ZOMATO, ZOMATO: A DIY VALUATION OF ZOMATO!

Stories and Numbers

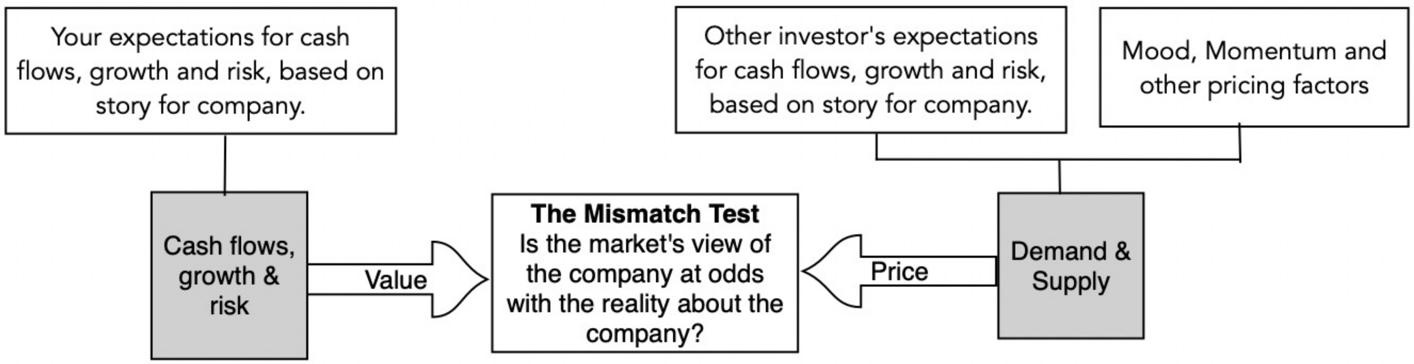
The Lead in…

- Just over a week ago, I valued Zomato ahead of its market debut and as with almost every valuation that I do on this forum, I heard from many of you.
  - Some of you felt that I was being far too generous in my assumptions about market share and profitability, and that I was over valuing the company.
  - Many others argued that I was understating the growth in the Indian food market and the company's potential to enter new markets, and thus undervaluing the company, a point that the market made even more emphatically by pricing the stock at about three times my estimated value.
  - A few of you posited that I was missing the point entirely, and that Zomato is a trader's game, and that there are plenty of reasons for traders to be optimistic about its prospects.
- In this post, rather than impose my story (and value) on you, I offer a template for telling your own story about Zomato, and arriving at your own value.

The Prelude

- After I posted my valuation last week, I did find some of the portrayals of what I had found to be a little unsettling.
- Each notification started by describing me as some kind of valuation luminary, and then proceeding to report my valuation as the result of deep research.
  - First, there is nothing in valuation that merits the use of "expert" or "guru" as a descriptor, since it is for the most part, common sense, layered with a few valuation basics.
  - Second, while valuation practitioners have created their own buzzwords to create an aura of mystery, and added complexities, often with no reason other than to intimidate outsiders, I believe that anyone should be able to value a company, as I hope to show later in this post.

Good companies? Good Investments?



Views of company's future cashflows/value		
Your expectations	*Market expectations*	*Investment judgment*
Great	Great	Neutral
Great	Good/Average/Bad	Buy
Good	Great	Avoid
Good	Good	Neutral
Good	Bad	Buy
Bad	Great/Good	Sell
Bad	Average	Avoid
Bad	Bad	Avoid
Buy	*Investment will earn more than risk-based break-even return*	
Sell	*Investment will earn less than risk-based break-even return*	
Neutral	*Investment will earn a fair return, on a risk-adjusted basis.*	
Avoid	*Not a good investment, but not bad enough to sell*	

Investment Advice?

- I value companies for an audience of one, and that audience member is very forgiving and understanding, because I see him in the mirror every day.
- It has always been my belief that as investors, each of us needs to take ownership of our investment decisions, and that buying or selling a company because someone else is doing so, even if that person has legendary credentials, is a dereliction of investment due diligence.
- Thus, if you find Zomato to be cheap and buy it, I have no desire to talk you out of your decision, since it is your money that you are investing, and that decision should be based upon your assessment of the company's prospects, not mine.

Story to Numbers: The Steps

Step 1: Develop a narrative for the business that you are valuing
In the narrative, you tell your story about how you see the business evolving over time. Keep it simple & focused.

Step 2: Test the narrative to see if it is possible, plausible and probable
There are lots of possible narratives, not all of them are plausible and only a few of them are probable. No fairy tales or runaway stories.

