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What Will It Take for Uber to Become Profitable?

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Uber has to fix its business model to make it profitable in a sustainable way, and the wake-up call for that has come from its second-quarter results, according to experts. More worrisome than the loss in the latest quarter of $5.2 billion — inflated by a one-time, non-cash stock charge of $3.9 billion related to its IPO — is that while the company has thus far emphasized growth over short-term profit goals, even it is decelerating.

Revenue rose by 14% to $3.2 billion, the slowest quarterly gain in its history. It has reported slowing growth over the past four quarters — from 58% to 12%. In the second quarter, gross bookings decelerated to 31% to $15.8 billion from 49% in the 2018 quarter. Meanwhile, Uber continues to burn through cash, with net cash used in operating activities jumping six-fold to $922 million from $153 million in the same quarter a year earlier.

"You can get away with these large losses when the growth rates are quite high, because many of your expenses, of course, are investments in the future," said David Wessels, adjunct professor of finance at Wharton. "But in this particular case, it's just bad news when the numbers are so low." He noted that rival Lyft posted "some pretty nice growth numbers" — up 72% in revenue and 41% in active riders in the second quarter of 2019.

Leonard Sherman, adjunct professor of business at Columbia Business School, said what's more troubling than the big loss is Uber's difficulty in becoming profitable on an ongoing basis. "That number per se is not a worry," he said, noting that it doesn't even come close to making it to the top 10 worst quarterly losses in history. "The big number was their quarterly cash burn." Uber's profitability problem "continues to exist, with the added pressure that we now have essentially diluted current stockholders in a money-losing enterprise. And it's not a pretty picture."

Wessels and Sherman discussed Uber's latest earnings report and business model on the Knowledge@Wharton radio show on SiriusXM. (Listen to the podcast at the top of this page.)

"The main theme of Uber's business model is the positive network effects. With more drivers, the value for riders go up — lower wait times, cheaper prices," said Gad Allon, Wharton professor of operations, information and decisions. "The more riders, the higher the value for drivers — or more work, and less wait time. The combination of the two can result in a powerful cycle, in which the firm's costs goes down and the revenue goes higher."

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>
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However, "Uber's growth is slowing down, and the costs are not slowing down," Allon continued. "There are many reasons [for those], but fundamentally, the issue is that Uber competes in both markets: riders and drivers. So, they can't pay drivers less and they cannot charge riders more, basically breaking the main assumptions that underline its growth strategy. In that light, working on other verticals of mobility (such as Uber Eats) is a viable strategy, as it waits for either … self-driving cars [to reduce driver costs] or a merger with Lyft [to consolidate operations]."

Uber CEO Dara Khosrowshahi described the $5.2 billion loss as a "once-in-a-lifetime" hit in an interview with CNBC. "We think we can not only survive, but we can really thrive in this business," he said. In his earnings call with analysts, he pointed out that Uber's adjusted net revenue this past quarter was $2.9 billion, representing a 26% year-on-year growth, and that it is set "to accelerate beyond 30%" in the second half of this year.

Warning Signs Ahead

In the meantime, Uber's cash trough has limits. "The clock is ticking," said Wessels. He noted that Uber has about $15 billion in cash, and that gives it about 15 quarters to get its business right and become profitable. (Those cash resources include about $8 billion in net proceeds from its IPO; $500,000 from its PayPal investment; $1 billion from investments by Toyota, Denso and SoftBank and other cash and cash equivalents, according to a company statement.) Uber's cash burn is a persistent problem.

While stock-based compensation expenses did inflate Uber's second-quarter loss, this charge is "not something that can be completely overlooked in a broader scale," Wessels contended. Investors would be concerned about its dilutive impact on earnings per share, he noted. Moreover, while it won't drain any cash, over the long run it still means "giving away ownership in the company," he said. "It's sort of a stealth way of giving benefits out without hurting from a cash flow perspective."

While Wall Street did expect Uber's second-quarter earnings to be walloped by a big stock compensation charge related to its IPO, the company still fell short of expectations for revenue and earnings per share. The stock plunged, hitting an all-time low of $32.92 intraday before rebounding to $34.61 on August 19. Its valuation has fallen to $58 billion from the $75 billion at the time of its IPO.

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In the meantime, Wall Street is bracing for another possible sell off in the stock once early investors can dump their holdings after the lockup expires on Nov. 6. "Until we get past that lockup, it would be very problematic for investors with a lot of money at stake to say, 'We're going to scale back operations; we've got to raise prices; we're going to consciously trade off growth with profitability and all those other things,'" said Sherman.

