Richard Kramer - Analyst
Arete Research Services LLP
richard.kramer@arete.net
+44 (0)20 7959 1303

Sam Lourensz - Analyst
Arete Research Services LLP
sam.lourensz@arete.net
+44 (0)20 7959 1331

Rocco Strauss - Analyst
Arete Research Services LLP
rocco.strauss@arete.net
+44 (0)20 7959 1304

Uber and Lyft: Dangerous Driving?

Initiating on Uber with a Sell Rating, Lyft at Neutral   *23 July 2019*

We wrote of our uncertainty around the business models of Uber and Lyft (*Uber: Roadblocks on the Path to Profits?*, May '19, and *Lyft: Questions to Pick Up On…,* Apr. '19) before and shortly after, respectively, their IPOs. **Yet after several months of looking deeply into the underlying markets, we still question whether *either* can become *structurally* profitable in the medium-term, while consensus has not factored in any likely recession in their outlooks**. We see issues with ride-sharing profits, given already-boosted take rates (with autonomous being years off), the low likelihood of a benign competitive dynamic in key markets, and other challenges in usage, insurance costs, and regulation. **We are initiating coverage with a Sell rating on Uber and a Neutral on Lyft, only because the latter is likely to "beat" what we think is oddly low 2Q19 guidance. Our '19E DCFs need to stretch forecasts until 2030E as we do not see either company becoming EBITDA profitable until '24E, and see Uber "worth" $33 (25% downside) and Lyft at $54 (18% downside).** Our models assume slowing ride-sharing growth (reflecting recession risk to what is discretionary spend), while new initiatives (from electric scooters to Lagos boat taxis to autonomous driving) are immaterial. **We are concerned that four major issues have been seemingly overlooked by the Street and the many banks in the IPOs:**

Growth, For How Long? Ride-sharing sales growth slowed to 9-12% for Uber in the last two Qs, while Lyft's growth rates will fall as it laps pricing changes. This is not a case of *awareness* – both brands are well-known. **We think the "TAM" has been over-stated, and usage patterns (rides per active user) are clearly seen to reach a series of plateaus.**

From Benign to Brutal. Lyft relies on the US, where Uber has a dominant 70% market share. We think the current *détente* will ultimately prove unstable. LatAm markets show how Uber could be damaged by a well-funded new entrant, before it "grows the pie." **We think the prisoner's dilemma is resolved in a "knife fight" dynamic, with food delivery even more fragmented.**

An End to Squeezing Drivers? Lyft got 40% of sales growth since '16 from cutting driver take rates. The scope for regulatory arbitrage is narrowing, as seen in many cities, and a pending California law (AB5) could add further costs. **With the "autonomous revolution" still far off, we think the labour arbitrage underpinning both companies is nearing its limits.**

Food Delivery Adds Growth, Burns Cash. Uber had ~$1bn of "uneconomic" delivery costs in '18; cars are a poor solution for food delivery in many urban markets. Uber faces entrenched rivals, with Eats #1 in just one of the top 10 US markets. **We can see Lyft seeking a merger with GRUB, as a source of customers and cash flow, but this would be highly dilutive.**

Table 1: Summary Financials, '17-'20E				Ticker: UBER US			Price at 22 July '19: $43.7	
Market Cap.: $74bn				**Target Price: $33 (-25%)**			**2030 DCF Value: $33**	
Y/E Dec.	Sales	Sales Growth	Ride-Sharing Growth	Uber Eats Growth	Adj. EBITDA	Adj. EBITDA Margin	EV/Sales	EV/FCF
2017	$7,932	106%	95%	470%	-$2,642	-33%	9.1x	nm
2018	$11,270	42%	33%	149%	-$1,847	-16%	6.4x	nm
2019E	$13,640	21%	11%	74%	-$4,210	-31%	5.3x	nm
2020E	$16,302	20%	10%	53%	-$4,190	-26%	4.4x	nm

| Table 2: Summary Financials, '17-'20E				Ticker: LYFT US			Price at 22 July '19: $66.0	
Market Cap.: $19bn				**Target Price: $54 (-18%)**			**2030 DCF Value: $54**	
Y/E Dec.	Sales	Sales Growth	Revenue Per Active Rider	Active Riders (m)	Adj. EBITDA	Adj. EBITDA Margin	EV/Sales	EV/FCF
2017	$1,060	209%	$101	12.6	-$696	-66%	16.0x	nm
2018	$2,157	103%	$131	18.6	-$944	-44%	7.9x	nm
2019E	$3,478	61%	$154	24.5	-$985	-28%	4.9x	nm
2020E	$4,308	24%	$158	28.9	-$757	-18%	3.9x	nm

Source: Arete Research estimates.

For Reg. AC certification and Important Disclosures, see the last page(s) of this report.

