4 October 2023

Investment thesis on IndiaMART InterMESH

Summary

IndiaMART has runway to grow Free Cash Flow (FCF)[1] at 15-20% CAGR for long periods of time as it has multiple levers to support longevity of growth and expand margins.

- Its "core", i.e., the listing business has potential to grow revenue at 15%+ CAGR for long periods from both increase in paid supplier base and ARPU[2] over time.
- The management is showing vision and prudence in capital allocation. They are targeting adjacencies in "white spaces" (example Accounting) which are large and growing, which have synergies with the core business, and where they could potentially emerge as #1 or #2 player.

We see scope for margin expansion in the medium and long term.

- Current EBITDA margin of 28% are not representative of true margins as the management is investing aggressively for supplier growth. Over time, EBITDA margins will trend higher from upsell, cross sell, price hikes and operating leverage.
- We believe the core business could be a 40%+ EBITDA margin business in the long term. Naukri's job portal - which is also a winner takes all business- has seen EBITDA margins expand by ~11% over the last decade to ~60% at present.

Over 95% of businesses have FCF significantly lower than PAT as they need to re-invest for growth into Fixed Assets and Working Capital. IndiaMART is a rare exception where FCF > PAT as they are negative Working Capital and Fixed Asset light. Surplus capital is returned to shareholders via dividends and buy backs. This enables IndiaMART to enjoy an infinite ROIC, which is very rare.

IndiaMART has opportunity to generate asymmetric returns over this decade. Its prospects for growth, longevity, and dominance in a winner takes all domain justifies a ~31x TTM core FCF[3] multiple.

In this note we cover

1. A brief outline of what IndiaMART does and its evolution so far.
2. Competitive edge.
3. Expected evolution over time.
4. Our approach to valuing IndiaMART.
5. Our variance perception on key concerns we have heard from peers.

Important Disclosure

- We disclose position names for transparency and context.
- We reserve the right to change our minds and may not be able to inform you if we do.
- Please read detailed disclosure at the end of this document

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1 When we calculate FCF, we include float income on Deferred Revenue as we believe this income should be considered as core business income.

2 Average Revenue per User

3 At current market price, Market Cap is ~17400crs. We estimate core Market Cap excluding surplus cash and investments in adjacencies to be ~15,700crs and FCF (including float income on Deferred Revenues) Q2FY24e TTM to be ~500crs.

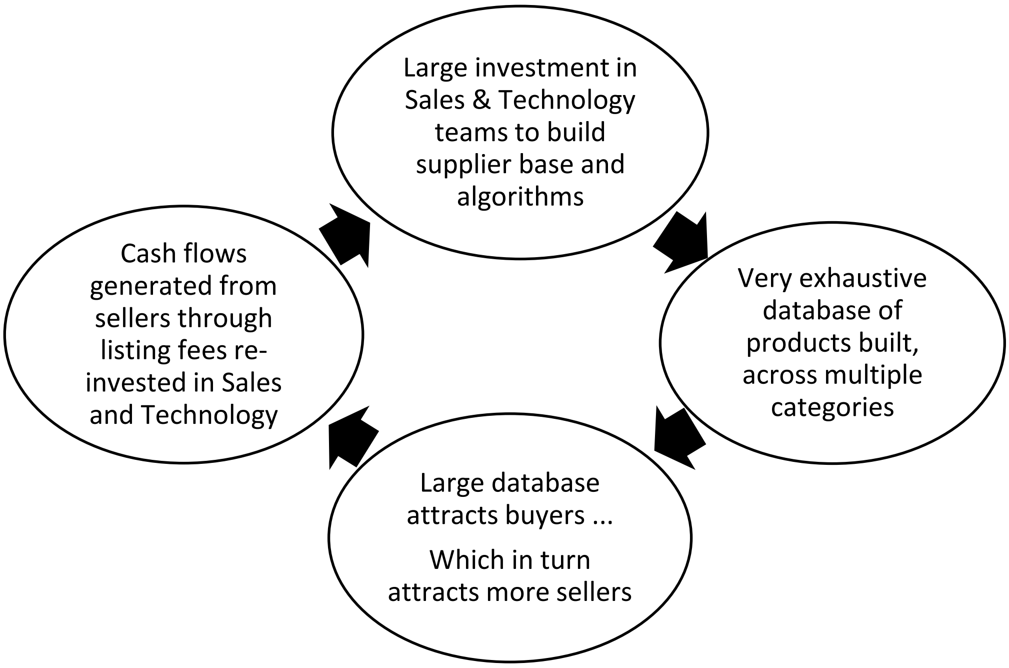
What does IndiaMART do?
IndiaMART was started in 1996 by Dinesh and Brijesh Agarwal as an online exporter's directory. Over time, it has evolved into the leading B2B listing platform in India that allows buyers to discover suppliers of products and services in India. It operates with a "freemium" model. The platform is free for buyers to post their lead requirements whereas suppliers are allowed to list for free but can pay to get more visibility and access to buyer leads.