Step 3: Convert the narrative into drivers of value
Take the narrative apart and look at how you will bring it into valuaton inputs starting with potential market size down to cash flows and risk. By the time you are done, each part of the narrative should have a place in your numbers and each number should be backed up a portion of your story.

Step 4: Connect the drivers of value to a valuation
Create an intrinsic valuation model that connects the inputs to an end-value the business.

Step 5: Keep the feedback loop open
Listen to people who know the business better than you do and use their suggestions to fine tune your narrative and perhaps even alter it. Work out the effects on value of alternative narratives for the company.

And the feedback loop…

- Talk to a diverse audience: We live in a world of specialization, and we have created workplaces, where these single-subject specialists often interact entirely with each other, making their isolation almost complete. I am lucky that I am able to interact with people with very different backgrounds (bankers, VCs, founders, CFOs, regulators), from different geographies and with very different perspectives, through my teaching and writing.
- Transparency over opacity: I would rather be transparently wrong than opaquely right. Consequently, when I value companies, I try to take a stand on value and be be open about process, data and mechanics, so that anyone can not just replicate what I did, but find their own points of disagreement and reflect those changes in value. I am also well aware of the risk that by putting out valuation details, I could be proven wrong in the future, but I like the accountability that comes with disclosure.
- Listen to those who disagree with you: On every company that I value, I know that there are people out there who know more than I do about some aspect of the company (its products, market or competition), and I can learn from them.
- Be willing to change: The three most freeing words in investing and valuation are “I was wrong”, and I would be lying if I said it comes easily to me. That said, it does come more easily now that I have had practice saying it, and while some view it as an admission of weakness, I think it releases you to tell a better, and sometimes different, story.

Feedback on Zomato

- Indian food delivery: I have learned more about online food delivery and restaurants in India in the two weeks since I posted my Zomato valuation. I have learned why Zomato Pro has not caught on as quickly as the company thought it would, why some of you prefer Swiggy and even what you like to order from restaurants.
- Tax rate: Some of you noted that the corporate tax rate in India is 25%, not 30%, and while the Indian tax code with its predilection to add in surcharges that seem to last forever, and exceptions, does still leave me confused, I will concede on this point (pushing up my value per share marginally from 41 INR/share to about 43 INR/share.
- Market size: I have had pushback on my story's focus on Indian food delivery, with some pointing to the potential for Zomato to expand its market globally and others to the expansion possibilities in Indian grocery deliveries and from cloud kitchens. While I believe that the networking advantage that works to Zomato's benefits will stymie them if they try to expand to large foreign markets and that the grocery delivery market, at least for the moment, offers too small a slice of revenues to be a game changer for the company, those are legitimate points.

A DIY Valuation of Zomato

- In the pages that follow, I will list out the choices on the key inputs driving Zomato’s valuation, and the story line behind each choice.
- I will highlight the choice I made, but I would like you to pick your own on each dimension.
- Once you have made your choices, I have done the plumbing to convert your choices into cash flows and value.

1a. TAM

Total Addressable Market	Expected Market Size (in ₹ millions)	Description
A1. Indian food delivery, anemic growth	₹ 1,125,000	Food delivery ($15 billion approximately)
A2. Indian food delivery, solid growth	₹ 2,000,000	Food delivery ($25 billion approximately)
A3. Indian food delivery, high growth	₹ 3,000,000	Food delivery ($37.5 billion approximately)
A4. Indian food & grocery delivery market	₹ 5,000,000	Food + Grocery ($60 billion approximately)
A5: Direct input	₹ 4,000,000	Enter your number

1b. Growth Acceleration

Growth Scaling (over time)	Growth Rate factor (yrs 1-5)	
B1. Constant Growth Rate	1.00	Same CAGR every year
B2. Moderately higher growth rate in first 5 years	1.50	1.5 times CAGR for years 1-5
B3. Strongly higher growth rate in first 5 years	2.00	2 times CAGR for years 1-5
B4. Exponentially higher growth rate in first 5 years	4.00	3 times CAGR for years 1-5
B5. Direct input	2.50	Enter your number

2. Market Share

Network Effects	Market share of potential market	
C1. No network effects	10%	Open competition in every market
C2. Weak network effects	20%	Four to five winners in the market
C3. Moderate network effects	30%	Three winners in the market
C4. Strong network effects	40%	Two winners in the market
C5. Dominant network effects	60%	Market dominance
C6: Direct input	50%	Enter your number