An Overstated TAM

Uber and Lyft ambitiously claimed the addressable market for transport as a service (TaaS) was the total societal transport spending. **We think this is both an overstatement, and misleading.** Uber says it now serves "2% of the population" across its "offering in 63 countries with an aggregate population of 4.1bn people." Penetration is far higher in wealthier developed markets. Our analysis for the US (330m population), 100% and 59% of sales for Lyft/Uber, respectively (ignoring Canada), removes 75% of those outside the ages of 18-55 (125m) and ~15% living in rural areas (another 50m). Ride hailing works in urban/suburban regions, but not in rural areas. We overlay that with the ~30% (100m+) within the lowest income brackets (90m out of 165m wage earners in the US make <$35K p.a.). **At best, this leaves a "TAM" of ~120m, of which we think Lyft and Uber combined currently serve more than 40%, and much of this requires major changes in consumer behaviour.**

Uber does not break down its 93m monthly active platform consumer (MAPC) count by geography or service (Ride-hailing vs. Eats). Yet consumer data and estimates using Uber/Lyft net revenues or implied gross bookings (based on Uber geographic sales and a likely ~28% take rate in North America) suggest Lyft has a 30% US market share. Based on Lyft's 20.5m active riders, we estimate Uber has 36-42m US MAPCs – a lower proportion to sales/gross bookings market share vs. Lyft, as Uber users complete more trips on average (likely skewed by international business and the inclusion of Eats food deliveries within "Trips"). This would put ~40% of Uber's active users in North America (contributing 59% of sales), which includes ~6m Eats consumers based on its 15m user-count in 4Q18. If we assume a high proportion of Uber Eats users also use ride hailing in the US (even though Uber says the ratio is just 50% for all users), we subtract 2m to reach Uber's ~37m N. American ride hailing user base. To account for those who use *both* Uber and Lyft to find the cheapest ride or shortest wait time, we subtract 10% of the ~58m users. Shifting usage between platforms would stem from incentives and steep *introductory* discounts, while both apps claim to focus on customer retention and loyalty. **We therefore estimate ~52m unique ride users in the US; current penetration levels are already ~42%.**

Fig. 1: US Market Is Near 50% Penetrated (De-duped for cross-platform users, m)

Lyft: 18.5, Uber: 33.3, Unaddressed market: 58.3

- Lyft ▪ Uber ▪ Unaddressed market
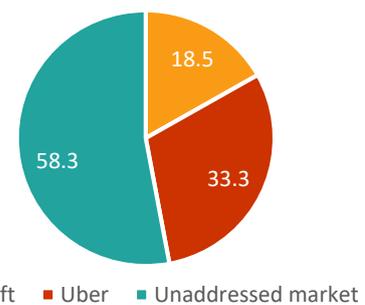
Source: Uber, Lyft Company Filings, Arete Research estimates.

Usage Naturally Plateaus…

After a decade of being "in market" and near-ubiquitous brand recognition, why is usage not much higher for Uber? We think it is because "Transport as a Service" requires a material shift away from the habit of car ownership. Serving the "other half" of the U.S. TAM (of tech-savvy users with income) has to wean consumers off their "own" cars (to which they are emotionally and financially committed), daily commutes, extensive infrastructure around driving and parking (esp. with immediate convenience) and habits of a lifetime. Cars are seen as a source of freedom, and heavily marketed to consumers, something that will take a generation to change. **We see ride hailing as a service that settles into a pattern of habitual – and *occasional* – use for most consumers, after a burst of initial adoption.** Uber and Lyft have generated incremental *riding,* while also providing a more convenient model for taxi services (multi-city, short wait times, and smartphone-based booking), but for relatively infrequent usage, as the cohort data shows (all riders fall into a rough average of 2-3x rides per month). Lyft has now removed disclosure of the number of rides; Uber reports rides, but unhelpfully combines Ridesharing, Eats and "New Mobility" (i.e., scooters and bikes). Uber failed to grow trips per user for four consecutive quarters, despite continued "high growth" of Uber Eats and expanding its scooter business. **We think "power users" have already been captured and new customers are less frequent users**. Table 3 shows new cohorts go through a rapid take-up phase, then converge around a natural range of 30-35 journeys for Lyft, and 50-70 for Uber, each year. **Ride-sharing is an occasional "luxury" item for most.**

Table 3: Average Number of Rides Annually for Lyft's Cohorts (based on when they started as users)

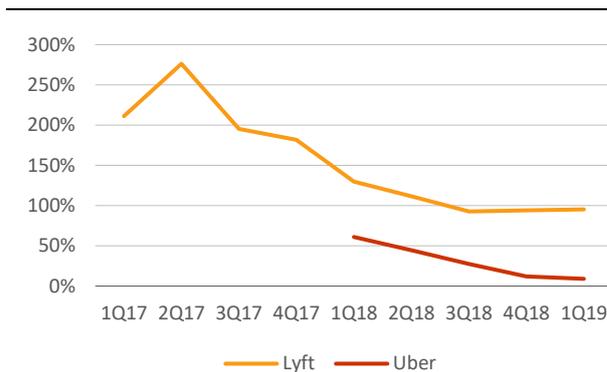| Cohort	2016	2017	2018
2016	17.7	29.0	29.8
2017		23.4	33.6
2018			28.3

Source: Arete calculations based on Lyft S-1.

Fig. 2: Rides Per Active Rider: Reaching a Plateau
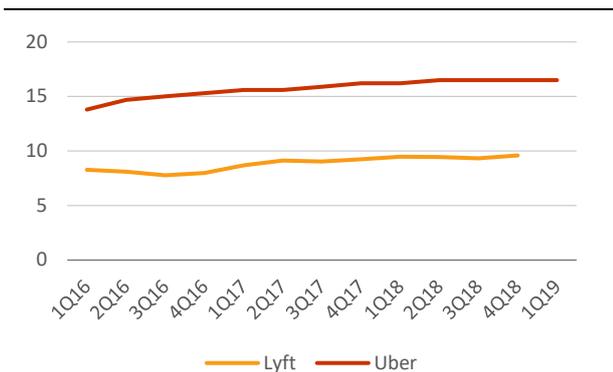
Source: Uber, Lyft Company Filings. *Lyft stopped disclosing "Rides" in 1Q19.

