present, the situation is that none of the initial founders are holding controlling stake or voting rights in the company, except for Amazon.in, which is a subsidiary of Amazon Asia Pacific Resources Private Limited and Amazon Eurasia Holdings S.A.R.L, Luxembourg. However, they also invested a large amount in their Indian subsidiary in different time periods since their formation in 2013.

**The risk factor**

Although the high amount of PE investment helped the sector to grow and enabled the participating firms to expand their operations, it also raised some concerns in the industry. The major concerns are related to the opportunistic behaviour of the PE firms. For example, they invest in certain companies to earn profit and then sell their stakes at a higher price. They generally seek for short term investments, ranging from seven to 10 years or less, with minimum 15 per cent of annual rate of return (Badunenko and others, 2009). They acquire stakes in a growing firm, hold them for certain period and then sell it to others. The buyers can be different PE firms or any other type of investor. At the first stage, they finance the enterprise and allow it to grow, and after a short period of time, that is once the firm's market valuation grows, they exit often with at a very high premium, resulting in large outflow and smaller net inflow. For instance, the PE investors of Just dial (an Indian local search site) earned 850 per cent returns on their investments by selling the shares in the IPO after holding them for five to six years.[6] An analysis of the Article of Association of Flipkart reveals that maximum time period investors kept five years, with minimum of five times higher return on investment. A similar situation was also found in case of Myntra.com.

In addition to the above considerations, PE firms are also criticized on the ground that they strategically invest in two competing firms and gradually increase their stakes, eventually forcing them to merge with each other (Posner and others, 2017). The acquisition of Mynta (a fashion e-commerce company) by Flipkart is an example in this regard. A close analysis of the acquisitions that took place recently in the Indian e-commerce industry reveals that all targeted firms were running short of funds and incurring substantial losses. Some were also struggling for their survival and were not able to raise fresh funds neither from existing nor from new investors. The investment of the PE firms in both target and acquirer firm has helped them to merge the two entities easily. Here, the strategy of the PE firms is simple. First, they finance two smaller competing firms for two to three rounds. Once the appetite of the firms for the fund increases, they stop providing funding. As they run short of money and start struggling to compete in the market, the two competing firms are forced to merge for their survival. In some cases, the acquisition of one firm by another is also financed by PE firms. As the two merged firms become a larger entity, the PE investors come out of the investment by selling their shares at a premium rate. As the Indian e-commerce sector has started developing and growing rapidly, it has not yet witnessed any PE investors to sell out their shares after the acquisition of two firms.

There are a large number of companies in the Indian e-commerce sector who have acquired their competitors with backing from PE investors. Yes, also the target and acquirer were both funded by the common investor. Table 3 gives detail about some of the important acquisitions in Indian e-commerce sector in recent times. In 2011, Flipkart acquired Chakpak with Accel Partners as common investor. Similarly, Tiger Global was common investor in 2014 when Flipkart acquired its rival firm Myntra.com. Tiger Global was holding more than 40 per cent stake in both firms at the time of the acquisition. Accel Partners and Tiger Global were also the common investors when in

[6] See: https://economictimes.indiatimes.com/markets/ipos/fpos/just-dial-ipo-closes-at-15-gain-founder-vss-manis-wealth-now-worth-a-massive-rs-1300-crore/articleshow/20452037.cms Accessed 21 Dec 2017

November 2012 Myntra acquired Exclusively.in. At the global level, the acquisition of Uber's South Asian business by Grab is a recent addition to these examples, with SoftBank gaining large profits as common investor in both firms.

**Table 3: Select acquisitions in Indian e-commerce sector**

| Year | Target company | Acquirer company | Common PE Investors |
|---|---|---|---|
| **2011** | Chakpak.com | Flipkart | Accel partner |
| **2012** | letsbuy.com | Flipkart | Accel Partners and Tiger Global |
| **2014** | Myntra.com | Flipkart | Tiger Global |
| **2012** | Exclusively.in | Myntra.com | Accel Partners and Tiger Global |
| **2012** | Shersingh.com | Myntra.com | Accel Partners |
| **2013** | Inkfruit.com | Zovi.com | Saif partners |

*Source:* Compilation of the author from various newspapers reports

**What is the way out?**

When funding from PE firms is so harmful, what other options are available to entrepreneurs to fund their growth? The companies receiving PE funds are well informed about the portfolios of their investors. They are also aware about the fact that these PE firms will take out their investment with premium rates after a short period of time. Despite this, they still agree to these funding options, mainly because getting loans from a private or public sector bank is not easy. It is even more difficult for start-up firms with a new business idea in a highly volatile industry. For up to six years after incorporation, it is nearly impossible to get a loan for a firm which has not made any profit and has no collateral. In this situation, entrepreneurs are left with no other options then to raise funds from a PE company.

In contrast, it is comparatively easy to raise funds from a PE firm by issuing equity in the investee firm. The process of raising funds from these investors is also less complicated compared to receiving a bank loan. In this situation, the Government should intervene with policies encouraging entrepreneurship and simultaneously protecting the interests of the investors. This emerging sector should also be protected from the possible monopoly which may arise due to the acquisition of rival firms by others with the funding from PE investors, as this may result in decreased competition and high prices. The recent acquisition of Uber's South Asian business by Grab is an example which can help policy makers to take informed and better decision in the future. Start-ups should be given more leniencies in the policy space, while helping to acquire bank loans. A preferential treatment in tax regime could also be initiated to encourage start-ups and entrepreneurship. The recent initiatives undertaken by the current Government of India to promote entrepreneurship and start-ups. The announcement of start-up funds of INR 10,000 crore, the launching of Stat up India scheme and Skill India Scheme, are some of the commendable step undertaken by Government of India in this regard.

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