William Tylko – Uber, Inc. 10/23/20

Overview:

Uber shares today are still lower than where they were in June 2016, when Uber privately fundraised $3.5bn at $36.7/share. This round represented 8.25x FY17 revenue, whereas today Uber trades at 3.2x FY21 revenue (ex-investments). This stark valuation contrast highlights the change in Uber's outlook over the last 5 years: Uber has evolved from a hot Silicon Valley startup to a leaderless toxic capital incinerator.

As a result of COVID-19 and aggressive capital allocation decisions, Uber's capital incinerator status is about to change. If Uber does spin out its autonomous vehicle division (ATG) as rumored, combined with other already formalized cost reductions of $1bn, Uber will reduce annual fixed cost expenditures by $1.5bn relative to their 2019 spend. Once Uber Mobility returns to pre-virus levels, Uber's lower fixed cost structure will enable Uber to swing into profitability, fundamentally changing the market's view of the company.

Uber should be viewed by the market as a beneficiary of COVID-19. The extent of COVID-19's damage to Uber was limited to a reduction in Uber Mobility's EBITDA by $1bn relative to 2019. In exchange for this, UberEats grew 100% y/y to a projected $5bn in revenue in 2020. Uber's successful growth of UberEats infrastructure through establishing a network connection between restaurants and consumers via their app will likely prevent reversion to pre-virus demand levels once the world recovers.

The thesis here is simple: As Uber turns the corner on profitability, the stock will rerate to a more appropriate multiple based on future cash flows. The underlying businesses should support at least 15% annualized growth for the next several years, which is attractive considering incremental free cash flow margins of around 40%. Investors should expect to receive 20-30% upside from valuation combined with annual revenue growth of at least 15%. If Uber executes as expected, we think the company could be worth closer to $94/share within the next 4 years, based on 5.7x 2024 revenue / 31x 2024 EBITDA.

Uber's Business Model:

Uber's core business relies on its ability to build and maintain efficient supply and demand networks. The company jumpstarts these networks with aggressive up-front investments in the form of customer discounts and driver bonuses. Over time, Uber creates more demand for its service by lowering prices and increasing volume. Once a local network is established and successful, Uber cuts the additional incentives and the network crosses into profitability. Uber evaluates these local networks individually, dividing them by segment and regional area. There are three main Uber networks: Rides (ridesharing/taxi), Eats (food delivery), and Freight (freight shipping). The Rides network has achieved scale and is profitable, while Eats and Freight are still seeing heavy investment. When considering future growth and business models, it is important to understand how quickly the model can be adapted. UberEats, on track to do over $6bn in revenue in 2021 (enough to qualify as a Fortune 500 company,) was only started just 6 years ago.

Uber's corporate strategy is to establish itself as the leader in each segment and market in which it operates. To achieve this dominance, over the last several years Uber has been divesting businesses where it faces fierce competition, often from local competitors. It then invests the proceeds from these sales into other markets, in an effort to consolidate competition. Once the competition is reduced to several players, the marketplace becomes an oligopoly, and competitors can decrease investment and raise prices.

The majority of Uber's revenue comes from the United States (60%), but it also has significant operations in Brazil (7%) and the rest of the world (33%).

Segment Overview:

Uber reported results in five operating segments: Rides, Eats, Freight, Other Bets (UberWorks etc.), and ATG/Other Tech (autonomous vehicles). In addition to these five segments, the company has approximately $2bn of unallocated Corporate G&A and R&D.

Rides: Rides is Uber's most mature segment. In 2019, Rides bookings increased by 20% y/y to $49.7bn, revenue grew 14% y/y to $10.7bn, and the segment produced $2.1bn of Adjusted EBITDA. Revenue growth in 2019 was challenged in the U.S. as Lyft increased its market share from 15% in 2016 to >30% in 2019, mostly because of the negative press associated with Uber. The U.S. mobility market has quickly become an oligopoly controlled by Uber and Lyft, which comes with vast benefits. Both companies have reduced promotional investment, increasing profitability substantially. Additionally, given this dynamic, Lyft management has signaled that going forward they will follow Uber's lead on pricing, enabling both to charge more. Prior to Covid, the Ridesharing market was expected to grow by 20% CAGR (link) through 2025.

