Betting on the Best: Alphabet

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Kase Learning
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I was very skeptical of Alphabet when it first went public, as I outlined in a presentation I gave at Alphabet’s headquarters on Nov. 21, 2014 entitled:

A Google Skeptic Eats Crow –
And Thoughts on the Stock Today

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My Worst Call Ever (1)

- In a column published on The Motley Fool website on July 30, 2004 entitled *The Tech Stock Opportunity*, I wrote:
  - **Fertile ground**

    Despite my reservations about the tech sector, I actually think that it is -- or at least should be -- fertile ground for value investors for the simple reason that most of the investors in the sector are irrational, momentum-driven speculators. Thus, the sector is characterized by wild mood (and therefore price) swings, as investors overreact to favorable or unfavorable developments. While overvaluation has been the more common state of affairs during the past decade or so, there have been a few points -- October 2002 most recently and, to a lesser extent, March 2003 -- when tech investors panicked and all sorts of tech stocks were downright cheap…

    Not only does the tech sector offer occasional opportunities to buy 50-cent dollars, but when it returns to favor, one can sometimes sell such dollars for $2, $3, or more... Now *that's* a way to make real money!

My Worst Call Ever (2)

- However, of Google I wrote: :
  - **Dell vs. Google vs. McDonald's**

    Regarding the former, there's a huge difference between, say, Dell and Google. While both are lumped into the tech sector, I would argue that Dell is primarily a manufacturing/assembling, sales and service business, not a technology company. Dell doesn't really care which hardware and software products win the technology wars -- it simply buys, assembles, sells, and supports whatever its customers want. In short, I think the odds are very high -- say, 80%-90% -- that Dell is a major computer company in 20 years. (This is not to say that I recommend buying Dell stock -- as much as I admire the company, I wouldn't buy it at half of today's price.)

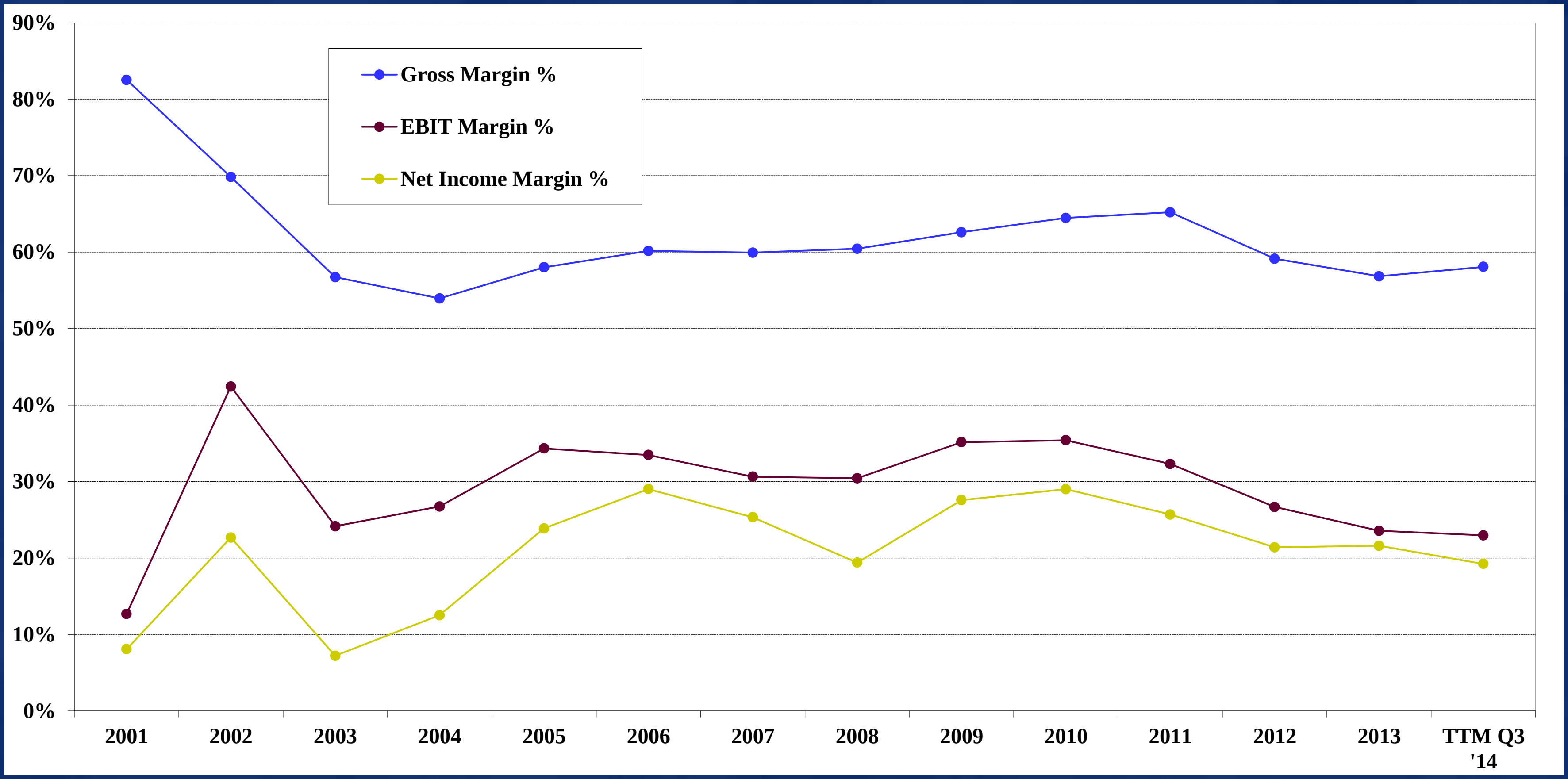
    Google, in contrast, is a more typical tech company -- one that must invest heavily to remain on the cutting edge or its customers will quickly and easily flock to competitors. Just as Google came out of nowhere to unseat Yahoo! as the leading search engine, so might another company do this to Google. I admire Google and what it has accomplished -- and I'm a happy user -- but I am quite certain that there is only a fairly shallow, narrow moat around its business.

