Grubhub (NYSE: GRUB) – Long

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INVESTMENT SUMMARY

This memo recommends Grubhub (GRUB) as a long because of its leading position in the quickly expanding food-delivery industry, ability to retain customers with specialized customer service and consistent strong financial health under a competitive market.

COMPANY DESCRIPTION

Grubhub is an American food-delivery company that was founded by two web developers who were looking for an alternative to paper menus in 2004. The company serves diners and restaurants in more than 1,100 U.S. cities and London. The company creates a platform (both APP and website) for diners to find different restaurants, as well as delivery services, database and corporate programs.

INDUSTRY ANALYSIS

Grubhub operates in the food delivery industry, which currently is still dominated by traditional delivery but quickly shifting more focus to online delivery. The overall industry is also quickly expanding in recent years with an expected growth rate at 25% per year till 2018 then at 14.9% till 2020[1].

Many venture-backed competitors are entering the market in recent years due to the expansion of online delivery service. The food delivery doesn't have a high entry barrier in terms of capital or technology needed, but the process of building the effective network to connect local restaurants with customers takes time and specialization. Platforms are usually sticky; 80% of the users rarely switch to another platform[2]. Therefore, the key to success in the online delivery industry is the company's ability to get the most customers sign up in the shortest amount of time. Grubhub is the biggest online ordering platform that connect most independent restaurants with consumers, and due to its specialization in delivery and customer service, Grubhub retains more than 90% of its customers. The biggest competition is still from traditional delivery conducted through phone calls. The online delivery has been rapidly expanding its penetration, and the rate is expected to reach 65% in about 10 years.

BUSINESS MODEL

- Website (grubhub.com and seamless.com)
    - To use the websites, diners either enter their address or use geo-location within the mobile applications. Once an order is received, the Company transmits it to the restaurant while saving the diners' preferences for future orders.
- Apps (Grubhub and Seamless)
    - Offers diners access to the network through its mobile applications which provide diners with the same functionality as the websites; For restaurants, all mobile orders are received in the same way as the website-based orders, and the Company charges the same commission for both.
- Corporate program

[1] http://www.mckinsey.com/industries/high-tech/our-insights/the-changing-market-for-food-delivery
[2] http://www.mckinsey.com/industries/high-tech/our-insights/the-changing-market-for-food-delivery

- Provides employees a wide variety of food and ordering options and consolidated ordering and invoicing, eliminating the need for employee expense reports and therefore reducing administrative overhead relating to office food ordering.
- Delivery
    - Offers delivery services to restaurants on its platform and broadens the number of restaurants it can offer to diners, which benefits the restaurants by allowing them to focus on great food while Grubhub handles the delivery network
- Database (allmenus.com and menuPages.com)
    - Provides an aggregated database of approximately 380,000 menus from restaurants across all 50 U.S. states and a link from restaurants' menus to grubhub.com and seamless.com through which diners can then place their orders.

The way the company makes revenue:

1. The Company does not charge the restaurants in its network any upfront or subscription fees, does not require any discounts from their full price menus and only gets paid for the orders the Company generates for them. The Company charges restaurants a per-order commission that is primarily percentage-based. In certain markets, the Company also provides delivery services to restaurants on its platform that do not have their own delivery operations.
2. The Company generates revenues primarily when diners place an order on its platform. Restaurants pay a commission, typically a percentage of the transaction on orders that are processed through the Company's platform. Most of the restaurants on the Company's platform can choose their level of commission rate, at or above the minimum rate, to affect their relative priority in the Company's sorting algorithms, with restaurants paying higher commission rates generally appearing higher in the search order than restaurants paying lower commission rates.

THESIS & KEY POINTS

1. Dominating position in the food delivery industry (expanding market share by their own delivery service); industry potential. The quickly expanding online delivery market and its promising outlook offset the fierce competition for market share among competitors.
    a. A study of the food delivery market by Morgan Stanley analysts says the online food delivery market, currently worth about $30 billion, has more than $200 billion total addressable size and expected compounded annual growth rate of 35% (See exhibit 3)
    b. Grubhub takes the dominating position in online ordering and delivering market. The company expanded its offering from five markets to almost 50 markets and connected more than 50,000 restaurants. In every ten independent restaurants, there is approximately one restaurant that partners with Grubhub. Grubhub at the same time has a positive impact on the restaurant's revenue as restaurants have a 50 percent increase in orders after one year of partnership with Grubhub
    c. Through working with Grubhub, restaurants realize free marketing, generate more orders, gain processing efficiency and valuable insight into consumers' preferences. A series of benefits motivate the quick transition to online ordering service.
2. Specialization in food delivery and comparative advantages over competitors
    a. Grubhub focus only on provide food delivery service connecting dinner and restaurants. Thus, it emphasizes on professionalism and excellent customer service, gaining high customer satisfaction (90% returning dinners). Further discussions of Grubhub's comparative advantages over its competitors are shown in *Misconception* section
3. Cash flow & revenue growth (See exhibit 4 for charts summarizing profitability and important financials of Grubhub)