Rides in Q2'20 were highly impacted by the pandemic because consumers travelled substantially less. While bookings decreased by $-9,000mn y/y (-75%), the segment's EBITDA only fell by $456mn, demonstrating the high variable costs in the model. In August, Rides bookings rebounded to -50% y/y, a major improvement. Trips should continue to recover as we approach vaccination deployment, which Superforecasters currently expect a 50% probability before the end of Q1'21 and >90% probability before the end of Q3'21. Once the economy recovers from the virus, the Rideshare market will return to its long-term growth projection.

Management believes Rides will have a terminal state 25% take rate (net revenue as percent of bookings) and a 45% EBITDA margin. In 2019, Rides had a 21% take rate and a 19% EBITDA Margin.

Eats: Eats is Uber's food delivery segment and represents a massive opportunity for the company because the online food delivery market is highly underpenetrated. According to Euromonitor, just 7% of all food orders in the U.S. took place over the internet in 2018. A large amount of demand has existed for delivery food for decade. However, now for the first time technology is enabling smaller restaurants to operate delivery at low costs. In the long run, restaurant penetration today is still small – roughly 10-20%.

In the U.S., Uber is the second largest delivery app, with a 30% market share (37% if including Postmates), second only to DoorDash. Outside of the U.S., Eats is positioned strongly in Australia, France, Canada and Japan. In 2019, Eats bookings grew by 83% to $15bn, the segment reported $2.5bn in total revenue, and lost $-1.4bn of EBITDA.

Going into 2020, Uber was planning to reduce promotional investment (discounts) on a permanent basis starting in the first quarter. In Q2, the virus had a positive impact on delivery, demand for delivery soared, and Eats bookings in the second quarter increased by 106% to a $7bn run rate.

In Q2, Uber reached a deal to acquire Postmates for $2.6bn of Uber Stock, a valuation of 4x runrate Q2'20 revenues. This deal will increase bookings by 15%, and immediately lift margins, as Postmates was already breaking even on an adjusted EBITDA basis. Uber expects they can drive $200mn worth of additional synergies with the acquisition. Management expects that competition should ease in the U.S. once Doordash completes its long-awaited IPO, as then the company will be forced to take profitability into consideration.

Management believes Eats will have a terminal state 15% take rate (net revenue as percent of bookings) and 30% EBITDA margin. In 2019, the unit had a 10% take rate and -55% EBITDA Margin.

Freight: Freight is a relatively new service for Uber. Its goal is to connect freight shipments to freight truckdrivers. It leverages Uber's app to offer a streamlined service for users on each end, and of course it charges a commission. Freight's primary competitors are trucking firms, which hire truckers to ship goods on a schedule they provide. The $800bn trucking industry is an extremely fragmented market, with the top 50 producers only controlling up 38% of the market (VIC Murman, link). Uber's key advantage is their brand and the ability to provide better customer service relative to regular freight providers.

Freight reported revenues of $731mn in 2019, up 105% y/y. In 2020, growth slowed down to 27% y/y in Q2, likely due to the virus. EBITDA margins for Freight are currently at -30%. Because of the high per ticket revenue, Freight has a decent probability of having larger long-term margins.

While Freight is an exciting business unit to consider, management seems less excited about its potential. In 2020, they sold off European operations, and months later sold 18% of the business for $500mn to private equity at a post-money valuation of $3.3bn. It is difficult to understand why Uber would sell out of a business this early, especially considering they can raise debt at 6%.

Other Bets: Other Bets included JUMP (Uber Scooters), Uber Transit, Uberworks, and Uber's incubator. In Q2'20, Uber sold JUMP to Lime and discontinued the segment to reduce costs. The segment was a large loss center for Uber, generating -$250mn in EBITDA in 2019 on $119mn of net revenue.

ATG and Other Tech (ATG): This segment includes Uber's autonomous vehicle project, and Uber Elevate. The segment is vastly unprofitable, generating $-500n of losses on $-42mn in revenue. Uber's autonomous technology has fallen years behind its competitors. Uber's CEO is evaluating the company's options, including outside funding, a complete shutdown, or a spinoff (SPAC needed?) with exclusive Uber network rights. According to The Information, the autonomous vehicle needs to pass ~29,000 road test cases to drive public roads, and the vehicle could only pass 3.9% of them as of July 2020.

