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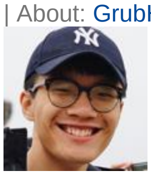
GrubHub's Premium Valuation Hard To Justify Considering Increasing Competition And Margin Contractions

Feb. 5, 2019 9:15 AM ET|

| About: GrubHub Inc. (GRUB)



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Long only, value, growth at reasonable price, contrarian

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Summary

Online food delivery industry is a high growth industry and GrubHub is the best of breed company.

However, intense competition from competitors who have or will receive capital injection in the near future means that GrubHub will have to spend more thus face margin contractions.

A wait and see approach is best suited to evaluate if GrubHub can defend its market and revenue share while continuing to turn revenue into profits.

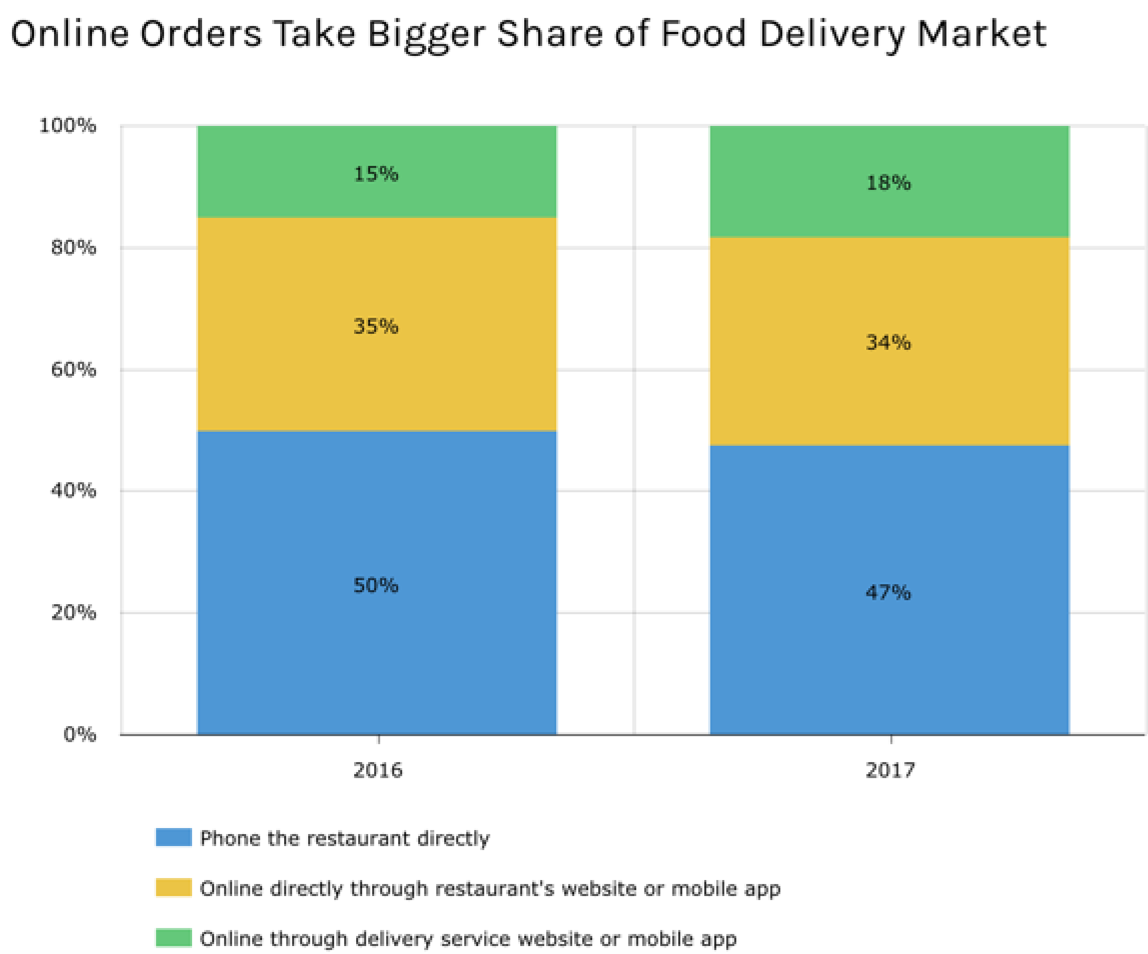
GrubHub (GRUB) is a high growth company (as seen in the below graph) in an industry (online food delivery) that has enjoyed significant secular growth in the past years. However, in order to determine if GrubHub can continue to achieve high growth in the future, it's important to understand how big the US food delivery market currently is, how fast the industry can grow in the near future and whether GrubHub can grow at a rate faster than the market and its competitors.

Data by YCharts

Total Addressable Market (TAM)

A McKinsey report published in Nov 2018 concludes that the "market for food delivery stands... (at) 1 percent of the total food market and 4 percent of food sold through restaurants and fast-food chains." Furthermore, most food deliveries (90%) are placed directly with the restaurant (e.g: ordering pizza directly through Domino's (NYSE:DPZ)) which offers its own delivery service. Of these traditional food deliveries, only 26% are conducted online.