    [continued]

My Worst Call Ever (3)

Think about it. What are the odds that it is the leading search engine in five years (much less 20)? 50/50 at best, I suspect, and I'd wager that odds are at least 90% that its profit margins and growth rate will be materially lower five years from now. Yet investors appear ready to value this company at as much as $36 billion, nearly 200 times trailing earnings! Google with the same market cap of McDonald's (a stock I own)?! HA! I believe that it is virtually certain that Google's stock will be highly disappointing to investors foolish enough to participate in its overhyped offering -- you can hold me to that.

I Was Right That Margins Would Decline…



…But Totally Wrong About Growth

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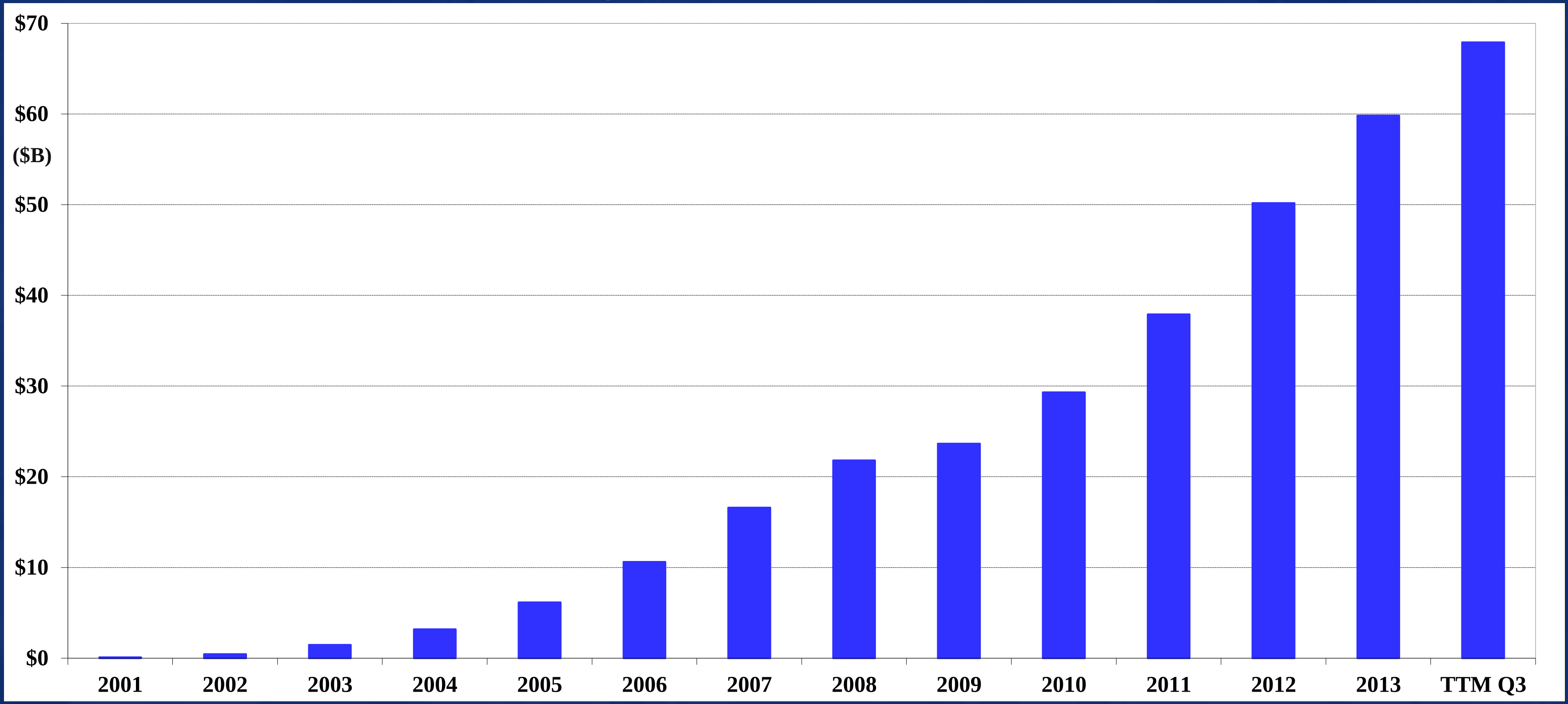
Revenue has grown more than 20x since 2004



Revenue Growth Has More Than Offset Declining Margins, Resulting in Phenomenal Growth in Earnings