3. Revenue Slice

Revenue Slice	Slice of Gross Receipts	
D1. Cut-throat competition	10.00%	Unrestricted entry + No pricing power
D2. Strong competition	15.00%	Unrestricted entry+ Some Pricing Power
D3. Status Quo	21.03%	Unrestricted entry + Pricing Power
D4. Duopoly/Monopoly Power	25.00%	Restricted entry + Pricing Power
D5: Direct input	22.00%	Enter your number

4a. Operating Margin

Operating Margins	Operating Margin	
E1: Strong economies of scale, no or limited competition	45%	Strong pricing power + scaling benefits
E2: Strong economies of scale, serious competition	35%	Weak pricing power + scaling benefits
E3: Weak economies of scale, no or limited competition	25%	Strong pricing power + no scaling benefits
E4: Weak economies of scale, serious competition	15%	Weak pricing power + no scaling benefits
E4: Direct input	20%	Enter your number

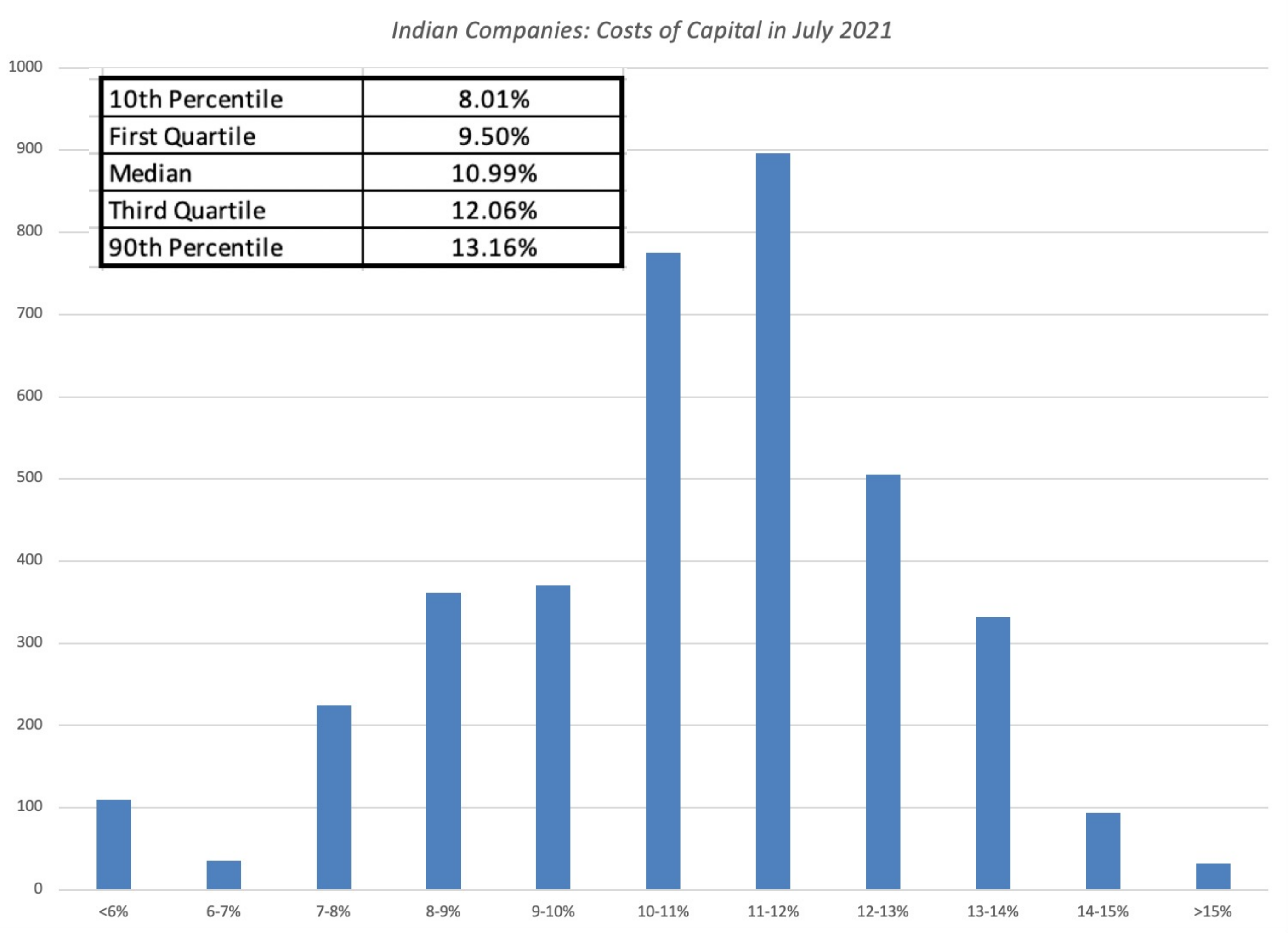
4b. Pathway to Profitability

Margin Improvement	Year target margin reached	
F1. Fast convergence	3	Target margin reached in year 4
F2. Moderate convergence	5	Target margin reached in year 7
F3. Slow convergence	10	Target margin reached in year 10
F4. Direct Input	7	Enter your number

