2Q Results Positive; Uber Should Divest from Self-Driving

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Key takeaways

- We believe Uber should divest its self-driving unit and focus on its core software business as a ridesharing provider. The company should concentrate on building partnerships with leading autonomous vehicle competitors, given the high capital intensity of developing autonomous technology and how far ahead the competition is.
- We see Uber's results for 2Q 2018 as being mostly positive, with net revenue rising 63% year-over-year and net losses shrinking by 16%, bringing the company closer to eventual profitability.
- Increased competition from Lyft and personal mobility alternatives likely contributed to gross bookings growth deceleration in the quarter. Uber is investing in the space, and its deployment of corporate capital is reflective of broader investor interest in personal mobility startups.

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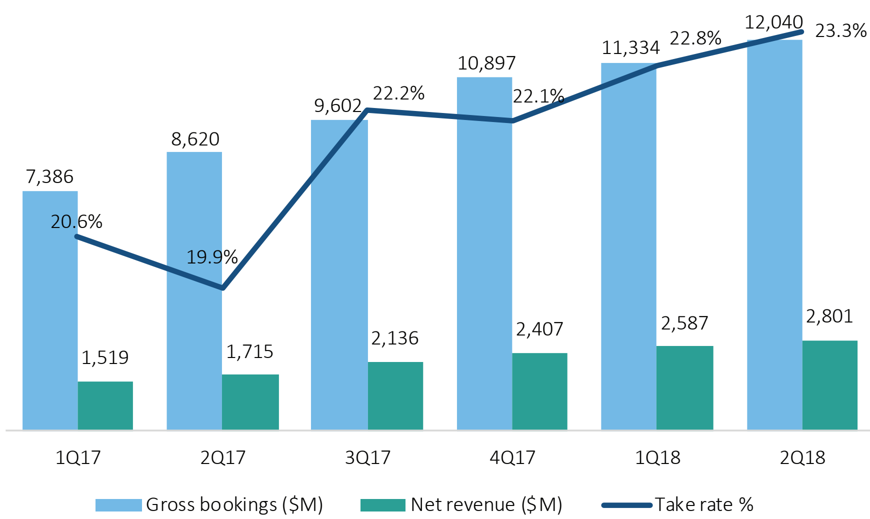
As Uber continues its march toward becoming a public company, investors are taking a close look at its financials in the months leading up to its potential IPO in 2019. The company recently released its financial results for 2Q 2018, which we see as being mostly positive.[1] Net revenue rose 63% over the same period last year, while net losses shrank by 16%, bringing the company closer to eventual profitability as it scales.

One less than stellar spot was the company's gross bookings growth, which decelerated to 41% year-over-year (YoY) compared to last quarter's stellar growth of 55% YoY, likely driven by increased competition from Lyft and other ridesharing players, as well as personal mobility startups like Ofo and Lime. According to a policy researcher at Uber, bikesharing has begun to replace some Uber trips during congested periods.[2] This comes in the wake of New York City's recently enacted bill to place a cap on the number of ridesharing vehicles in the city for a year. This measure will likely add to Uber's woes—New York City is Uber's largest market, representing an estimated 9% of gross bookings in 2017,[3] and this bill could somewhat curb the company's growth potential.

Uber's take rate continues to trend higher

Uber gross bookings and net revenue by quarter



Source: Wall Street Journal[4]

Nevertheless, Uber partially offset the gross bookings number with its exceptional take rate. The company was able to increase the commission it receives as a percentage of gross bookings to 23.3%, which is significantly higher than the 20.1% it received during the same period last year and above our expectations. For the past six quarters, Uber has gradually increased its take rate by reducing net partner earnings (driver's wages) to 68.5% of bookings from 70.8% last year. This YoY improvement in