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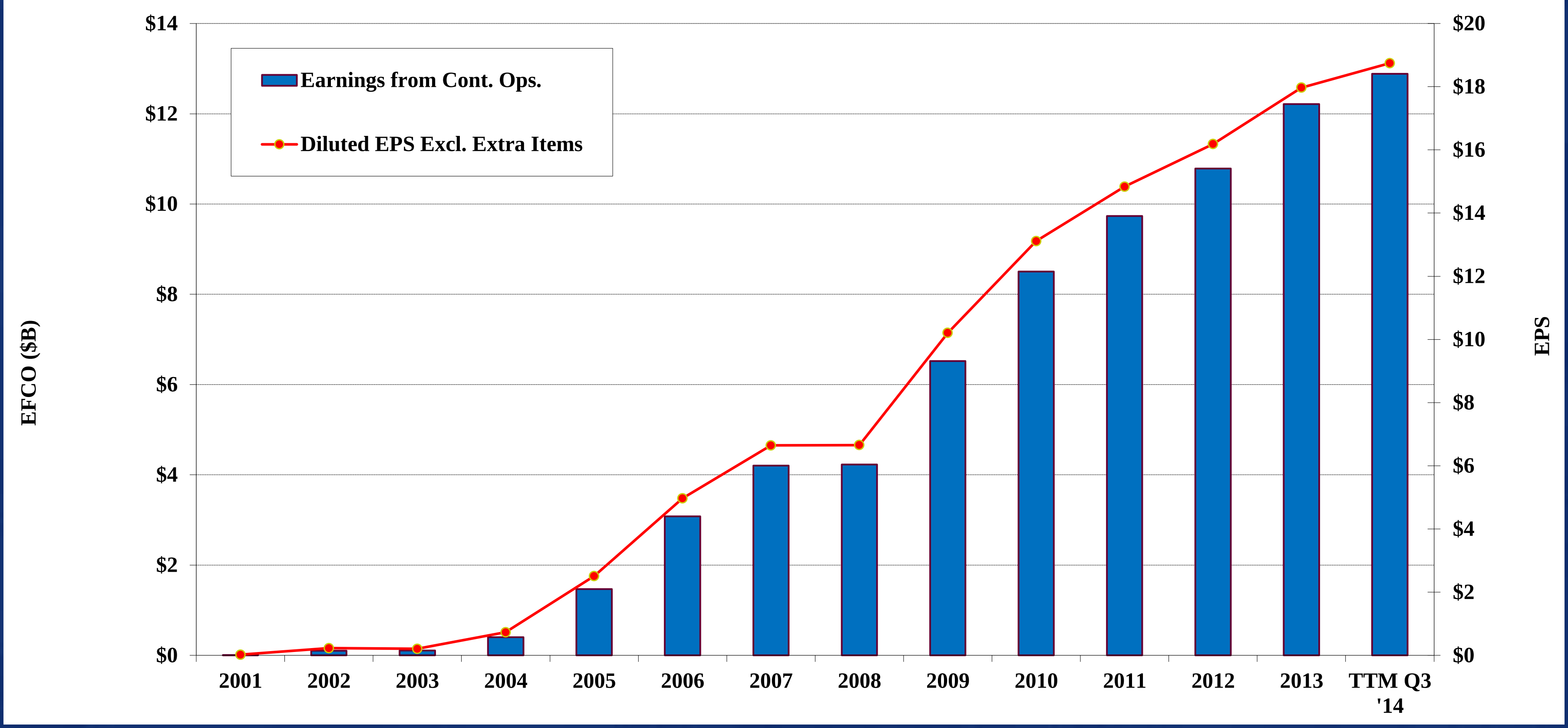
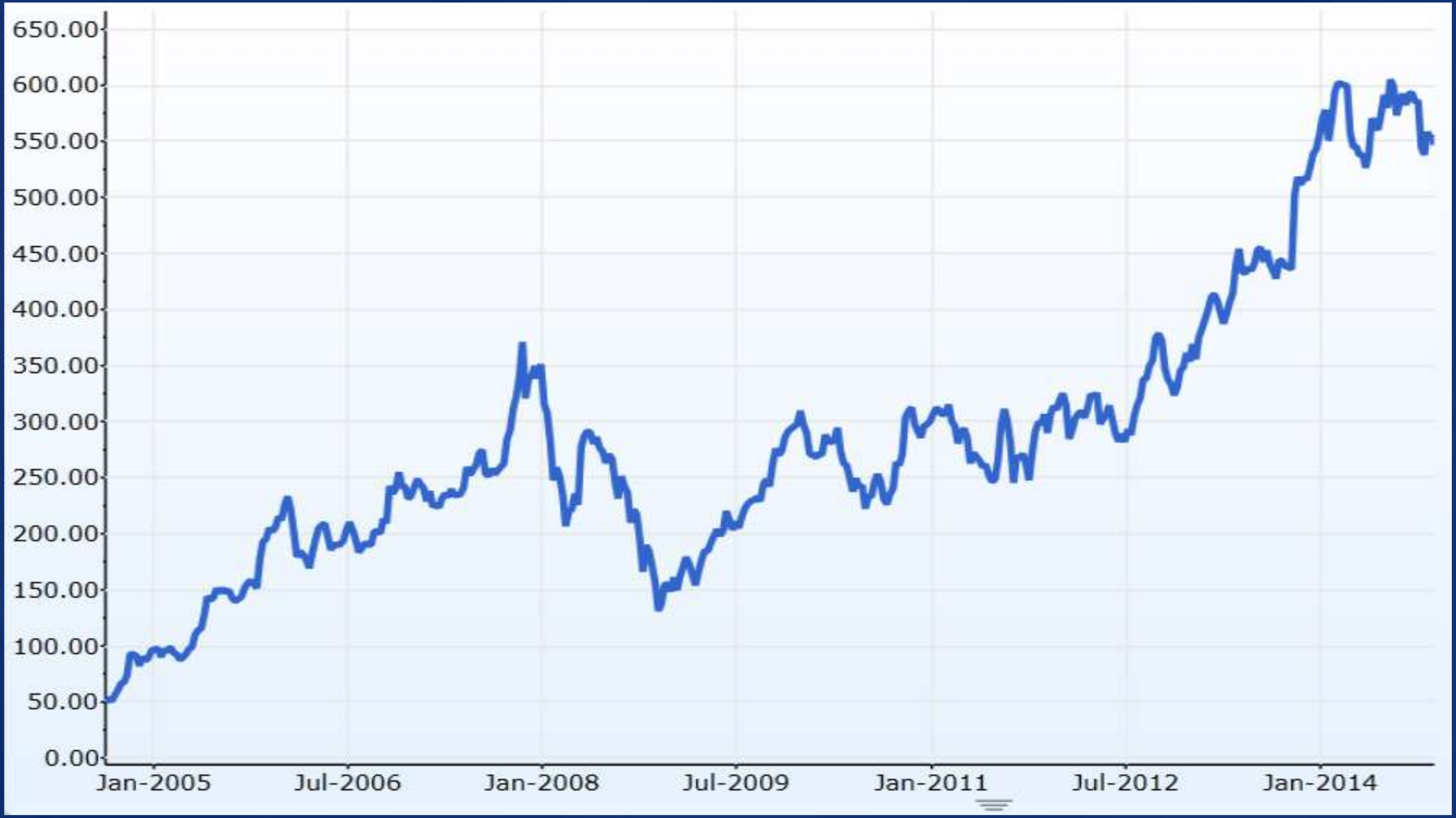


