High Cash Burn in a Price Conscious Economy with Low Switching Costs

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Through this paper, we have discussed the present Indian start-up ecosystem. Start-up these days are burning cash on a huge scale to attract and retain customers. While they do so to maximize their profit and attain monopoly in the market, they tend to burden themselves with negative cash flow. Our intention is to prove that such companies cannot achieve the desirable market share through price wars. We have used Cournot's principle and a primary survey to explain our point.

Keywords: Cash Burn, Startup Ecosystem, Switching Cost, Price Wars, Price Conscious Economy, Aggregator, Cournot's Principle, Brand Loyalty, Discounts, Monopoly, Switchers, Rational Consumer, Profit Maximization

1. Introduction

The start-up scenario in India is in its pinnacle. There are more funds available in the market for start-ups than it was ever before. However, if we look into the earnings of most of the Unicorns of India, we find that they have been incurring losses for the past few years.

This losses are mostly because of the cash burned for consumer acquisition and consumer retention. It is assumed that the cost of acquiring a customer is minimum ₹ 2000. With an average ticket value of ₹ 200, these figures don't seem so promising for start-ups. To add on to the load, there is a price to retain customers and also in form of huge discounts and offers. The problem is that most players in the market provide similar discounts at the same time and therefore the switching costs for consumers is very low. This phenomenon is specially observed in case of start-ups following aggregator based models.

Such start-up ecosystem leads to customers who aren't loyal to any brand, also known as 'switchers'. Switchers are an indicator of fragile brand loyalty. Therefore, the essence of cash burned for customer acquisition and customer retention isn't realized. Even though evident, companies are still burning ample cash with an assumption that this will lead to extinction of competition and create a permanent customer base. At the same time, this increases the entry barrier for new enterprises in the market.

So, unless the switching cost of the customer isn't high enough, the Customer Life Time Value (CLTV) has a negative impact. For profitable business, it is always advisable to have the CLTV higher than the Customer acquisition costs but due to the competition, we see price-shoppers who are only loyal to the lowest price and not to the brands. Therefore, the start-ups find themselves in a vicious cycle where they are bound to keep running the discounts and thus the net cash burn keeps increasing, decreasing the CLTV. In addition to this, aggregator services often find themselves in a dichotomy between their customers, both sellers and consumers. Pleasing either of them leads to an additional burden on the other. This greatly impacts the decision making capacity of the aggregator service. The intended results of cash burn is therefore never realized - the expected market share though cash burn is not possible.

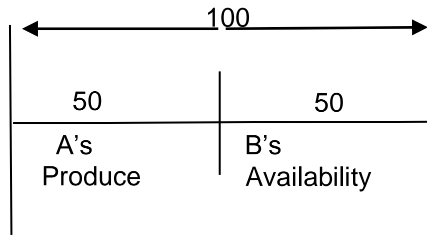
2. Limitation of the Study

This research along with the survey is primarily based on the Indian market. While the economic concepts are applicable on any monopolistic market, the lack of data from other markets makes this paper more relevant to Indian start-up ecosystem.

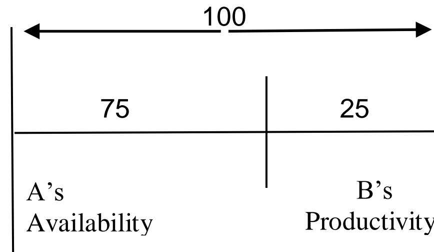
3. Main Argument

To elaborate on the above concepts, we use the economic principles by Cournot's backed by a primary survey. Let us assume there exists two companies A and B, aggregators delivering food from nearby restaurants and food joints. Given that it is an aggregator based service, they work on a commission basis and therefore are in perfect shape to fight each other. **We intent to prove that profit wars will never get more than normal profits although,** advertisement is a factor that can get above normal profits.

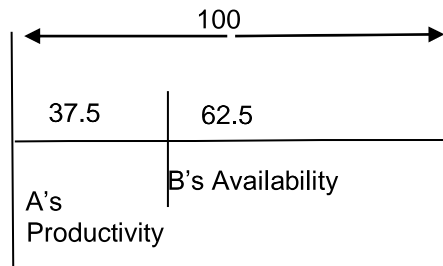
Initial Situation: Both companies do not change their outputs and are happily enjoying their market share.(This will not happen in the real world)