Fig. 3: Ride Hailing Sales Are Slowing Substantially

Source: Uber, Lyft Company Filings. *Lyft 2016 sales figures (and hence 2017 growth rates) calculated using ARPU and user figures.

…and so Must Growth Rates

Uber grew ride-sharing *sales* (77% of its total) at just 12% and 9%, respectively, in the last two quarters. Sales grew 95% for Lyft in 1Q19, but it is now lapping an "industry-wide price increase" in 2Q18, and consensus sees growth rates halving from '19 to '20E (which we think it can "beat"). Alongside a smaller TAM and less *incremental* usage, we see prior growth drivers – higher fares or lower pay-outs to drivers – as less applicable in a maturing market. We see limited scope for co-ordinated price hikes, without putting adoption at risk, or enticing new entrants. **We think consumer sensitivity to the ride-sharing price premium (esp. vs. public transport alternatives) limits pricing power, and neither can risk losing US market share by increasing fares.** Standing behind these figures are troubling "straight line" – and, in our view, lazy – business model assumptions needed to turn two businesses with a collective LTM cash burn of $4bn to cash profitability. **Consensus expects a "re-acceleration" of sales growth in 2023 or 2024 for Lyft and Uber, conveniently when most five-year DCF valuations and terminal values are set.**

Risks to growth were seen by Uber in selected international markets, where it was attacked by well-funded rivals. Didi acquired Brazilian ride-hailing player 99 at YE17, then expanded into Uber's key LatAm markets, challenging its near-monopoly positions (market shares of ~55-87%). LatAm is Uber's 2nd-largest market (18% of '18 sales), seen as a major growth driver with a growing mobile user base, with sales up 215% in '17. Didi has poached Uber staff and drivers, and undercut its prices to users; Uber's growth slowed to 22% in '18 and was -13% in 1Q19. Ola took a similar approach in India and, alongside Bolt (formerly Taxify), are launching in London, one of Uber's top five markets. Bolt is enticing Uber drivers with two months of a 7.5% commission, 15% thereafter, compared with Uber's ~25%+ take rate (Uber group average is 21%, diluted by lower take rate EMs vs. Lyft's 29% in the U.S.). After its introductory 50% discount, Bolt says fares will be 5-10% cheaper than Uber. **With the low barriers to entry, low customer loyalty and commodity nature of ride hailing services, we see Uber facing competition globally and sales growth slowing as it struggles to maintain shares in key markets and grow its presence in new markets. Unlike in food, Uber lacks a "cash cow" market from which to draw funds.** Uber gets 24% of ridesharing sales from five cities, with all five facing some competitive threat. Lyft's US share skews towards the West Coast (~40-45% share of SF and LA, two of Uber's top five cities).

Fig. 4: Uber Enjoyed a Near Monopoly Position in LatAm (in Aug. '17)

Source: Dalia Research.

Take Rates and Regulation: Backlash Brewing?

A key factor of Lyft and Uber's growth has been increasing take rates, or the fee portion it takes from drivers, which also boosts prices for riders (both pass on *absolute* amounts, not percentages of "surge pricing" increases). Lyft's take rate rose from 18% in '16 to 27% in '18; Table 4

Table 4: Increasing Take Rates Helped Drive Lyft's Sales Growth in '17 and '18

	FY17	FY18	FY16-FY18 Growth
Revenue Growth Rate	209%	103%	528%
Revenue Growth (@ FY16 take rate)	141%	76%	323%

Source: Lyft Company Filings.

shows how much this drove sales growth: we compare growth rates to those if the take rate remained flat at FY16 levels. Rising take rates increased sales by 68% and 27% in '17 and '18, respectively. Uber's ride-hailing take rate (21%) is not comparable to Lyft's; drivers say it has similar take rates in N. America, while international units have lower rates, diluting the group figure. Drivers in the US are painfully (and noisily) aware they were squeezed for a higher proportion of ride fares over time, with recent protests over making minimum (or below) wages. The Uber driver app shows both the customer's cost and driver fee, enabling them to clearly see how *platform fees* change over time, whilst "*driver friendly*" Lyft no longer provides gross fees, effectively hiding take rates from drivers. With surge- and upfront-pricing, Uber and Lyft may often take more than their headline ~25% take rate, with drivers complaining of take rates as high as 80%. These moves frustrate drivers, dis-incentivise them to continue working *for* Uber/Lyft and invite protests, while both need to recruit a continual supply of drivers needed (nearly 50% quit in their first year). **Driver sentiment may cap take rates, beyond non-transparent moves like raising "starting fees" or cutting incentives for number of trips in a week.**

