The Uber Dilemma: Valuing Startup and Early Stage Companies with Negative Earnings.

BY SCOTT A. BARNES, CPA, CFF, CGMA

Valuing startup and early stage companies is enormously challenging, especially in litigation and shareholder disputes. Technology companies and emerging service platforms with disruptive technologies and/or disruptive business model further enhance the challenge.

That brings to mind the valuation of a firm like Uber, which on its latest equity round raised $3.5 billion in June 2016 at a $62.5 billion valuation. The dilemma is Uber reportedly lost $1.2 billion during the first six months of 2016 and significant losses are expected for the remainder of this year and continuing into 2017. The company has lost more than $4 billion since it was founding in May 2009. The enterprise value of Uber has rapidly escalated since its founding as summarized in the following graphic.

**History of Uber Financing Rounds and Enterprise Value**

Source: Crunchbase
Effectively, the enterprise value of Uber since 2011 has more than doubled every six months. During this same time period, the operating losses of Uber also continued to escalate at a similar pace. The company’s value has followed its revenue growth and not its actual earnings, or lack thereof.

Uber’s current enterprise valuation of $62.5 billion would make it the 17th most valuable technology company among publicly listed companies. Uber’s current valuation is higher than well-established companies such as Adobe ($53.9 billion), ADP ($39.9 billion) and Hewlett-Packard ($26.7 billion). All of which are profitable companies.
To put it into perspective, Uber’s current valuation anticipates long-term cash flow from “future profits” to approximate $12.5 billion per year based on a blended venture capital expected cost of capital of 20%. Future expected annual profits averaging $12.5 billion per year would place Uber in the top 20 of the most profitable global companies. Are these expectations realistic? Likewise, is Uber’s current valuation realistic?

Entities with negative earnings or companies experiencing cyclical and/or structural financial problems do not allow for the use of traditional valuation concepts, since it is unclear how and when the company will produce positive cash flow for its investors. Therefore, to value a startup or early stage company with negative earnings requires a more in-depth analysis and understanding of external and internal forces that can affect a company’s ability to generate positive cash flow. In the end, zero positive cash flow eventually equals no value! The dot-com bubble at the turn of the 21st century clearly demonstrated that when the hype stops, startups and early stage companies must produce a financially successful business model that generates cash flow to investors.

Start up and early stage companies are generally valued on a prospective basis, with the underlying economic assumption that the business model of the company being valued will eventually succeed (i.e., stay a going concern). That is in fact what investors are betting on, especially for a company like Uber. One of the keys to success and to achieving the valuation placed on a startup and early stage companies is the ability to raise sufficient capital to cover the operating losses until profitability is reached. One of the most significant assumptions and issues to address in valuing a startup or an early stage company is sufficiency of capital to achieve the business plan. Undercapitalized startups and early stage companies by their nature are doomed and the valuations placed on them subject to scrutiny.

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1 “Future profits” are being used synonymously for cash flow available to equity owners.
The current value of Uber is totally dependent on having sufficient capital and the ability to continue to raise capital to fund operating loss in a ride sharing market place that has drawn a substantial number of competitors. The number of competitors that have entered the market place to compete with Uber, plus the amount of venture capital investment made in them is staggering.

<table>
<thead>
<tr>
<th>Ride Share Company</th>
<th>Year Founded</th>
<th>Investment Raised in Past 12 Months</th>
<th>Total Amount of Investment Raised</th>
<th>Current Valuation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Uber</td>
<td>2009</td>
<td>$4.65 billion</td>
<td>$8.71 billion</td>
<td>$62.5 billion</td>
</tr>
<tr>
<td>Lyft</td>
<td>2012</td>
<td>$500 million</td>
<td>$2.01 billion</td>
<td>$5.5 billion</td>
</tr>
<tr>
<td>Didi</td>
<td>2012</td>
<td>$7.3 billion</td>
<td>$7.44 billion</td>
<td>$28 billion</td>
</tr>
<tr>
<td>Ola</td>
<td>2010</td>
<td>$500 million</td>
<td>$1.23 billion</td>
<td>$5.0 billion</td>
</tr>
<tr>
<td>Grabtaxi</td>
<td>2011</td>
<td>$350 million</td>
<td>$1.43 billion</td>
<td>$1.8 billion</td>
</tr>
<tr>
<td>Gett</td>
<td>2010</td>
<td>$300 million</td>
<td>$522 million</td>
<td>$2.0 billion</td>
</tr>
<tr>
<td>Via</td>
<td>2012</td>
<td>$100 million</td>
<td>$137.6 million</td>
<td>N/A</td>
</tr>
<tr>
<td>Scoop</td>
<td>2015</td>
<td>$5.1 million</td>
<td>$5.1 million</td>
<td>N/A</td>
</tr>
<tr>
<td><strong>Total Industry</strong></td>
<td></td>
<td><strong>$13.7 billion</strong></td>
<td><strong>$21.48 billion</strong></td>
<td></td>
</tr>
</tbody>
</table>
Over the past seven years, the ride share market place has received approximately $21.48 billion of venture capital investment, with approximately 64% of all the investment received within the past 12 months. Industry competitors are positioning themselves for a long battle for market share. Stiff competition between Uber and Didi in the Chinese market during 2015 and 2016 has already led to Uber exiting the Chinese market place through the sale of Uber-China to Didi in a stock transaction valued at $7 billion. This transaction will allow Uber to better focus its resources and attention to US and EU markets.