5. Reinvestment

Reinvestment	Sales to Capital Ratio	
G1. Minimal capital needs, no acquisitions (10.00)	10.00	Effortless, capital-less growth
G2. Minimal capital needs, small acquisitions (5.00)	5.00	Very efficient growth
G3. Small investment in technology, small acquisitions (4.00)	4.00	Efficient growth
G4. Big investment in technology, Large acquisitions (2.50)	2.50	Status quo
G5. Tech company median (2.00)	2.00	Tech company median
G6. Capital intensive company median (1.50)	1.50	Capital intensive business median
G7. Direct input	2.25	Enter your number

6. Cost of Capital - Perspective



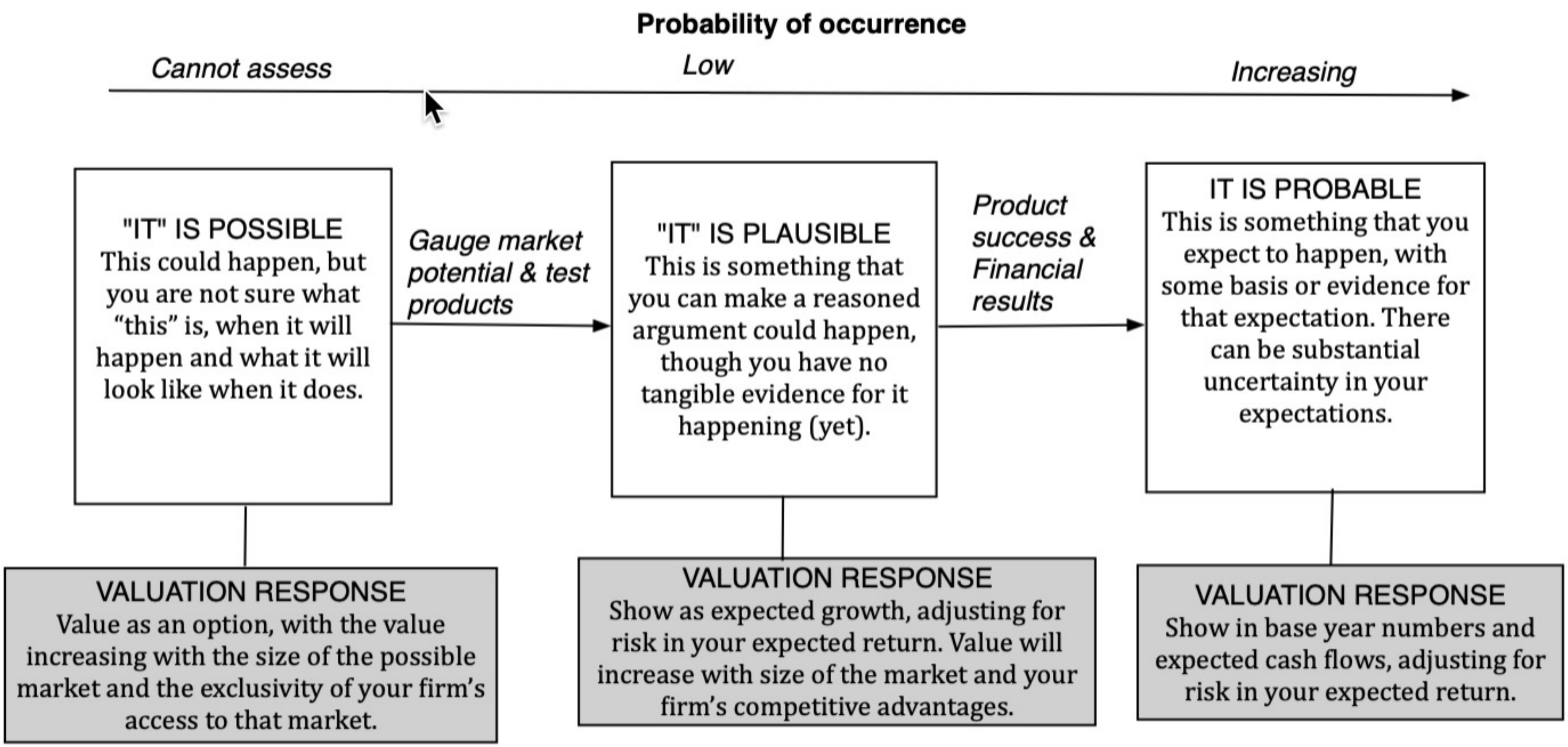
10th Percentile	8.01%
First Quartile	9.50%
Median	10.99%
Third Quartile	12.06%
90th Percentile	13.16%