Uber (and Lyft) and Introducing Upfront Pricing: Uber originally charged riders based on a starting fee, a booking fee and a combination of mileage and time, paying drivers a lower per mile/minute amount and a cut of the starting fee, effectively arbitraging drivers and riders on its platform, in order to take 20% of gross booking fees. Uber then re-named starting fees as "safety" fees (said to cover driver training, background checks and inspections, which Uber later scrapped and was sued for by drivers) and kept 100% of it before paying drivers 80%, which later fell to 75%. **Uber increased its booking fee multiple times, since this fee is *not* shared with drivers, and also cut the minute/mile rates paid to drivers.** Uber complicated the system by introducing "upfront pricing," whereby drivers continue to be paid a per trip and per minute/mile rate calculated from the *actual* journey, but riders are charged based on what Uber/Lyft estimate what the fare *should* cost, not what the actual journey entails. In theory, this should benefit riders who know upfront what their ride will cost, but Uber and Lyft appear to over-estimate the cost in many cases, leaving drivers with even lower pay-out rates (as low as 30-40%). **Riders are charged more, but drivers, still paid based on the actual journey, not sharing in the increased fares**. Drivers see upfront pricing as a way for Uber and Lyft to overcharge riders and under-pay drivers. Lyft also increased fees and introduced upfront pricing but masked the impact (seen in its S-1) by hiding gross fares from drivers. **Uber and Lyft actually have higher take rates than headline figures suggest (excluding promotions) – because of the $2.30 "starting fee" – but this is still insufficient to make them profitable businesses, in our view.**

There is risk of a step-change rise in costs if California legislation (AB5) passes that re-classifies regular drivers as employees, entitled to minimum wages, benefits and health care: passing these costs on to riders would likely curtail demand, and reduce the "flexibility" so prized by ride-sharing firms. California's proposed law stems from the Supreme Court *Dynamex* ruling, which suggests an "ABC" test to determine whether a worker is an employee or independent contractor. To be ruled the latter, a driver must be free from the company's control, doing work that isn't central to the company's business (something almost impossible to avoid for Uber/Lyft), and has an independent business in the same industry. Contractors need to meet all three of these criteria. With income inequality a hot topic in the US, Uber and Lyft may see rising costs at just the time when demand is under pressure from the wider economic backdrop. Many other states take their legislative cues from California, and Uber and Lyft have unsurprisingly joined forces in opposition to the bill.

Prisoners' Dilemma, or Knife Fight?

Whilst both Lyft and Uber aim to "reduce rider incentives" and focus on "brand," to boost sales and curtail S&M costs (due to how incentives and bonuses are classified), we do not think this prisoner's dilemma will last. Lyft is just in the US and Canada and needs to grow share to reach scale; Uber must have learned from its past CEO's missteps, which boosted Lyft's share. Uber sees US "gross bookings" share as stable at ~70%, but we think Lyft will clearly grow far faster in '19. Yet Lyft is not #1 in any of the top 15 US markets and needs to get to profit with worse unit economics than Uber, in our view. **We think this inevitably leads to a "knife-fight" dynamic, whereby the**

Fig. 5: Lyft Is on the W. Coast, Uber Dominates E. Coast (May '19)

Source: Second Measure.

two companies battle based on price, promotions and proposition/brand. This does not suggest both firms can limit cash burn, but we think Lyft has no choice but to continue attacking Uber with aggressive pricing and promotions, just like Didi/Ola did elsewhere. **This dynamic likely prevents** *either* **firm from raising prices unilaterally, for risk of near-term share loss.**
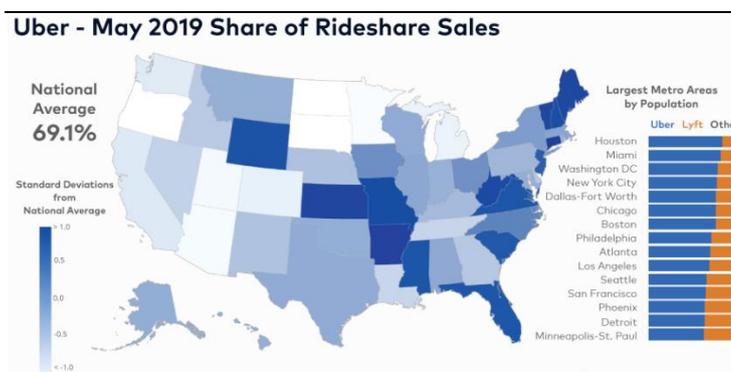
Discretionary Demand in a Recession?

Many of the same 30+ banks that IPO'd Uber and Lyft have strategists warning of a looming US consumer recession. Some of the slowing we forecast in 2020 ride-hailing sales reflects this, which we think is a prudent investor view to take. The US Consumer Expenditure Surveys showed local transport expenditure declined 5% in '08 and 15% in '09, with spending not recovering to previous levels until 2011. This contrasts with consensus growth estimates for net ride-sharing sales of 14% in '19 rising to 20% for '20 for Uber (although clearly not just U.S.), while Lyft consensus sees growth of 54% in '19 and then 27% and 25% in '20 and '21, respectively. **It appears that consensus is not considering the potential headwind of a US recession.** Already there are media reports of up to 74% of drivers making less than minimum wage (in their relevant states), with drivers in over-supply in many markets, which will worsen during any recession. For example, in New York, ~13,500 yellow cabs compete with 80,000 app-based drivers, increasing supply 500%+ (with most being full-time drivers). While this brings low wait times, in the event of softer demand, drivers would see fewer (and shorter) journeys and suffer lower incomes, and any moves to further increase pay-outs for Uber or Lyft would invite a further backlash or regulation. **While Uber and Lyft do not bear** *direct* **costs of lower activity in a recession, their high multiples are based on years of** *uninterrupted* **growth. Setbacks have a particularly bad impact on DCF-based valuations.**

Insurance: Honeypot or Headache?