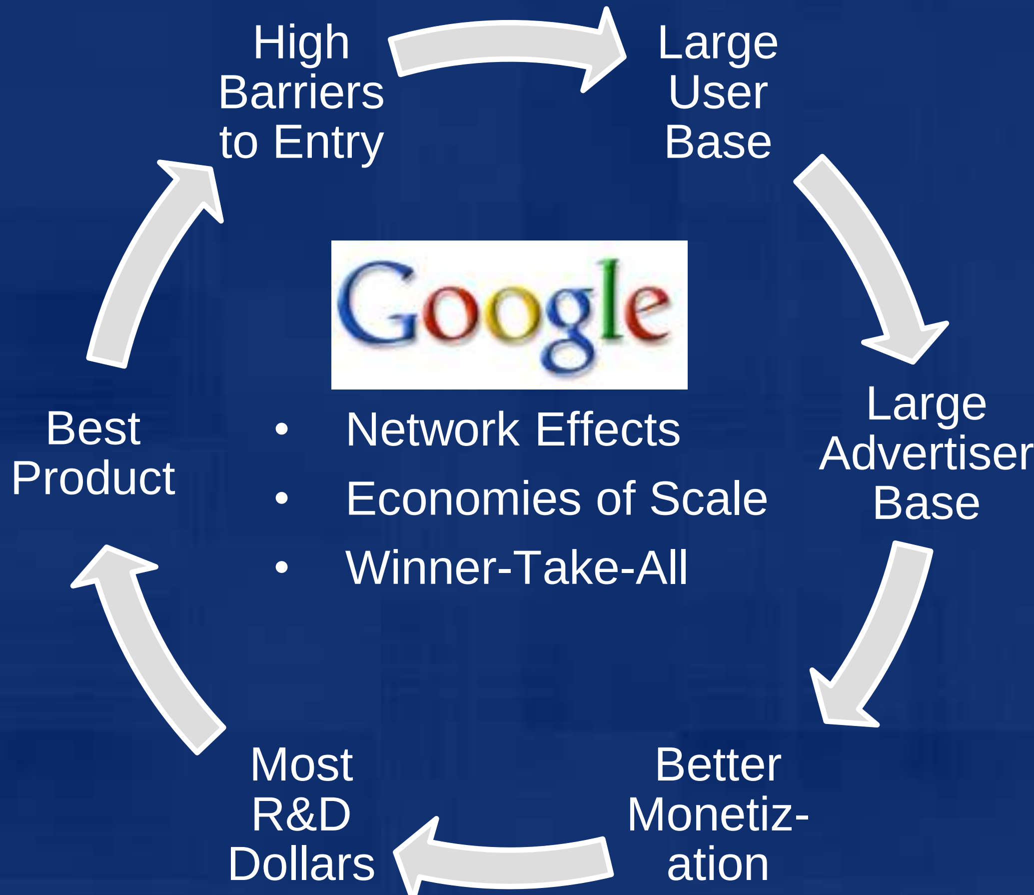
Excerpt from *A Google Skeptic Eats Crow*, 11/21/14

Google's Stock Has Increased By More Than 10x Since My Misguided Call



What Did I Miss?

- I was completely wrong that Google has "only a fairly shallow, narrow moat around its business"
- Google has a very powerful virtuous cycle at work:



Excerpt from *A Google Skeptic Eats Crow*, 11/21/14

The Bull Case: New Platforms Continue to Create New Revenue Streams

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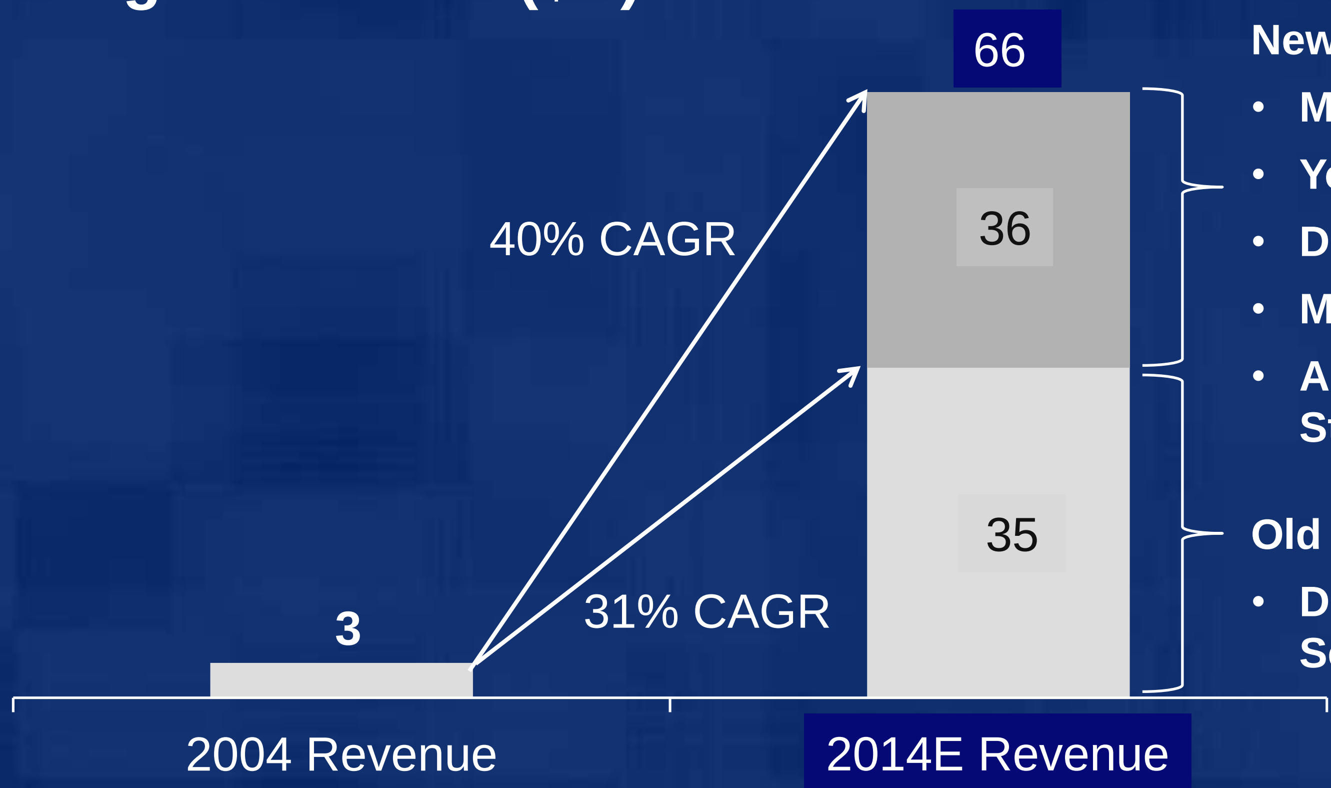
Google Revenue ($B)