a. The company has experienced continuing revenue growth. The company generated 361.8 million USD in 2015, 43% more than the previous year.
b. At the same time, the cost of revenue has also grown over the years, which is a result of the company offering new delivery services to restaurants that don't have delivery services themselves. Refer to the analyst (in VAR) we talked to, independent delivery system allowed Grubhub to expand its market share and have more restaurant utilize Grubhub's service.
c. The company has steadily increasing free cash flow, which is an important indicator of its financial health in the highly competitive food delivery industry
d. The free cash flow of the company takes up 9.1% of the revenue, which points at the company's potential to continuously generate more cash even in face of fierce competition
e. Even though Grubhub issued more shares, its value was not diluted; the stock price was able to be kept at a constantly growing trend

4. Strategic and Synergistic Acquisitions (see Exhibit 2 for clear visual representation of brands merged with Grubhub)
   a. Over the past two years, GrubHub has made a slew of acquisitions that have been helpful in strengthening Grubhub's position as the market leader in the food delivery industry. Some of the major acquisitions GrubHub made includes Delivery Dish (2015) and Restaurants on the Run (2015). Both companies were instrumental to GrubHub's expansion into the food delivery service industry. Before June 2014, GrubHub only worked with restaurants who already had their own delivery system. In order to bring more orders to restaurants that don't operate their own delivery service and to provide a better customer experience, thereby capturing a larger market share, GrubHub chose to expand into the food delivery service industry, even though it was notoriously difficult to break even. With the acquisition of these two companies, GrubHub was able to accelerate their food delivery services' growth by leveraging their market knowledge and GrubHub's scale to provide delivery at lower overall costs
   b. GrubHub's merger with Seamless (2013) was essential for GrubHub's current position as market leader. Preliminary analysis of GrubHub's data sample shows that around half of GrubHub's orders were made through Seamless' platform
   c. Strategic and synergistic acquisitions such as this will put GrubHub in a great position to capture a large share of the U.S. food delivery industry as they have been able to expand to most states and major cities through their acquisitions
   d. These synergistic mergers and acquisitions also points to the competency of the management team at GrubHub. They have made well decisions over the past few years, and we are confident that they would continue to grow GrubHub in a sustainable manner

PERCEPTIONS

1. Grubhub's current position as the market leader in the food delivery industry is shaky as bigger and better financed competitors such Uber and Amazon has recently entered this industry.
   1. *UberEats* **(market's perception)**: Uber can leverage on their extremely well-developed network of drivers to engage in food delivery services. This will be much less of a logistical nightmare compared to GrubHub, which had to invest heavily in order to ramp up their very own food delivery service. Also, Uber can leverage on their huge customer base, therefore enabling it to ramp up UberEats' sales in a much shorter period of time.
   2. **Why this is a misperception**: UberEats only operates in big cities. This means that they are unable to capture the potential customers from smaller cities where GrubHub reigns supreme. There has been some dissatisfaction amongst UberEats drivers as the pay is really low (customers pay around $5 for each delivery trip, of which Uber takes a cut, thereby leaving the driver with around $3-4 per trip). This problem is further exacerbated by Uber's stance on tipping. Uber generally discourages tipping, therefore, it is very likely that some UberEats drivers are unable to make any money at all due to the cost of gas while doing deliveries.

Therefore, it seems that UberEats have some fundamental problems with their delivery service and drivers. This, along with the fact that they have been unable to set foot into smaller cities due to the lack of drivers, might suggest that the market's perception of UberEats as being a threatening competitor to GrubHub might be unfounded or over-exaggerated.