Alongside driver pay and S&M, insurance is a major cost for Uber and Lyft. Ride-hailing platforms are liable for their drivers when they "log in" (i.e., even before they pick up a passenger), and coverage increases once riders are "matched." Lyft has been "over-paying" insurance – building reserves (liabilities) on its balance sheet – leading bulls to hope Lyft, and Uber to a lesser extent, can ultimately reduce contributions and P&L costs of losses paid (based on % of sales), as *growth* in reserves slows once they reach *adequate* levels. However, insurance claims often take years to pay out, leaving P&L costs higher than the losses paid in the medium-term, whilst any changes will limit changes in working capital, with no material overall benefit to FCF. Table 5 shows Lyft has a greater exposure to insurance costs, as it is exclusively in the US and does not make food deliveries (which carry lower costs). Lyft hopes to cut insurance costs through "technology and data science", using telematics, routing drivers to lower risk routes and AI to screen fraudulent claims. **We question whether taking riders on longer and costlier routes won't limit the convenience of services.** Lyft claims it should see material improvements in its insurance costs, whilst Uber acknowledges that insurance is a variable cost.

Table 5: Insurance Reserves for Uber and Lyft

		FY16	FY17	FY18
Insurance Reserves (EoP) - $m	Uber	712	1,996	2,937
as % of ride-sharing sales		*20%*	*29%*	*32%*
	Lyft	132	377	810
as % of sales		*38%*	*36%*	*38%*
Insurance Reserves per Ride ($)	Uber	0.39	0.53	0.56
	Lyft	0.81	1.00	1.31
Estimated P&L Insurance Cost as % of Sales	Uber	*16%*	*17%*	*15%*
	Lyft	*34%*	*32%*	*30%*
Losses Paid as % of Sales	Uber Ride-Sharing Sales	*5%*	*6%*	*7%*
	Lyft	*7%*	*9%*	*10%*

Source: Companies, Arete Research calculations.

Food Delivery: A Slice of the Pie, at What Cost?

As ridesharing growth slowed, Uber looked to Eats to drive sales, rising 149% in '18 (and 89% in 1Q19). As discussed in *Food Delivery: Finally, the Right Recipe* (Dec. '18), order frequency and density is critical for food delivery to be profitable. GrubHub has 19.3m US-based active customers, compared with Uber Eats' 15m across six continents (as of 4Q18) and many cities. In the US, Uber Eats has a leading share in only one of the top 10 cities and is lagging DoorDash's heady growth. Like ridesharing, food delivery requires extensive driver coverage to give consumers low wait times but draws on the same pool of drivers. Yet food delivery already has many more established players, with the more mature ones

Fig. 6: Uber Eats Has a Leading Share in One Top 10 US City (Apr. '19)

Source: Second Measure.

having a "cash cow" market to fund expansion elsewhere. **Displacing GRUB or DoorDash in US cities where they have a dominant market share will not come easily for Uber Eats.** Ride-sharing drivers can easily switch between working for either Lyft and Uber, but *food delivery drivers* tend to have outfits or branded food boxes. This explains why Uber Eats drivers, paid on a *per delivery* and *per mile* basis, are falling short of the order levels required to make adequate incomes, forcing Uber to incentivise drivers with large bonuses to make it *worth* their time and comparable to ride hailing.

In many cases, Uber is paying drivers *more* for deliveries than the fee it charges customers, resulting in "excess driver incentives," which totalled a staggering $687m in '18 for Eats, and grew 200% to $291m in 1Q19 (a $1.2bn run-rate). Uber Eats had adjusted net revenue growth of 106% in '18 (but slowing dramatically to 31% in 1Q19) but lacks local market scale to reduce incentives. Uber faces multiple well-funded rivals and fragmented markets, even *within* major cities. Uber faces a dilemma: increase cash burn for excess driver incentives to grow share (as in a 2Q19 marketing push), or see growth slow further. **We believe Uber's accounting for excess driver incentives, while understandable, is mis-**

Fig. 7: Uber's Excess Driver Incentives Cap Gross Margins

Gross Margin (% - LHS)

Excess driver incentives ($m - RHS)
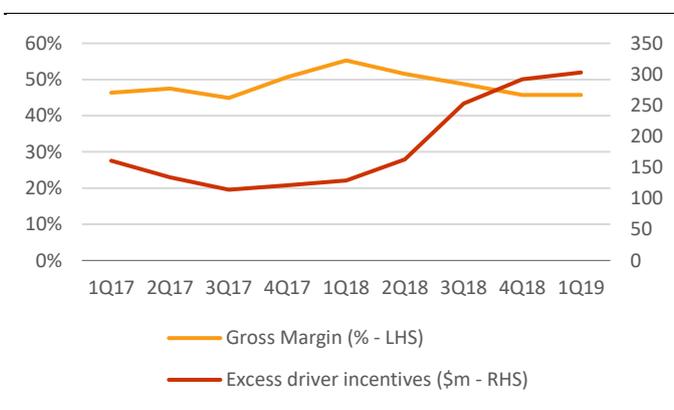
Source: Uber company filings.

