Insight beyond information

EXECUTIVE BRIEFINGS
BUSINESS & MANAGEMENT: START-UPS

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Changing terms of engagement

Twenty-two years ago when I resigned from employment with an investment bank to set up IMA, I was stubbornly anxious about profits and cash flows. With limited funding, I wasn't really blessed with choices. Perhaps I lacked vision; perhaps the environment all those years ago did not encourage me to think scale and a mind-set of frugality possibly impeded the growth and evolution of my company. But it also ensured that we were profitable fairly quickly. Things have come a long way since and the approach of start-ups is palpably different now.

Today, young entrepreneurs commonly focus their attention on the creation of a product and given the possibility of scaling its offering, seek to monetise their effort through a sale or divestment of stock rather than churn out profits. They sometimes have exaggerated assumptions about what they can create, rather than the odds of making profits or even generating positive cash flows. Glory is sought in the conception of something that has a large social or consumer impact with little relation to profitability. Products are backed by slick technology and even offer a life enriching experience. Growth, scale and market share constitute the basic terms of engagement; profits are rarely in the initial consideration. In all of this start-ups occasionally forget the old rules of business – economies of scale do not create a business, they only optimise it.

But things have begun to change, with investors becoming more demanding on cash flows. They have condensed previously generous timeframes on expected returns. A few months ago PepperTap a grocery delivery service shut down its operations in six cities including Bombay, Madras and Calcutta, laying off 400 delivery workers. A rival offering by Grofers earlier sealed doors in nine cities, all in a bid to conserve cash. Possibly persuaded by investors, these firms may now focus harder on financial metrics, redesign their products and ensure profitability before searching for scale.

The rush of funding seems to be ebbing. Unlike in previous years when investment transactions were sealed in a matter of weeks, investors now seem more circumspect and ask the obvious questions. However, that is not to say that funding for start-ups has evaporated. According to a report by InnoVen Capital, 130 Indian start-ups are expected to raise USD 700 million in the course of this year. But entrepreneurs have to work harder in refining their business models and can no longer expect lofty valuations. Interestingly, the report also alluded to the fact that the appetite for growth capital – involving sums of USD 25 million – is limited, as venture funds prod their portfolio companies towards a path of profitability. In 2015, USD 16 billion was poured into the start-up ecosystem but going forward both valuations and cheque sizes may be greatly reduced. The focus is going beyond consumer and social impact to fundamentals and profitability.

In the longer term the cycle of booms and busts will continue as greed and rationality repeatedly replace each other as the domineering force amongst investors. But start-ups are here to stay. They are now critical contributors to economic growth, employment creation and perhaps above all in their ability to enrich our lives. They are often led by people of vision with an aptitude for technology who churn out clever offerings. Had I been blessed with some of these traits, IMA might for better or worse have been in an altogether different business. Still, as in all things, it must be about the right balance.