It’s Time We Talked About Uber…

Uber lost a lot of money again according to a recent Bloomberg story:

“In the first quarter of this year, Uber lost about $520 million before interest, taxes, depreciation and amortization, according to people familiar with the matter. In the second quarter the losses significantly exceeded $750 million, including a roughly $100 million shortfall in the U.S., those people said. That means Uber's losses in the first half of 2016 totaled at least $1.27 billion.”

“Subsidies for Uber's drivers are responsible for the majority of the company's losses globally, Gupta told investors, according to people familiar with the matter. An Uber spokesman declined to comment.”

Uber is reportedly valued by private investors at around $70billion and is still one of the darlings of the technology/financial press. But its place on the pedestal may be getting, well...just a bit insecure. Here are a few observations about Uber and some questions stimulated by recent events.

<u>Systematic Underpricing</u>

Uber is open about the fact that it is using its investors’ equity to buy market share in the U.S. by systematically underpricing its services. The goal is to increase its already dominant market share and drive competitors with shallower pockets (read Lyft) out of business.

Comment: Then what? Will Uber be able to raise prices because it has monopoly pricing power? Does Uber think that there would be no governmental response to a pricing action of this type? And don’t dominant players need barriers to entry to hold their position, usually technological or regulatory in nature? What barrier is there (other than an apparently endless supply of investor-provided equity) that would prevent other well-funded entrants from reproducing the Uber model and preventing price increases?

<u>Driver Supply is the Key Constraint</u>

Driver supply appears to be Uber’s key growth constraint in its current markets. It can’t increase the number of rides without more drivers. Uber is pricing its services at a level low enough to attract consumers but too low to adequately compensate drivers to drive for it. They can’t make a living as an Uber driver, especially as Uber introduces innovations like flat pricing which further cut revenue per ride.

Comment: So would anyone drive for Uber without the subsidies? If, as it appears, the answer is no for a significant number of drivers, then the entire Uber model looks perilous. If your business requires equity-funded subsidies to keep the plates spinning, is it really a business?

<u>Uber as Subprime Shadow Bank</u>

As part of the same driver-growth/retention strategy, Uber is providing many of its drivers with very expensive subprime auto leases to encourage them to acquire cars to drive for the company. Uber’s program is funded by credit lines from Wall Street banks. That’s the program behind the flood of recent immigrants with low English skills driving new black Toyotas for Uber in New York City. Press reports suggest that many drivers can’t make their lease payments driving for Uber, even with driver price subsidies, suggesting that the level of credit risk is high. This program effectively makes Uber a multi-billion dollar, unregulated, wholesale-funded shadow bank.

Comment: Uber is holding an unspecified but clearly material amount of subprime consumer auto credit risk on its balance sheet at what appears to be an inflection point in the current auto finance credit cycle. Do its technology investors understand the risk interplay between used car prices and consumer credit trends that drives gains and losses in auto lending? Do they understand that Uber's wholesale funding will disappear in a nanosecond when institutional funders get nervous? We will all find out when credit performance deteriorates.

<u>What Self-Driving Cars Portend for Uber</u>

At the same time as it tries to increase the number of Uber drivers and top line revenue, Uber is investing heavily in self-driving car technology. Uber apparently believes that this technology will ultimately enable it to operate and continue to grow without needing drivers at all. This would of course solve the driver subsidy/driver lending problem. But if Uber moves to a self-driving fleet, its entire business model is turned on its head. Instead of drivers providing free capital-- in the form of their own vehicles-- for use by Uber (albeit with some recent financing help as noted above,), Uber will have to find the capital to finance the acquisition, maintenance and regular replacement of its entire vehicle fleet. While estimates vary, it appears likely that Uber drivers use more than one million cars today. It would probably cost $30-$40 billion for Uber to buy all self-driving cars to replace the current driver-owned fleet.

Comment: How will it pay for that capital investment when the time comes? Won't it still be losing money at that point due to the continuing need for subsidies?

<u>Asia's Not Looking So Good</u>

Uber has largely failed in its efforts to expand in China, India and Southeast Asia Because there are no real barriers to entry for car-hailing service competitors, Asian-based services had a head start in their home markets while Uber had a big head start in the US. These Asian markets are where most of the population/wealth growth is occurring in the world.

Comment: How much growth can Uber expect if its further expansion is limited to more mature markets? Certainly much less than it thought a year or two ago

<u>Cash</u>

Uber has about $8 to $10 billion in cash and borrowing capacity at present.

Comment: That seems like a lot, but it's only a couple of years' losses at its current burn rate, and far less than that if Uber expands its driver financing program and self-driving car plan. Looks like more money will be required from equity investors, presumably at increasing valuations.

<u>Takeaway—Hard to See a Successful Long-Term Strategy Here</u>

Putting this all together, what I see is this:

Uber's strategy requires its equity investors to keep delivering new cash at ever-increasing valuations to fund multi-year structural operating losses as it uses subsidies and subprime lending to hold onto its under-compensated drivers and drive out competitors in the U.S. and a discrete group of other low-growth geographic markets. Eventually, Uber plans to pivot, change its business model and embark on an enormous capital acquisition program to buy an entirely new fleet of self-driving cars for the purpose of eliminating its need for drivers. Because its current strategy results in large structural losses, and it will need to be highly profitable to afford the required investments, it will need to raise prices significantly and soon But those pricing actions will only be possible if Uber has sustained monopoly market and pricing power immune to both government intervention and disruptive, lower-priced competition.

Although Uber has convinced a lot of very intelligent people that it is a winner, this is not a convincing strategy. If I were an Uber investor, I'd be looking for an exit.