



# A ZOMATO UPDATE: VALUE, PRICE AND THE GAP

An India bet reassessed!

# Setting the table

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- Just about a year ago, I valued Zomato just ahead of its initial public offering and arrived at a value of about ₹41 per share.
- The market clearly had a very different view, as the stock premiered at ₹74 per share and soared into the stratosphere, peaking at ₹169 per share in late 2021.
  - The last few months have been rocky, as the price has been marked down, partly in response to disappointing results from the company, and partly because of macro developments.
  - At close of trading on July 26, 2022, the stock was trading at ₹41.65 per share, and the mood and momentum that worked in its favor for most of 2021 had turned against the company.
- In this post, I will begin with a quick review of my 2021 valuation, then move on to the price action in 2021 and 2022 and then update my valuation to reflect the company's current numbers.

# My IPO Valuation

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Zomato						Jul-21
The Story						
Zomato will benefit as the Indian food delivery market grows, driven by overall economic growth and more digital access, and it will be one of a few (two or three) players who will dominate the market; there will be a near term COVID bounceback effect. While Amazon Food remains the wild card, economies of scales will allow the company to generate high operating margins, and the company will continue to reinvest (acquisitions and technology) as it grows. The risk of failure is low, given the company's post-IPO cash balance and access to capital and its operating risk reflects its exposure to Indian country risk.						
The Assumptions						
	Base year	Next year	Years 2-5	Years 6-10	After year 10	Link to story
Indian Food Delivery	₹ 225,000	₹ 337,500	30.00%	15.27%	₹ 1,961,979	Indian food market rebounds in 2021 and grows to about \$25 billion in year 10
Market Share	42.15%	41.72%		40.00%	40.00%	Zomato is one of two or three lead players in Indian food delivery market
Revenues as % of GOV	21.03%	22.00%			22.00%	
Revenues (a)	₹ 19,937.89	₹ 30,975	Total Market * Market Share * Revenue as % of GOV		₹ 172,654	COVID rebound in 2021 + Growth in food delivery market in India long term
Operating margin (b)	-24.10%	-10.0%	-10.00%	35.00%	35.00%	Margins improve as growth wanes
Tax rate	30.00%		30.00%	30.00%	30.00%	Indian corporate tax rate over time
Reinvestment (c)		5.00	2.50	3.00	35.42%	Acquisitions & technology investments needed to sustain growth
Return on capital	-7.15%	Marginal ROIC =	127.01%		12.00%	New working benefits allow for high ROIC, near and long term.
Cost of capital (d)			10.25%	8.97%	8.97%	Cost of capital reflects Indian country risk
The Cash Flows						
	Total Market	Market Share	Revenues	EBIT (1-t)	Reinvestment	FCFF
1	₹ 337,500	41.72%	₹ 30,974.78	-₹ 3,097.48	₹ 2,207.38	-₹ 5,304.86
2	₹ 438,750	41.29%	₹ 39,852.91	₹ 498.16	₹ 3,551.25	-₹ 3,053.09
3	₹ 570,375	40.86%	₹ 51,270.19	₹ 3,247.17	₹ 4,566.91	-₹ 1,319.74
4	₹ 741,488	40.43%	₹ 65,951.07	₹ 5,770.72	₹ 5,872.35	-₹ 101.64
5	₹ 963,934	40.00%	₹ 84,826.17	₹ 10,762.32	₹ 6,291.70	₹ 4,470.62
6	₹ 1,203,471	40.00%	₹ 105,905.47	₹ 14,994.01	₹ 7,026.43	₹ 7,967.57
7	₹ 1,440,555	40.00%	₹ 126,768.85	₹ 24,503.10	₹ 6,954.46	₹ 17,548.64
8	₹ 1,650,156	40.00%	₹ 145,213.72	₹ 35,577.36	₹ 6,148.29	₹ 29,429.07
9	₹ 1,805,271	40.00%	₹ 158,863.81	₹ 38,921.63	₹ 4,550.03	₹ 34,371.60
10	₹ 1,881,995	40.00%	₹ 165,615.52	₹ 40,575.80	₹ 2,250.57	₹ 38,325.23
Terminal year	₹ 1,961,979	40.00%	₹ 172,654.18	₹ 42,300.27	₹ 14,981.35	₹ 27,318.93
The Value						
Terminal value			₹ 578,790.83			
PV(Terminal value)			₹ 225,869.40			
PV (CF over next 10 years)			₹ 50,979.90			
Value of operating assets =			₹ 276,849.30			
Adjustment for distress			₹ 13,842.46	Probability of failure =		10.00%
- Debt & Minority Interests			₹ 1,591.72			
+ Cash & Other Non-operating assets			₹ 135,959.70	Includes cash proceeds from IPO of		₹ 90,000
Value of equity			₹ 397,374.81			
- Value of equity options			₹ 73,244.53			
Number of shares			7,946.68			
Value per share			₹ 40.79	Stock was offered at = ₹ 70.00		