The platform is monetized via a subscription model which encourages repeat usage.

- IndiaMART offers tier-based packages - Silver (Monthly/annual) at entry level, and Gold & Platinum which are premium packages (Annual and multi-year).
- The approach is to keep pricing low for the Silver package to encourage paying suppliers to join the platform (encourage trial) and upsell them higher value packages over time.

IndiaMART is currently incubating business lines that are adjacencies to its core business (Accounting software, Logistics enablement etc), that are needed by its core SME customer base.

IndiaMART has built a strong competitive moat.
IndiaMART enjoys a strong first mover advantage in its domain. While there is no like to like competitor, JD Mart (Just Dial), TradeIndia and ExportersIndia have similar business models, IndiaMART is the dominant player. Powerful network effects result in the dominant platform getting stronger over time from a virtuous cycle and earns disproportionate share of the industry profit pool.



IndiaMART's product database has been built over the last two decades. It has deep depth of product/supplier information across a wide breadth of categories (~98million listed products across 96K categories), which has attracted large number of sellers and buyers without advertising (~76 lac suppliers on platform and ~88mn unique business inquiries FY23). Thus, it will be very challenging for a new entrant to displace its position or replicate what it has built.

IndiaMART has shown good progress on key business metrics.

Particulars (In Mn unless stated)	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23	FY16-23 CAGR
Total products listed	NA	NA	50	61	67	72	83	95	14%
Supplier store fronts	2.3	3.2	4.7	5.5	6	6.5	7.1	7.5	18%
No of paid suppliers (000)	72	96	108	130	147	152	169	203	16%
ARPU (000)	32.9	32.1	37.2	38.4	42.3	43.6	44.3	46.3	5%
Buyer traffic	262	326	553	723	748	960	1071	1021	21%
Unique business inquires	23	31	53	73	74	96	97	88	21%
Repeat buyers	NA	NA	52%	55%	55%	55%	54%	54%	

Source: Investor presentation. FY18-23 CAGR for total products listed.

The strong value proposition for its key customers (Gold/Platinum suppliers) is reflected in low churn rates for those categories.

Paying supplier churn by category	FY22	FY23
Platinum	10%	8%
Gold	12%	10%
Silver	45%	40%
Overall	33%	29%

*Source Kotak IC

The edge is reflected in strong financial performance. IndiaMART enjoys infinite return on capital and generates significant Free Cash Flow (~500crs FCF in Q2FY24e TTM).

Particulars	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23	FY16-23 CAGR
Sales (In Rs crores)	238	309	404	497	624	665	751	939	22%
GPM (%)	NA	NA	67%	68%	72%	82%	79%	75%	
EBITDAM (%)	-26%	-8%	-50%	2%	28%	49%	41%	28%	
Net working capital days	N/A	-402	-422	-464	-425	-425	-466	-468	
FCF (In Rs crores)	34	65	201	270	289	357	431	488	

Source: Investor presentation, Ace Equity

IndiaMART has made significant investments in adjacencies.

IndiaMART raised 1070Cr via a QIP in 2021 which has been invested in strategic stakes in companies in adjacent categories like Accounting software, Inventory Management, Logistic Solutions etc. These are services which every SME needs, and IndiaMART could become the #1 or #2 player over time.