3. *Amazon Restaurant* **(market's perception)**: Amazon has become somewhat of a household name. There are worries that with Amazon's gigantic Prime customer base, and the sheer economies of scale, they are able to drive prices down, thereby forcing the existing competitors out of the market.
4. **Why this is a misperception**: As a value-add service for prime members, Amazon Restaurant remains more of a tool to attract new Prime members, and to retain old Prime users. This means that they are neglecting a significant portion of the populace who do not have Amazon Prime. Therefore, although Amazon has some advantages over GrubHub such as their technological and economies of scale, GrubHub and Amazon are competing on a fundamentally different field, each having their own goals and objectives.
5. *Yelp Eat24* **(market's perception)**: Yelp is an immensely popular restaurant review-cum-food delivery site. In theory, their acquisition of Eat24, a food delivery platform, provides great synergy between Yelp's restaurant reviews and Eat24's food delivery services as customers are able to find their preferred restaurants through the countless reviews available, and once selected, they are able to order from these restaurants.
6. **Why this is a misperception**: Firstly, Yelp does not have its own delivery system, therefore, restaurants without their own delivery system will have to engage third-party delivery service. This can translate into unreliable delivery timings for such restaurants, and might alienate Yelp's customers as their orders might take a long time to get through. Furthermore There have also been complaints that a lot of the reviews on Yelp are fake, and cannot be taken at face-value. Therefore, although in theory this combination of service seems to have all the upsides without any downsides, there are still gaps in Yelp Eat24's business strategy, thereby allowing GrubHub to maintain a competitive edge over them.

2. There are concerns that GrubHub's margins will not have a chance to grow due to the fierce competition present in the industry.
    1. **Why this is a misperception**: Grubhub's currently employs a two-pronged strategy focusing on lowering the delivery cost, and at the same time, acquire more users. In order to do so, Grubhub has spent considerable amounts of money acquiring food delivery companies such as "DiningIn", and "Restaurants on the Run."
    2. Apart from this, Grubhub recently scooped over 30 to 40 engineers from "Zoomer," a small delivery logistics provider with an exceptional product. This will drive up technological costs up in the short term, however, in the long run, these engineers will be able to hugely increase the efficiency of GrubHub's delivery network, thereby reducing the cost of delivery.
    3. Therefore, although it is true that GrubHub's margins will probably suffer in the short run, due to rising costs, in the long run, we believe that GrubHub's investments in delivery logistics will pay off, thereby improving efficiency and driving costs down. Also, the analyst (refer to VAR) we talked to agreed with our judgement.

INVESTMENT TIMELINE

We believe that GrubHub's phenomenal growth will be steady and consistent over 2017, however, the future remains uncertain, and there are signs that GrubHub is gradually reaching the final phases of its growth stage. Therefore, we aim to exit from our position within one year, or when GrubHub's stock price hits our targeted price range. Below are some important dates to keep in mind:

1. Early May 2017: Release of GrubHub's 2017 first quarterly report.
    1. If our investment thesis is correct, GrubHub's growth in revenue and active diners should be consistent within the 35-40% and 20% range, respectively.

    2. GrubHub's stock prices will move closer towards our final target price.
2. Late July 2017: Release of GrubHub's 2017 second quarterly report.
    1. Similar to the first quarter, we have to keep an eye out for all key metrics that are instrumental to our investment thesis and valuation of GrubHub.
3. Late October 2017: Release of GrubHub's 2017 third quarterly report.
4. Early February 2018: Release of GrubHub's 2017 fourth quarterly report and 2017 annual report
    1. By this time, according to our investment thesis, GrubHub would have grown by a considerable amount compared to 2016, and their stock price should reflect this growth.

Throughout the year, if an exit opportunity presents itself to us (target price reached before the end of the year), we will exit from our position in GrubHub. This is because we believe that GrubHub is prone to attacks from short sellers, especially if they happen to fail to hit their growth targets for each quarter. Already, around 12% of outstanding GrubHub shares are being shorted. Therefore, we wish to exit from our position within this year, riding on GrubHub's current phenomenal growth.

SIGNPOSTS

1. One of the most important metric to look out for is Grubhub's number of Active Diners. From 2015 to 2016, GrubHub's Active Diners grew by 21%. This growth rate is crucial to GrubHub's current market value, and signs of this growth rate slowing down might lead to unfavorable fluctuations in GrubHub's stock prices. This metric will be present in GrubHub's quarterly reports, therefore we have to keep a lookout for this number, and be sure to reevaluate our position when signs of slowing down occurs.