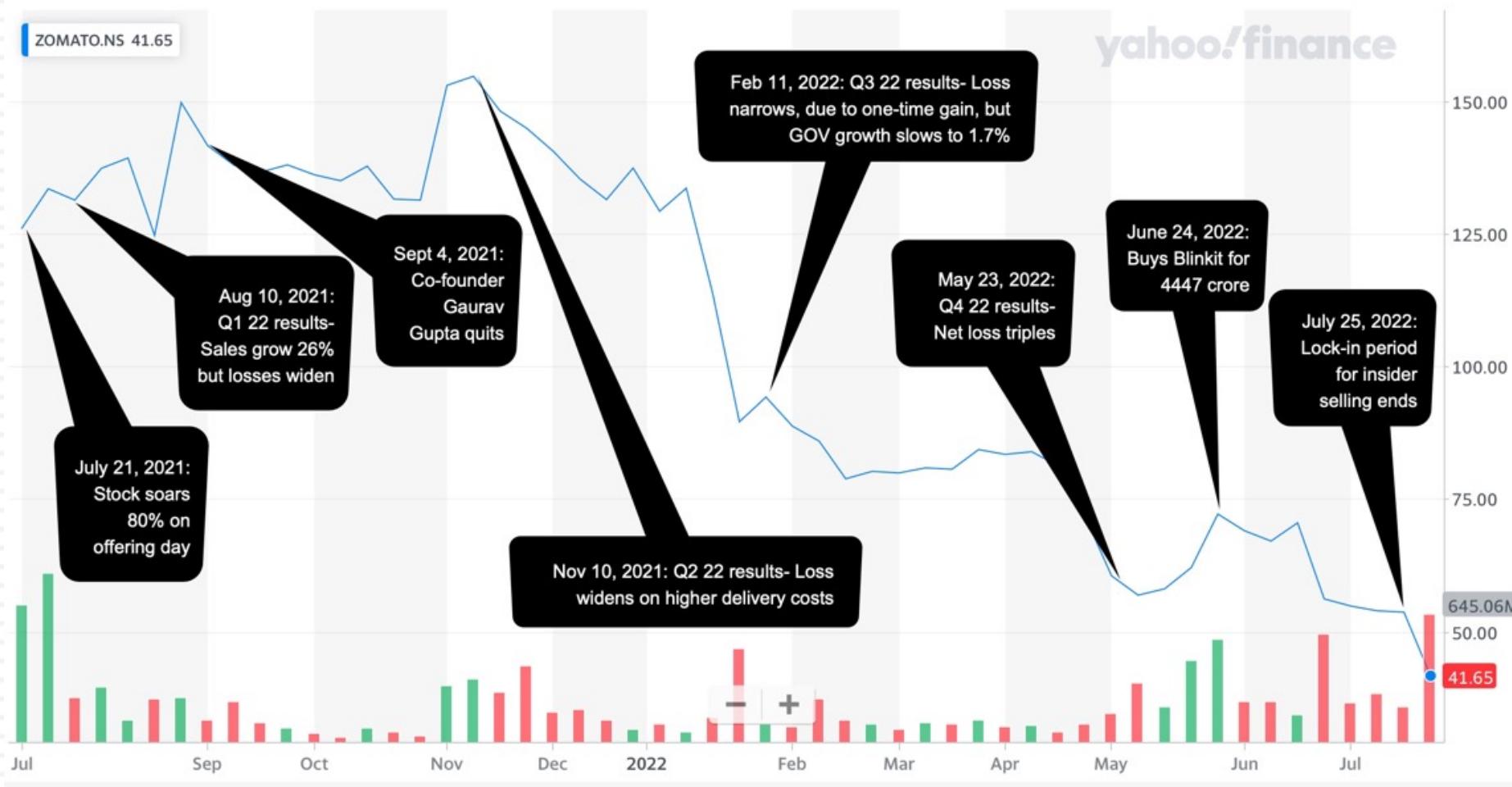
# Pushback, and response...