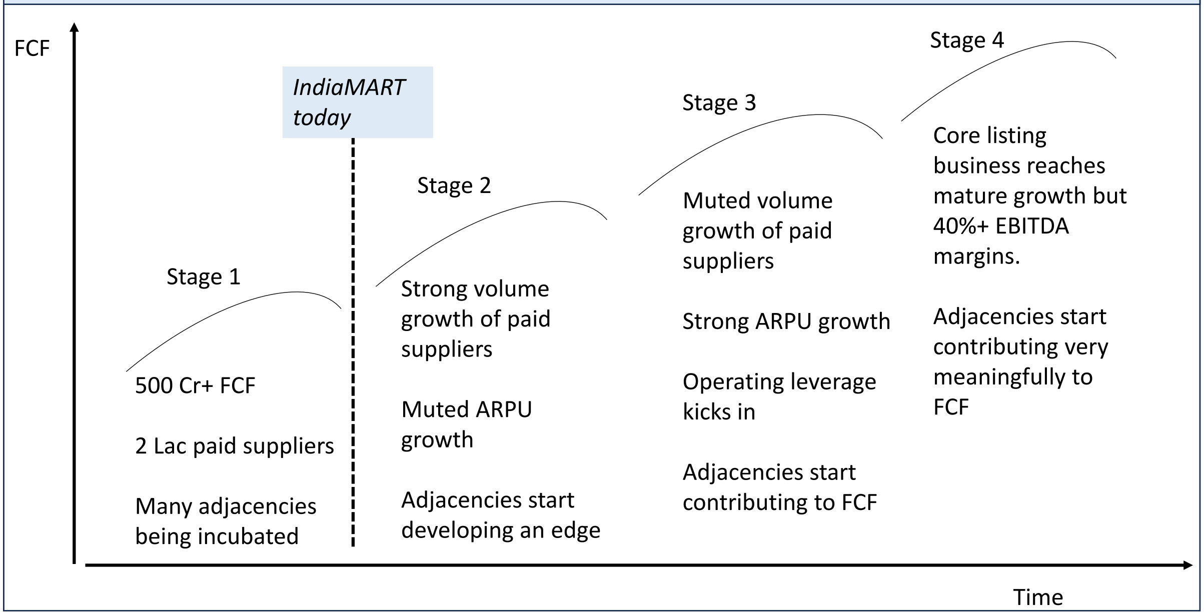
Some of the larger investments made so far.

Adjacencies	Investments	What does business do?	Amt invested Rs Cr
Accounting	Busy Infotech	On premise accounting software for SMEs	500
	Vyapar	DIY mobile first business accounting software for micro & small businesses	97
	Livekeeping	Tally on web and mobile	46
E – commerce	IB Monotaro	Industrial B2B e-commerce marketplace	104
Logistics	Fleetx	Freight and fleet management software	91

Distributions and sales force management	Bizom	Distribution and salesforce automation	45
Discounting and factoring	M1 Exchange	Invoice discounting solutions	32

We think IndiaMART can possibly grow FCF at 15-20% CAGR for over a decade as different levers kick in to support growth. We see IndiaMARTs future evolution in 3 stages.

IndiaMART can grow FCF at 15-20%+ for long periods of time.



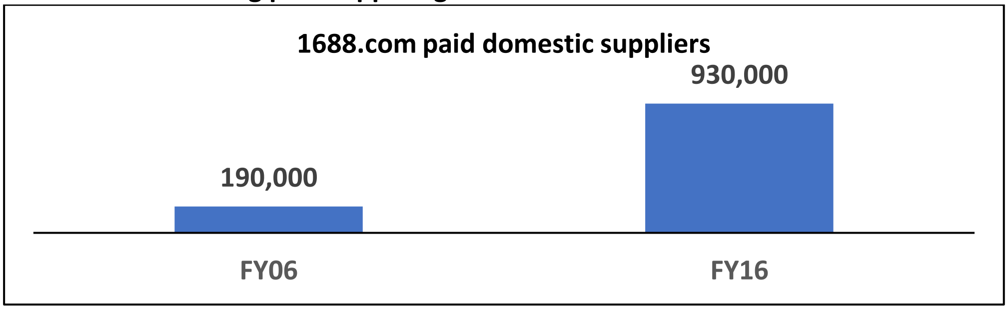
Stage 2: High volume growth, muted ARPU growth, incubation of existing and new adjacencies.

Large market opportunity exists in its core business to support volume growth.
In this stage, we expect strong paid supplier growth from existing ~2 Lac paid suppliers as many SMEs are still to be tapped.

- 120 Lac SME GST registrations in India[4].
- 20 lacs paid users of Tally software[5].
- While no business model across countries is an exact like to like, they provide some insights on growth possibilities. 1688.com, a similar business model in China owned by Alibaba, has ~10 Lac paying customers. IndiaMART at present has roughly the same number of suppliers 1688.com had in 2006.

[4] Kotak Institutional Equities.
[5] Moneycontrol.com

1688.com saw strong paid supplier growth over 2006-16.



Source: JM Financial report.

