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THE CURIOUS CASE OF VALUATION

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ABSTRACT

The new disruptive business models evolving in the 21st century are posing great challenges for valuation professionals. Big names like Uber, Xiaomi, Flipkart, Snapdeal, Ola, Amazon etc. have suffered huge variations and flips over the past few years. The startup sector is bracing for impact as some half-a-dozen midsized companies issued layoff notices to hundreds of employees in a bid to reduce costs and conserve cash in what portends to be a tough time for an industry struggling to deal with the effects of fast-paced growth. This paper largely examines the valuation juggernaut of Uber and the views of two group of investors who sees the valuation upsides and those who support the valuation mark downs. Only time can tell who is right.

1. INTRODUCTION

Valuation is fundamentally the value of a company. Valuation matters to entrepreneurs because it defines the share of the company they have to give away to an investors in exchange for money. The current valuation of Uber is a sign of tech insanity and just another fantasy marketed by Silicon Valley (James Ball, The Guardian, 2014). David Wessels, Wharton adjunct finance professor says- “Their business model is fantastic, it’s a real business, with real tangible cash flow”. According to Prof. Aswath Damadoran – NYU Stern School of Business- “Disruption is easy but making money off disruption is difficult”. Uber is a unique beast for which there is seemingly insatiable investor appetite. These investors seem perfectly willing to finance this growth even with large losses” says Nikhil Krishnan, tech industry analyst at CB Insights. The question is who is right? Let’s get to the bottom-line.

2. THE DISRUPTIVE BUSINESS MODEL:

The recent years have seen the advent of a new form of business / business model which is pertinently referred to as ‘Platform Businesses’. Platform businesses are asset light, lean and simply connect the ‘Producer/Seller’ of a product / service with the ‘Consumer’ using technology and believe in growth/ scaling up through partnerships and networking eco systems. Uber, Ola, Airbnb, Alibaba, Amazon, Flipkart etc. are classic examples of platform business which disrupted the traditional business models and in the process attracted unbelievable valuations.

3. UBER: A STORY WORTH TELLING

Uber is the result of "clever resource integration" on the part of its founders, serial entrepreneurs Travis Kalanick and Garret Camp. "They integrated a mostly unused stockpile of personal automobiles, a large pool of potential drivers and the resources of a digital ecosystem that can be accessed on a Smartphone". Uber followed a very simple concept and developed a world class Platform business – they just enabled a user (rider) to use their app and order a vehicle / car for transportation. They helped the riders to get a simple but seamless and pleasant experience – easy 24 hour accessibility to cars, simple payment mechanisms, no dependence on cash, no tips, no haggling, transparent fares, easy tracking etc. They also took care of their driver partners who are the backbone of their service through attractive incentive schemes and support. A lean on the ground operations team handled all the support functions – driver recruitment, CRM issues, PR issues, local lobbying etc. Launched in 2010 Uber has established it's foothold in major cities in the world and attracted investor attention. Uber positioned itself as a 'tech company' and not as a 'transportation company'. Uber did not own any vehicles nor did it employ any drivers but only partnered with them.

4. THE VALUATION STORY:

In 2014, just after 5 years of its starting, Uber raised around $1.2 billion and based on industry estimated this funding pegged the value of Uber at around $ 17 billion. At this price Uber at that time was valued more than companies like United Airlines, Whole Foods and Alcoa one of the largest aluminum producer in the world. The story did not end here!

In June 2016 Uber further raised $ 3.5 billion from Saudi Arabian Sovereign Fund at an implied valuation of $ 62 billion. The valuation upside keeps rolling despite the mounting losses of Uber and series of operational problems like regulatory issues, passenger safety concerns, labour disputes etc.

