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# STARTUP VALUATION ERRORS AND THE PARADOX OF INVESTOR LOSSES IN HIGH-GROWTH INDIAN STARTUPS

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**Abstract:**

*The rapid expansion of the Indian startup ecosystem has resulted in escalating valuations driven primarily by elevated revenue growth, unreasonable capital inflows, higher margins and expectations of long-term market dominance. However, several high-growth startups have experienced valuation corrections and investor losses despite reporting strong top-line expansion. This study examines valuations from various perspectives in the Indian startups using an integrated framework combining Steady-State Value (SSV), Future Value Creation (FVC), capital cycle (outlined by Edward Chancellor) perception, liquidity and much more. The research demonstrates that growth does not inherently translate into value creation unless growth is backed by execution and incremental returns exceed the cost of capital in order to justify high valuations. By analyzing the interaction between capital allocation efficiency, competitive intensity, capital dilution, operating leverage, terminal value assumptions, pricing power, future growth prospects, guidance and industry size, the study explains how valuation inflation during expansionary phases can lead to PE de-rating and investor wealth erosion.The study is meant to simplify the process of valuing high growth startups for the larger public through theoretical concepts with significant real word explanations. The findings highlight the need for disciplined valuation anchored in economic indicators rather than narrative-driven growth expectations and story formations.*

**Keywords:** *Startup valuation, Future Value Creation, Steady-State Value, Capital cycle, ROIC, PE de-rating, Dilution, Growth investing, Investor losses, Indian startups, Competitive Intensity, Operating Leverage*



## Introduction:

Over the past decade, Indian startups have attracted significant venture and public market capital, resulting in rapid investor interest and expanding valuations. Valuation methodologies in such firms often emphasize forward revenue multiples, built on continued high growth expectations, expanding total addressable market assumptions, and long-term dominance narratives. While growth metrics appear impressive, investor outcomes have frequently diverged from expectations, particularly during periods of heightened competition, piling losses or macroeconomic tightening.

The paradox emerges when high-growth companies deliver strong revenue expansion yet experience valuation compression and loss of investor trust.

This disconnect suggests that growth and value creation are distinct economic phenomena interconnected only when few elements mix in seamlessly.

This study seeks to explain the structural causes behind such valuation disconnects by understanding the concepts

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of Steady-State Value (SSV), Future Value Creation (FVC), operating leverage, narratives and capital cycle theory. The objective is to establish a disciplined framework for assessing sustainable value in high-growth Indian startups.

**Review of Literature:**

Existing research on startup valuation highlights the challenges of not including various constituents impacting the business on a real time basis like competition and competitive advantage but rather focus on vague and inaccurate spreadsheets and calculations. Venture capital literature emphasizes growth as a primary driver of valuation, often supported by forward-looking multiples rather than realized profitability.

**Michael J. Mauboussin and Dan Callahan, CFA (2014)**: Summarizes understanding P/E ratios and market expectations along with providing a comprehensive framework for interpreting price-to-earnings (P/E) ratios as reflections of market expectations and scenarios rather than simple valuation multiples. Their work explains that high P/E ratios embed assumptions about future growth, profitability, inflation, growth prospects and capital efficiency. They further opine that investors seeking to invest in startups should first evaluate the incremental returns on investment the company will make in the future and only then look at the impact of growth. This is the brief explanation of the holy grail of investing, which states that "The key to understanding valuations is to first understand the business".

The study highlights how investor returns depend on changes in expectations rather than absolute performance, offering critical insight into PE de-rating and the paradox of investor losses in high-growth firms.

**Steven D. Bleiberg and William W. Priest, CFA (2019):** Deconstructing the P/E ratio and its link to growth, risk, and value Creation and reinterpreting the price-to-earnings ratio as a function of market expectations rather than a simple valuation metric. The authors demonstrate that the P/E ratio reflects three key drivers: expected growth, return on incremental invested capital, and the duration of competitive advantage. The study explains that high P/E multiples are justified only when firms can sustain superior returns on capital over extended periods which in the laws of economics is nearly impossible to retain other than few exceptional businesses. Conversely, when growth expectations moderate, competitive pressures increase, or incremental returns decline, valuation multiples compress even if earnings continue to rise. This framework is critical for understanding PE de-rating and explains why investors may experience losses despite strong revenue growth in high-growth companies.

