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Grubhub (GRUB) EQ Update 12/19 Qtr.

Current EQ Rating*	Previous EQ Rating
2-	3-

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

*For an explanation of the EQ Review Rating scale, please refer to the end of this report

We are cutting our earnings quality rating to a 2- (Weak) and expecting more negative issues

After 4Q results, several signs at GRUB worsened and guidance isn't much better. Adjusted EBITDA which adds back stock compensation is forecast at $15-$25 million for 1Q20 vs. $51 million in 1Q19 and >$100 million for 2020 vs. $186 million in 2019. That's worse than it sounds as 2019 results declined from 2018. Here are some other concerns in our view:

- **With negative operating income in 2019 and guidance for that to weaken in 2020 – ROI should be a negative figure for both years too. Goodwill and Intangible Assets are essentially 100% of equity value and 64% of total assets.** With negative operating income and declining cash flow from operations plus the stock price about 35% of its peak – there are **many signs pointing to a potential impairment of these assets.** Investors should remember that GRUB had positive operating income in 2016-18 with only a modest drop in 2018.

From a cash flow standpoint, there are pressures there as well and cash flow is already declining too.

- **Profitability per transaction and Volume growth (DAG – Daily Average Grub) have plummeted and it happened fast.** The company reports profitability per transaction on adjusted EBITDA, which adds back stock compensation to boost that figure.

Adj. EBITDA/Order	4Q19	3Q19	2Q19	1Q19
2019	$0.58	$1.28	$1.24	$1.09
2018	$0.98	$1.57	$1.78	$1.63
2017	$1.60	$1.54	$1.46	$1.45

Y/Y DAG Growth	4Q19	3Q19	2Q19	1Q19
2019	8%	10%	16%	19%
2018	19%	37%	35%	35%
2017	34%	14%	16%	21%

The 8% volume growth in 4Q was helped 150bp by weather driving demand for deliveries. The company is only forecasting that it will be stronger than 6% for 2020. Adjusted EBITDA/Order will likely rise above a dollar again for some quarters in 2020 – but, may still decline y/y again.

- **Grubhub's profitability contraction is not coming from signing up more QSRs (Quick Service Restaurants like Taco Bell and McDonalds). The company illustrated that is not profitable on those orders and signs them up to please diners** who want the most options. Partnered Independent Restaurants generate more revenue to GRUB per transaction, a higher commission rate, and more profit per delivery ($4 per order) than non-partnered restaurants where profit is $1 and QSRs at $0. **GRUB made a point of saying in 4Q results that it launched 5 new Partnered and Small Chain locations for every QSR location of late.** That is reflected in the commission rate to gross sales ratio rising y/y again:

Commission Rate	4Q19	3Q19	2Q19	1Q19
2019	22.0%	23.0%	22.3%	21.6%
2018	20.9%	20.4%	19.6%	18.7%

- **4Q showed evidence that customers may be demanding faster payment from GRUB. Food payables were essentially flat sequentially on higher gross sales. DSOs on those payables dropped under 10 days.**

DSOs on Food	4Q19	3Q19	2Q19	1Q19	4Q18	3Q18	2Q18	1Q18
Gross Sales	$1,552	$1,400	$1,459	$1,502	$1,377	$1,214	$1,220	$1,245
Commissions	$341	$322	$325	$324	$288	$247	$240	$233
Net to Restaurants	$1,211	$1,078	$1,134	$1,178	$1,089	$967	$980	$1,012
Food Payables	$132	$131	$124	$140	$127	$123	$110	$127
DSOs	9.9	11.1	10.0	10.9	10.7	11.6	10.2	11.4

Customers get paid on credit card receipts the next day (or after a Sunday or holiday). With Grubhub, they get paid 10-11 days later. We see a risk that competition drives this figure down and hurts GRUB's cash flow. This source of cash flow with double-digit growth in sales and rising commission rates was only $4.4 million of GRUB's $183 million in cash flow. Guidance is for slower volume growth, revenue growth that may slow to as low as 7%. **What happens if the DSOs drop 4-5 days? Suddenly, cash from operations may have a $60-$70 million negative swing.**

- **Cash Flow and EBITDA also rely on paying wages in stock compensation. The company is giving guidance for lower results and higher spending to obtain lower volume customers.** Marketing will continue to rise – it was 23.6% of sales in 2019 vs. 21-22% in prior years. **How much longer will employees want GRUB stock?** In 2018, options were issued with exercise prices at $63 and RSUs at $94. In 2019, options had a strike of $77 and RSUs at $74. The employees have seen the stock price fall 65% - even after the recent recovery. Many of their options remain out of the money.

	2019	2018
Stock Comp	$72.9	$55.3
CFO	$182.6	$225.5
Stock Comp %	40%	25%
EBITDA	$109.2	$170.9
Adj. EBITDA	$186.2	$233.7
Stock Comp %	39%	24%

To us, it appears that GRUB has risks of seeing cash flow decline by over 30% from customers and competition speeding up payments and as much as another 40% if employees want to be paid in cash if the stock price continues to languish below their strike prices. A potential impairment of goodwill and intangibles seems likely

Explanation of EQ Rating Scale

6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor “red flag”, but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
3- "Minor Concern"	Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.
2- "Weak"	Indicates the company’s recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.
1- "Strong Concerns"	Indicates that the company’s recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

In addition to the numerical rating, the EQ Review Rating may also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into the next quarter. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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