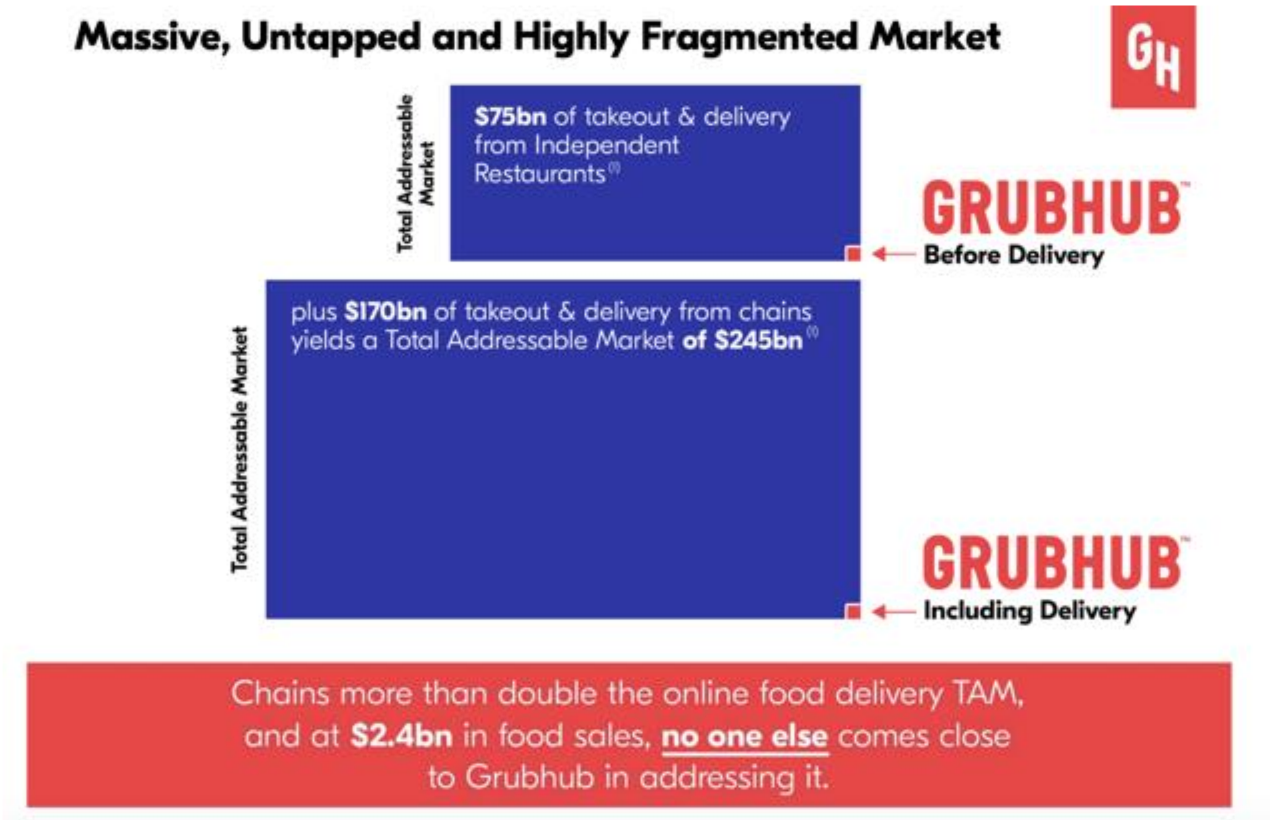
Hence, the bull thesis based on the premise that GrubHub and its competitors will be able to convert these traditional methods of food deliveries into its customers as restaurants find it more cost efficient to outsource the logistics of delivery and benefit from GrubHub's large following. This is seen in Morgan Stanley's 2017 report on the food delivery industry which shows that online orders particularly through a delivery service is taking a bigger share of the food delivery market (15% to 18% in a year). This complements the two sources of customer demand driving the food delivery business - food delivery as substitutes for dining at restaurants & substitutes for cooking at home.



Source: Morgan Stanley

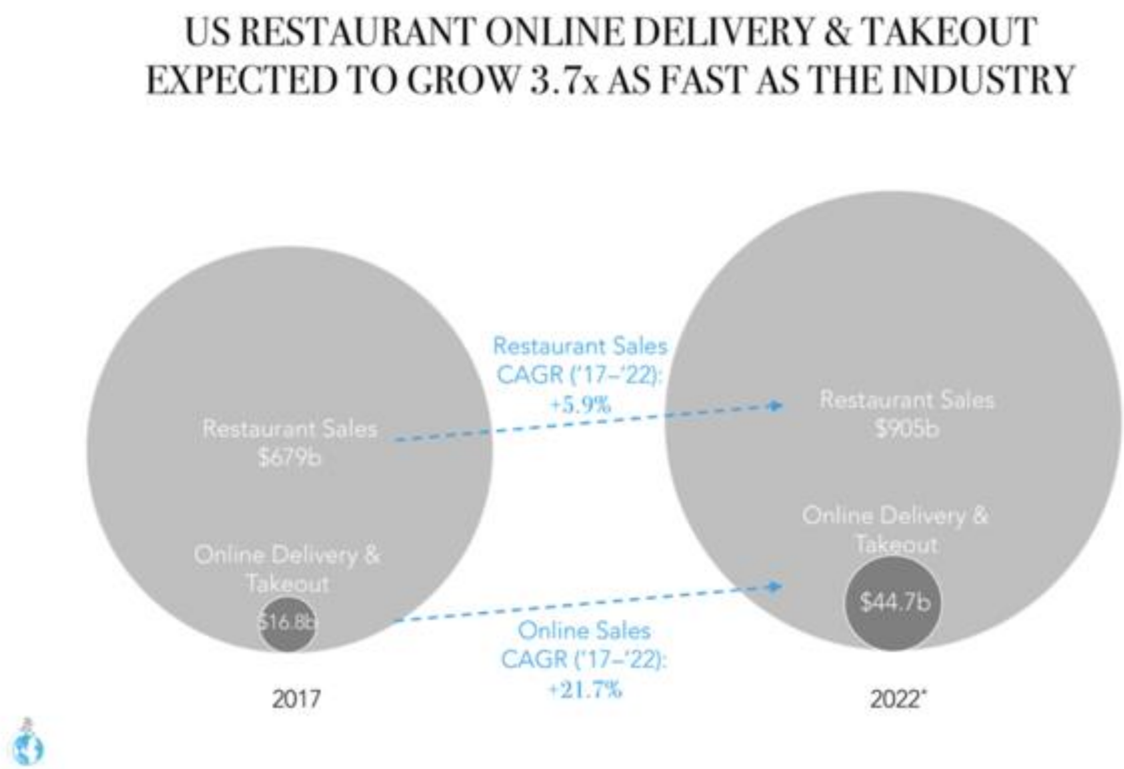
But what exactly is the TAM for the online/mobile app food delivery service business? In its 2015 investment pitch deck, GrubHub claims that the American TAM is $245 billion including delivery & takeout of independent and chain restaurants. Morgan Stanley has a slightly different number.

40% of total restaurant sales—or $220 billion could be up for grabs by 2020, compared with current sales of around $30 billion.