2. Entrance of new competitors, especially well-established ones such as Amazon or Uber. The food delivery industry is already reaching a saturation point, and the entrance of new competitors might hurt GrubHub's margins. Well-established companies such as Amazon and Uber are especially important to lookout for as they will be the ones exerting the most pressure on GrubHub and their pricing strategy.

3. GrubHub is still in its rapid growth stage, therefore, its revenues are still projected to grow at a fast rate. However, we must keep an eye out for its expenses as well. Is the growth sustainable, and is the expenses growing at a faster rate than the revenue? This information can be taken from quarterly and annual reports. From 2015 to 2016, GrubHub's revenue increased by 38%, while their costs and expenses increased by 35.5%. We should reevaluate our position when the costs and expenses increases at a higher rate than the growth in revenue as this might indicate a slow-down in organic growth.

RISKS

1. Retaining existing restaurant partners and acquiring new ones - GrubHub's main attraction is the plethora of restaurants available on their platform. However, it is hard for restaurants to develop real loyalty towards GrubHub as many restaurants utilize not just one online platform, but multiple platforms. If GrubHub is unable to retain their restaurant partners, they might lose a huge chunk of their customers as restaurant choices dwindle. Therefore, it is up to GrubHub's management to come up with strategies to retain their restaurant partners in the long run.

2. Slowing growth in Revenue and Active Diners can be devastating for GrubHub. If GrubHub fails to meet analysts' expectations and forecasts, it might send GrubHub's stock price spiralling down. (refer to Signpost 1)

3. The intense competition present in the food delivery industry is undeniable. How well can GrubHub navigate its way through this remains to be seen. Although the current situation puts GrubHub in a very favorable position to capture the majority share of the rapidly growing global market for food delivery, it is uncertain if GrubHub will be able to maintain their edge over their competitors in the long run. If they fail to retain their market leader position, it will result in dire consequences. The worst case scenario would be GrubHub going down, or being acquired by another bigger and more efficient competitor.

VALUATION AND FINANCIAL INFORMATION

See the link
https://docs.google.com/a/virginia.edu/spreadsheets/d/1l5QpCMIwIp7Wvt9cM0761VTRNom9iZSHH4y_DEz-Y7A/edit?usp=sharing

VAR EXHIBITS

We talked to an experienced analyst who had done deep analysis of Grubhub. Opinions of the analyst are combined into our discussion of the third thesis point and the second misconception point.

EXHIBITS

Exhibit 1: Grubhub and Seamless (merged with GRUB in 2013) have higher ratio of heavy users