6. Your cost of capital & failure risk

Cost of Capital	Cost of Capital (in ₹)	
H1. Lowest decile of Indian companies	8.01%	Very low risk (with 4.25% riskfree rate)
H2. 25th Percentile of Indian companies	9.50%	Low risk (with 4.25% riskfree rate)
H3. Median for Indian companies	10.99%	Average risk (with 4.25% riskfree rate)
H4. 75th Percentile of Indian companies	12.06%	High risk (with 4.25% riskfree rate)
H5. 90th Percentile of Indian companies	13.16%	Very high risk (with 4.25% riskfree rate)
H6. Direct Input	8.97%	Enter your number

The cost of capital captures operating risk, but it is not a good device to reflect failure risk, i.e., the chance that your company will not make it. In my base case, I assumed a 10% chance of failure, which you can change.

Possible, Plausible and Probable



Checking your story

- As you navigate your way through the choices, you may be tempted as an optimist to go with the most positive (for Zomato's value) choices on each variable (biggest market, highest market share, highest margin, lowest cost of capital) or the most negative (smallest market, lowest market share, lowest margin, highest cost of capital).
    - In fact, the former if often labeled a "best case" and the latter a "worst case" valuation, when in fact, neither passes the possible/plausible/probable test, since assuming that you will go after the biggest market will mean accepting lower margins and higher reinvestment.
    - Thus, I could tell you that the best case value is ₹423 and that my worst case value is ₹0, but that would be both useless and misleading. That said, you can already see, no matter what your priors, that there is a whole range of stories for Zomato that pass the test, and that they can yield values per share that are very different

Plausible Stories

Story	TAM (in ₹ millions)	Market Share	Revenue Slice	Target Margin	Cost of Capital	Value/share	
Delivery Juggernaut	₹ 5,000,000.00	40%	25%	45%	9.50%	₹ 150.02	
Delivery Star	₹ 5,000,000.00	40%	22%	35%	9.50%	₹ 93.00	Plausible
Delivery Leader + Competition	₹ 5,000,000.00	40%	15%	35%	10.99%	₹ 61.55	
Restaurant Delivery Juggernaut + High Growth India	₹ 3,000,000.00	40%	25%	45%	9.50%	₹ 94.31	
Restaurant Delivery Star + High Growth India	₹ 3,000,000.00	40%	22%	35%	9.50%	₹ 59.02	
Restaurant Delivery + Competition + High Growth India	₹ 3,000,000.00	40%	20%	25%	10.99%	₹ 35.52	Probable
Base Case, Positive	₹ 2,000,000.00	40%	25%	45%	10.25%	₹ 56.66	
Base Case	₹ 2,000,000.00	40%	22%	35%	10.25%	₹ 39.48	
Base Case, Negative	₹ 2,000,000.00	40%	20%	25%	10.25%	₹ 26.16	
Restaurant Delivery Juggernaut + Low Growth India	₹ 1,125,000.00	40%	25%	45%	9.50%	₹ 36.48	
Restaurant Delivery Star + Low Growth India	₹ 1,125,000.00	40%	22%	35%	9.50%	₹ 24.02	Plausible
Restaurant Delivery + Competition + low Growth India	₹ 1,125,000.00	40%	20%	25%	10.99%	₹ 16.58	

Playing the Zomato Game

- If enough buyers line up to buy Zomato shares, perhaps drawn to it by the success of others, there is no reason why the price cannot continue to rise, no matter what the value. I don't disagree with that sentiment, and it goes back to the contrast I draw not just between value and price, but between investing and trading.
  - As an investor, I am having trouble finding a pathway to justify paying 140 INR per share, for Zomato, even with the most upbeat stories that I come up with, for the company. That may of course reflect a failure of imagination on my part, and you may be able to find a narrative for the company that allows you to invest in the company.
  - As a trader, the question of whether you should buy Zomato comes down squarely to whether you are good at playing the momentum game, knowing when to get on, and more importantly, when to get off. For you, the value of Zomato may be irrelevant, and you will need a different set of metrics (charts, price and volume indicators) to make your decisions.