leading: it inflates reported Eats sales as long as "incentives" grow faster than "adjusted net revenue" removing these costs (230% vs. 106% in '18). Whilst Uber Eats' accounting of excess driver incentives boosts sales, the impact is even greater on *cost of sales* growth, eating into gross margins. The effect on Eats cannot be isolated given cost of revenue is aggregated, but the impact is large enough to hit group gross margins (shown in Fig. 7). Expanding into new cities limits Uber's leverage to bring down its 50% cost of revenue. Although introducing additional service fees for low value orders will curtail EDIs, Uber Eats is also rolling out a subscription service, offering unlimited deliveries for $10/month. If adopted by Uber's "power users," it would expose Uber to delivery costs well above the $10 fee, unless other "hidden" charges are added.

While there are synergies Uber can realise providing both ride hailing and food delivery services through its apps, we need to distinguish between "business" and more limited "operational" synergies. On the "business" side, one sees efficiencies in areas such as cloud hosting and customer acquisition/marketing. Whilst food delivery still incurs insurance costs, these are less onerous, but help Uber reach scale to demand better insurance terms than a ride hailing pure-play might (Lyft's insurance costs were 30% of sales in '18 vs. 15% for Uber, but there are multiple factors, notably the non-US portion of Uber sales, explaining this). Providing a food delivery service also enables ride hailing players to *further monetise* their user base, helping offset the stagnating "rides per active rider" that Uber and Lyft are experiencing. We see limited "operational" synergies. Uber would need to match the fleet of mopeds/bikes for food delivery, but these cannot be shared with ride-hailing. Car drivers face difficulties in key large cities in fulfilling orders (with parking at a premium) and cannot easily switch between delivering food and passengers. **In short, the overlap in usage of the "fleet" of drivers for food and ride-sharing is limited.**

Since Lyft would need its own fleet of drivers to enter food delivery, we think it needs to attach itself to a brand to realise "business" synergies, suggesting an acquisition of GrubHub. While we don't believe this would fundamentally resolve Lyft's structural problems, it would let Lyft address GrubHub's user base, with a ~32% share of the US market, equal to DoorDash (whose $13bn private valuation is a steep premium to GRUB's $7bn EV). GrubHub is profitable – it generated $150m of FCF in '18, which should rise to $220m in FY19E – while Lyft FCF burn in '18 was -$350m (softened by insurance reserves in working capital). GrubHub lagged the growth of DoorDash or Uber Eats, but could seek new clients in Lyft's user base: as seen in Fig. 6, Grub is particularly dominant in New York, Chicago, Philadelphia, etc., whilst Lyft share is skewed towards W. Coast cities (see Fig. 5). **If Uber is correct that there are synergies between ride hailing and Eats, from single-offering customers expanding use to the other service, Lyft could realise the same benefits from buying GRUB, which itself needs an "answer" to the faster growth of DoorDash and Postmates, in our view.** As Uber likely moves towards integrating its ride hailing and Eats apps – and other services – with broader subscription offerings, Lyft would otherwise be left with a *narrower* offering without a food delivery option.

Food Delivery: Feeling Full? While food delivery is indeed a large opportunity, and established players like TKWY, DHER, JEAT and GRUB show attractive economics, Uber faces several hurdles to match them: 1) **Eats lacks the marketplace business** that rivals built before expanding into delivery. JEAT's marketplace was 73% of sales in FY18; its ~50% UK adj. EBITDA margin gives JEAT the funding for expansion into delivery. Uber Eats is now offering a marketplace in many EU markets, but is "late to the party" and the integration of order systems means it has to displace established players *inside* the restaurants (as well as acquire far more restaurants). Eats needs years to establish its marketplace so as to stem losses and cash burn. 2) JEAT and GRUB can **leverage their existing user *and* restaurant base when rolling-out delivery services,** helping them reach scale and target areas it makes economic sense to serve. 3) Compared with peers (excl. US competitors like DoorDash), we think **Uber is more reliant on orders from large QSRs like McDonald's and more recently Starbucks,** which given the scale of their operations, negotiate a much lower take rate and provide lower AOVs, helping to explain why Eats' economics look unfavourable and are deeply loss-making. In many EU markets where a large rival is well-known, Uber is primarily targeting infrequent visitors, and not capturing orders from a vast, fragmented base of local restaurants. **We can see the attractions of food delivery for Uber, but it has a long road to reach the position where it can challenge the incumbent brands we see in nearly every large market.**

Lyft: Buy or Die?

The equity story for Lyft is one of a plucky, nimble competitor battling against a larger rival with better unit economics. **We think the risk is that its current far faster growth rates – (95% in 1Q19, vs. ~10% for Uber) – fade over time to more closely resemble market growth, and that its incentives for riders are matched by Uber in its main US market.** In the short term, Lyft's 2Q19 guidance of $800-810m looks far too low to us, allowing it to "beat" initial expectations. Table 6 shows how this would require a steep fall in both of Lyft's revenue drivers, with active riders increasing ~0.7m sequentially compared with an average of 1.6m for the last four quarters, and revenue per active rider flat seq. and yoy growth halving from 1Q19 (with Lyft blaming "difficult comps" after lapping "industry-wide price increases" in 2Q18).