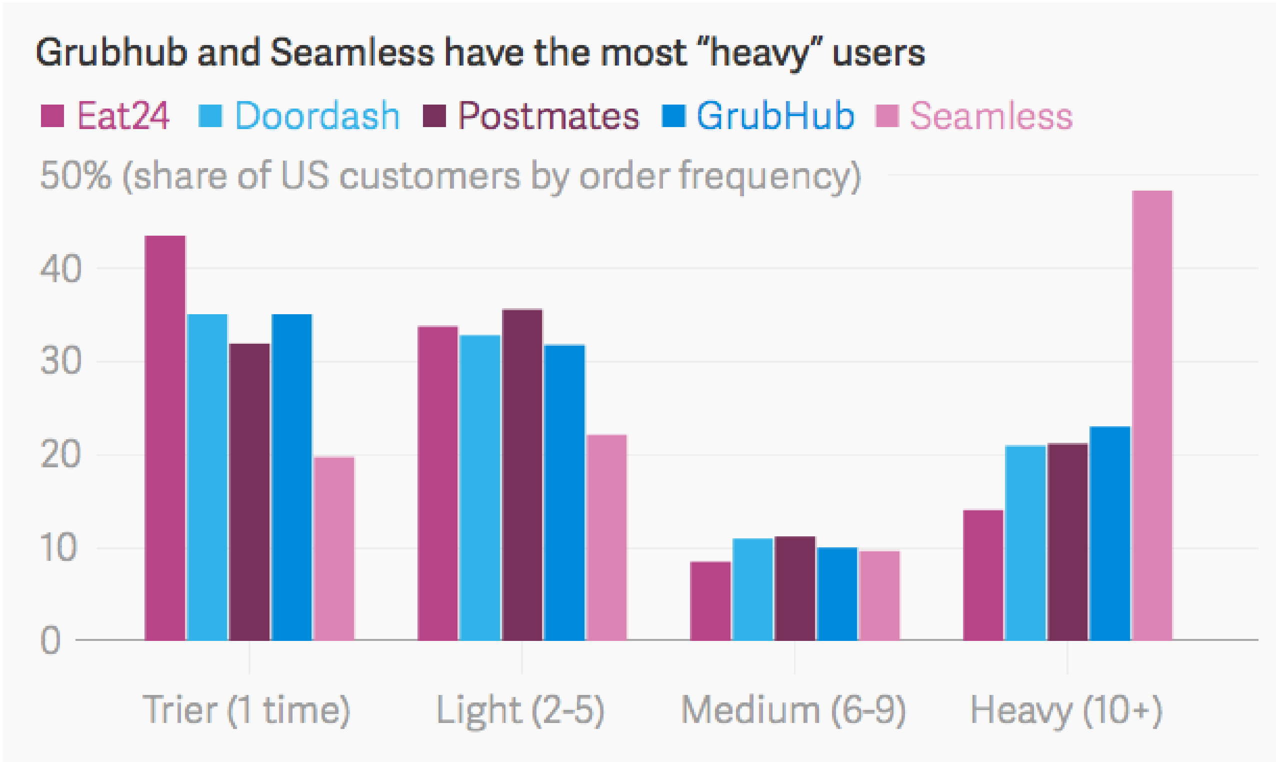

Exhibit 2: Mergers and Acquisitions of Grubhub

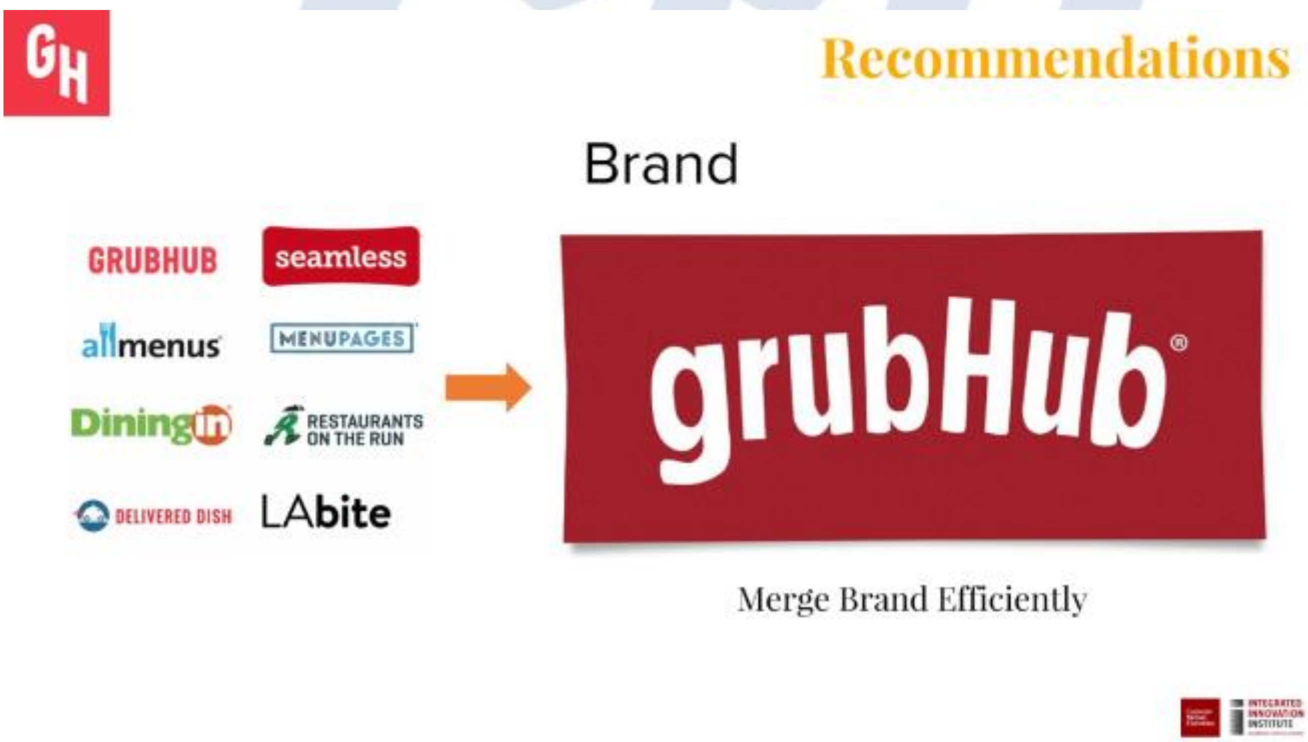

Exhibit 3: Market for online food delivery is increasing

Exhibit 4: charts showing profitability and important financials of Grubhub.