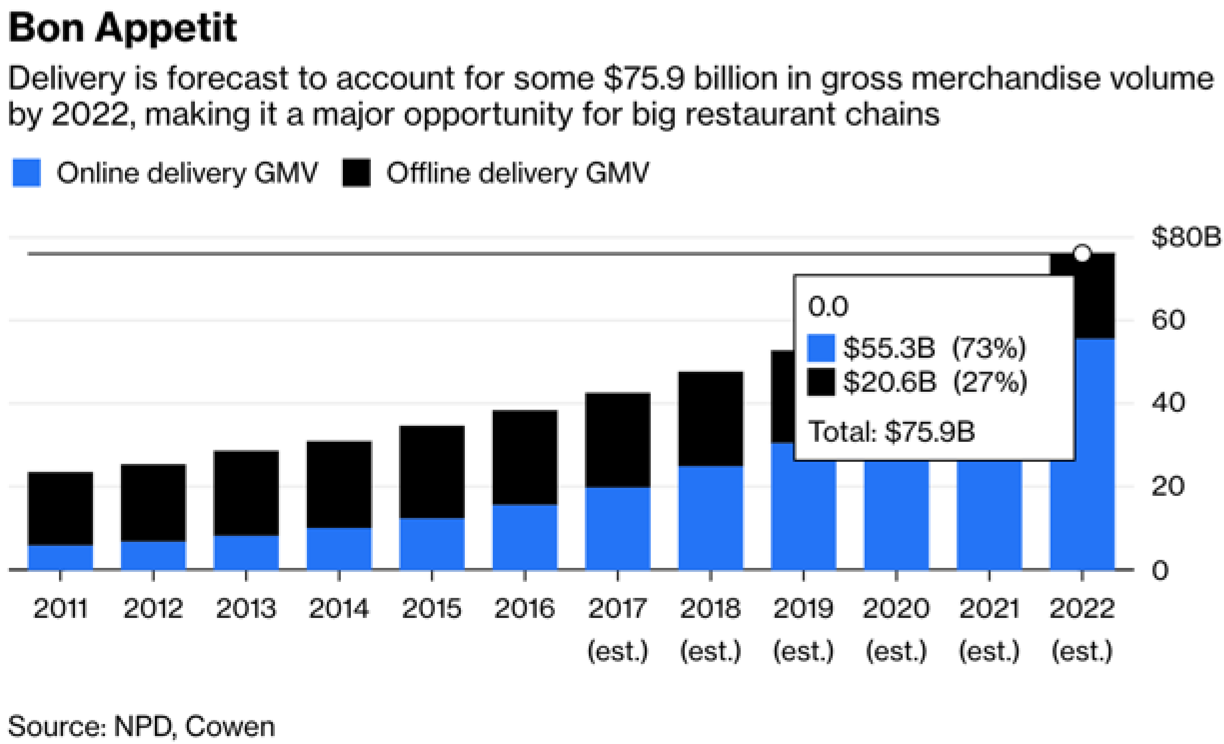
However, the over 200 billion TAM projections (especially the one provided by GrubHub itself) probably include traditional methods of delivery (direct from restaurants) which currently make up around 80% of all food delivery orders. Orders through a delivery service currently make up 18% (up from 15% in one year) of all orders and if one predicts that market share will grow to around 20-25% by 2022, this would be equal to around $45 billion.

This is similar to predictions made by Aaron Allen & Associates which predict a 21.7% CAGR with online delivery and takeout predicted to grow to $44.7 billion.



Source: Aaron Allen

On the other hand, investment firm Cowen is more optimistic. It is forecasting that the online food delivery industry in the US will grow from to $76 billion in 2022, 12% annually over the next five years.

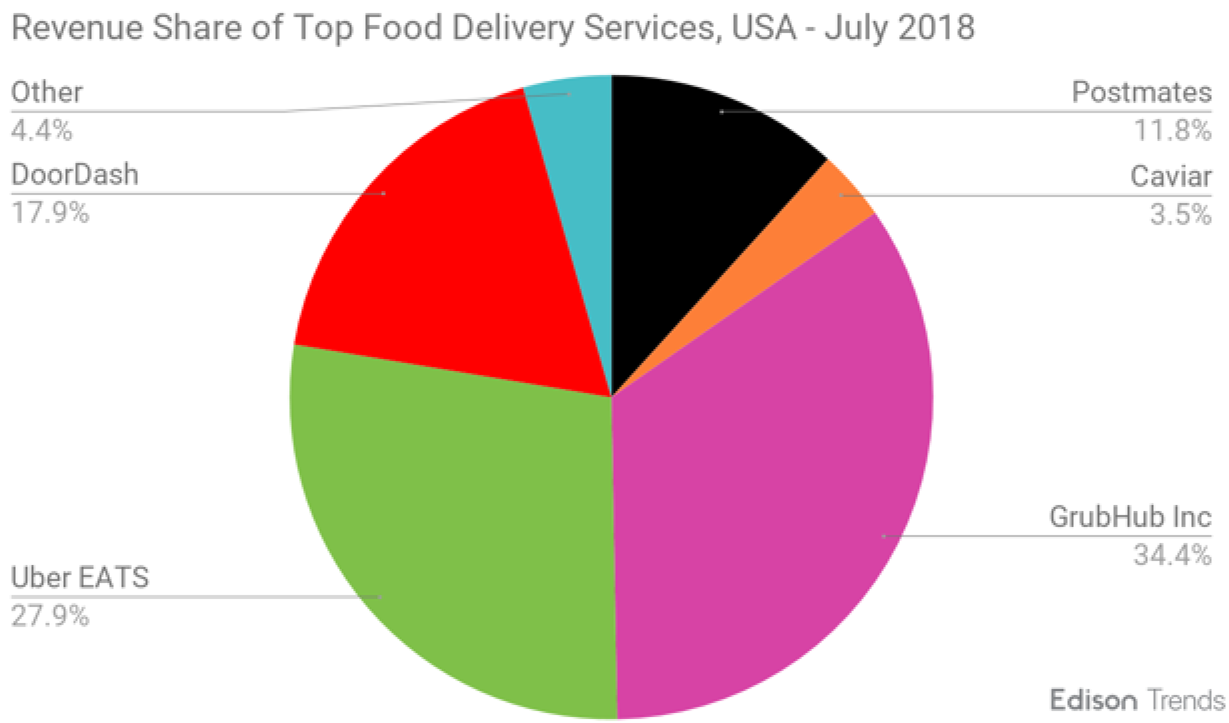


Source: Bloomberg

If GrubHub manages to maintain its current market share of 34% and if assuming that it continues to earn a 19.5% cut on all orders (calculated by dividing revenue by gross food sales), this would be mean GrubHub earning a revenue of $2.98 billion 2022. This is equivalent to a 198% increase from 2018 sales projection of 982 million. Clearly, the online food delivery industry is in an exciting stage of high growth but the more important question is whether GrubHub will be able to maintain its current market share and commission.