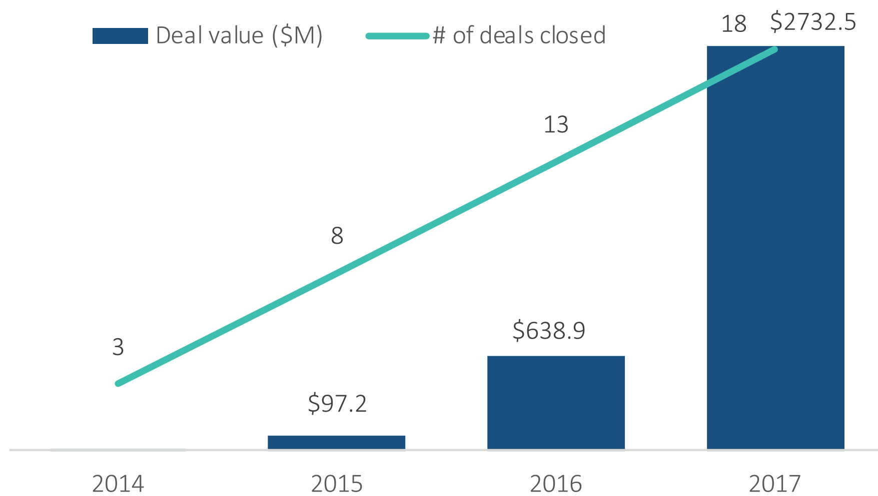
1: "Uber's Financials: An Inside Look," The Wall Street Journal, Greg Bensinger & Rolf Winkler, August 15, 2018
2: "Understanding multimodality: An analysis of early JUMP users," Medium, Santosh Rao, July 19, 2018
3: Per Morningstar data shared with PitchBook.
4: This chart is a PitchBook synthesis of Uber's financials as published originally by The Wall Street Journal.

contra-revenues contributed to approximately $300 million of incremental net revenues during the quarter. This is an impressive feat considering the current tight labor environment, especially among drivers. Given the nature of the decentralized "gig economy," we believe the labor pool Uber attracts consists of similar workers that can choose between ridesharing companies as well as a host of other industries such as traditional delivery and service. As such, Uber is competing with these other industries to attract workers in a macroeconomic environment in which unemployment is low and competition is fierce. Despite this, whereas adjacent industries such as commercial trucking are seeing driver shortages and upward wage pressure negatively impacting margins, Uber has been able to significantly increase its take rate, an important driver of profitability as the company scales. This helped the company deliver an adjusted EBITDA margin of -25.4%, down 970 basis points from 1Q 2018 but a significant improvement over -45.1% in the same quarter last year.

The company recorded a net income loss of $891 million, narrowed by 16% from $1.1 billion during the same period last year, but up approximately $340 million from 1Q 2018's adjusted figure. Some of the increase in losses has resulted from the company's recent foray into personal mobility—bikesharing and scooter-sharing startups. In April, Uber bought JUMP for an estimated $200 million, and in July the company announced an investment and partnership with Lime. Overall, these moves could be viewed as a response to the headwind presented by personal mobility. By acquiring these startups, Uber can capture a share of the fast-growing personal mobility market instead of being left behind as consumers shift from ridesharing to bikes and scooters during rush hour. Moreover, this strategy is representative of Uber's desire to become the dominant platform of urban transportation, serving as a medium for ridesharing, public transportation and now personal mobility, which tackles the last mile of transportation. Uber's deployment of corporate capital in the space is reflective of broader investor interest in personal mobility startups, which saw an explosion in VC in 2017, even as venture investment in ridesharing startups declined in 2017, although 2018 is currently on pace to surpass 2016.

