The Valuation Game*

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The universe of Indian startups is teeming with 'unicorns', industry slang for firms with valuations in excess of $1 billion. But most have yet to show the profits that legitimise that valuation, and many are bleeding. That was ignored till New York headquartered WeWork, the leader in the coworking office space business, which was expanding as if there are no limits to the demand for shared office space, hit a roadblock. Now Indian celebrity firms like OYO and PayTM, also backed by Softbank among others, are under the scanner.

OYO's business model was typical of the start-up boom fuelled by the internet ecosystem across the world. That consists of making profits out of other people's businesses or, as in the case of Uber and Ola, their hard work. The way this is most often done is by locating an entity between buyers and pre-existing sellers by aggregating information on supply and prices, purveying it online, and earn a commission from matching demand and supply. OYO's choice of field was the budget hotel business, where it made itself a leading channel of search for buyers by offering choice, and promising quality at reasonable prices. The key to success was an expanding set of buyers and providers willing to transact through its portal. More the number of providers in its network, the more attractive it is as a channel for buyers, and vice-versa.

There are, however, two (among many) difficulties the model must overcome. One is, it should find ways of building a big enough initial base of buyers and providers before the network effect, whereby new transactors join because there are many already there, gains momentum. The other is, even after business begins to grow, the firm must find ways of sustaining and accelerating expansion so that other firms or new entrants picking up the same idea and field of business do not grab a significant share in the market. For this it must win the loyalty of providers, getting them to link with the OYO brand and stay with the e-commerce intermediary, which is in the game of skimming off a part of their margins. What is more, to satisfy the quality requirements it promises buyers in hotel facilities on offer, it would need to persuade these providers to make investments of varying magnitudes to improve their services. To ensure that, there must be something on offer for the provider, similar to the incentives provided to drivers by aggregators of taxi services like Ola. Among the offers made were a minimum level of revenue independent of occupancy, provided by OYO in case it could not find an adequate number of hotel guests.

Since any shortfall in actual revenues relative to the minimum promised to hoteliers have to be met by OYO for its rapidly rising network of branded budget hotels, it soon notched up losses. But that did not seem to matter, since what were seen as losses incurred in the growth phase could be met through rounds of funding from financial investors buying into equity. All that was needed for investment-target hungry investors that they would profit from appreciation in stock values. Valuation gains are important for promoters as well because they need to mobilise large sums through sale of equity. Since there are limits to how many shares can be credibly created in each round of funding, valuation is key. Since there is no evidence of profit to warrant such appreciation in equity values, it can occur only if the stock concerned becomes the target of speculation, and there is a surfeit of capital in search of avenues for speculative investment. Without the backing of finance through multiple rounds of funding, a start-up would be short-lived.

This explains why the start-up surge is a feature of an age when finance is abundant and the financial sector dominates economic activity. But the dominance of finance influences the nature of the non-financial sector because financial investors decide on which ideas to back. Since investment in equity once made is not recovered unless sold for a profit, the tendency is to back the project even if profits are not being made, in the hope that conditions would change or another investor may find reason to bet on the loss maker. But as the WeWork experience showed, this trend can lose momentum. Speculative investments had taken the valuation of WeWork to close to $50 billion. But when the company chose to attract more capital through a public offer of equity, it could not persuade investors to value it at even $20 billion, forcing it to postpone the its first public offer. But since that affected the ability of WeWork to continue functioning it had to be taken over by lead-investor Softbank, which is retrenching assets even while ploughing more money into the business.

OYO has been approaching a similar place for some time now. In a 2019 funding round it had doubled its valuation to $10 billion. Buoyed by the backing it received from finance, it chose to expand not only in India, but into foreign destinations such as China and the United States. However, while it has expanded hugely and at a rapid pace, its bottom line has remained red and negative. Not surprisingly, it has been under pressure from its financiers, including Softbank, to improve its performance and turn a profit. Given its odd business model, this pressure has elicited peculiar responses from the company. First, it decided to squeeze its network of hoteliers to reduce costs. To do that it has adopted multiple means to trim the “Minimum Guarantee Fee” it had promised to pay them, irrespective of occupancy. Hotel owners claim that on flimsy grounds OYO has been making deductions for violation of contract clauses and faults and errors. Early in 2019 the Federation of Hotel and Restaurant Associations of India (FHRAI) claimed that more than 200 hotels had ended agreements with OYO because of disputes of various kinds. In China, OYO claims to have a network of close to 20,000 hotels across more than 300 cities. But matters are souring there as well. In October, the Financial Times reported that a letter signed by 172 hoteliers across China charged OYO with resorting to “unclear bills and arbitrary deductions” and threatened legal action.

The second response, perhaps triggered by the difficulties faced with the first, is to change its character. While starting off as a budget hotel chain created by renovating and rebranding other people’s properties, the company is moving to a franchise model where rather than booking rooms for customers, it acquires, on lease or otherwise, hotel properties which it then rents out to its clients, becoming a full-fledged hospitality player. The company is also diversifying into new areas like ‘coworking’ in shared office spaces and ‘coliving’, involving fully-furnished rental housing with associated services to those wanting shared accommodation. In normal circumstances, if a young company changes its business model, that would be seen as a sign of failed expectations. But clearly in the start up universe success is not judged by what you do, but how successful you are in attracting investments at rising valuations. The game is financial and not material.

The third response has been to accelerate expansion with the company managing more than a million rooms in around 80 countries. Such expansion is possible because rising valuations allowed the company to mobilise large sums in successive funding rounds. But the expansion was also needed to keep valuations rising, setting off a difficult-to-sustain spiral in which valuation and expansion drive each other.

This seems to have elicited a fourth response in which the promoter buys back equity and invests more, sending out a message of confidence by having more skin in the game. In this case, promoter Ritesh Agarwal chose to invest $2 billion in the middle of 2019, of which $1.3 billion was spent on buying equity held by Lightspeed Venture Partners and Sequoia Capital, and $700 milion invested as part of a financing round that raised $1.5 billion. The promoter here was spending money to keep valuations rising.

The problem in this model is that expansion does not guarantee profitability. In OYO's case it has not delivered. Now, even if belatedly, questions are being posed about OYO's strategy, not just by disgruntled hoteliers, but its investors. WeWork's problems may have served as the trigger, especially as Softbank was the main investor in that company as well. As the Financial Times put it, the company "is one of the most valuable start-ups in India but in the wake of the delayed WeWork IPO, critics have questioned the company's valuation and its breakneck growth." But so long as liquid financial capital is in free flow, the OYO spiral may keep unfolding.

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