Table 6: Lyft 2Q19 Guidance Requires Sharp Declines in Both Active Rider and Revenue per Active Rider Growth

	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19 Guidance	2Q19 Arete
Active Riders (m)	**8.1**	**9.4**	**11.4**	**12.6**	**14**	**15.5**	**17.4**	**18.6**	**20.5**	**21.2**	**22.0**
yoy growth (%)	131%	109%	100%	91%	73%	65%	53%	48%	46%	37%	41%
Sequential increase in active	1.5	1.3	2	1.2	1.4	1.5	1.9	1.2	1.9	0.7	1.5
Revenue per Active Rider ($)	**21.4**	**25.3**	**26.6**	**27.3**	**28.3**	**32.7**	**33.7**	**36.0**	**37.9**	**37.9**	**38.4**
yoy growth (%)	35%	79%	47%	48%	32%	29%	27%	32%	34%	16%	20%
Sequential increase in revenue	2.89	3.87	1.3	0.75	0.93	4.4	0.98	2.39	1.82	0.04	0.53
Sales ($m)	**173**	**239**	**304**	**345**	**397**	**505**	**585**	**670**	**776**	**804.8**	**844.9**
yoy growth (%)	211%	276%	195%	182%	130%	111%	93%	94%	95%	59%	67%

Source: Lyft, Arete Research estimates.

However, this ignores changes Lyft made to its pricing for both drivers and riders, which led to increasing fees and commissions. Just recently (June '19), Lyft replaced "Prime Time" earnings with "Personal Power Zones," replacing the earnings multiplier with "dollar amount" bonuses for rides during peak hours (de-coupling driver and rider payments). Lyft also claims pressure for rider incentives is receding. Lyft reports sales net of driver pay, while some incentives also sit within S&M. An easing of competition (which we doubt will last) could boost take rates and revenue per active rider. Lyft also enters its "first summer" with both bikes and scooters, with these short low-value journeys eating into revenue per active rider. This will have a limited impact: Lyft is in 300+ markets but only nine for bikes and 15 for scooters. Despite different pricing, Lyft takes ~30% of car journeys and near 100% on bike/scooter rides. Data suggests the average scooter ride (1.6 miles) costs ~$3 vs. Lyft's overall revenue per ride of $3.50. Whilst bike/scooter riders might "ride" less often, thus dampening revenue per active rider, this would only come if they onboard a new cohort of active (bike/scooter) riders. **We therefore think a sharp decrease in both active riders and revenue per active rider is unlikely, and instead expect Lyft to *surprise* on active riders and sales. With current short interest of ~50% of free float, we could see the shares surge on "better" earnings, but this does not resolve longer-term structural issues with the business model.**

To counter Uber's claims of scale, Lyft argues it should be judged on *individual* markets; our discussion of "business" and "operational" scale shows how Lyft can get increased leverage in insurance, platform costs, advertising, etc. ("business" costs), but individual market dynamics set "operational" costs; for example, within a specific city, higher share improves order frequency and density, giving drivers more riders/hour, reducing the need for promotions and incentives (and increasing take rates). Weather can also play a large factor in profitability of a specific city/region. Lyft is smaller than Uber – as shown in Fig. 5, it lacks a #1 position in any of the Top 15 US cities. **We see Lyft remaining structurally disadvantaged against its big (bad) brother.**

This puts Lyft in a "damned if you do, damned if you don't" dilemma: if it continues gaining share, Uber will be forced to respond with characteristically aggressive price and promotions. If share gains fade, Lyft will need its own programmes, or provide a fresh equity story for investors (beyond being "nicer"). This becomes more difficult as both seek to lock users in with loyalty plans via subscriptions and incentives. All this points to another round of a bruising battle with Uber. **In our view, Lyft will be forced to provide a new *story* for investors, suggesting an acquisition of GrubHub.** GrubHub would re-align Lyft's offering with Uber's, help reduce its overall insurance burden, better address East Coast markets, and give it a larger combined user base (rising to 30m US users, de-duped, assuming a 50% use crossover). **There is little evidence Lyft can manage a large acquisition such as GRUB, but we think it will be forced to act as sales growth slows into 2020, while we still expect FCF burn of $450m and $400m in '19 and '20.**

Uber: Gorilla in the Mist

For the industry's "900-pound gorilla" and a business with over a decade of operating history, Uber has made a remarkable number of missteps and seen relentless management turmoil (which has not ended since its new "gentler" CEO took over). Moreover, we think its financial reporting, under an investment banker CFO, has been deliberately opaque, failing to break out segments by geography, active users or individual dynamics, while also swallowing vast sums in excess driver incentives to fuel its food delivery growth engine, to divert attention from dramatically slowing ride-sharing growth. **Uber is under attack on any number of fronts – in its key international markets (with Didi running its "China Playbook"), in the US (by Lyft as well as DoorDash), and by the sheer number of regulatory battles it needs to win (in multiple EU markets as well as US states).**