VC investing in personal mobility accelerated in 2017

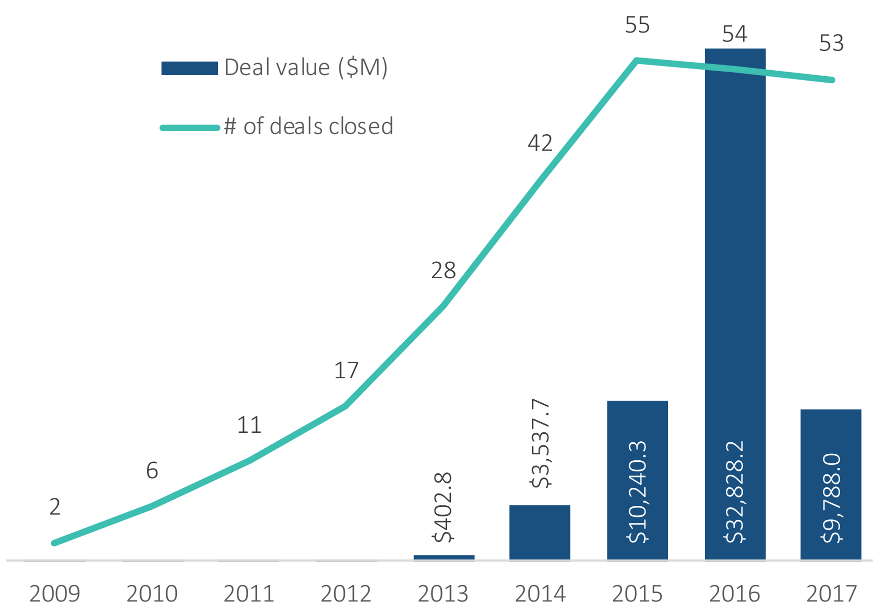
Deal count and deal value of VC-backed personal mobility companies



Source PitchBook
*As of August 13, 2018

VC investing in ridesharing declined in 2017

Deal count and deal value in VC-backed ridesharing companies

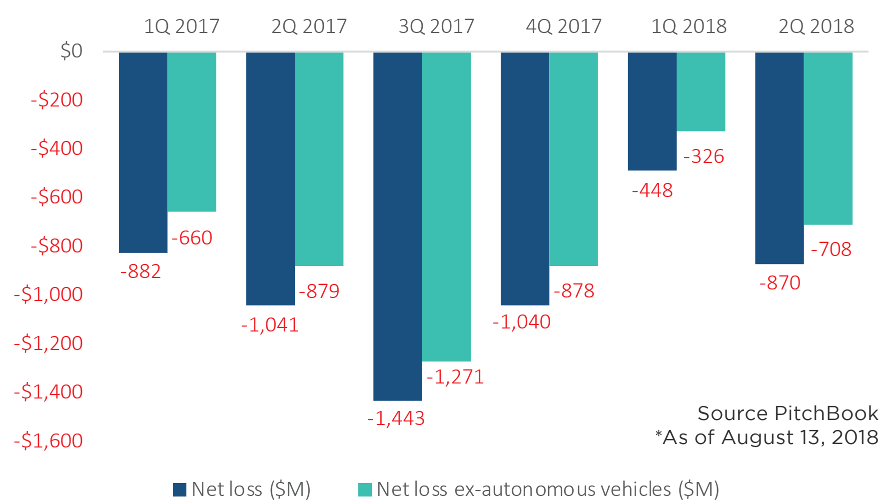


Source PitchBook
*As of August 13, 2018

Another project contributing to Uber's losses is the company's investments in autonomous vehicles. According to The Information, Uber's self-driving car unit has racked up losses between $125 million and $200 million per quarter for the past 18 months, and over $3 billion in the past three years.[5] This represents up to 30% of the company's loss every quarter. As a result, some investors and executives within the company want Uber to divest its self-driving car unit in preparation for the company's upcoming IPO. According to the New York Times, CEO Dara Khosrowshahi is currently undecided between the two

5: "Uber's Losses Mount at Self-Driving Car Unit," The Information, Amir Efrati, August 15, 2018 camps.[6] On the one hand, canceling the self-driving program would better position the company's financials and streamline its operations. On the other, Uber risks being left behind by others rolling out their own autonomous solutions.

Uber could narrow its losses by paring back its autonomous vehicle investment



Overall, we believe it is in Uber's best interest to divest its autonomous vehicle unit. Doing so would allow the company to pare back some of its ongoing losses and bring the company closer to profitability. Although we view autonomy as the endgame for ridesharing companies in terms of achieving profitability, we believe that within the autonomous vehicle ecosystem, Uber is well behind the leading competition in terms of creating a technologically sound and scalable solution. Shareholders in Uber are likely to have seen the company's technology firsthand, and their informational advantage relative to others in the marketplace isn't enough to justify the company's rampant spending on the program. In addition, our research indicates that the company is well behind other public technology competitors such as Waymo, automobile manufacturers such as GM (through its subsidiary Cruise Automation) and Daimler, and other VC-backed companies such as Zoox.