New Revenues:

- **Mobile Search**
- **YouTube**
- **Display**
- **Maps**
- **Android / App Store**

Old Revenues:

- **Desktop Search**

How Google's Stock Could Double in the Next Four Years

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Drivers:

- Grow search ~10% annually
- Grow display ads ~25% annually
- Grow YouTube ~30% annually
- Grow new products (Google Play, etc.) ~40% annually

Valuation in Four Years:

- Revenue growth of ~20%
- Maintain margins
- P/E multiple remains constant ~20x
- Results in the stock doubling over four years

Note: This slide and the previous two are from the presentation of a friend who wishes to remain anonymous.

Here's What Alphabet Has Done Since My 2014 Presentation

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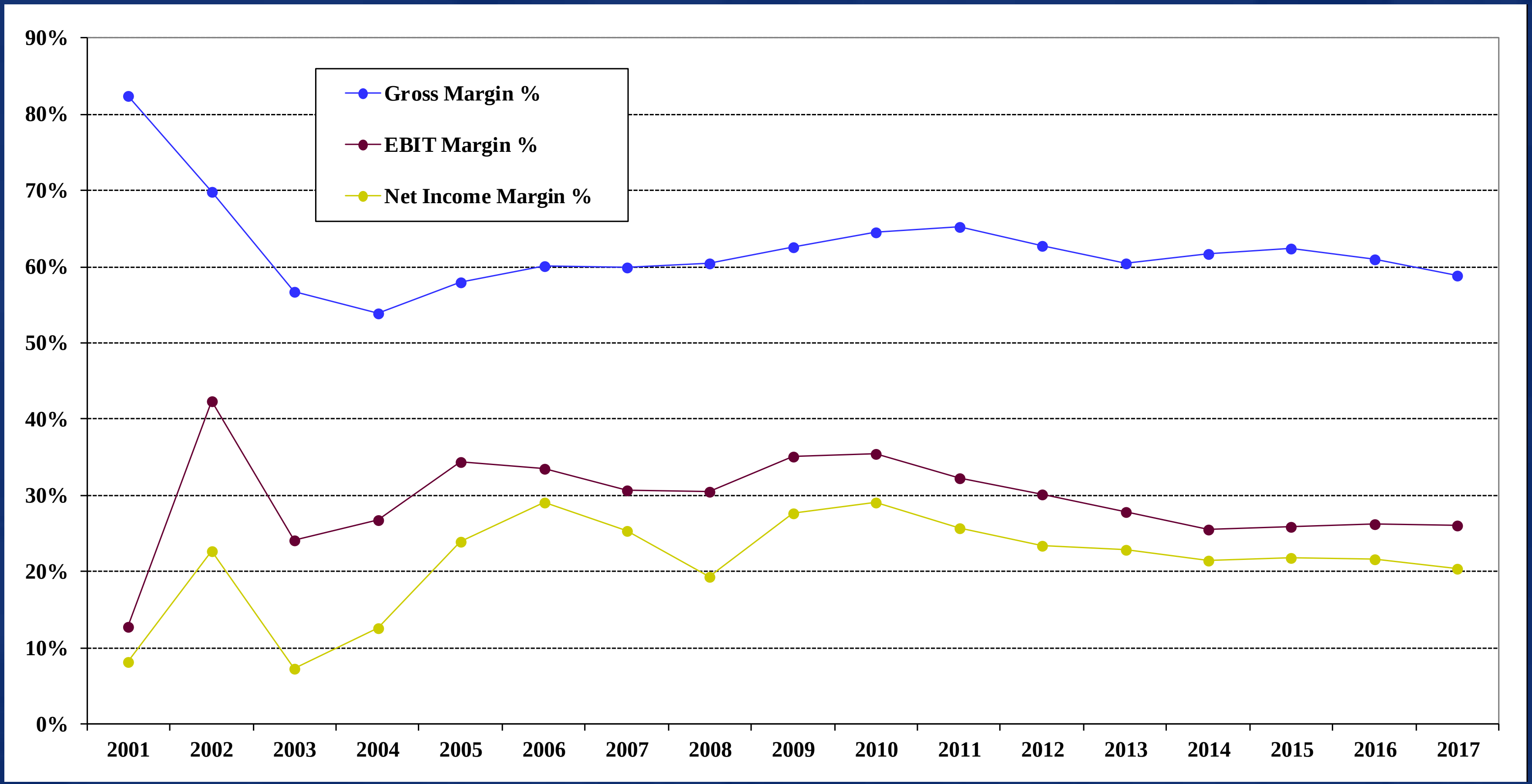
Margins Have Remained Stable