**Dhamecha Kinjalben Pareshbhai and Dr. Chetana R. Marvadi (2024):** The study examines how startup valuation models disproportionately emphasize projected growth over current profitability fundamentals. It highlights that investors often rely on forward-looking narratives rather than steady-state earnings capacity. The paper argues that inflated expectations regarding market capture and scalability frequently lead to valuation distortions. The study also emphasizes that capital inflows affect competitive intensity and long-term return on invested capital along with impacts of excessive funding in emerging sectors accelerating expansion and weakening ROIC. It also addresses concerns over how people elongate the magnitude of high growth phases in companies which further leads to bubble formation and its inevitable bust.

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**S. Benjamin Christopher and Dr. M . Manickam (1992):** The study integrates retained earnings strategically to a company's growth trajectory. For a profitable and growing company, the retention of earnings is often prioritised to fund profitable investment opportunities, which is intended to increase the overall wealth of the shareholders over the long term. Conversely, a company lacking such investment prospects may choose to distribute a higher quantum of its earnings as dividend. The study does not define one as better than the other but rather the most effective choice depends on a company's specific circumstances and growth opportunities.

**Anna Yartseva (2025):** This paper offers one of the most methodologically rigorous empirical investigations into multibagger stocks to date, analysing 464 US listed stocks that achieved at least tenfold returns between 2009 and 2024.

The author examines that multibaggers returns are not led by solitary features but rather a group of elements underlying the business. Under the Fama French model it confirms that traditional factors, small market capitalisation, high book-to-market value, and robust profitability, remain relevant predictors of outperformance. However, high free cash flow yield emerges as the single strongest predictor of multibagger returns, along with aggressive asset growth driving outperformance only when accompanied by commensurate EBITDA growth. Yartseva challenges several widely held practitioner assumptions most notably, that earnings growth is a prerequisite for significant stock appreciation finding no statistically significant relationship between earnings growth and future returns.

**Objectives of the Study:**

***To examine structural valuation errors prevalent in high-growth Indian startups.***

1. To analyze the distinction and importance of Steady-State Value and Future Value Creation in startup valuation.
2. To evaluate the role of incremental ROIC, dilution, and capital allocation efficiency in determining investor outcomes.
3. To study how competitive intensity and capital cycle dynamics influence valuation sustainability.
4. To explain the paradox of investor losses arising from PE de-rating despite revenue growth.

**Research Methodology:**

The data interpretation was carried through primary theoretical questions, relying on percentage analysis to gain a deep level of understanding from various facets including valuation expectations, growth assumptions, capital allocation awareness, and investor return outcomes. This methodology was designed to address the research objectives concerning valuation errors, losses, familiarity with steady state and future value models, competition impacts on business and PE de- rating in start ups.

1. ***Target Population:***

   The study targeted individuals between 18 and 50+ years of age, inculcating various disciplines like, undergraduate students, postgraduate learners, early-career professionals, mid-career individuals, and senior participants with exposure to finance, business, or investment decision-making and not only restricted

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to finance professionals or students. This ensured to capture a wide range of perspectives on startup valuation and investment behaviour.

2. ***Sampling Technique***

A stratified random sampling technique was employed to ensure balanced and representative participation across demographic and experiential categories. The sampling framework included:

- Proportional representation across age groups (18–25, 26–35, 36–50, and 50+)
- Inclusion of respondents from varied educational backgrounds and professional domains
- Representation of individuals with differing levels of financial and investment awareness

This approach ensured diversity of viewpoints while maintaining fairness and analytical reliability.

3. ***Sample Size***

A total of 260 respondents constituted the study sample. The sample included participants from multiple educational backgrounds, professional fields, and levels of financial literacy, enabling comprehensive analysis of investor perceptions and valuation understanding from Kalyan down to the Sangli district.

**Theoretical Framework:**

***Steady-State Value (SSV)***

Steady-State Value represents the intrinsic value of a firm assuming normalized growth, sustainable margins, and stable free cash flows.

SSV= (Net operating profit after tax (normalized)/ Cost of capital) + excess cash

It serves as the intrinsic valuation floor and reflects the business's ability to generate economic value independent of aggressive expansion.

***Future Value Creation (FVC)***

Future Value Creation represents incremental value generated through reinvestment at returns exceeding the cost of capital.

FVC = Investment (ROIC − Cost of Capital) × Competitive Advantage Period/ Cost of capital * (1 + cost of capital)

Growth creates value only when incremental ROIC exceeds the required return. If ROIC equals or falls below the cost of capital, expansion does not generate economic surplus.