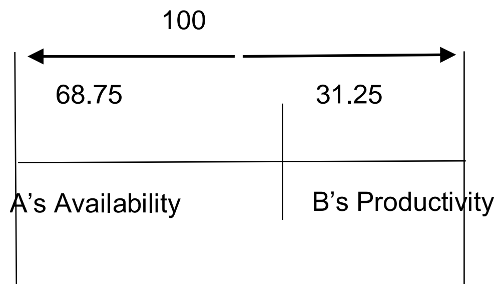
Let us assume that A changes its outcome and B will not change it. In the assumption, A captures B's market by half. And therefore, increases its shares by $\frac{1}{2}\left(1-\frac{1}{2}\right)=\frac{1}{4}$



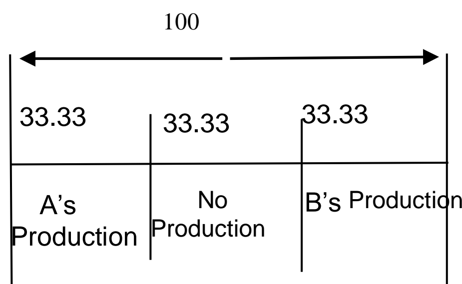
B, now responds to A's capture by releasing promotions. It now captures half of A's produce and therefore reduces A's produce to: $1/2\,(1-1/4)=3/8$.



A again responds to B's tactics with its promotions and brings B's production to $\frac{1}{2}\left(1-\frac{3}{8}\right)=\frac{5}{16}$



This war follows a geometric pattern which in the end is



Here, we notice that both A and B produce 33.33 percent share of the market and remaining one third is uncaptured. We can take such price war to $n$number of players, the reduced formula shall be $1/(n+1)$ for a firm's share in the market and $n/(n+1)$for an industry's share in the market. In anycase, $1/(n+1)t$□ market share remains untouched.

This goes on to suggest that either firms loose on its market shares in this price war. Also, with low entry barriers, there is always a competition coming in and therefore, firms will not be able to charge more either.

To add on to our point, we seek the help of the ten principles coined by the famous economists Gregory Mankiw. In his 4th Principle he says “People respond to incentives”. By this, he means to say that incentives induce rational customer to act. In a competitive scenario, with n number of players, there is always someone giving discounts. In fact, the entire cash burn economy has made it impossible to acquire new customer unless the company burns cash to incentivize customers to use its service. We conducted a primary survey to understand how important it is to burn cash in order to acquire and retain customers in the 21st century market. Also, through this survey we could analyze the extent cash sensitivity of the market.

In the survey, we asked questions relevant to the present Indian market startup scenario where an individual enjoys choices between a lot of companies. We narrowed our survey to the food aggregator industry because of its recurring demand.