In August 2016, Uber reported that it now controls approximately 84% to 87% of the US ride share market place. To maintain that level of market share, Uber will be required to meet all competition on (1) price of service and (2) incentives to attract and maintain drivers from switching to competitors. The advent of a potential “driverless service” by Uber is requiring the company to substantially increase the amounts of capital investment into such vehicles and the associated technology to develop and perfect it for the market place.

There are many internal and external forces impacting the value of the competitors within the ride share industry, most of all the valuation of Uber. Presently, Uber’s dash for cash from venture capital and now other institutional investors like the Saudi Arabia Public Investment Fund ($3.5 billion in June 2016) and debt financing from Morgan Stanley ($1.15 billion in July 2016) is seeking to suck all the available venture and institutional capital out of the ride share market place to ensure its own survival. All this is to the detriment of its competitors that are also seeking to raise additional funding from venture capital, institutional and strategic partners to compete with Uber. The ensuing battle for market share and the competition for the most favored business model as chosen by both drivers and consumers will leave many competitors drained of existing cash on hand and potentially limit their ability to raise additional capital that will be vital to their survival and support of their current valuations. Venture capital investors do not like to see down rounds, especially those investors that made their investment in later rounds at every increasing valuations.

Software and logistic application business models, like Uber, are subject to consumer preference, and that preference can change suddenly with a loss of application users if service, ease of use and satisfaction of service changes. Car ride sharing services are even more dependent upon dedicated drivers who sign up to actually provide the car service. A loss of drivers seeking better benefits and revenue sharing arrangements can quickly and negatively impact current and future earnings. This is precisely the reason that Uber is pursuing a “driverless” technology platform to be
able to control the actual provider of the service. This business model is more capital intensive and subject to regulatory, legal and consumer acceptance concerns. At the same time, this new expansion of the Uber business model into a driverless technology must continue to match or beat the price to consumers among other competitors currently in the market place. In effect, Uber is currently burning the candle at both ends by spending cash to stay off competition and build a defensible strategic position with a driverless technology platform.

Start Up and Early Stage Company Valuations are Dependent Upon Internal & External Forces

Understanding the causes of these internal and external forces requires being able to answer the question of “why a startup and early stage company’s earnings are negative or not meeting their original projections? Put more simply, it is the ability to determine if the lack of earnings is the result of a temporary or a more troublesome long-term problem. This makes it necessary to clearly understand a startup and early stage company’s business model and the unique economic issues in order to select the appropriate valuation method. The valuation approaches and methods will be significantly affected by whether the unique economic issues are (1) temporary, (2) operational or (3) structural.²

Temporary Issues

Sometimes, the negative earnings or lack of meeting previously projected earnings may be the result of temporary problems, such as:

- a delay in the rollout of a new product or service,
- pending regulatory approval,
- workforce disruption, or
- changes in business or marketing strategy.

All of these issues represent company specific problems, however, there are certain instances in which outside factors can affect a startup or early stage company’s earnings or cash flow such as:

- increased costs to provide service or to manufacture,
- rejection of regulatory approval,
- new competition,
- changes in capital markets,
- economic recession, or
- changing consumer preferences.

For example, Uber is currently experiencing increased costs to provide its service due to incentives needed to both attract and maintain drivers using its application platform. The effect of increased driver costs will be felt throughout the industry among all competitors. Accordingly, the path to profitability has been extended in terms of time for all competitors due to competition for supply of drivers. The critical economic issue is how long will competition continue to be financed by negative earnings, all which should have a negative impact on the current valuation. Venture capital and institutional investment will only finance losses for a finite period of time.

Application software platforms such as Uber are also highly impacted by changing consumer preferences. As quickly as an application gains acceptance, consumer taste can quickly change if there is:

- a disruption to accessing the service,
- consumer tastes change,
- a better application is created by a competitor, or
- the actual service providers do not meet expectation.
With regard to Uber, its current valuation is dependent upon (1) consumers continuing to download the application and use it and (2) third-party drivers continuing to support the platform and provide a good experience and value to consumers. Any loss, disruption or dissatisfaction of service could negatively impact continued use by consumers. This is the “Myspace” dilemma, which lost consumers to Facebook. In 2007, Myspace was valued at $12 billion. In 2011, Myspace was sold for $35 million after losing the social platform battle to Facebook, which entered the market place in 2007.

