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The Mirage of Innovation: Assessing the Impact of Overvalued Startups on Competition and Economic Health

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ABSTRACT

The ease of access to VC funding has led to the proliferation of overvalued startups with unsustainable business models. Consequently, this literature review will conduct a critical evaluation of the key impacts of such startups on Competition and Economic Health while investigating whether these are idiosyncratic or systemic risks of such a system using surveys and statistics published. The paper will finally conclude with a personal recommendation for a possible solution to be researched into that could alleviate the impact of such wide-spread phenomena.

Keywords: Blitzscaling; Overvalued; Startups; Unsustainable; Venture Capital

Introduction

The broad sentiment across the population is that investors will see through overvalued startups with unsustainable business models, their eyes sharpened with enough experience to cut through the flowery future sold by founders and not get caught up in "What could be?" These cases are portrayed as rare "bad apples," perhaps even beneficial inevitabilities fundamental to a rational economic system. Regardless, these instances occur far too often to not hint at deeper undercurrents, thereby warranting a critical analysis of their effects on competition and, more importantly, on the broader economy.

Why are Startups Overvalued?

To understand how loss-making startups can even be valued so highly, we must first realise the valuers' intentions. Venture capitalists and early-stage private equity funds do not earn returns from a share of profits but from selling their stake. They typically invest in the initial funding rounds and leave by the IPO, seldom holding their investments beyond this point (Schwienbacher, 2008, p. 1891) (Vernon, 2022). This means that VCs are attracted not to

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profitability but to the potential for substantial returns, as evidenced by the fact that only 15% of unicorns are profitable on average (Jain, 2023). Therefore, valuations rely on opinions of scalability and the entrepreneur's qualitative factors as seen by a survey of 835 institutional VCs from 681 firms, where "20% of all VCs and 31% of early-stage VCs reported that they do not forecast cash flows when they make an investment" (Gompers et. al, 2020, p. 176) despite cash flow being a core valuation tool. This is because the reliability of net present value and internal rate of return calculations are insufficient without the predictability that established firms bring.

This lack of data provides room for ambiguous opinions, and one can anecdotally surmise as much through observing the variability of assessment in VC/Angel Investor TV shows like Shark Tank. This difference in opinions may cause one's overvalued to be another's undervalued startup. This can also be explained via the greater fool theory, where individuals knowingly purchase stakes in overvalued businesses owing to the belief that someone else will buy the stake at a higher price. This perpetuates a cycle that typically exploits ignorant retail investors at the IPO stage (Lin, 2011, p. 70). These factors are the primary underlying reasons behind overvaluations in the private startup market, where scarcity of data makes valuation interpretation ambiguous and vulnerable to the promises of an unsustainable strategy. After all, as the joke among investors goes, "How much can you really value two engineers, a PowerPoint, and a dog?"

The nature of VC fund management revolves around selling their stake at the highest price in the shortest amount of time. Consequently, to achieve the audacious valuations required to deliver the promised return to their own investors, VCs incentivise aggressive growth strategies that make the businesses appear more viable and valuable to potential buyers. Achieving this scale means a company has penetrated the market, secured a dominant position, and gained customer loyalty (Cooiman, 2022, p. 587). A far more appealing startup to buy into for profit-making compared to the tumultuous early-stage where VCs would have entered.

Impact on Competition

This phenomenon of aggressive growth by startups can be explained by blitzscaling, where startups seek to maximise their first-mover advantage upon disruption by scaling before competitors can catch on and emulate.

An integral part of this strategy is aggressive marketing, typically prescribed to use approximately 20-50% of VC funds as reported by Bradley (2022), which results in the actual business model not individually interacting with the free market mechanisms of consumer reality. Although this is claimed to be aimed at educating the market, this rapid pace often

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renders competitors obsolete. This problem is exemplified when disruptors undercut existing competition through penetration pricing and other unsustainable models.

Nevertheless, these outlandish models disrupt rentier capitalism, forcing firms to innovate rather than exploit existing revenue streams, thereby encouraging competition and stimulating innovation (Mueller, 2017).

However, by witnessing their meteoric, albeit unprofitable, rise, VCs often begin to seed inflated short-term expectations as they each search for the next big thing, the next unicorn. This occurrence makes it significantly harder for sustainable, albeit less groundbreaking, startups to secure funding (Zeng 2023, p. 2751). Even for those that do, VCs, driven by "FOMO," start recklessly weaselling in plans of blitzscaling (a relatively recent concept, pioneered by The Big Five) or other new trends to emulate those successes, thereby upending otherwise sound business models, as broadly referred to by Broughman & Matthew (2023, pp. 1299-1300). Yet, it is countered that even though this is a recurring theme, one might argue that it is a question of VC-founder fit. However, such considerations and care in choosing investors are difficult to expect from founders when funding itself is hard to access - even for businesses that later end up overvalued.

Societal Impact & Economic Health

The extrinsic influences of startups on competition are well-documented, but there is little research of those behind the scenes enabling overvalued startups to grow rapidly. Firstly, regarding the employees: while the comparison of pay scales between established corporations and startups is nuanced, unskilled employees for B2C startups receive disproportionately higher salaries next to comparable jobs with those skills. A prime example is the food delivery industry, where the lack of entry barriers has led to thousands of youths signing up. What's not included in the contract are the long hours, variable pay, and pressing deadlines that often lead to employee burnout while the business itself is in the burn stage (Katrodia, 2020, p. 708). Moreover, while this provision of mass employment is commendable, it diverts youth from the enduring value of education in favour of immediate monetary rewards. This lack of education quickly snowballs as it fails to utilise the employees' potential and the more value-adding goods and services they would otherwise produce for society at large in the future.