Survey Results

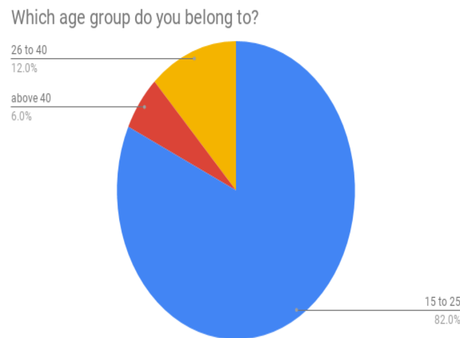


Figure 1

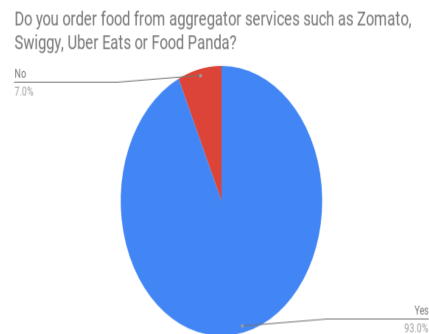


Figure 2

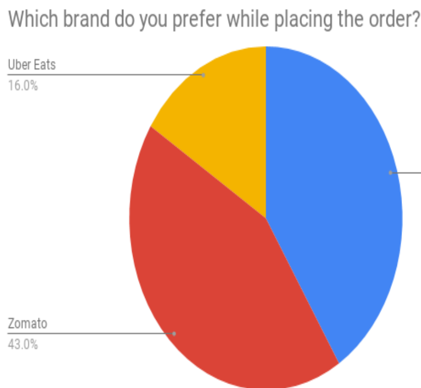


Figure 3

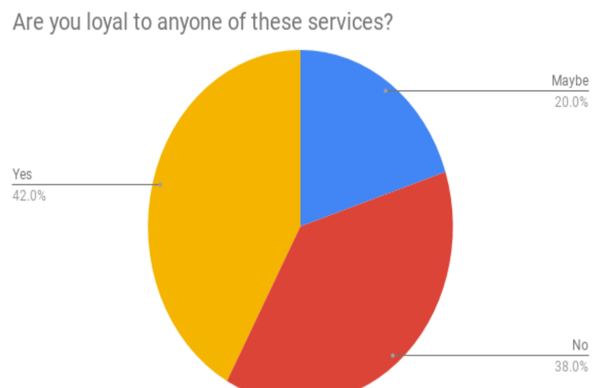


Figure 4

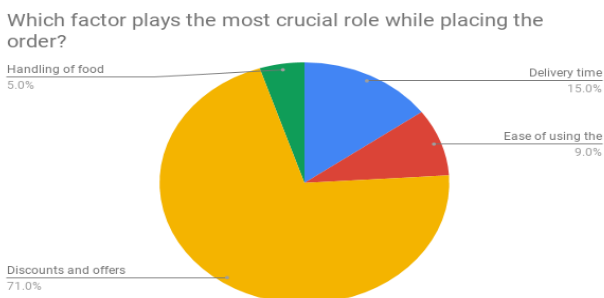


Figure 5

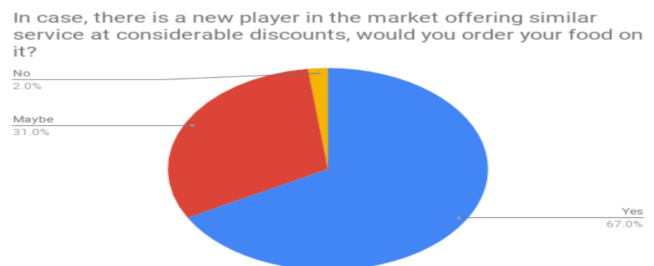


Figure 6

Major findings from the survey are as follows:

1. People respond to incentives: Majority (71%) of the sample choose discounts and offers as their decision making criteria while ordering food.

2. As predicted, their are very low switching cost in a price conscious economy. Majority (67%) of the sample would even consider opting a new service over old trusted brand if there were discounts offered.
3. Price war has made people habituated to discounts. Their loyalty is questionable: even though 42 % of people said they were loyal to a brand, major chunk of the acclaimed loyal customer would still choose a new - untested player in market if it was offering discounts.
4. Despite big time cash burned for customer retention, none of the big companies have been able to capture the majority of the market. This goes in line with Cournot's principle, where no player in a price war is able to achieve a majority and $1/(1+n)t$ market share is always uncaptured.
5. Since, the major (82%) part of the sample is between 15 to 25 years in age, we can safely say that the switching mindset will be prominent even in the near future.
6. Swiggy and Zomato: The old brands which also happen to have burned the highest cash still share similar market shares. The price war was incapable in giving either a market share. Uber eats is fairly new in the market and still possess 16% of the market share.
7. A rational consumer is a switcher.

4. Conclusions

Through this research, we figure out that price war in a price conscious economy leads to neither profit maximization nor monopoly. InfactCournot's principles helps us to understand that the market in case of a price war can never be entirely covered. $1/(1+n)t$ part of the market is always left uncatered.

Through our survey, we also discovered that the switching costs in Indian market is fairly low and therefore companies burning cash to attract consumer are trapped in a never ending cycle of “discounts and offers”. We suggest companies under an industry to mutually end price wars. Please understand that we in no manner discourage cost leadership - we mean to say that the serviced market share of a company is always less than the total market share achievable.

5. Suggestion from the Authors

Cash burn is not bad, provided it meets the desired goals of achieving customer loyalty and eradicating competition. However, this is not always the case. We highly suggest start-ups to evaluate themselves on a competitive advantage framework. For this, we recommend the VRINE Model. Using the VRINE model, we expect the start-ups to introspect and it is completely up-to them whether to proceed with cash burn or not.

In the VRINE Model, the alphabets stands for:

V for Valuable

- Is the product offered by the start-up a specific solution for a specific problem?
- How valuable is the product for the customer?

R for Rare

- Is the solution provided by the start-up rare?
- Is there anyone else working on similar idea?
- Do you possess rare resources to fuel the growth?

I for Inimitable

- Is the product easily imitable?
- Do you have a copyright or patent to protect their product?
- How strong is the USP of their product?

N for Non-Substitutable

- Is your product substitutable?
- What are the switching cost involved?
- Is imitating your product easy?

E for Exploitable

- Is the product reachable to the mass?
- How easy is it for you to bring traction in your sales?

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