

Indian Start-ups – A Bubble Waiting to Burst?

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Abstract

Start-ups has become the buzz word in both political and business circles of late. And, not without a reason. India has attracted worldwide attention for trying to build a successful ecosystem for start-ups to boost economic growth. And rightly so. The facts that have emerged out of the National Association of Software and Services Companies (NASSCOM) report – “Indian Tech Start-up Ecosystem – Leading Tech in the 20s” - are very encouraging. During 2019, more than 1300 start-ups were added and the country added seven unicorns to the already existing 17 unicorns. A unicorn is a technology based start-up that has achieved a valuation of a billion dollars or more. With 24 unicorns, India ranks third in the world, after USA and China.

India is the third largest start-up ecosystem in the world. The total number of tech start-ups in India at the end of 2019 was between 8900-9300, compared with 7700-8200 in 2018. During January – September 2019, the country saw an investment of US\$ 4.4 billion in start-ups across 450 start-ups. There are 335 incubators and accelerators in the country that are capable

of supporting over 5000 start-ups every year. The start-up ecosystem has created more than 4.3 lakh direct jobs so far, and in 2019 alone more than 60000 jobs were added.

But, the failure rate of start-ups in the country is alarmingly high. The high rate of failure can be attributed to various reasons - lack of managerial skills amongst the entrepreneurs, excess cash burn in an effort to quickly garner market share, unrealistic expectations from Venture Capitalists/Angel Investors, improper valuation of start-ups, lack of innovative products, no emphasis on creating Intellectual Property Rights, so on and so forth.

The trend that we are witnessing with respect to the high failure rate of start-ups can be compared to the dot com bust that happened in the United States of America during 1999-2000. Is the Indian start-up ecosystem a bubble waiting to burst, just like the dot com bubble that burst in 1999-2000?

The research paper will touch upon all of the above points and more. The research type will be qualitative in nature and the researchers will make use of extensive secondary data that is already available in public domain to write the paper.

Key words: Entrepreneurship, Start-ups, Venture Capital, Angel Investors, Ecosystem

2.0: Introduction

Of late, India has garnered global attention and ranks third amongst the global start-up ecosystems. 3 to 4 start-ups are being established on a daily basis in India, and the country received a total start-up funding of US\$ 5 billion in 2015. The number of Private Equity, Venture Capital, and Angel Investors making investments in India doubled in 2015, and the amount of funds invested by these investors increased by 125% as compared to 2014. The country is also one of the youngest start-up nations in the world, with the average age of 72% of the founder-entrepreneurs being less than 35 years.

All this attention that the country was receiving in the start-up world prompted Shri Narendra Modi, the honourable Prime Minister of India to state "*I see start-ups, technology, and*

innovation as exciting and effective instruments for India's transformation". Guided by the Prime Minister's vision, the Government of India, in February 2016, announced the Start-up India policy for nurturing and promoting start-ups in the country.

Start-up India is a flagship initiative of the Government of India, intended to build a strong eco-system for nurturing innovation and start-ups in the country that will drive sustainable economic growth and generate large scale employment opportunities. The Government, through this initiative aims to empower start-ups to grow through innovation and design. According to the Start-up India Action Plan, the Government of India will provide funding support to the start-ups via a Rs.10,000 crores corpus.

The Start-up India policy defines a start-up as "*Start-up means an entity, incorporated or registered in India not prior to five years, with an annual turnover not exceeding INR 25 crores in any preceding financial year, working towards innovation, development, deployment, or commercialization of new products, processes or services driven by technology or intellectual property*"

As part of the Start-up India policy, the Government will partner with 108 incubators and 20 industry associations to promote and nurture start-ups. The policy envisages a three point action plan: *simplification and handholding, funding support and incentives, and industry-academia partnership and incubation.*

According to the Global Ecosystem Report of 2015, Bangalore has between 3100-4900 start-ups and has achieved the second highest growth rate for exit volume and Venture Capital investment among the top twenty start-up eco-systems in the world and as a result, ranks amongst the top fifteen start-up destinations in the world.

In view of the above, in April 2016, the Government of Karnataka announced the Karnataka Start-up Policy 2015-2020.

The vision of the Karnataka Start-up Policy is "*to create a world-class start-up eco-system in the state through strategic investments and policy interventions, leveraging the robust*

innovation climate in Bangalore". The goals of the policy include: stimulating the growth of 20,000 technology based start-ups including 6000 product start-ups by 2020 in Karnataka, achieve creation of 6 lakhs direct and 12 lakhs indirect new employments in the sector, mobilize Rs. 2,000 crores funding for investment in start-ups through Government intervention alone and facilitate generation of at least 25 Innovation Technology Solutions with a social impact in sectors like healthcare, food security, clean environment, and education for all, etc.