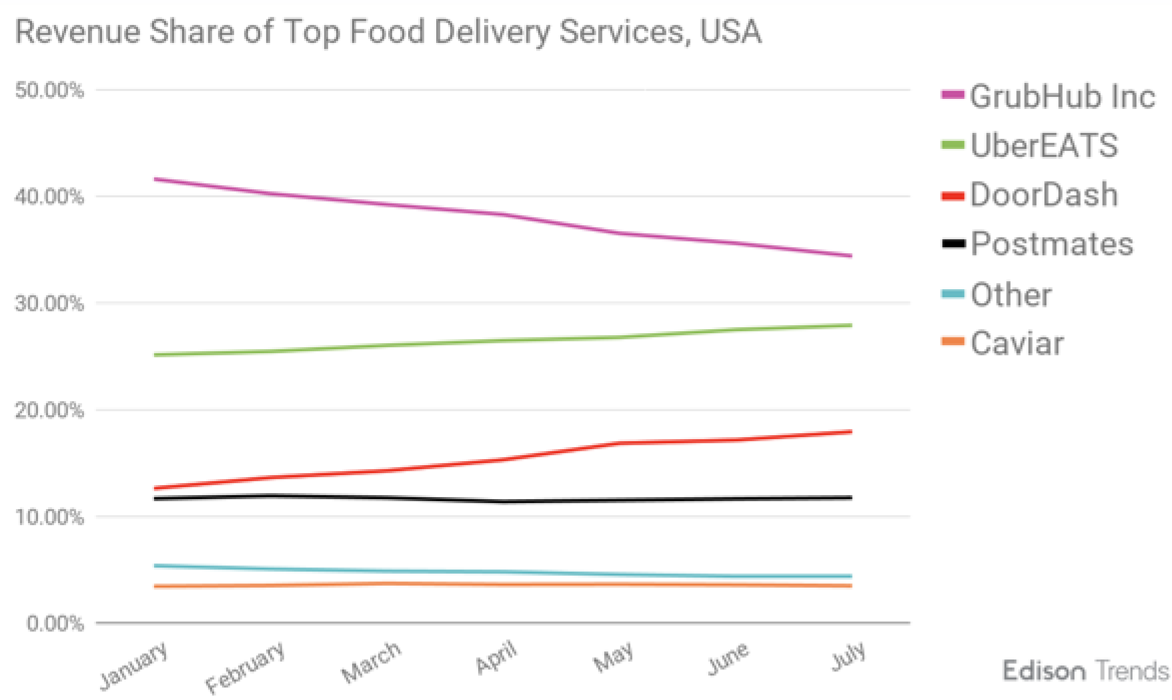
GrubHub's position in the industry

With a first mover's advantage over its competitors, GrubHub has managed to establish a market leading position in the industry at 34.4%. While some analysts have said that it's a rather fragmented industry, the top 5 companies have a 95.6% market share.



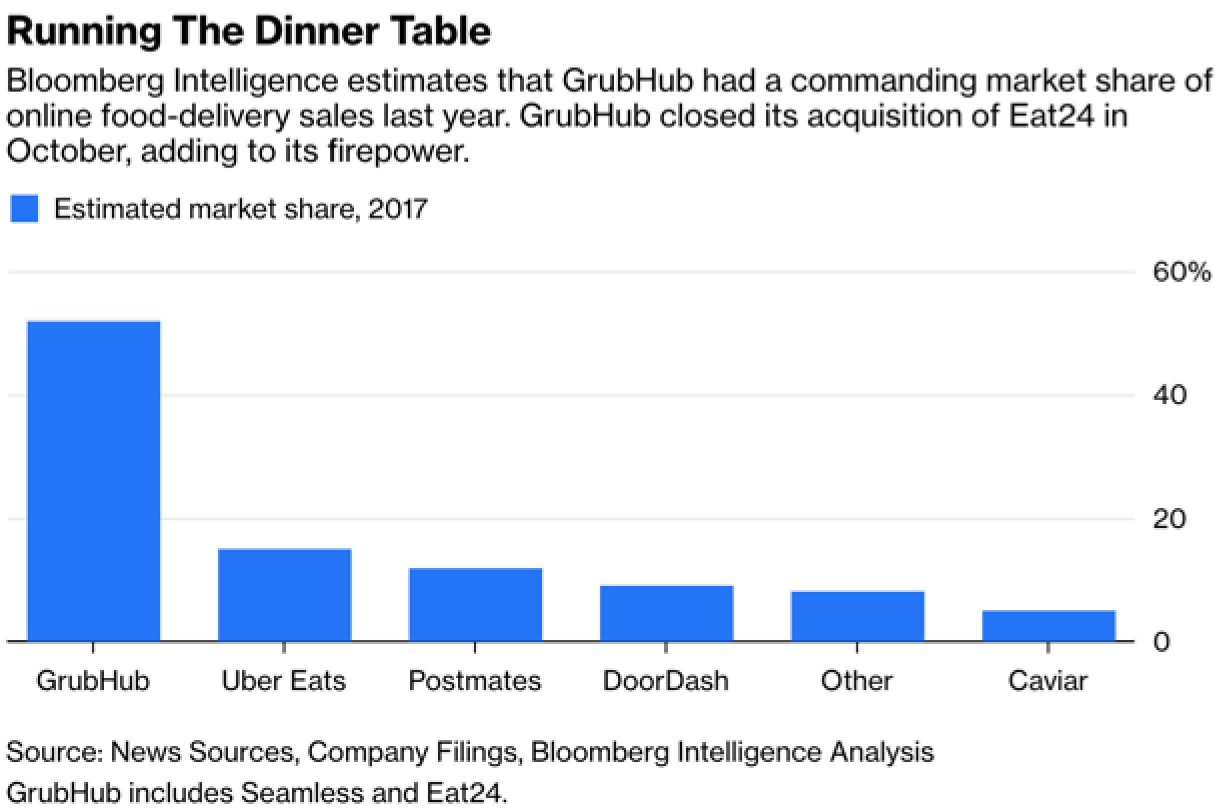
Source: Edison Trends

However, it is incredibly worrying that GrubHub's market share has fallen from around 41-42% at the start of Jan 2018 to 34% in Jul 2018! It is facing stiff competition from Uber Eats (UBER) as well as DoorDash (DOORD) which has seen significant growth in market share in 1H 18. Given this worrying trend, I would not be surprised to find GrubHub's market share to be even lower towards the end of 2018.



Source: Edison Trends

The below graph of the breakdown of market share in 2017 shows just how quickly GrubHub has lost much of its substantial lead on Uber Eats in little less than a year.