5. THE GREEN SIDE:

The company's focus is "not about the market that exists; it's about the market we're creating," Uber CEO Travis Kalanick said in a story in The Wall Street Journal. He added that the company's vision is to "make car ownership a thing of the past". The supporters of Uber valuation rely on the following arguments / premise to look at the business as promising with great future potential: -

- Uber has a truly disruptive business model – they have provided a meaningful and inexpensive substitute for car ownership which has attracted customers from all walks of life all over the world.
- Uber's potential to transform the industry is immense thereby giving it opportunity to scale up easily. When you invest in a business and make essential services cheaper and easily accessible people tend to consume more. Uber will soon replicate in transportation industry, what Charles Schwab did in brokerage industry.
- Uber is optimizing its resources by expanding beyond transportation – its getting into delivery business, messenger services etc.
- Scott Kupor, managing partner at venture capital firm Andreessen Horowitz has an interesting view on determining market potential and growth (see Exhibit 1)

Exhibit 1 – Seeing Possibilities – views of Scott Kupor, managing partner at venture capital firm Andreessen Horowitz.
According to Kupor," most analyses of tech valuations tend to be short-sighted because they extrapolate projections based on existing markets. As such, they miss the boat by underestimating the start-up's true potential. For example, Airbnb, a service that matches people who have vacant rooms or beds in their homes with travelers in need of lodging, was gauged by the traditional metric of hotel stays. But

what many people failed to realize, Kupor says, was that Airbnb — which Andreessen Horowitz is backing — has created a much bigger market: People who never would have thought to enter the hospitality business began renting out rooms in their private homes. “You can dramatically change the market size opportunity by enabling a use case that didn’t exist before,” The same opportunity exists in the so-called “sharing economy” for car services, he adds.
Source: knowledge@wharton

6. THE DARK SIDE:

An Expert in Valuation Says Uber Is Only Worth $28 Billion, Not $62.5 Billion – Lots of risks ahead screams Prof Aswath Damadoran of NYU Stern School of business. After crunching some numbers, he believes that Uber's true valuation is actually south of $30 billion, less than half of the $62.5 billion it was pegged at in its most recent round of funding.

Every coin has 2 sides - There is a view from the other side also – a sizeable section of analysts believe that Ubers valuation is over hyped and not sustainable – for the following reasons: -

- Uber is no longer viewed as a ‘platform industry’ or ‘market maker’ – Regulators and Courts look at Uber as a player in the transportation industry – This process will force Uber to subject itself to regulations, pricing supervision, surge pricing rules, licensing, driver background checks etc.
- Unionization of Uber drivers is showing up and can become a distinct reality thereby increasing the bargaining power of the suppliers (drivers).
- Entry barriers are gone – competition is emerging with a force although for the time being their scale and size is small – Main competitors being Ola in India, GrabTaxi in Malaysia, Lyft in the USA etc.
- Investor impatience is showing up – Investors who invested expecting to unlock value in Uber IPO which was expected soon are now realizing that their wait for IPO is growing – against this background attracting new investors / convincing existing investors to further fund the cash burn may be difficult.
- Ubers contention that it will grab a significant market share and become a market mover (Winner takes all concept) in no longer proving right – competitors are not vanishing but continuing their fight and also have deep pockets.
- Big players (Apple? Google?) are eyeing this ride-share market and may enter it in the near future.

7. CONCLUSION:

We are going through testing times and turbulence. Difficult situations call for extra-ordinary solutions. Valuation professionals have to change their mind sets and look at new valuation metrics. Net profits and positive numbers aren’t the only parameters that determine value – even net loss firms can command value. Finally remember the old English saying “Beauty lies in the eyes of the Beholder” – everyone looks at the given situation differently and what is attractive to one person is not attractive to the other person. Also remember – 'Value' is always different than the 'Price' one is willing to pay. The Uber valuation story is a bit confusing – but as long as there are investors who buy the Uber story buyers will pay a premium (Price) and buy from the existing investors (sellers). The Uber model is here to stay at least for some time – Customers love Uber and Uber is now part of our daily life. 'Ride sharing' is becoming popular and accepted.

In the near to medium term however Uber will have to reinvent its business model and become sustainable through revenue management (maybe increase fares, unconventional revenue streams, pre-scheduled rides etc.) and expense management (maybe Lesser incentives to drivers, pricing incentives from car makers / preferential lease agreements etc.) so that the cash burn of the investor is kept under control. Always remember that no investor will eventually forget the 'bottom line' – however the answer to the question 'Who is right?' is still not clear – we can expect a lot more ammunition and interesting twists and turns.

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