There are also times when a drop in earnings is the result of a greater macro issue such as a recession. Recessions or negative changes in current economic will tend to be only temporary; however, a startup or early stage company requires sufficient capital to weather the storm.

Where it is determined that a drop in earnings is just temporary as opposed to more persistent, the appropriate method to estimate value would be to “normalize future estimated earnings” to take into account the time period where profitability and cash flow will be realized. Basing a valuation on normalized future earnings assumes that a company will reach profitability in the near future and has sufficient cash on hand or continued access to capital at normal costs of capital for startup and early stage companies.

**Operational Issues**

There are times when a negative earnings is due to a more serious long term problem resulting from:

- operational inefficiencies,
- lack of acceptance of the technology or service,
- under capitalization, or
- poor strategic management decision.

Strategic issues can affect a startup or early stage company if it has, for example, chosen a technology, service platform or marketing strategy that has not been well received by the investor community, end consumer or interrelated third-party that is required to participate in the service to the consumer. The increased costs associated with certain strategic problems can potentially lead to a drop in earnings. This decline in earnings and the delay in the time period of when future profits can be expected to be realized requires a need to thoroughly understand the depth of the problem and determine how long the problem will persist.
Operational issues and the cost to correct may take more investment capital and time than the market place may accept, resulting in a failure of the entity and the loss of all perceived value. The impact on value will be dependent on having sufficient cash-on-hand or the ability to continue to raise sufficient capital to weather the operational storm. Other competitors that have not been encumbered by the operational or strategy issue may leap frog ahead. Again, think of Myspace.

Depending on the industry and market place the startup or early stage company is competing, it may be appropriate to use the industry average as a basis for estimating the company’s future margins, since it is reasonable to assume that if a startup or early stage company is going to be competitive it at least needs to be as good as the average for the relevant industry after considering the cost and the time period to implement the new strategic initiatives. In the instance of Uber, no industry average currently exists considering the relatively young nature of the entire industry. However, sufficient operating history exists to at least determine the reasonableness of underlying cost to provide service in a normalized competitive market place. This means competitors must exit the battlefield so competition for market share ends and normalization occurs.

Inefficient operations or poor management decisions that result in increased costs may also cause a company to experience long-term economic problems. A good example of this type of scenario would be a company in which the management team has initiated an acquisition policy to gain market share, expand or integrate ancillary services or eliminate competition and has in many cases overpaid for the acquired companies. As a result, these operational problems may have a negative impact for a number of years. Therefore, in valuing a startup or early stage company experiencing these types of issues requires a detailed cash flow projection using sustainable future profit margins may be the most appropriate valuation method to use. In the instance of Uber, its large war chest of capital investment may well be intended to make acquisitions at prices more tolerable than incurring future negative earnings through competition.

The key issue is determining when the startup or early stage company’s sustainable margin can be achieved. For instance, if a company’s economic problems are related to management issues, it may take many periods for new strategies and cost cutting plans to be implemented and achieved. For that reason, the discrete cash flow projections should reasonably estimate the expected growth of the company and the anticipation of when the company will reach profitability. Again, the
sufficiency of cash-on-hand or the ability to continue to access the capital markets to fund negative earnings is required.

**Structural Issues**

A startup or early stage company may also experience negative earnings because it has chosen the wrong capital structure to fund its launch, expansion or has been forced to accept harsh investor or venture capital terms. For example, convertible debt may have been used to finance the company making future capital raises difficult as new investors will not wish to be subordinated to early debt owners, especially those with secured debt with liens on the technology or assets of the company. This does not mean that in these instances the company automatically has no value, particularly if the company has strong revenue growth. To estimate the value of company with negative earning with balance sheet structural issues requires valuing the company on a recapitalized basis since that is the economic reality that is needed to achieve long-term profitability.

**Determining Long-Term And Temporary Economic Problems**

One additional aspect for valuing startup and early stage companies is to consider is whether a company’s economic problems can be considered long term or temporary. This process involves determining the credibility of management, how much information about the problem is available, validating the claim that the negative earnings are a result of an economic downturn or temporary issues, and analyzing how long the problem will continue. In terms of critiquing management, it must be realized that some management teams are much more forthcoming about a company’s problems and taking action. In performing a valuation of a startup or early stage company, eventually requires that a judgment be made on whether or not the representations of management are valid as to why earnings are negative and the time period that profitability will be reached.

A lack of information, delays in addressing issues and management reaction to the problem may be indicative of greater issues within the startup or early stage company. The estimated value is wholly dependent on achieving future profitability.

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