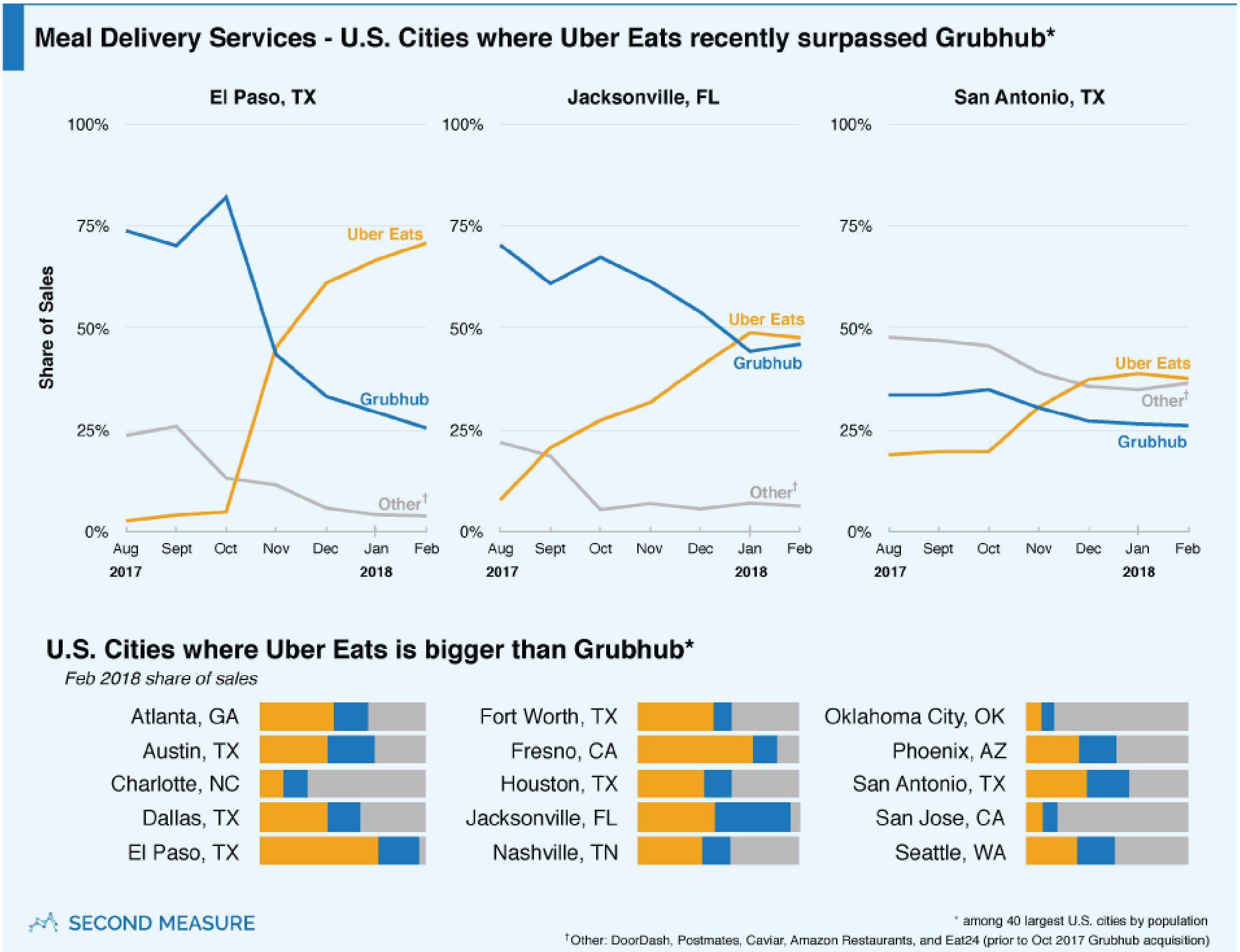
Source: Bloomberg

Here are what some of GrubHub's competitors are doing or planning to do to increase their market share:

Uber Eats

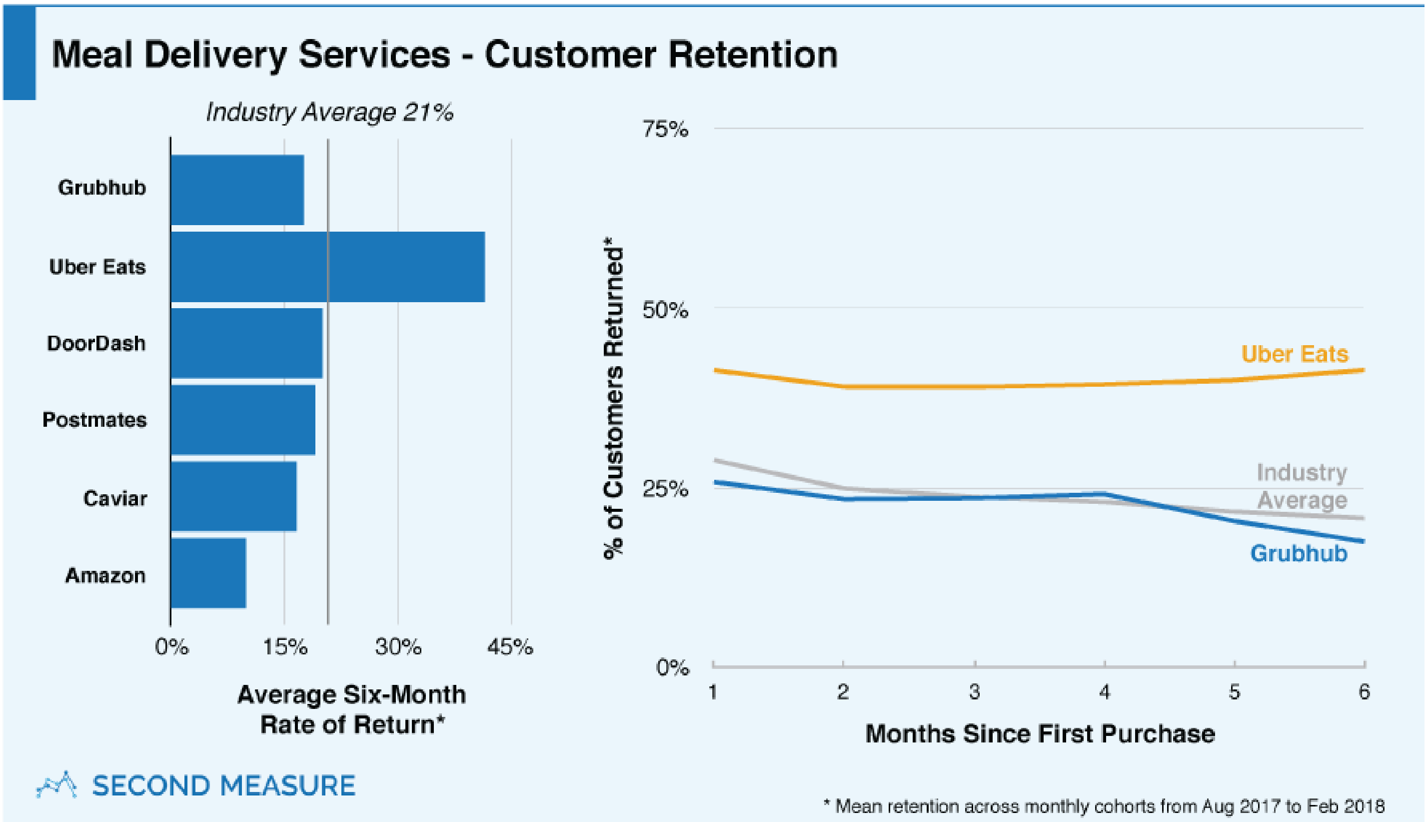
Earlier in Oct 2018, Uber Eats announced that it would expand and by year-end cover 70% of the US population, thus doubling the number of cities that it operates in. Its expansion will allow it to expand to smaller cities and the suburbs.

Furthermore it has sought to increase its popularity among consumers in the US by partnering with popular chain restaurants that consumers like. For example, it announced an exclusive partnership with Starbucks (NASDAQ:SBUX), Popeye's, Subway and McDonald's (NYSE:MCD). This has allowed Uber Eats to grow at over 200% (according to its CEO) and has a total gross bookings worth over $6 billion worldwide as compared to GrubHub's $3.7 billion. It was also announced in Apr 2018 that Uber Eats now owns a greater market share than GrubHub in 15 major cities as it ramps up spending.



Source: Second Measure

Uber Eats also appears to be a stickier service than GrubHub and its other competitors. It has an industry-leading retention rate of 41% where 41% of its customers use the app again within 6 months. This is a great number especially when compared to GrubHub's meager 17% retention rate.