Secondly, regarding the customers: it might seem straightforward to assume that these startups negatively affect established businesses through their unsustainable strategies. However, these cases are the exception while the rule is that these startups galvanise innovation and break monopolistic practices with those very strategies, even if only for their short lifetime (Arend, 1999, p. 31). Their disruption will elicit a new way of thinking until another startup eventually

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emerges, making a few changes for a sustainable business model. These factors undeniably add dynamism and consequently new products that enhance our quality of life.

However, the strategies used to keep the unsustainable model functioning can sometimes turn unethical as founders attempt to deliver outsized returns, especially in the key factor of blitzscaling - marketing. This often occurs in startups when a significant lifestyle change is requested, requiring greater persuasion (Morris & Kuratko, 2020, pp. 87-88). A case in point is the ed-tech start-up Byju's that resorted to shady accounting practices and nefarious sales tactics such as spam calling, instilling fear of exam failure, and signing up customers for loans without them fully understanding the terms. This has dampened long-term Ed-tech enthusiasm and created enormous short-term losses for Byju's investors as broadcasted by various conventional news agencies such as Bloomberg (Saritha, 2022) and Malik (2024). Once evidence of the courses' quality failing to meet the promised standards became known, public opinion of the industry soured. Therefore, although the market was educated on this new industry, the negative perception has made it challenging for subsequent businesses to capture the historical lucrativeness of the industry without careful navigation. This has been achieved by a few businesses now but the initial hurdle was present.

Apart from these blemishes, the impact of startups is overwhelmingly positive for the health of the economy - even if they are overvalued and unsustainable - because that is a function of investor confidence in the ecosystem. This is important to note since investment is one of the primary drivers of long-term economic growth.

Overvalued: Systemic or Idiosyncratic?

To answer this, we must first decode the circumstances enabling overvaluations. Our financial markets are overtly governed by sentiment. This is evident in bull runs, when not only do existing businesses in public markets become overvalued, but the sentiment among startup investors also turns optimistic as seemingly everything and everyone begins minting money. In fact, it is only in the sharp correction that occurs when or leading to earnings failing to meet analysts' inflated expectations is the business model of the startup tested without the ability to fundraise if reserves run out, commonly known as the funding winter.

This raises an interesting point: without the spectacular failure of startups, will the market self-correct as VCs downgrade expectations? In a market where opinions play an enormous role in valuation, a balancing mechanism is essential. Overvaluations, then, are not exceptions, but the part of the system, the very self-correcting mechanism maintaining market rationality.

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Recommendations Intended for Future Research

Although these failures may keep the market rational, is there any way of minimising this volatility in the startup funding ecosystem to reduce the impact?

It is often claimed to advocate for a shift from qualitative to more quantitative appraisals, even for early-stage startups. This approach would involve quantifying conventionally qualitative factors like the examples given by Monika & Sharma (2015, p. 466), “entrepreneur’s characteristics, product, competitive strategies, market size and growth” or factors surveyed in the 681 firms sample space by Gompers et. al (2020) such as, “attractiveness of the market, strategy, technology, product or service, customer adoption, competition, deal terms, and the quality and experience of the management team.” This can then be rated on a 10-point scale to derive an overall score, weighted according to the company’s investing philosophy which corresponds to a valuation band.

For instance, while management/founding team may be rated as the most important factor by 47% of firms (Gompers et. al, 2020), that specific firm may place more importance on the product. Investors could then compare these scores - including categorical scores - to those of similar businesses they invested in previously and their subsequent outcomes for tweaking, somewhat similar to the scorecard valuation method.

Therefore, this method creates an ever-growing database of precedent-setting peer companies. This is not only useful for valuations but can be used to incorporate governance learnings from previous companies with similar categorical scores, which could overall lead to more sustainability for funded startups and help VCs refine their screening based on what works.

While this method does look to quantify a startup's unique set of factors, it is inspired by industries where this practice is used, particularly the college admissions processes at top institutions that score applicants on a numerical scale, as shown with the dissection of the case files of the Harvard lawsuit (Franklin & Mccafferty, 2018).

Conclusion

This model aims to bring a more structured approach to startup valuations through clear parameters for analyst discussions. This clarity, through scoring, combats a salient cause of overvaluation, which is when the startup is particularly good at one category, such as perfect timing or a stellar team, this would otherwise, in a subjective setting, divert focus away from the rest of the parameters. Therefore, this system circumvents the inadequacies of conventional quantitative approaches that rely on financial modelling like discounted cash flow forecasts and

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cost-to-duplicate for valuations, which are simply impractical in the information-sparse startup market.

In conclusion, the overvaluation of businesses with unsustainable models is a serious issue raising questions about the rationality of our financial and economic systems. These startups, once effectively marketed to VCs, are then pressurised to meet ambitious growth targets to reach the validity for VCs to make a profitable sale in the later series or at the IPO (Vernon, 2022). This often leads to long-term impacts on employees and induces unethical decisions that deceive investors and customers. Finally, when the true business model is tested without the support of extensive marketing, the unsustainability and unethical practices unravel, primarily impacting investors through vast losses.

Nevertheless, the effect on competition is quite positive. This disruption elicits innovation in the industry by challenging rentier capitalism, and even when the new startup fails, other new businesses emerge with similar, albeit sustainable, changes to the business model. This process also showcases investor confidence in the country’s market and, more broadly, the economy.

However, overvaluations still unnecessarily intensify booms and busts, hindering stability and wasting resources. While it might be easy to attribute this to the role emotions must play in decision-making and to then liken these events to the market's usual self-correction. We can strive to address the root of overvaluations, which is often the ambiguity of assessing a company’s qualitative factors - particularly prevalent in startups. Thus, only by incorporating a qualitative factor scoring system based on what a particular VC fund values may we render the art of valuations a science.

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