Strong Revenue Growth Has Continued

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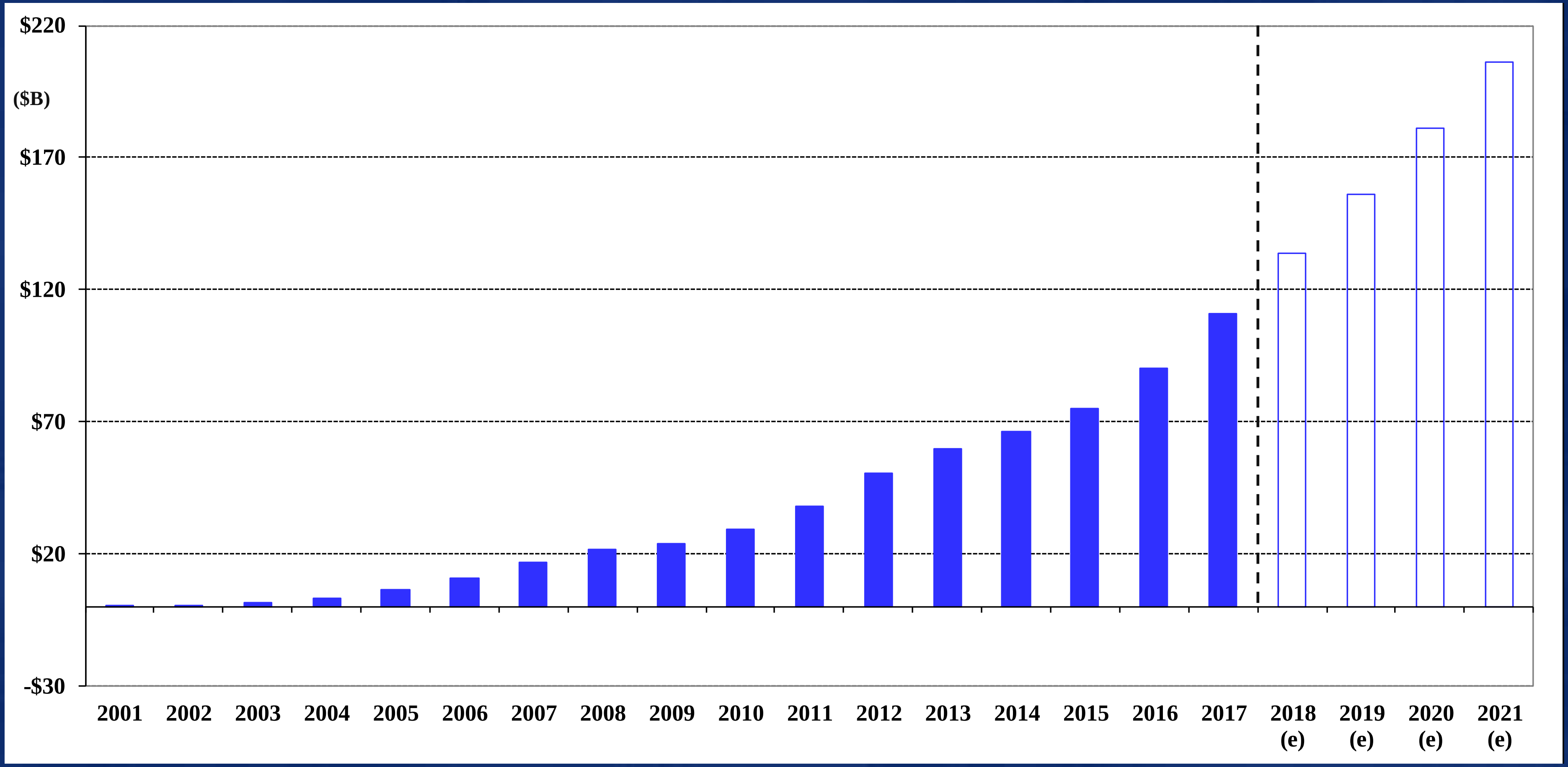
Revenue has now grown *35x* since 2004



Phenomenal Earnings Growth Has Continued

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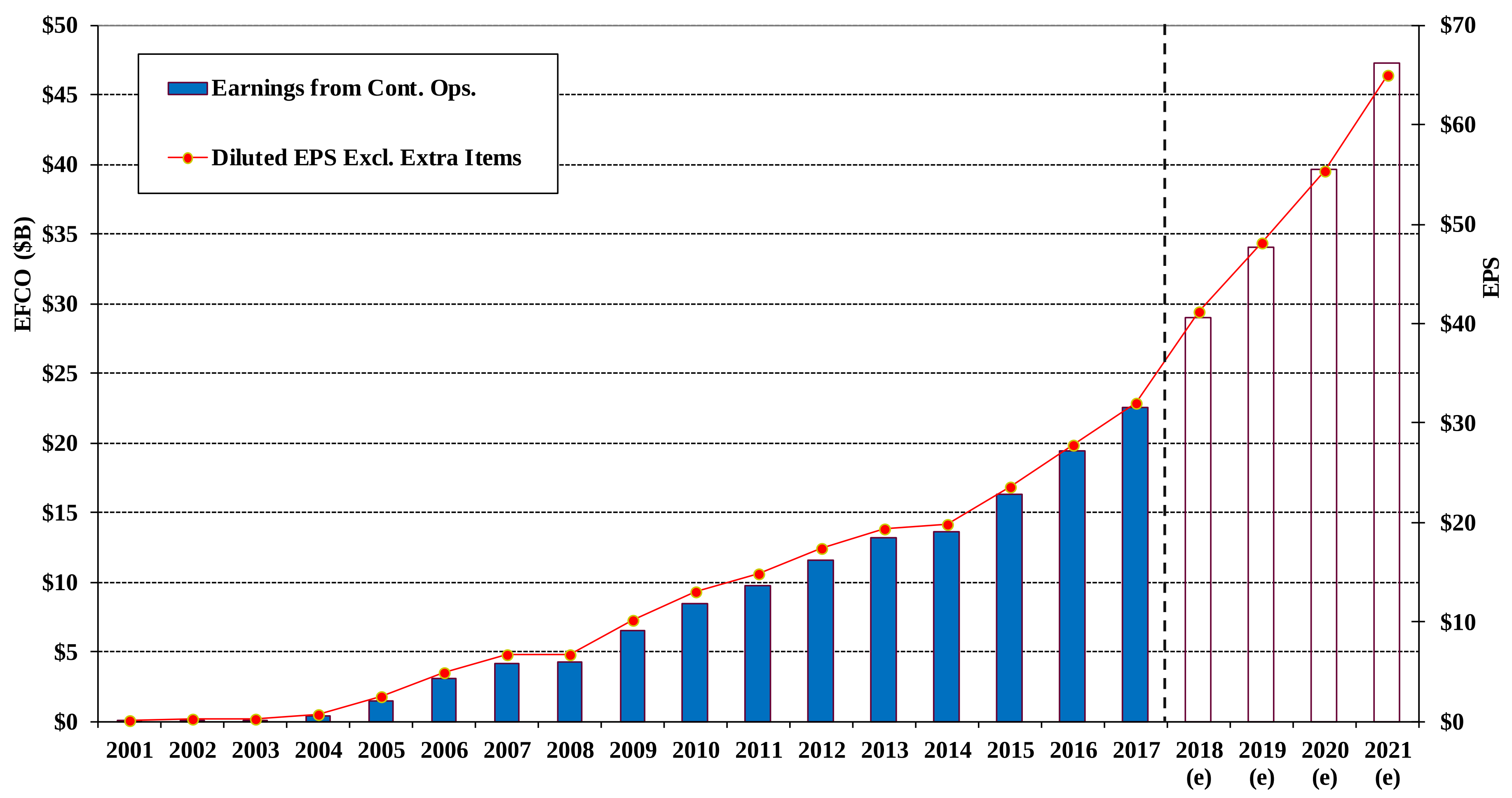