Source: Second Measure

Amazingly, its huge growth has been done very organically especially as compared to GrubHub. While GrubHub has made 12 acquisitions since 2011, Uber Eats has only made one acquisition since 2014. Despite this, Uber Eats has enjoyed far higher growth. Its recent acquisition in Jan of 2018 has led to speculation that Uber Eats would adjust its growth strategy to be more in line with GrubHub especially after its 2019 IPO which will provide it with more capital to make such acquisitions and continue its high growth strategy.

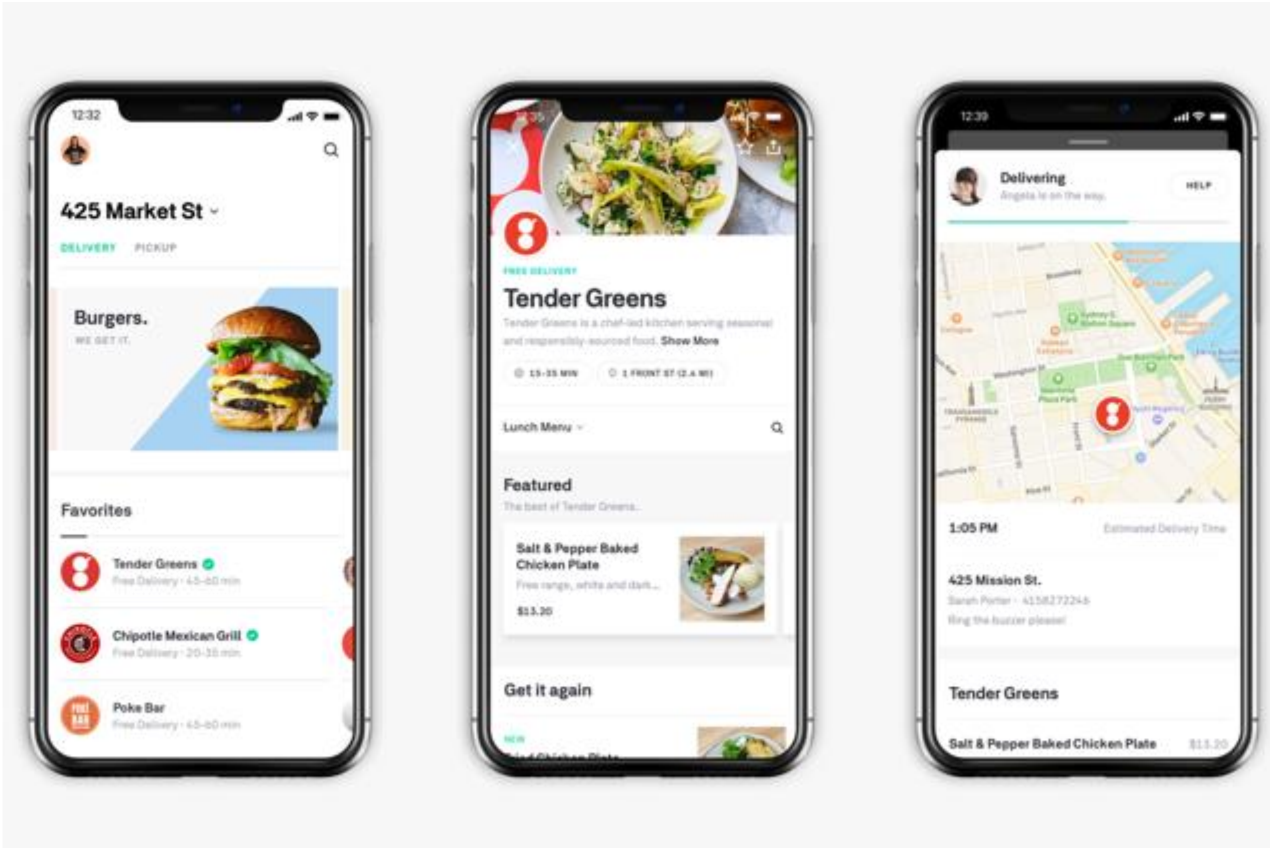
Postmates and DoorDash

Besides Uber Eats, the other online delivery app that has enjoyed some of the highest level of growth in 1H of 2018 is Postmates (POSTM). Postmates and Doordash have created an intense rivalry as challengers to GrubHub and Uber Eats.

Postmates is currently valued at $1.85 billion and has introduced a robot delivery service called Serve which will be rolled out in several cities to help make the last mile delivery. Doordash was valued at $4 billion in August 2018, nearly tripling in value a few months after its $1.4 billion valuation in March 2018.

Source: Fortune

It has also managed to secure several big name partners. For example, in 2018, it added Walmart (NYSE:WMT) and Chipotle (NYSE:CMG) to its list of partners. This is similar to Doordash which has partnered with 50 of the top 100 restaurant chains in the US including Wendy's (NYSE:WEN) and The Cheesecake Factory (NASDAQ:CAKE).



Source: Recode

More interesting are the persistent rumours of a merger between DoorDash and Postmates that will provide it with the scale to compete with Uber Eats and GrubHub. However, talks have stalled and Postmates has hinted at a 2019 IPO thus providing it with more capital to take on its bigger rivals.