Analysis And Data Interpretation

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***Descriptive analysis***

**Table 1**

***Age***

| Category | Frequency | Percentage % |
|---|---|---|
| 18 - 25 | 145 | 56.4% |
| 26 - 35 | 53 | 20.3% |
| 36 - 50 | 56 | 21.8% |
| 50+ | 6 | 2.3% |
| **Total** | **260** | **100%** |

*Source: Compiled from Primary Data*

The dataset clearly indicates the structural composition of different age groups participating in the survey, predominantly categorised by people from (18-25) years of age constituting the majority of responses at (56.4%). The second highest number of responses were from individuals ranging from 26-35 and 36-50 years of age comprising (20.3%) and (21.8%) respectively. The remaining (2.3%) were contributed by seniors from 50+ years of age.

***Table 2***

***Q: Which Financial factor do investors tend to underestimate most ?***

| Answer Options | Frequency | % Responses |
|---|---|---|
| Cash flow sustainability | 129 | 49.6% |
| Profit margin | 52 | 20.4% |
| Customer growth | 49 | 19.2% |
| Brand value | 30 | 11.8% |
| **Total** | **260** | **100%** |

*Source: Compiled from Primary Data*

The responses indicate a clear consensus regarding the financial dimensions investors tend to underestimate when evaluating high-growth startups. Nearly half of the respondents (49.6%) identified cash flow sustainability as the most overlooked factor. Sustainable cash flows form the most significant part of steady state value which further extrapolates high cash flows into durable economic returns.

***Table 3***

***Q:If startup reports strong growth but persistent losses ,how would you view its valuation***

| Answer Options | Frequency | % Responses |
|---|---|---|
| Justified by future growth | 110 | 42.30% |
| Slightly overvalued | 60 | 23.6% |
| Significantly overvalued | 42 | 16.5% |
| Unsure | 48 | 18.9% |
| **Total** | **260** | **100%** |

*Source: Compiled from Primary Data*

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The responses reflect a clear growth-oriented bias in valuation perception despite ongoing losses. A plurality of respondents (42.3%) considered such valuations justified by future growth, whereas (23.6%) viewed these firms as slightly overvalued, while (16.5%) considered them significantly overvalued additionally (18.9%) remained unsure. This strongly indicates heavy reliance on forward-looking expectations when assessing high-growth startups.

These findings reinforce the study's argument that valuation premiums in high-growth startups are often anchored in Future Value Creation assumptions rather than steady-state financial strength.

***Table 4***

***Q:When valuing a startup, which do you consider more important***

| **Answer Options** | **Frequency** | **% Responses** |
|---|---|---|
| Future growth potential | 146 | 56.1% |
| Market size opportunity | 65 | 25% |
| Current earnings potential | 40 | 15.3% |
| Investor sentiment | 9 | 3.6% |
| **Total** | **260** | **100%** |

*Source: Compiled from Primary Data*

The majority of the individuals(56.1%) were more focused on the future market potential of the firm, while (25%) are more market size oriented.This structure clearly indicated that respondents prioritize forward-looking expectations over present financial fundamentals when valuing startups. Only (15.3%) considered current earnings potential as the most important factor, and a negligible (3.6%) explicitly acknowledged investor sentiment as a key driver. This finding strongly supports the central argument of the study that valuation frameworks in high-growth startups are disproportionately influenced by assumptions of Future Value Creation (FVC) rather than Steady-State Value.

***Table 5***

***Q: Do you believe investors tend to overestimate future growth potential in startups***

| **Answer Options** | **Frequency** | **% Responses** |
|---|---|---|
| Strongly Agree | 51 | 20.4% |
| Agree | 185 | 71.1% |
| Disagree | 21 | 8.4% |
| Strongly Disagree | 3 | 1.2% |
| **Total** | **260** | **100%** |

*Source: Compiled from Primary Data*

A clear testimonial to our topic, A significant majority of respondents believe that investors tend to overestimate future growth potential in startups. Nearly the majority of participants either agreed (71.1%) or strongly agreed (20.4%) with this statement, while only (8.4%) expressed disagreement. This seems to be clear evidence where respondents tend to believe that growth projections embedded in startup valuations are frequently optimistic and may not fully account for competitive pressures, capital intensity, or execution risks.

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*Table 6*

***Q:When competition intensifies in a startup's sector, what is the most likely impact***

| Answer Options | Frequency | % Responses |
|---|---|---|
| Improved profitability | 35 | 13.7% |
| No major change | 42 | 16.4% |
| Reduce margin | 155 | 59.6% |
| Unsure | 28 | 10.9% |
| **Total** | **260** | **100%** |

*Source: Compiled from Primary Data*

The findings systematically indicate strong general understanding of the risks and impacts on businesses having higher competitive understanding. A substantial majority of respondents
(59.6%) believe that intensified competition is most likely to reduce margins. In contrast, (16.4%) expect no major change, while (13.7%) believe competition could improve profitability. A smaller segment (10.9%) remains unsure. This evidence supports how PE derating and valuation is also impacted by competitive dynamics of a business and industry.