Alphabet's Stock Has Continued to Rise

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Alphabet Today

Valuation of the Stock Today

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- Stock price (2/26/18 close): $1,143.70 (GOOGL)
- Market cap: $795 billion
- Cash & STI: $102 billion ($147/share)
- Debt: $4 billion
- Enterprise value: $686 billion
- TTM EPS* and P/E: $32.01, 35.7x
- 2018 est. EPS and P/E: $41.45, 27.6x
- TTM EBITDA and EV/EBITDA: $40.7 billion, 19.5x
- 2018 est. EBITDA and EV/EBITDA: $51.6 billion, 15.4x

* All EPS numbers include stock-based comp

Q4 ‘17 Earnings Were Very Strong

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- Revenue up 24%
- Operating income up 15%
- Aggregate paid clicks up 43%

Year-Over-Year Revenue Growth Has Been *Accelerating* Over the Past Three Years

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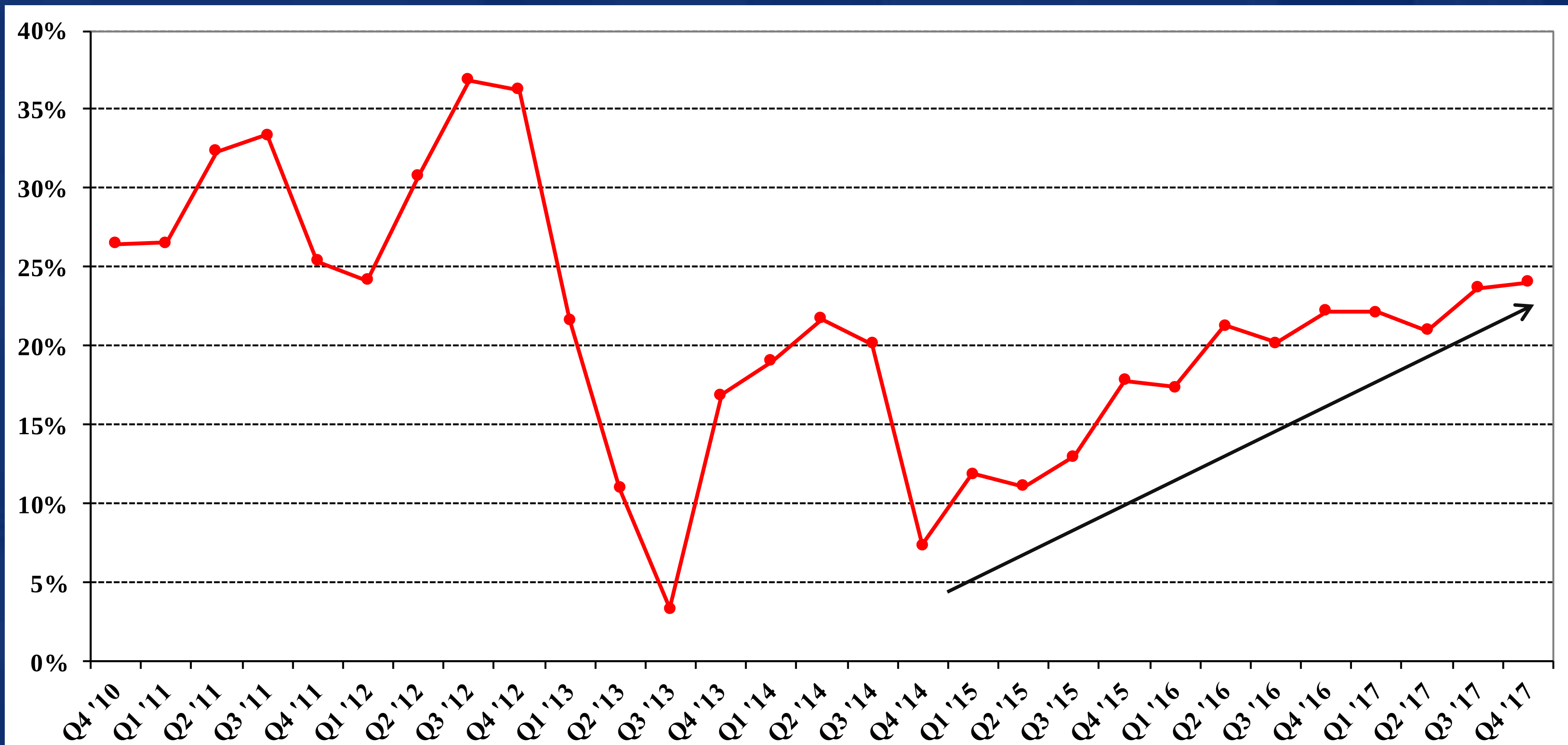