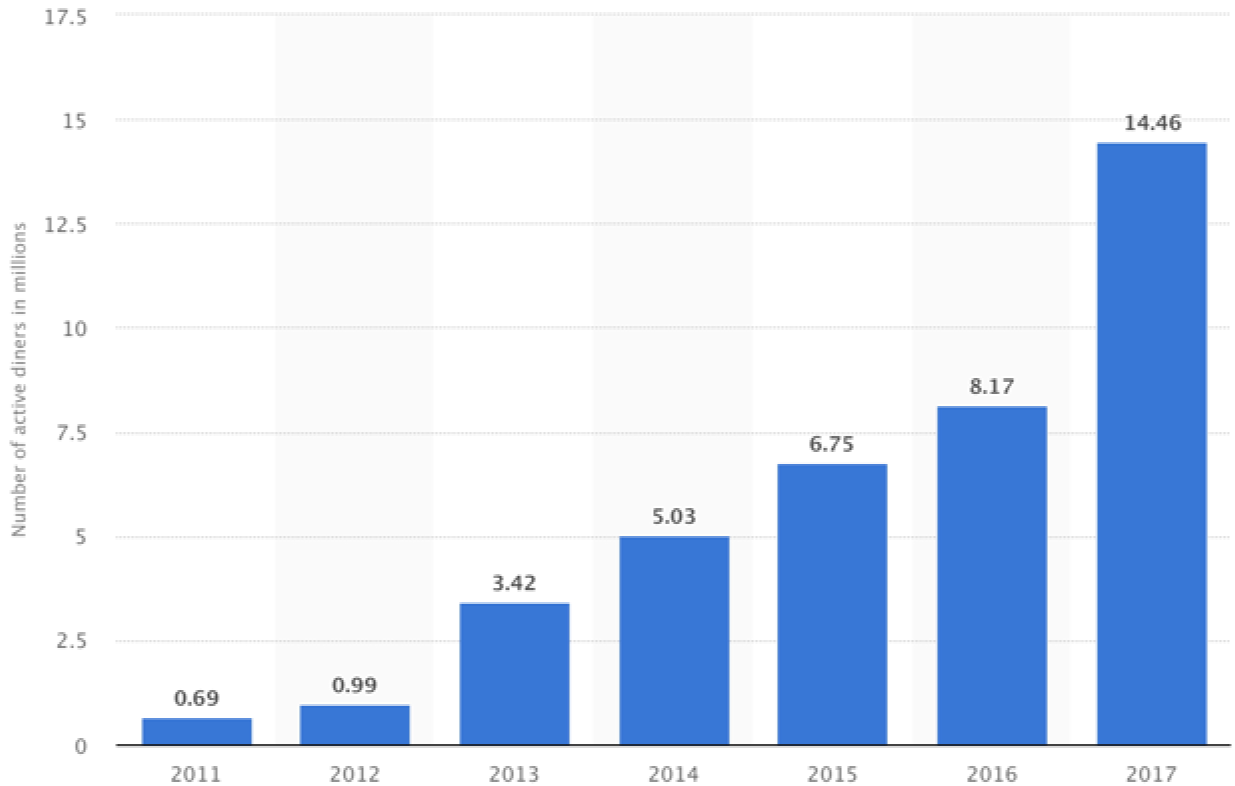
GrubHub's strategy

GrubHub has fuelled its growth through two main ways - acquisition and exclusive partnership with chain restaurants.

Among its more notable acquisitions include Tapingo which focuses on food delivery on college campuses (can be found in more than 200 campuses), Eat24 which was Yelp's food delivery service and Seamless, a food delivery service that it merged with earlier in 2013.

GrubHub has also consistently tried to forge new partnerships with popular chain restaurants. Among its more successful attempts are its recent partnership with Yum! Brands (NYSE:YUM) where GrubHub will delivery for Taco Bell and KFC. However, I also believe that a great value proposition for users to try services such as GrubHub is to try and discover new food hence the importance of onboarding non-chain and independent restaurants. Here are some examples of great independent restaurants that can be found on GrubHub.

While GrubHub may not be growing as quickly as its competitors, its two-prong strategy has allowed it to enjoy significant growth. For example, its number of active users have grown significantly from 0.69 million to 14.46 million in 2017 and its most recent number of 16.38 million (Q3 18) with over 400,000 orders placed daily.

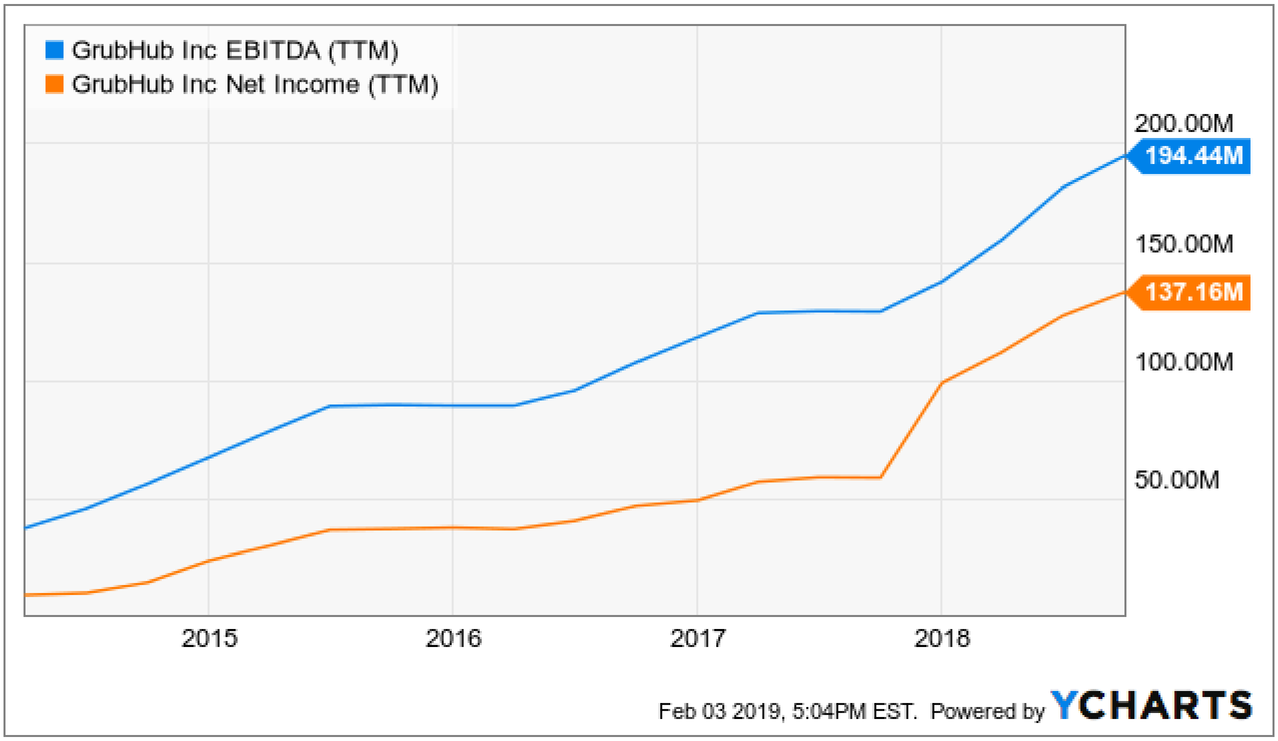


Source: Statista

According to Second Measure, GrubHub's customers are among the most frequent users of online delivery. "In the first 10 weeks of this year, 17 percent of GrubHub’s customers ordered food at least once a week, on average. And over 2 percent of its customers placed orders an average of three times per week or more. At Uber Eats, that number was only 1 percent."

Lack Of A Moat

Besides possessing a first mover's advantage, I believe that recent events show that GrubHub does not possess any particularly durable or significant moat. It is seeing its market share dwindle rapidly as Uber Eats and Postmates see rapid growth. Furthermore, its user metrics are also inferior when compared to its competitors (with the exception of attracting frequent users). Instead, I see GrubHub's only exemplary feature being its ability to turn a profit (as seen in the below chart).



Data by YCharts

This is in stark contrast to its competitors worldwide. For example, despite enjoying more than 85% revenue growth in 2017, Postmates saw an operating loss of 75 million from a revenue of around $250 million while Doordash also indicated to CNBC in Aug 2018 that it was yet to be profitable. This is similar to the online delivery market in the rest of the world. Takeaway.com (OTCPK:TKAYF) (market leader in several European countries such as Germany and the Netherlands) posted a 1H 18 loss of around 14.7 million euros as compared to a 110 million euros revenue.