*Table 7*

***Q:If companies in a sector raise large amount of funding simulataneously, what usually happens***

| Answer Options | Frequency | % Responses |
|---|---|---|
| Sustainable growth | 50 | 19.6% |
| Overcapacity and price competition | 158 | 60.7% |
| Immediate earnings growth | 41 | 16.1% |
| Decrease in earnings | 11 | 4.3% |
| **Total** | **260** | **100%** |

*Source: Compiled from Primary Data*

As the theory of capital cycle clearly points out, that increase in overcapacity breeds lower ROIC over cost of capital and hence lower value creation. This overcapacity is led by higher equity dilution, especially among start-ups as reinforced by the respondents with (60.7%) agreeing with overcapacity and price competition being the major cause of equity dilution. In contrast, (19.6%) anticipate sustainable growth, while (16.1%) expect immediate earnings growth. Only (4.3%) foresee a direct decrease in earnings. This distribution reflects an intuitive understanding of how capital inflows alter industry structure. Moreover validating the need of our study's argument that capital cycle dynamics are central to valuation sustainability Table 8

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*Table 8*

***Q:If a company's revenue grows but its stock price falls, what is the most likely reason?***

| Answer Options | Frequency | % Responses |
|---|---|---|
| Declining growth expectations | 79 | 31.3% |
| PE multiple reduction | 86 | 33% |
| Market manipulation | 52 | 20.6% |
| Temporary volatility | 43 | 17.1% |
| **Total** | **260** | **100%** |

*Source: Compiled from Primary Data*

A combined (31.3%) of respondents attributed a decline in stock price to either declining growth expectations or P/E multiple reduction (33%). In contrast, (20.6%) believed market manipulation was the primary cause, while (17.1%) viewed such declines as temporary volatility. This shows the nuanced yet incomplete knowledge among respondents. The fact that the majority identified expectation moderation and multiple compression as key reasons suggests an awareness that stock prices are driven not solely by revenue expansion but by embedded growth assumptions. Although the seemingly high attribution for stock price being guessed as market manipulation suggests there is still headroom for acknowledging the primary findings of this research.

**Table 9**

***Q:What do you think causes PE multiples to decline***

| Answer Options | Frequency | % Responses |
|---|---|---|
| All of the above | 149 | 57.3% |
| Rising competition | 53 | 21% |
| Slowing future growth expectations | 29 | 11.5% |
| Profitability concerns | 29 | 11.5% |
| **Total** | **260** | **100%** |

*Source: Compiled from Primary Data*

The findings reveal a strong consensus regarding the multifaceted drivers behind valuation multiple compression. A majority of respondents (57.3%) selected "All of the above," indicating recognition that P/E multiple decline is rarely attributable to a single factor but instead results from an interplay of structural forces. This reinforces the study's central proposition that valuation sustainability depends on the durability of competitive advantage, growth visibility, and capital efficiency.

**Hypothesis:**

$H_0$:- There is no distinction between Steady State Value and Future Value Creation

$H_1$:- There is a clear distinction between Steady State Value and Future Value Creation and have a significant impact on the valuations of Indian start-ups.

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$H_0$:- There is no role of incremental ROIC, dilution, and capital allocation efficiency in determining investor outcomes.

$H_1$:- There is a high degree of the role of ROIC, dilution, and capital allocation efficiency in determining investor outcomes.

$H_0$:- Does competitive intensity and capital cycle dynamics influence valuation sustainability.

$H_1$:- Competitive intensity and capital cycle dynamics heavily influence valuation sustainability.

$H_0$:- Does PE de-rating occur despite high revenue growth. $H_1$:- PE de-rating does occur despite higher revenue growth.

**Results and Findings:**

1. ***Incremental ROIC Determines Value Creation:*** Revenue growth alone does not guarantee value creation. The critical determinant is incremental ROIC relative to cost of capital. During expansion phases, rising competition, increased customer acquisition costs, and higher capital intensity may reduce incremental returns. When incremental ROIC declines toward the cost of capital, the spread that drives FVC compresses. Under such conditions, reinvestment may increase scale without increasing intrinsic value.
2. ***Dilution and Capital Structure Effects:*** High-growth expansion frequently requires repeated capital infusion through equity issuance or stock-based compensation. While enterprise value may expand, per-share intrinsic value may stagnate or decline due to dilution.

   Enterprise growth does not automatically translate into shareholder wealth creation. Dilution combined with declining return efficiency can erode investor returns even when operating metrics improve.
3. ***Narrative Premium and Expectation Inflation:*** Valuations during growth phases often embed narrative premiums based on optimistic assumptions regarding market size, competitive advantage, and margin scalability.