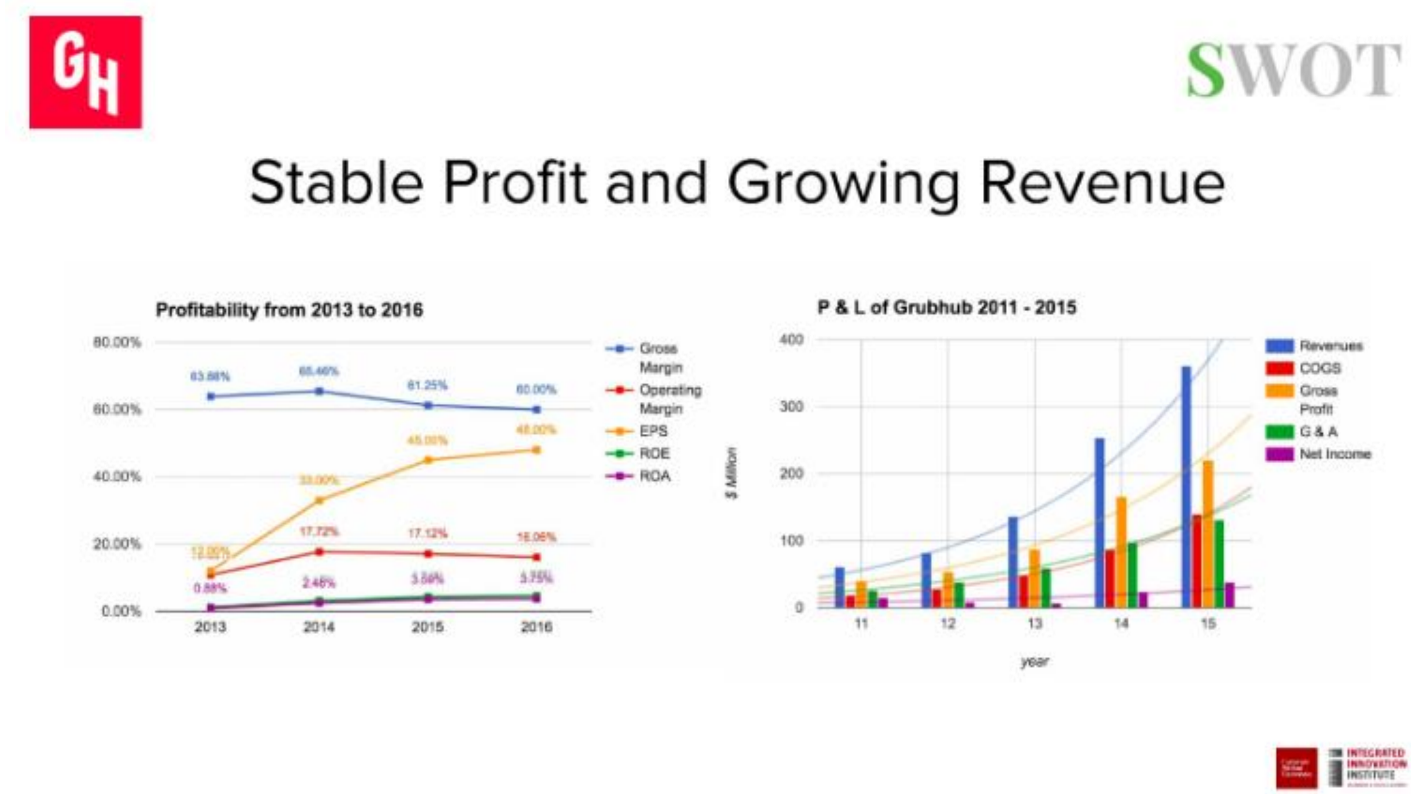

Exhibit 5: How many users are there each year (Derived using SQL)
See the other document called “User Count”

Exhibit 6: On average, how many times does each user use Grubhub each month? (Derived using SQL)
See the other document called “User Frequency”

Exhibit 7: What is the revenue for each year? (Derived using SQL)
See the other document called “Revenue”