Deliveroo, another online food delivery giant saw pre-tax losses balloon to 184.7 million pounds with a 2017 revenue of 277 million pounds. This is the same in China where Ele.me, Didi and Meituan are all operating loss-making businesses in online delivery. Hence, I find GrubHub's consistent ability to convert revenue into net profit quite incredible in such a cut-throat industry.

However, I believe that given the increasing competition in the US market as well as the projected increased capital injection into many of GrubHub's competitors in 2019, GrubHub will have to spend more than it did in order to even maintain its current market share.

Margin contraction as a result of increased expenses were mentioned by management which projected a $10 million increase in expenses to expand driver capacities in new markets. GrubHub is also projecting for increased spending (increase in $10-20 million) in marketing which includes incremental discount offers. This has led management to re-guide Q4 EBITDA to about $40-50 million ($25 million less than initial guidance).

One of my greatest fears for the online food delivery business in the US is that it might spiral into a full-out price war. GrubHub's management has already hinted that it would provide "incremental discount offers" when explaining the increase in marketing costs. The perfect example is China where competition is so fierce that companies are offering massive discounts in order to increase its market share. As can be seen below, a meal ordered on the Meituan app would cost 32.5 RMB but after discounts provided by Meituan, the user only had to pay 1 cent. This is a concern reflected by management in its recent Q3 earnings call

Other people are more willing to sacrifice basic profitability and unit economics in order to achieve scale and come to build a network that would rival ours

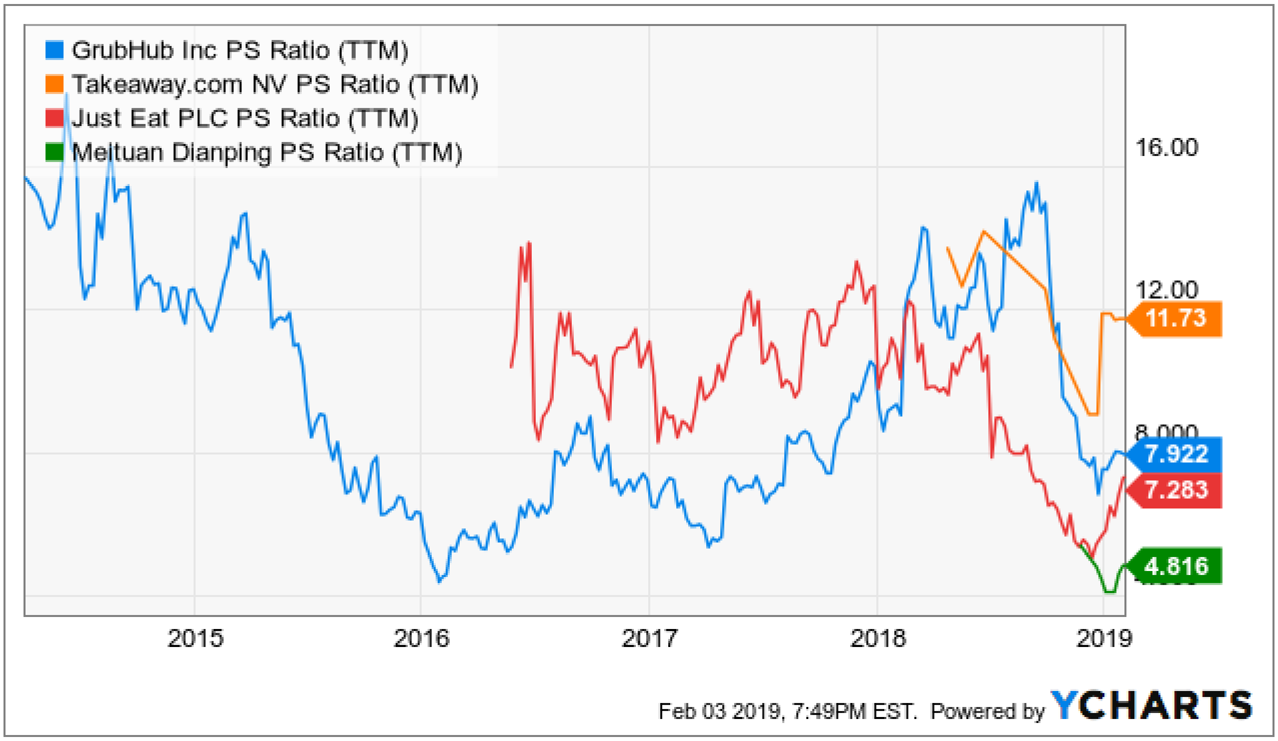
Dongchi Meal Box	
Chicken rice	¥27
Package fee	¥3
Delivery fee	¥2.5
Delivery fee waiver	-¥2.5
Meituan red packet	-¥15.99
Coupon	-¥14
Total	**¥0.01**

Source: The Quartz

Valuation

Given its continued high growth, ability to turn a profit and market-leading position in an industry that has many secular growth drivers, there is no doubt that despite increasing competition, GrubHub is a good company. However, where the problem often lies is the valuation of a company with no considerable moat and competitive advantage. This is reflected in the Barron's article, " GrubHub: A Good Company at the Wrong Price."

GrubHub currently trades at a P/S ratio of 7.9 which is neither historically high nor particularly low. It is also around the middle of the pack when compared to other publicly listed food delivery companies as shown below.



Data by YCharts

However, how does GrubHub's valuation compare to its US peers. According to Edison Trends, GrubHub's 1H 18 revenue was $472.3 million giving it a 34.4% revenue share in the US. This would imply that Uber Eats with 27.9% of revenue share had a revenue of $383 million, DoorDash with $245.76 million and Postmates with $162 million.

Based on 1H growth, I extrapolate 2018 revenue to be around $1 billion for GrubHub, $589.8 million for Doordash and $364 million for Postmates. This translates to the following P/S Ratio.

Company	Market Cap	P/S Ratio
GrubHub	$7.2 billion	7.2
Postmates	$1.85 billion	5.1
Doordash	$4 billion	6.7

Hence, as can be seen, GrubHub is valued at a slight premium to Doordash despite Doordash being the fastest growing online food delivery company in the US. Some may argue that its premium valuation can be explained by its ability to make profits but future margin contraction is definitely a huge worry. In a year Q3 operating margin contracted from 10% to 8.8%. The uncertainty around future expenses and hence margins makes it less useful to conduct a DCF.

Conclusion

While I am bullish on the industry (online food delivery) due to its severe under-penetration and changing habits and tastes of consumers, I believe that the premium valuation placed upon GrubHub makes it overvalued. This is considering the intense competition that has taken a big slice of GrubHub's market share. The recent and future capital injection into its competitors also makes it certain that margin contractions are an inevitable part of its future as it is forced to ramp up spending on marketing (and discount offerings) as well as operational expenses in order to enter new markets.

Hence, I am prepared to take a wait and see approach and re-evaluate GrubHub's operational metrics in the upcoming quarters. If GrubHub's stock price falls to the low $60s, I will be tempted to initiate a position as its P/S ratio will be a far more reasonable 5.1-5.4.

Disclosure: I/we have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.