Potential capital investment in self-driving fleet

	Waymo	Cruise	Uber
Miles driven (M)	8	1	3
Miles per intervention	5,600	1,250	13
Potential fleet size	82,000	72,360	24,000
Estimated cost per vehicle	$47,000	$46,296	$59,500
Capital invested ($M)	$4,364	$3,350	$1,428

Source: Waymo, Uber, General Motors, The New York Times, Volvo, Chrysler, Jaguar, PitchBook estimates

6: "Uber's Vision of Self-Driving Cars Begins to Blur," The New York Times, Mike Isaac, Daisuke Wakabayashi & Kate Congar, August 20, 2018

Moreover and perhaps more importantly, seeking to ultimately operate an autonomous vehicle fleet could be significantly detrimental to the attractiveness of Uber's business model to investors. Today, we believe that Uber is fundamentally a software business and should be valued as such. Currently, the company does not own or operate each individual vehicle, and instead provides the network on which drivers can be matched with riders. We believe this is the best strategy for the company going forward. This allows the company to maintain an asset-light operating model and thereby limit its downside risk during an economic contraction. Owning and operating a large vehicle fleet could change that; purchasing vehicle fleets would represent a significant amount of capital. Uber's announced fleet purchase of 24,000 Volvo XC90s and associated autonomous equipment could represent a capital investment of over $1.4 billion, which would be financed by taking on additional debt. Moreover, Uber would now be responsible for the running costs, depreciation and maintenance inherent to operating such a large fleet. This could reduce the attractiveness of its business model, potentially transforming the company from an asset-light, variable cost-structured software business with limited downside into an asset-heavy, fixed-cost-based, cyclical transportation company with significantly greater downside potential. If investors come to see Uber as more of a transportation company rather than a mobile software company, the company's post-IPO valuation multiple could begin to see downward pressure. For a company adept at operating an asset-light, software-based model, this kind of operating shift makes little sense. Instead, the company should continue to focus on operating as a network provider, matching vehicles with passengers.

Investor perception is important, especially ahead of an upcoming IPO. One could argue that divesting from self-driving could cast a cloud over the company's IPO by signaling to investors that the company does not have a clear path to autonomy. On the other hand, divesting from self-driving would help Uber narrow its focus to the business lines that matter and have driven the company's growth over time. In addition to divesting, Uber should aggressively seek partnerships with leading autonomous vehicle companies to get their vehicles on the ridesharing giant's global network. That seems to be the path the company is on currently; in 2017, Uber announced a partnership with Daimler to put the company's autonomous vehicles on Uber's network.[7] In addition, SoftBank Group is a major shareholder in Uber, and its recently acquired 19.6% stake in Cruise could potentially bring the two companies together at some point. In March, reports suggested that Uber was in conversations with Toyota to supply autonomous driving technology.[8]

7: "Uber and Daimler Join Forces on Self-Driving Cars," Uber, Travis Kalanick, January 1, 2017
8: "Toyota, Uber in talks on self-driving tech: Nikkei," Reuters, March 15, 2018

And in May, Khosrowshahi revealed that Uber was in talks to get Waymo vehicles on Uber's network.[9] We believe these are positive steps, and the company should continue to explore partnerships with leading autonomous vehicle players instead of attempting to create its own solution. Doing so is critical—we see autonomy as the ultimate endgame for ridesharing, and the potential for autonomous vehicle leaders such as Waymo to disrupt the ridesharing market represents an existential threat for ridesharing incumbents like Uber. For more of our thoughts on Uber's positioning within the autonomous vehicle space and the company's prospects for its upcoming IPO, please see our Morningstar collaboration "Uber May Pick Up Investors, Along With Riders, in Its IPO."

9: "Uber CEO Dara Khosrowshahi says he's trying to convince Alphabet to put Waymo self-driving cars on the company's network," Recode, Johana Bhuiyan, May 31, 2018