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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	Plausible
Delivery Star	₹ 5,000,000.00	40%	22%	35%	9.50%	₹ 93.00	
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	Probable
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	
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	Plausible
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	
Restaurant Delivery + Competition + low Growth India	₹ 1,125,000.00	40%	20%	25%	10.99%	₹ 16.58	

# The Zomato Pricing Game

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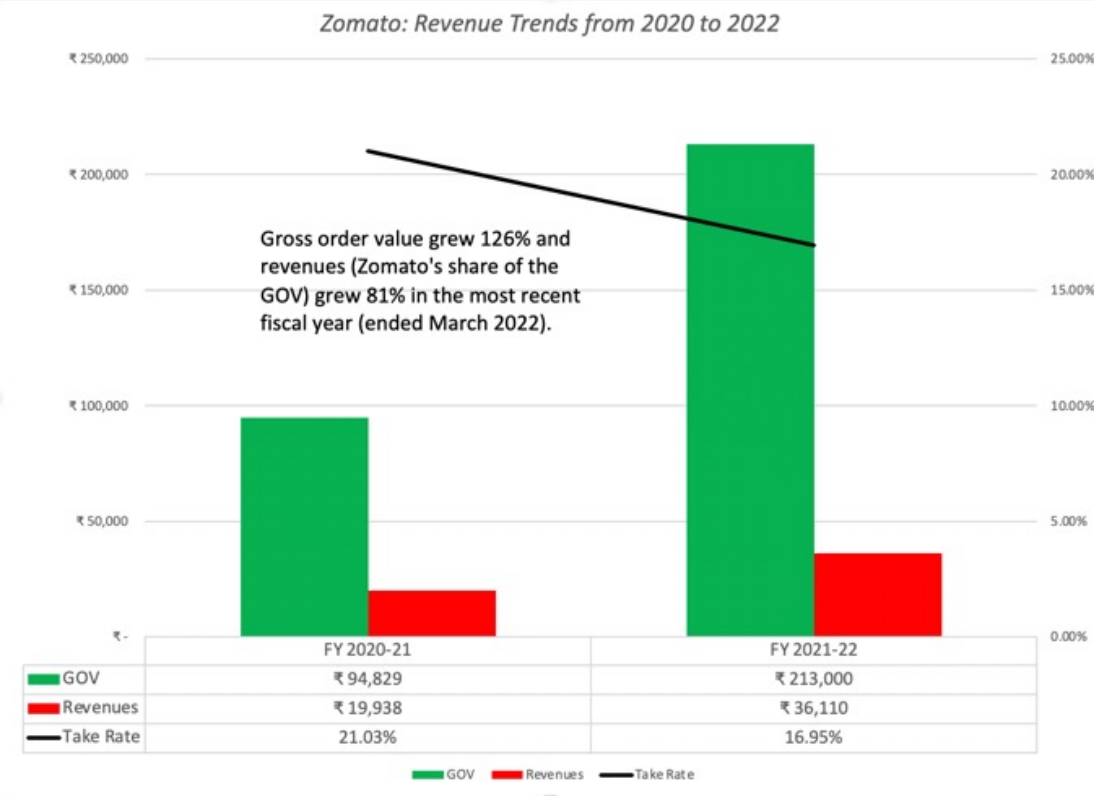
# Vindication or not?