   When competitive dynamics change or margin expansion is delayed, these embedded expectations are revised downward. Valuation multiples contract rapidly because markets reprice anticipated future value rather than current earnings alone.
4. ***Operating Leverage Dynamics:*** Startup models often rely on operating leverage, where fixed costs decline as a percentage of revenue with scale. However, if growth slows or competitive spending increases, operating leverage may not materialize as projected.

   Delayed margin expansion weakens steady-state assumptions and lowers the intrinsic valuation floor.
5. ***Terminal Multiple Sensitivity:*** A significant portion of startup valuation derives from terminal value assumptions.

   High-growth firms are frequently priced higher using elevated terminal multiples based on long-term dominance and growth expectations.

   Even modest reductions in terminal multiple assumptions materially reduce enterprise value due to compounding effects in discounted cash flow models. Terminal multiple compression is therefore a major contributor to PE de-rating.

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6. ***Capital Cycle Dynamics: Valuation corrections align with capital cycle theory***
   1. Capital abundance enables rapid expansion.
   2. Expansion attracts competition.
   3. Competition compresses incremental returns.
   4. Growth visibility declines.
   5. Valuation multiples contract.
   6. Capital discipline gradually returns.

   Such cycles are structural and recurring within high-growth sectors.
7. ***Cash Flow Conversion as a Stability Indicator:*** Sustainable Steady-State Value requires consistent free cash flow generation. Low cash flow conversion relative to revenue or EBITDA indicates reliance on continued capital infusion.

   When FVC expectations decline and SSV remains modest, valuation becomes highly vulnerable to correction.

**Suggestions:** Several loop holes still exist which require further more deep dives.

1. This current empirical research was based on a relatively small number of datasets incorporating large scale Indian start- ups to validate theoretical relationships proposed between incremental ROIC, capital cycle dynamics, and PE de-rating, thereby strengthening the findings beyond a survey-based methodology.
2. The geographic location of the survey could be expanded to include more urban and suburban areas where similar capital cycle and valuation distortions are observed.
3. These findings assume that all the sectors act simultaneously in a similar fashion however reality suggests that various sector-specific studies would be particularly valuable, as capital intensity, competitive structure, and margin dynamics differ significantly which facilitates the functioning of efficient capital cycle, ROIC and equity dilution.

**Significance of the Study:**

This study provides a structured framework for evaluating high-growth Indian startups beyond revenue growth metrics. By integrating SSV, FVC, and capital cycle theory, it offers a disciplined approach to assessing sustainable value creation and investor risk. The study also helps to make the process of evaluating start-ups fairly easy by foregoing all the hard mathematical standpoints and keeping the understanding of business based on real time elements, like capital cycle and competition. This helps achieve the main objective of the report, which was to simplify the process of e-valuation by the masses, which ultimately increases awareness among investors to invest their money logically for less losses and more returns based on a risk return perspective. These findings can be applied by anyone investing in the markets, from a young student to a highly experienced veteran investor.

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**Limitations of the Study:** The major limitation of this study emerged from a restricted geographic focus and major responses from a younger age bracket (18-25) having a moderate level of investing experience making it difficult to fathom discussed topics in the first try. The analysis is conceptual and based on theory, hence does not incorporate firm-specific financial modeling. Some exceptional businesses may still deliver exponential returns even after being listed at high valuations but coming across them are not so common.The study addresses businesses from an economical standpoint and not focused on social and cultural impacts the business might have on the environment.

Variations across sectors and business models may affect return dynamics. Empirical validation using large-scale financial datasets may enhance future research.

**Conclusion:** The paradox of investor losses in high-growth Indian startups arises from systematic overestimation of Future Value Creation during expansionary capital cycles.

Growth creates value only when incremental ROIC exceeds the cost of capital. When competitive intensity rises and return spreads compress, reinvestment fails to generate economic surplus. Steady-State Value remains modest due to weak free cash flow conversion led by higher working capital thus, valuations become highly sensitive to downward revisions in expectations.

PE de-rating, therefore, is not necessarily evidence of business failure but of expectation recalibration and narrative subsidisation

This research tries to condense all these aspects into a very easy applicable model, where sustainable value creation in start-ups could only happen with a reasonable starting valuation, lower competitive intensity, efficient capital allocation facilitating higher ROIC over cost of capital. This will eventually lead to both twin engines of returns coming in, that is higher growth coupled with PE expansion.

As the greatest investor repeatedly said, "Price is what you pay, Value is what you get" - Warren Buffet

Only when the latter part converges does expansion translate into durable investor wealth.

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