The Karnataka Start-up Policy 2015-2020 defines a start-up as *"a technology based company which is registered in Karnataka not more than four years from the date of application, employing at least 50% of its workforce in Karnataka, and having a revenue of not more than Rs. 50 crores"*.

The strategies enlisted in the Karnataka Start-up Policy 2015-2020 include: *encouraging entrepreneurship in education through the New Age Incubation Network (NAIN), fostering strong partnerships between R&D institutions and the industry, creating incubation infrastructure through Public Private Partnership (PPP), and providing state support in the form of incentives and concessions.*

Whilst the high rate of new venture formation is good news, the equally high rate of start-up failure is a cause of huge concern. Start-up failure impacts the economy in a negative way - job lay-offs, improper utilization of capital, and emotional/psychological turmoil for the entrepreneurs.

According to a report published by IPAN Research in September 2016, 97% of the start-ups fail, 1% get acquired, 1% become paper unicorns, and 1% become sustainable. Some common mistakes made by start-ups are: unsustainable business model, poor unit economics, lack of long term approach, improper guidance and mentorship, the team, timing, and estimating demand and supply.

Entrepreneurs who fail, seem to lack the depth of experience and the range of leadership skills required to transit their start-up ventures to success. This is despite the fact that the country has a fairly decent entrepreneurial eco-system to nurture and support entrepreneurs. Capital – either as debt or equity, is available in plenty. Private Equity, Angel and Venture Capital investors are keen to invest their money in innovative start-ups, with a hope of reaping rich benefits from their investments in the future. But, there seems to be a gap between the entrepreneur and the entrepreneurial eco-system.

3.0: Literature Review

In the middle of 2016 the IBM Institute for Business Value, in collaboration with Oxford Economics conducted a survey to learn more about the fast growing Indian start-up ecosystem and its impact on the economy (Entrepreneurial India – How start-ups redefine India's economic growth). The survey involved contacting 1300 executives, including 600 start-up founders, 100 Venture Capitalists, 100 Government leaders, 500 industry leaders, and 22 education leaders.

The survey identified that despite India having a strong start-up ecosystem that ranks third in the world, almost 90% of start-ups failed within the first five years. The 100 Venture Capitalists who were part of the study identified 6 reasons for the high failure rate of Indian start-ups:

- Lack of innovation
- Not hiring employees with the right skills
- Insufficient funding
- Inadequate mentoring of founders of start-ups
- Unethical business conduct
- Inexperienced leadership

In a 2015 blog titled “Why do most Indian start-ups fail?” published by the Department of Computer Science and Engineering of the Indian Institute of Technology in Delhi, the author of the blog identifies three reasons for the failure of Indian start-ups:

- Lack of ideas that are new, fresh, innovative, technically sound, free of legal issues, socially acceptable, and have the potential to make money
- Easy access to funding from Venture Capitalists and Angel Investors, combined with the ambition of the founders to achieve a good valuation and sell the company for huge profits, thereby neglecting the basics of business
- Hiring people who lack technical skills and communication skills

An article published in Inc 42 (2018 in Review: 10 of the biggest start-up failures in India) highlights the reasons for the shutdown of 10 start-ups during 2018. The 10 start-ups that were featured in this article had a total funding of US\$ 170 million and were part of the consumer services, e-commerce, and fin-tech industries. Incidentally, these were the very industries which had attracted the maximum investments, mergers and acquisitions during 2018. A majority of the companies in these industries have closed down over the past 3 years. The article identifies the reasons for failure as

- Unscalable business model
- Negative cash flow
- Fierce competition
- Legal issues
- Lack of follow-on funding
- Revenue slowdown.

In a May 2019 article titled “Why Indian start-ups are facing a lack of investors/business entrepreneurs”, Prashanth Agarwal argues that in order to be successful, start-ups should be innovative but observes that Indian start-ups are less innovative than start-ups elsewhere. The authors enlists the reasons for the lack of funding for Indian start-ups as:

- Lack of confidence of the entrepreneurs
- Lack of an innovative business model
- Inability of the founder to achieve growth for this company
- Heavy focus of all start-ups on already over-crowded urban markets

10000 Start-ups, a NASSCOM initiative lists the reasons for failure of start-ups in their blog “Lessons to learn from Indian start-ups that failed” as:

- Lack of innovation and uniqueness
- Weak business and revenue models
- Pre-mature expansion/scaling up
- Lack of market understanding
- Lack of talent and competency
- Lack of funding and/or follow on funding

Indianweb2, in their March 2018 analysis of the Start-up India program of the Government of India report that only 5% of the country’s adult population go on to start their own ventures and that the business discontinuation rate of 26.4% is among the highest in the world.