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- Though some have suggested that price dropping to my value is vindication of my valuation, I am not part of that group for three reasons.
  - First, it seems skewed to celebrate only your successes and not your failures, and it behooves me to let you know that I also valued Paytm at close to ₹2000 per share, and the stock is currently trading at ₹713.
  - Second, even if nothing in my valuation has changed, the value per share of ₹41 per share was as of July 2021, and if it is a fair assessment, the expected intrinsic value per share in July 2022 should be roughly 11.5% higher (i.e., grow at the cost of equity), yielding about ₹46 in July 2022.
  - Finally, the company and the market have changed in the year since I last valued it, and to make a fair judgment today, the company will have to be revalued.

# Updating fundamentals: Company good news..

- On the good news front, the food delivery market in India has continued to grow over the last year, and Zomato has been able to maintain its market share. In fact, there are signs that the market is consolidating with Zomato and Swiggy controlling 90% of the market share of restaurant deliveries.





# And more good news: its liquidity/cash buffer has improved..

- In addition, the substantial cash that Zomato raised on its IPO is providing it with a cash and liquidity cushion, with cash and short term investments jumping from ₹15,000 in March 2021 to ₹68746 (including short term investments) in March 2022.
- Since Zomato is a young, money-losing company, and the likelihood of failure acts as a drag on value, this will benefit the company, since it provides not only a cushion for the firm but also eliminates dependence on external capital for the next few years.



# The Bad News

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- On the bad news front, the take rate, i.e., the *slice of gross order value (GOV) that Zomato keeps* has dropped substantially over the last year, reflecting increased competition in the market, higher delivery costs and Zomato's entry into newer markets (like grocery delivery) with lower revenue sharing.
- In addition, *the growth has come in fits and starts*, and given Zomato's active acquisition strategy, it is not clear how much of the revenue growth is organic and how much is acquired.
- In addition, the Indian government put both Swiggy and Zomato on notice that they may be facing anti-trust action in the future, perhaps opening the door to more competition.

# And more bad news: Losses are mounting...

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- While there was a management narrative of economies of scale and improved contribution margins, the end numbers don't back up either contention, with *cost of goods sold rising much faster than revenues* and *operating and net margins both becoming more negative over the last year*. (And no, you cannot add back stock based compensation and come up with an adjusted EBITDA to claim otherwise....)

	FY 2020-21	FY 2021-22	Growth Rate
Revenues	₹ 19,938	₹ 36,110	81.11%
COGS	₹ 9,455	₹ 21,577	128.21%
Operating Profit (Loss)	₹ -6,041	₹ -15,179	
Net Profit	₹ -8,128	₹ -12,087	
Operatign Margin	-30.30%	-42.04%	
Net Margin	-40.77%	-33.47%	

# Still-to-be-decided news...

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- On the still-to-be-decided front, Zomato has *continued on a strategy of acquiring small companies* to advance its growth agenda, and while many of these acquisitions have been small, its most recent conflict-ridden acquisition of Blinkit has raised questions about whether this growth is coming at a reasonable cost. Even if true, the big question is whether an acquisition-driven growth strategy can create value is scalable and value creating.
- In addition, Zomato is also *building a portfolio of equity positions*, which do not show up as part of operating assets, and the founders rationalize this behavior by arguing that these are "the building blocks for a robust quick-commerce business in India, and will accelerate digitisation and growth of the food and restaurant industry which accelerates our core food business " ([from the 2022 Q4 shareholder discussion](#)). Even if we accept this argument for minority holdings, it will add to the complexity in the firm and make investors and traders more wary, especially in periods of uncertainty.

# The Macro Factors

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- Inflation returns: Inflation is back in almost every part of the globe, and has unsettled markets. The effects of inflation show up first as *higher risk free rates*, across currencies, and next in higher risk premiums, with both *equity risk premiums and default spreads rising*. [In a follow-up post a couple of weeks later](#), I looked inflation's effects on individual companies and argued that less-risky companies with pricing power and high gross margins would be less exposed than riskier, money-losing companies.
- Risk Capital flees: In a [post at the start of this month](#), I looked at how the retreat of risk capital, i.e., capital invested in the riskiest assets was playing out in higher equity risk premiums in mature markets, and in a later post a few days later, [even bigger increases in equity risk premiums in emerging markets](#). As a company with the bulk of its business in India, Zomato again is more exposed to these developments.
- Cost of capital up: A higher equity risk premium for India (9.08% in July 2022, compared to 6.85% in July 2021) and a higher riskfree rate in rupees (4.78% in July 2022, compared to 4.25% in July 2021) conspire to push up the cost of capital for Zomato (and other Indian companies) by about 1.5-2% from my IPO valuation.

