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Why The Uber IPO Is All About Network Effects

Uber Technologies' initial public offering has finally arrived and is the fourth-largest IPO since 2011, surpassed only by Alibaba, Softbank and Facebook. The offered price range translates into an aggressive valuation compared to rival ride-sharing service Lyft, as Uber has a rapidly declining growth rate compared to Lyft.

Buying shares in Uber comes with an unattractive risk-reward ratio and the valuation is essentially driven by whether one believes in long-term network effects or not. Lyft’s recent share price developments should be of great concern to any investor considering Uber. Our main message is to whether one should be lured into Uber by promises relating to the future of transportation and growth. In Uber's case, both factors are questionable.

A classic, low-float offering from Silicon Valley

Uber starts its prospectus with the words “we ignite opportunity by setting the world in motion” – the typical, buzzword-based style popular with new companies. The offered 190,628,298 shares to the public in a public offering of 180,000,000 shares with the remaining shares in private placement at the IPO with PayPal. According to PayPal CEO Dan Schulman, the investment provides “future commercial payment collaborations, including the development of Uber’s digital wallet.”

We have to wonder... will an ownership share of 0.6% really make any difference to partners? It seems like a waste of capital for PayPal shareholders.

In addition to the issuance of new shares, an over-allotment option to investment banks has been offered as well; it's worth 27,000,000 shares that, if exercised, will come from existing shareholders. In an unusual move, Uber has set aside 5,400,000 shares (out of the 180,000,000) for sale to certain qualified drivers in the US. Apparently this has been marketed as a bonus to drivers, but let’s be honest: it’s a sale offer that will only pay off in a relative sense if Uber’s shares do better than the S&P 500. Furthermore, by only including US drivers, Uber is essentially transferring wealth from international drivers to their US counterparts in case the share price performs well. In the firm's S-1, the CEO says that Uber will always do the right thing, but how this international element fits that statement is left unquestioned.

The free float, or the number of shares that will be freely traded on the exchange in percentage terms, is going be typically low at 13% – this is nothing out of the ordinary for Silicon Valley technology companies. These offerings are not truly public in the sense of being public companies with a large share of ownership actually held by the public. Instead, the firm will be privately owned by a few investors and founders with excessive voting power; the publicly listed shares are essentially a side show. On a positive note, however, Uber is not listing with dual share classes, as is the case at many other tech companies, but is instead sticking to more corporate governance-friendly, one share = one vote principle.

The business: market share loss and lower growth

Uber tries to differentiate itself from Lyft by being focused on its platform and network, and thus shying away from on-demand ride-sharing. The business is divided into three segments: Personal Mobility (on-demand ride-sharing), Uber Eats (competing with Just Eat and the like) and Uber Freight (competing against traditional logistics firms). In its prospectus, Uber plays with the idea of exponential growth and employs the “hockey stick” growth narrative in an effort to to excite investors. This diverts attention away from the real trends: slowing growth (and potentially fast decay) and a lower take rate due to incentives etc.

As with any IPO, Uber is arriving to the public markets with lower growth rates compared to previous years. In 2018, Uber made $11.3bn in revenue and saw an operating loss (EBITDA) of $2.6bn that constituted a 42% growth in revenue and a significant improvement in EBITDA margin (albeit from a very low number). Revenue growth was 106% in 2017, so the present growth decay is significant for Uber – hence the IPO.

Uber has been in business for 10 years but still does not generate any profit. Uber’s numbers start with gross bookings, or fares paid by customers. Uber then takes a cut (its revenue) and subtracts various variable costs related to operating its entire network (cost of revenue). Based on growth decaying by half a year, we expect the firm's revenue growth to be 21% in 2019, translating into revenue of $13.6bn assuming an unchanged take rate.

In its S-1 filing, Uber provides a few numbers from Q1 (unaudited) showing revenue of $3.04bn, up from $2.58bn a year ago – 17.8% year-on-year growth. This figure is already below our FY'19 expected revenue growth, but we believe Uber will take initiatives to increase revenue in order to not book 18% in y/y growth in 2019 as that growth decay would be too high for Wall Street to accept.

The firm's Q1 growth is coming in the wake of a significant slowdown in Q3 and Q4 of 2018 which gave rise to multiple "no growth" analyses (these were a step to far, however – there *is* growth, but its slowing). Uber's Q1 growth numbers were delivered by impressive growth in the Uber Eats segment, but as the table below shows, this has come at the expense of massive excess driver incentives.

This is the old playbook of the original Uber ride-sharing business (now called Personal Mobility) basically buying market share. In a low interest rate environment, this makes sense *if* it ensures a dominant market position.

The key competitive advantage Uber is trying to sell to investors is what it calls the “Liquidity Network Effect”. This is the idea that drivers and riders will prefer networks with the largest “liquidity”, as is the case on a financial exchange or on platforms from Facebook to PayPal. This is the silver bullet for investors: network effects are the only thing that can justify the firm's valuation

Investors buying Uber shares are buying into long-term network effects.

These dynamics may very well play out over time, but for now it’s questionable how substantial they are compared to those enjoyed by the dominant social networks. This will be an ongoing topic in our future updates on Uber.

Uber's autonomous driving strategy is built on its Advanced Technologies Group, which this month received significant investment from SoftBank Vision Fund, Toyota and DENSO. ATG has 1,000 employees and is working on self-driving cars, which could be a game-changer for a transportation network in profitability terms. However, our take is that Waymo's (Google's self-driving technology company) CEO is currently the best authority on when self-driving cars will arrive commercially, and his view is that it could take 20 years.

Unlike Tesla, Uber is downplaying this factor from a market value perspective. This is wise, particularly given Uber's 2018 accident in which a self-driving Uber test vehicle killed a pedestrian.

Valuation: priced for perfection and long-term network effects

Crowd behavior is profound in both financial markets and media, and the latter seem to be running with a market value figure of $90bn for Uber. Take Quartz's headline: "Uber's stunning journey to a $90 billion IPO changed transportation forever". Unlike many articles, this one at least contains link to the source of the valuation number, which in this case is Reuters.

The problem is that the market value is not $90bn if one actually looks at the S-1 filing.

Secondly, we are not sure that Uber really has changed transportation forever; mobile access to drivers is just a small, incremental improvement over hailing a taxi from the street. The platform economics stripping drivers of many employee rights, on the other hand, has changed everything for those employees while lowering the price for consumers.

Now back to the valuation...

According to Uber's S-1 filing , the company is issued new shares and converting preferred stock into 1,676,959,021 outstanding shares as of IPO day this gave the company a market value of $ *not* the $90bn figure being bandied about by media.

Risks

Buying shares in the Uber is not without risks. Here are some of the risks mentioned in the S-1 filing:

• Competition is fierce in all segments and network effects have not yet shielded Uber from competition. New entrants into the personal mobility segment could come from traditional carmakers.

• In order to preserve market share, incentives for drivers have gone up over the years (and could remain elevated).

• Uber is not profitable and states in the prospectus that its operating expenses are set to increase significantly for the foreseeable future, and that the company may not achieve profitability.

• For now, drivers are not classified as employees. If this should come to be the case in various jurisdictions, it would negatively impact profitability.

• Relationships with regulators are a key risk as a dispute with a particular city council can remove access to an entire market.

• International expansion is very important for the valuation but international regulators are often less free market-oriented than those in the US.

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