However, ARPU increase will be kept low to encourage new supplier additions/trials. This also strengthens the network effect as supplier base increases. Customers added at base Silver category over time will be upsold to Gold/Platinum (Historically ~20% of customers on average upgrade p.a.) which will drive ARPU growth.

There will be some margin expansion from fixed cost leverage, but margins will remain below true potential as IndiaMART continues to invest behind growth (employee headcount has increased by ~25% YoY in FY23).

IndiaMART's adjacent businesses will continue to be incubated. Its core business generates lot of Free Cash (~500crs FCF Q2FY24eTTM). Promoters are utilising this to make strategic investments in companies operating in natural adjacencies to their core business. Many of these adjacencies are "white spaces" where India MART can emerge as the #1 or #2 player over time. These companies can strengthen competitive positions without pressure to generate profits quickly as the core business is very profitable.

Stage 3: Low volume growth but higher pricing growth, improved quality of customer base.
In this stage we expect paid supplier growth to slow down as industry penetration starts saturating. However, revenue growth will be driven by higher ARPUs as IndiaMART starts using other levers (price hikes/differential pricing/ value add service like data analytics etc).

- 1688.com in China has evolved in a similar manner, where a slowdown in paid supplier growth in mature stage was compensated by higher ARPUs.
- Better pricing, lower reinvestments in the sales engine will translate into further EBITDA margin expansion.

Once 1688.com paid supplier growth slowed down, it saw strong ARPU growth from price hikes & more value-add services.

1688.com	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY16-22 CAGR
Revenues ($Millions)	664	825	1137	1491	1753	2180	2433	24%
Paid customers Mn	0.93	0.96	0.89	0.91	0.90	0.99	0.99	1%
ARPU (In $)	714	859	1282	1638	1948	2202	2457	23%

IndiaMART enjoys higher ARPUs with its top customers. Margins will improve over time as share of Gold/Platinum customers increase.

Particulars (In 000)	FY18	FY19	FY20	FY21	FY22	FY23	CAGR FY18-23
ARPU top 1% customers	508	501	588	608	690	790	9%
ARPU top 10% customers	150	155	174	181	194	214	7%
Average ARPU	37	38	42	44	44	46	4%

Stage 4: As listings reach mature stage of life cycle, adjacencies could become very material.
We believe this stage is long time away as 1688.com continues to grow at a healthy pace even today. However, 10-15 years later, the adjacencies could become very material.

Accounting could be a very large opportunity.
Accounting software is a key focus area for IndiaMART, with ~650crs cumulative investment made in this segment till date. Customer stickiness is very high in accounting which results in high lifetime value.

- Accounting is a ~5000crs[6] industry growing at double digits as compliance requirements have become stringent post GST. Over time, we expect piracy to reduce and pricing to improve.
- IndiaMART is participating across many Accounting software solutions (micro to large enterprises, on premise and cloud) via four investments in this space.
- "Busy", IndiaMART's largest acquisition (~500crs invested) shows promise.
    - Busy is a top 3 Accounting software player. It is predominantly North India focussed and only sold on premise software.
    - The company was capital constrained under old promoter. However, with IndiaMART as promoters, Busy should see more investments in products and sales.
    - There is also the ability to cross sell to IndiaMART customers over time.
- "Vyapar" has shown good progress. It had 15000 customers when IndiaMART invested which has grown to 1 lac+ customers[7].

Opportunity exists for "adjacencies" to grow at 20%+ CAGR for long periods of time. Margins in medium term in these businesses will be subdued as the company is in investment phase. Over time, margins will improve as businesses reach scale. Their true intrinsic value will only be revealed with time.

We find IndiaMART reasonably valued at current prices.
While we don't believe in making precise forecasts, we believe IndiaMARTs core listing business can grow topline at 15%+ CAGR and FCF at 15-20% CAGR for long periods of time. The business enjoys high FCF due to infinite ROIC (no Capital expenditure, negative Working Capital business model). High growth with high FCF deserves premium valuations.

While on reported PE basis, IndiaMART looks expensive at ~76x core PE Q2FY24e TTM, this is misleading as reported PAT needs adjustments.

- Revenue for long duration packages is recognized over the life of the package (could be upto 3 years) whereas selling expenses are recognized upfront in Year 1.
- Long term packages sell at discounts vs monthly/yearly packages. This discount is also taken upfront in Year 1.

[6] Busy IP.
[7] Source: Q2 FY22 IndiaMART concall.

- Management is investing aggressively in Sales at present and hence true margins are understated.
- One should add float income from Deferred Revenue as part of core Operating profits.