## Zomato

### A Bet on India (and Indian eating habits)

Zomato is at its core a food delivery company, but with its Blinkit acquisition, it is clearly signaling that it is ambitious about growing its grocery delivery business, representing a large total market but with a much slimmer revenue share than the restaurant food deliver market. The company will continue with its acquisition-driven growth strategy and while economies of scale have been slow to show up, they will over the next few years. The restaurant-supplies business (Hyperpure) and overseas growth (Australia & Middle East) will remain marginal businesses.

### The Assumptions

	Base year	Years 1-5	Years 6-10	After year 10	Story link
Total Market	\$500,000	B3. Strongly higher growth rate in first 5 years		₹ 4,000,000	Food delivery market + Grocery delivery market, in India
Gross Market Share	42.60%	->		30%	Duopoly in restaurant delivery, but more competition in grocery delivery
Revenue Share	16.95%	- >		15.00%	Expansion in grocery delivery comes with lower revenue slice
Operating Margin	-42.04%	->		35.00%	Economies of scale kick in on operating expenses, as company scales up.
Reinvestment	5.00	Sales to capital ratio stays stable		39.83%	Mostly in acquisitions of small technology businesses
Cost of capital	12.50%	->		11.00%	Median Indian company cost of capital, in INR.
Risk of failure	10.00%				Improved liquidity reduces failure risk, but still a cash-burning firm.

### The Cash Flows

	Total Market	Market Share	Revenues	EBIT (1-t)	Reinvestment	FCFF
1	\$ 708,089	41.34%	\$ 49,054	\$ (13,062)	\$ 2,589	\$ (15,651)
2	\$ 1,002,781	40.08%	\$ 66,567	\$ (7,470)	\$ 4,378	\$ (11,848)
3	\$ 1,420,118	38.82%	\$ 90,230	\$ 8,466	\$ 5,916	\$ 2,550
4	\$ 2,011,141	37.56%	\$ 122,159	\$ 22,640	\$ 7,982	\$ 14,657
5	\$ 2,848,135	36.30%	\$ 165,177	\$ 43,359	\$ 10,754	\$ 32,605
6	\$ 3,014,004	35.04%	\$ 166,667	\$ 43,750	\$ 372	\$ 43,378
7	\$ 3,189,533	33.78%	\$ 167,926	\$ 44,081	\$ 315	\$ 43,766
8	\$ 3,375,284	32.52%	\$ 168,934	\$ 44,345	\$ 252	\$ 44,093
9	\$ 3,571,853	31.26%	\$ 169,665	\$ 44,537	\$ 183	\$ 44,354
10	\$ 3,779,869	30.00%	\$ 170,094	\$ 44,650	\$ 107	\$ 44,542
Terminal year	\$ 4,000,000	30.00%	\$ 180,000	\$ 47,250	\$ 18,821	\$ 28,429

### The Value

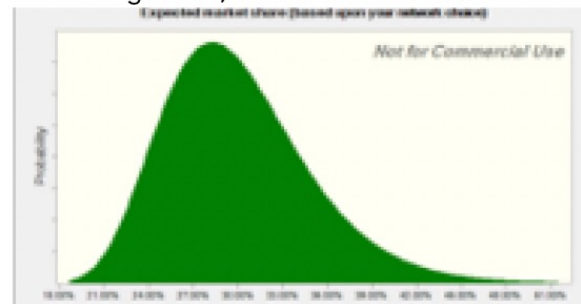
Terminal value	₹ 457,053.86		
PV(Terminal value)	₹ 146,520.87		
PV (CF over next 10 years)	₹ 94,084.86		
Value of operating assets =	₹ 240,605.73		
Probability of failure	10%		
Value in case of failure	₹ 0.00		
Adjusted Value for operating assets	₹ 216,545.15		
+ Cash on hand	₹ 68,786.00		
+ IPO Proceeds	₹ 35,356.00		
- Debt	₹ 704.00		
Value of equity	₹ 319,983.15		
- Value of options	₹ 16,246.58		
/ Number of shares	8502.08		
Value per share	₹ 35.32		