In December 2018, Quartz India in an article titled “Investors are chasing fewer but more valuable start-up deals in India” threw up some interesting facts:

- The unrealistic valuation of start-ups seem to have come to an end
- Venture Capitalists are choosing quality over quantity
- Since 2016, there have been fewer Venture Capital deals, but the quantum of funding has increased
- After a decade of hyper funding the Venture Capital industry had a dry spell, resulting in closure of as many as 1000 start-ups during the period June 2014 - June 2016
- The number of Venture Capital firms has increased from 157 in 2013 to 270 in 2018

In November 2018, The Economic Times published an article – “It’s raining money for start-ups, but only for the promising few”, wherein the author says that both Venture Capital firms and Entrepreneurs are becoming choosy about whom they would like to pick. Venture Capitalists are investing more in ideas that can become the next breakthrough. The successful exit of Flipkart has emboldened Venture Capitalists. They are also moving away from being generalist investors to investors specializing in newer industries that offer promise. On the other hand, keeping in mind the high rate of failure in the India start-up ecosystem, Venture

Capital firms are choosing their investments wisely on only those start-ups that offer more than 4X returns. The entrepreneurs too are looking at Venture Capital firms that can add value to the Industry that they are in.

The Financial Express, in a November 2019 article “VCs tightening purse strings: start-ups may find difficult to raise funding in 2020”, makes some predictions for 2020:

- Funding likely to grow at only 4% as compared to previous year
- Venture Capitalists to increase scrutiny of start-ups with high valuation
- The funding market is moving from turbulent ethics, fewer new entrants, smaller deal sizes to moderation

4.0: Objectives of the study

The objectives of the study are to:

- To understand the Indian start-up ecosystem both from the entrepreneur’s and the investor’s perspective
- To understand the reasons for the high failure rate of start-ups in India
- To investigate if the bubble called as the Indian start-up system is really ready to burst or not

5.0: Research Methodology

This research paper is qualitative and exploratory in nature. Data has been collected from secondary sources, by doing extensive literature review on the topics of failure rates of start-up companies in India and the investment eco-system available for funding of start-ups. The secondary data has been collected from published sources such as the Internet, blogs, survey reports, and published Government documents.

6.0: Data analysis and interpretation

Some of the key learnings, analysis, and interpretation from the review of literature can be summarised as follows:

Top reasons for failure of start-ups in India:

- Lack of innovation
- Lack of talent/skills both at the founder and at employee level
- Insufficient funding/follow-on funding
- Inadequate mentoring of the entrepreneurs
- Unethical business conduct
- Inexperienced leadership
- Poor financial management
- Inability to handle fierce competition
- Undue focus only on urban markets which are already highly competitive
- Over ambitious growth targets
- Failure of Governments, both at the Central and the State, to encourage entrepreneurship

Lessons learnt by the Venture Capital firms from the high failure rate of start-ups:

- The unrealistic valuation of start-ups seems to have come to an end
- Venture Capital firms are focusing on the quality of the deal and not so much on the quantity of deals
- The number of Venture Capital deals has come down, but the quantum of investments made has increased
- High failure rate of start-ups is still an area of concern for the Venture Capitalists

- Venture Capital firms have shifted their expectations on returns from less than 4X times to higher returns, including 10X returns
- Venture Capital firms are moving away from popular industries such as Fintech, Consumer Services, and E-Commerce to newer industries and are building skills in newer industries and are creating specialized teams to focus on such industries

7.0: Conclusion

The premise that the Indian start-up ecosystem is a bubble waiting to burst could be unfounded. Whilst the review of literature has undoubtedly highlighted the high failure rate of start-ups in India and the reasons for the failure, it also has brought to light the corrective action being taken by Venture Capital firms to protect themselves in a volatile, uncertain, complex, and ambiguous market. Lack of innovation, skills, talent, and capabilities seem to be the main reasons for failure of start-ups in India.

Whilst India has attracted Venture Capital firms in droves from across the world, it would serve them well to keep the high failure rate of the India start-ups in mind. The Indian Venture Capital industry has matured and has become wiser, having learnt from their mistakes and experiences of the past. Due diligence on the part of the Venture Capitalists while evaluating investment opportunities is being given much more prominence than earlier.

Whilst Venture Capitalists seemed to have learnt their lessons, the entrepreneurs don't seem to have learnt their lessons yet. However, the emergence of incubators and accelerators across the country seem to bridge the gap between what the investors expect and what the entrepreneurs are churning out.

Overall, there is hope that the Indian start-up ecosystem will evolve itself into the finest in the world and help contribute to the economic growth of the country.

The research paper has made an attempt to present an overview of the start-up ecosystem in India, the high failure rate of India start-ups, and to arrive at conclusions on whether the Indian start-up ecosystem is a bubble waiting to burst. However, since this is a paper which is

qualitative and explorative in nature, it does not offer empirical evidences to pinpoint the exact reasons for the failure of start-ups in India, thus paving the way for future researchers to delve more in detail into this topic.

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