Uber has historically believed that self-driving technology would be critical for ridesharing, and that is why they initially invested with ATG. However, given that there are dozens of companies working on self-driving cars, there will likely be many different solutions which can arm Uber's fleet in the future. Uber should divest the unit immediately to bring the company closer to profitability. Based on recent reporting, we believe Uber will separate itself from ATG in the next several months.

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Outlook:

In our forecast, Rides booking returns to normal in Q3 2021, and compound at an annual rate of 13% between 2021 and 2024. EBITDA Margins grow from 20% in 2020 to 32% in 2024, primarily a function of the fixed cost reductions and slightly increased take rates. A 13% growth rate is likely conservative given Uber was growing faster than that in 2019 while losing share to Lyft.

We project Eats bookings to fall in late 2021 y/y (including Postmates) as the economy reopens, since consumers will return to restaurants. Between 2020 and 2024, we forecast that Eats will grow by an estimated 20% per annum, compared to growing 72% in 2019 and 102% in 2020. Like with mobility, as investment decelerates, margins expand thoroughly. We forecast EBITDA margins increasing from -17% in 2020 to +13% in 2024. This marginal improvement in profitability is based on continued scale, and decelerating investment through promotions.

We project Freight grows at an annualized rate of 30%, relative to the 105% growth seen in 2019. ATG and Other bets are discontinued.

At the company wide level, the result of these forecasts is that Uber will grow into close to $30bn in revenue by 2024, a CAGR from 2021 sell side estimates of 21%. Adjusted EBITDA increases from -17% in 2020, to +10% in 2021, to 18% in 2024.

Valuation:

The appropriate multiple for any business is a multiple of future free cash flows. For high quality businesses, this can typically be 30x FCF. In the long run, if Uber can achieve its 25% EBITDA Margin while spending 3% on SBC and 3% on Capex, Uber would have a FCF margin of 19%. If Uber traded at 30x FCF, this would imply a revenue multiple of 5.7x 2024 revenue and investments + cash would equate to an market cap of around $185bn, or $94/share.

Investments (such as Didi) are modeled to increase in value at a 14% IRR, although this is likely on the conservative side given the expected price change with Uber's stock. Other assumptions include $5bn from selling ATG (vs $7.25bn last round 18 months ago) and 3% share dilution per year.

Risks and mitigates:

Platform risk: The largest negative thesis for Uber is the concern that Uber drivers net close to nothing after expenses, and that driver churn is so high that at some point they will run out of drivers. We feel this is more of a complaint than a reason the business will fail. There are many companies that sell products that are not net value positive for their end users (Herbalife), and there are many companies that sell a product that shouldn't strategically exist (Digital Turbine). More often than not, these types of models end up working because cash flow continues to come in and there is no catalyst to the thesis. Uber drivers continue to show up to work every day, even when unemployment was at its low point last year. Companies do not necessarily have to be a good platform to succeed. "A platform is when the economic value of everybody that uses it, exceeds the value of the company that creates it. Then it's a platform." Bill Gates

Competition: People often debate whether Uber has a barrier to entry, given that anyone can make an app. However, as Uber is currently viewed as a capital incinerator by the market at this moment in time, we would find it unlikely that anyone would want to create this business, unless of course the business flips into profitability and the valuation skyrockets.

AB5: California recently passed a law that would reclassify Uber's drivers as employees from independent contractors, increasing costs significantly in a market that represents 9% of Uber's global revenue. Uber believes these changes would force it to charge 25-100% more for rides. On November 3rd, California residents will vote on a proposition that would exempt ridesharing services from this law. Despite over $180mn in funding for campaigns supporting the law, polling indicates it could go either way. The risk is that similar laws like this gets passed everywhere, which is for now unlikely. If the proposition is unsuccessful, assuming a 50% decrease in bookings and a 25% increase in pricing, Uber would see a 3% headwind to bookings in the next year.

Autonomous: If Uber does sell ATG, Uber could be at risk of falling behind relative to an autonomous competitor. However, because there will likely be dozens of different approaches to autonomous vehicles, we think that Uber should be able to partner with at least one of these companies, and won't be materially disadvantaged.

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