# Dealing with Uncertainty: A Zomato Simulation

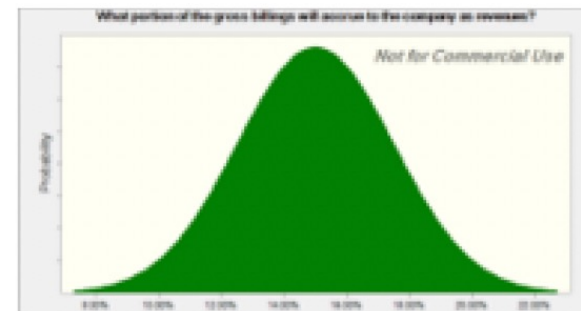
Total Market in 2032 (Range = 3,000,000 - 5,000,000, DISTR = Triangular)



Market Share in 2032 (Mean = 30%, Std Dev = 5%, DISTR = Lognormal)

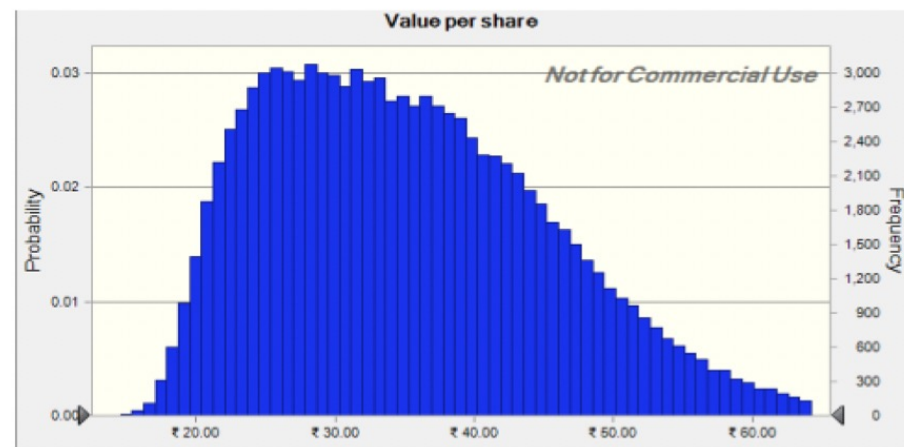


Operating Margin (Mean = 15%, Std Dev = 2.5%, DISTR = Normal)



Correlation = 0.50

Zomato: Valuation in July 2022



Percentile	Value per share
0.0%	₹ 13.78
10.0%	₹ 22.86
20.0%	₹ 25.75
30.0%	₹ 28.50
40.0%	₹ 31.29
50.0%	₹ 34.12
60.0%	₹ 37.11
70.0%	₹ 40.33
80.0%	₹ 44.12
90.0%	₹ 49.43
100.0%	₹ 89.43

# Action Plans: For Investors and Traders!

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- If you are an investor, at its current stock price (₹41.65 on July 26), the stock is still at the 70th percentile. That said a few more weeks like the last two will push the price below my median value, and if it does, I would buy Zomato, as part of a diversified portfolio (and not as a stand alone investment)
- If you are a trader, you are playing a different game entirely, and Zomato's value is not part of that game. You are gauging mood and momentum, which at the moment are extremely negative for the stock, and trying to get ahead of a shift back to the positive. To make that judgment, you will be better served poring over charts, looking at price and volume movements, consulting with an astrologer, or even visiting your favored temple, church or mosque.



# In Conclusion

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- *This is not a conspiracy.* I know that some of you did buy Zomato shares in their glory days in 2021 and are either continuing to hold, hoping for a come back, or have sold, and are licking your wounds. I am sorry for your loss, but please don't attribute to conspiracies (where insiders, founders and backers play the role of villains) what can be better explained by greed, and its capacity to cloud judgment.
- *If you live by momentum, you die by it.* Your consolation prize is that you have lots of company in this market (from Cathie Wood at Ark to the thousands of investors who put their money in Bitcoin, NFTs and other cryptos), and this too shall pass!