What matters is Free Cash Flow and not reported profits. Most companies generate significantly lower FCF vs PAT as they need to re-invest cash in Fixed Assets and Working Capital for growth. IndiaMART is a rare business where FCF is significantly greater than PAT. In an environment where value is hard to find, ~31x core FCF Q2FY24e TTM is a very reasonable price given long growth runway in core business, option value of adjacencies, winner takes all business with infinite ROIC, and a disciplined management team with good track record of capital allocation.

IndiaMART is a phase 3 company in our framework where we can go upto 8% position weight.

	Phase 1	**Phase 2**	**Phase 3**	**Phase 4**
Category	Special Situation	Emerging Leader	Almost Clear Leader	Clear Leader
Rationale for inclusion in portfolio	Very cheap. But not compounding stories at present	Potential to become compounders. But still need to demonstrate the ability to execute at scale.	Strong business model and moat visible.	Strong moat and clear competitive edge. Growth fly wheel is spinning
Position size per company	~3%	~3-5%	~6-8%	~8%+

Solidarity variance perception on key concerns we have heard from peers.

The online B2B space is getting more competitive.
While there are multiple players in the online B2B space, peers are solving for different customer problems. IndiaMART is unique in its customer value proposition.

We are aligned with IndiaMART's approach of not offering solutions like Credit which other B2B players are offering. We believe companies should focus on a core and expand only into adjacencies where they have a right to win. Categories like logistics, manufacturing services etc already have well established players who offer pan India solutions cost competitively. In the past IndiaMART had experimented in some of these segments via Tolexo however the business was quickly shutdown as they didn't see path to profitability. Growth in unrelated areas may generate additional revenue and some profits but is unlikely to contribute much to value creation unless it is accompanied by 15%+ ROE which only comes from a clear edge and right to win.

Players	**Core business**
IndiaMART	Horizontal listing & discovery platform
Udaan	Listing, logistics and credit to small businesses in fast moving verticals
Moglix	Industrial & MRO listing and raw material procurement platform
Infra Market	End to end presence in construction materials (Mfg, logistics, brand, retail)
Zetwerk	Contract manufacturing marketplace
Ofbusiness	Cash flow-based financing for buying raw materials

*Source: Company website, Ambit IC report.

IndiaMART is vulnerable to disruption like Just Dial.
All businesses are vulnerable to disruption. However, we should not distress ourselves with imaginings when no obvious disruptor is visible at present.

Just Dial saw its listings business get disrupted as Google replaced it for local business information and customers moved to vertical specialists like MakeMyTrip, Zomato & Bookmyshow etc. Just Dial only provided contact details of largely service providers which was easy to substitute. IndiaMART provides highly detailed specifications (photos/videos/technical specs/ratings) of over 98mn products, built painstakingly over last two decades.

Given its horizontal approach, the IndiaMART platform today has many buyers & sellers which gives it a strong network effect. It has become a category generic and therefore don't need to advertise to attract buyers. It is also investing to improve customer stickiness, for example using matchmaking algorithms to improve lead conversion ratio. All of these will make it harder for a new player to replicate and disrupt their offering.

Concerns on user experience (spam calls, counterfeit goods, irrelevant leads etc.)
We acknowledge there are product gaps that exist today. However, one must appreciate that every organisation learns and evolves, and issues must be seen in context of industry dynamics. For example, even Amazon faces issue of counterfeit goods sold on its platform.

What is key is management consistently improving the platform and customers recognizing the value it creates for them (low churn). IndiaMART ticks both boxes as it has added features over time to improve the platform (lead mgmt. tool, matchmaking algorithm etc) and the value it is creating for key customers reflects in high renewal rates (< 10% paying supplier churn p.a.) for its top 10% customers who contribute ~50% of sales and a much higher share of profits. A survey done by Kotak Institutional Equities revealed that "…Nearly 87% of paying sellers have been associated with IndiaMART for more than two years and 90% of them want to continue with IndiaMART subscriptions."

Buyer traffic in recent quarters has stopped growing.
Every business has cycles, with some businesses having shallower cycles than others. While buyer traffic in recent quarters has been flat YoY, FY2021 and FY2022 had strong Covid led buyer demand for Pharma and Healthcare products which was a one-off boost. The B2B online penetration in India is significantly under penetrated and we expect buyer traffic to pick up over time. If the need arises, IndiaMART has the cash flows to invest in advertising to boost buyer traffic. Hence, as long-term investors, this would not be a concern in context of current valuations and long-term growth prospects.

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