Uber needs to move towards profitability whilst also fending off rivals in key markets where it previously held monopoly positions, and growing its Eats business in a fragmented US market and against a number of established players internationally. Re-igniting ride-sharing sales growth requires increasing consumer pricing – risking slower adoption in an increasingly competitive market that has shifted towards customer retention – or decreasing driver pay-out rates, fighting negative public sentiment, growing driver discontent and inviting regulation. With ride-sharing sales growth having slowed to 9% in 1Q19 (vs. 61% in 1Q18), we think Uber will continue to aggressively push its Eats business, expanding into new markets and increasing losses and cash burn. Uber Eats has yet to reach scale, with excess driver incentives growing 200% in 1Q19 to 54% of Eats sales. Whilst Uber is trying to tackle the uneconomic nature of Eats with low order value service fees, it is fighting an uphill battle vs. DoorDash, whose growth outpaces that of Eats, and contends with established *profitable* rivals like GRUB, JEAT and TKWY as it looks to roll out a marketplace elsewhere. **We see Uber in a position where, with its back against the wall, it has been left with no option but to go** *all in,* **and will continue having to spend more to fend off various rivals (as seen with the 54% yoy rise in S&M in 1Q19).**

Consensus sees Uber's net ride-sharing sales growing at 14% in '19, then accelerating to 20% in '20. In our opinion, this requires Uber brushing off a worsening US economic backdrop, fending off competitors globally whilst squeezing more from riders and drivers. **We think Uber will be unable to entice users into** *riding more* **whilst also increasing prices.** Uber's '18 FCF burn of $2.1bn was limited by the near $5bn gain on the divestitures of its operations in Russia and South East Asia, and a questionable "fair value gain" on its private stake in Didi. **We estimate that FCF burn more than doubles in '19 to $4.7bn and does not peak until '20, at $4.9bn, and do not see Uber becoming FCF positive until '25.**

Uber and Lyft: Valuing the Dream

Our challenge with valuing both Uber and Lyft is three-fold: 1) neither company aims to be sustainably FCF positive in the coming few years; 2) valuations need to capture periods of uncertain economic backdrops, alongside assumptions about changes in consumer behaviour for which there is limited or contrary evidence (i.e., *newer* cohorts, show they ride *more*); and 3) the need to capture a competitive dynamic that could turn brutal within a short space of time (as Uber saw in LatAm). **Both stocks are unprecedented in the sheer market value (an aggregate $100bn) granted to companies with no track record of profitability and numerous material uncertainties (i.e., pending regulation).**

We value both Uber and Lyft using a '19E DCF: this yields a '19E target price of $54 (8.8% WACC, 3% TGR) for Lyft and 18% implied downside, and a '19E target price for Uber of $33 (8.8% WACC, 3% TGR), showing 25% implied downside. **A host of Internet and platform companies currently trade at around ~11x 2024E EV/EBITDA, and whilst we would usually blend a DCF with a multiple to incorporate the current market climate and valuations, we instead focus on a DCF given that we have no visibility of Uber and Lyft becoming EBITDA profitable until 2024.** We see a number of hurdles for both companies, which must balance their progression towards profitability and cash burn in an increasingly competitive market, and whilst most problems discussed are applicable to both companies, the near term "beat" potential for Lyft takes precedent, whilst Uber failed to provide guidance for 2Q19 and any impending beat seems less extensive, in our view, whilst its stock has much a lower short interest. **We therefore initiate coverage on Uber with a Sell rating and Lyft with a Neutral rating.**

Required Disclosures

Company Name: Lyft, Inc. (Neutral), Target Price: $54 (YE19)

Valuation Methodology: Our target price of $54 is based on a DCF (8.8% WACC, 3% terminal growth rate).

Investment Risks (to Our Target Price):
1) Lyft could increase its commissions on ride sharing while still managing to recruit drivers;
2) Lyft could address new cohorts of users, out-compete Uber, or expand abroad;
3) The intensity of competition and need for financial incentives and promotions may ease;
4) Lyft could see a rapid uptake of scooters/bikes, or more frequent ride-sharing use;
5) Lyft could charge high prices to riders with minimal impacts to demand;
6) Lyft could grow revenue per active rider and earnings helping it beat consensus estimates.

Company Name: Uber Technologies (Sell), Target Price: $33 (YE19)

Valuation Methodology: Our target price of $33 is based on a DCF (8.8% WACC, 3% terminal growth rate).

Investment Risks (to Our Target Price):
1) Uber could increase its market share in US ride-sharing from Lyft and outspend rivals in international markets;
2) Uber Eats could reverse share losses against entrenched competitors and then reduce financial incentives for drivers/riders;
3) Uber could increase pricing for ride-sharing or Eats where it would not reduce demand;
4) Uber's well-known brand could allow it to reduce CAC and S&M costs;
5) Uber's Other Bets like Uber Freight could see high up-take and displace existing players;
6) Uber could use its cohorts as a marketing channel for other brands and services.

LYFT Price Chart

Source: Arete Research estimates.

UBER Price Chart

Source: Arete Research estimates.

Primary Analyst(s) Coverage Group: Activision Blizzard, Alibaba, Alphabet, Apple, ASOS, Baidu, Criteo, eBay, Electronic Arts, Ericsson, Facebook, JD.com, Just Eat, LG Electronics, LiveRamp, Lyft, Nielsen, Nokia, Samsung Electronics, Snap, Sony, Tencent, The Trade Desk, Twitter, Uber Technologies, Xiaomi, Yelp, Zalando.

Potential Conflicts: None.

Uber and Lyft: Dangerous Driving? 23 July 2019

Uber and Lyft: Dangerous Driving? 23 July 2019