An Alternative to the Growth Narrative?

Since inception, Uber has pushed its growth narrative, but that may no longer be acceptable, Sherman noted. "When you don't have a profit story to tell, the only possible offset is [to say that] we're growing like weeds," he said. "The only possible future is to accept what should have been the way they approached this business from the beginning, which is to perfect [the business model] and then grow responsibly from there."

Sherman recalled that in the days of the internet bubble, grocery delivery startup Webvan and pet supplies firm Pets.com failed because they had a flawed business model. "[Uber] made the same mistake here with too much money being thrown too fast at the business that scaled before they understood what they were getting themselves into."

Wessels added that while Uber "wants to be in everything related to vehicles," it has to "pare back" to focus on those businesses it does best. He said it ought to focus on the core business of ferrying customers and then choose one or two other businesses it is particularly excited about. Also, Uber has to reassess whether it makes sense for the company to be in electric bike rentals, especially when it faces competition from firms such Bird.

In two years, Bird has grown rapidly to gain a presence in 60 cities across Europe, North America and the Middle East, and clocked 10 million rides in its first year. Uber entered this market last year buying bike sharing service JUMP, and it now has a presence in 28 cities in the U.S. and elsewhere. In 2018, Uber also launched its 'Transit' app that integrates with public transportation systems to help users plan their journeys.

Finding the Right Business Model

However, Uber could very well get its act right if it is resolute about it, said Wessels. "It's not like there are 40 competitors out there; it has one or two competitors nipping at their heels, who have their own problems to deal with," he added. "So, this could be a successful business, but at some point they're going to have to get serious." Reining in its billion-dollar quarterly burn should be a high priority, he said.

Sherman wasn't hopeful. "Unfortunately, I don't see the right response coming from Dara Khosrowshahi," he said. "The company continues to promote this idea that it is growth at all costs, which is, of course, what Travis did. (Travis Kalanick, Uber's founder, stepped aside in June 2017 amid controversies over the company's corporate culture.) Travis did an amazing job scaling this company. Unfortunately, he was replicating a fairly broken business model around the world rather than taking the steps necessary to strengthen the foundation of the business."

Both Kalanick and Khosrowshahi have promised that Uber will start making money after some big market play or market exit, but failed to do so, Sherman pointed out. Those promised turning points were its exit from China two years ago; its launch of Uber Eats five years ago (initially called UberFresh); or its migration to self-driving vehicles. Two months ago, Uber unveiled a self-driving car that will be built by Volvo in Sweden; it hasn't set a date for its launch, but said it could be in the next few years.

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However, "most folks who stay close to the sector realize that it's going to be a decade and probably a lot more before autonomous vehicles are widely commercially deployed," said Sherman. He said their launches have to be programmed city by city, and it also needs "continued massive breakthroughs in technology."

Even within its core business of ride hailing, Uber faces tough challenges in deciding which cities it wants to stay in and which it should exit because they are unprofitable, Sherman said. "Everyone's waiting for Uber to blink or Lyft to blink," he said. If Uber does decide to exit a market, it would have to cede the area's business to Lyft, "and Lyft is probably sitting there and thinking the same thing," he added.

Urban Transportation: A 'Crappy' Business

Sherman pointed to what he called an "inconvenient truth" with urban transportation. "As an economic sector of activity, urban transportation services is a crappy business," he said. "Not a single major rideshare company around the world is making money. That includes Didi in China, which after Uber pulled out in 2016 had "a near monopoly control of by far the largest ride share market in the world" and still incurred losses of $1.6 billion in 2018, he noted. Also, Singapore-based Grab, to which Uber sold its Southeast Asia business last year, "continues to be unprofitable," he said, adding that Lyft is also unprofitable.

Urban transportation is an unprofitable business as governments want those services to be subsidized to spur economic growth and welfare, Sherman explained. "Unfortunately, Uber has no way to take advantage of the positive externalities it creates — all those happy drunken passengers who go to bars on Friday night, and make lots of business for bars." At the same time, Uber will continue "to be punished for the negative externalities," such as regulatory barriers erected in cities such as New York and restrictions pending in Los Angeles.

On the other hand, taxis have never been profitable for operators or drivers in cities where they've been allowed to grow without regulation capping the number of allowable taxi permits, Sherman noted. "That almost guarantees that Uber can't make money" because the company and its competitors keep adding drivers, and it is "ultimately is a race to the bottom." Added Wessels: "At some point Uber has to focus and show us that the business model does make sense because taxis have never been a very good business."