Alphabet Is Not Capital Intensive – Most Cap Ex Is Investing in Growth

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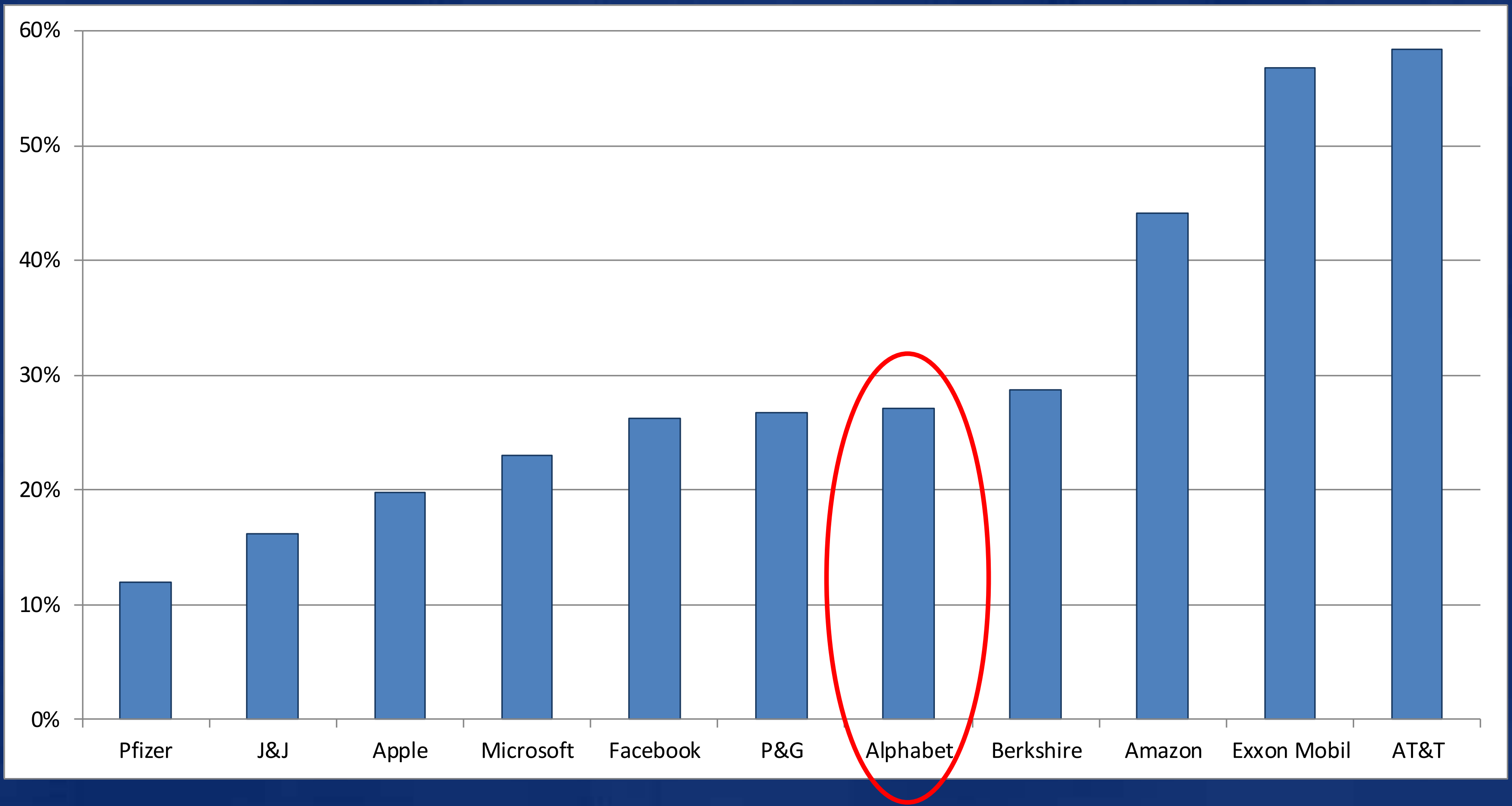
Cap ex as a % of operating cash flow for selected companies



Note: TTM through Q1 '17

Why Did I Change My Mind and Buy Alphabet A Year Ago?

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Why Didn't I Buy Alphabet's Stock Long Ago?

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- I use Alphabet's products/services every day, so it's not a circle of competence issue
- Rather, it's in part because the stock has always appeared expensive me, using the traditional valuation metrics with which I'm most comfortable
- But there are other reasons, rooted more in emotion than logic:
  - As a contrarian and value investor, I don't like owning what everyone else owns
  - I don't like buying stocks that have already risen a lot (instead, I prefer to bottom-fish among the beaten-down stocks of out-of-favor companies, betting that they can turn things around)
  - I felt extreme regret for not having long ago purchased the stock of this incredible company – a classic case of the "I missed it" phenomenon

The Emotional Aspects of Not Buying Alphabet Became Clear to Me at the 2017 Berkshire Mtg

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Buffett and Munger were asked, "…what have you learned about investing in technology companies?" Munger answered that their "worst mistake in the tech field" was not investing in Alphabet:

- Well, we avoided the tech stocks, but as we felt we had no advantage there and other people did and I think that's a good idea not to play where the other people are better, but you know, if you ask me in retrospect, what was our worst mistake in the tech field, I think we were smart enough to figure out Google. Those ads worked so much better in the early days than anything else. So I would say that we failed you there and we weren't smart enough to do it and didn't do it. We do that all the time too.

The Emotional Aspects of Not Buying Alphabet Became Clear to Me at the 2017 Berkshire Mtg (2)

Buffett agreed that he “blew it” on Alphabet:

- We were their customer very early on with GEICO, for example; …as I remember, we were paying them $10 or $11 a click or something like that and any time you're paying somebody $10 or $11 every time somebody just punches a little thing where you have no cost at all, you know, that's a good business unless somebody's going to take it away from you and so we were close-up seeing the impact of that.

  …You know…you've…almost never seen a business like it. I think [clicks] for LASIK surgery…were $60 or $70 a click with no incremental…cost.

  They [Google’s founders] came to see me…so I had plenty of ways to ask questions or anything of the sort and educate myself, but I blew it.

The Emotional Aspects of Not Buying Alphabet Became Clear to Me at the 2017 Berkshire Mtg (3)

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- These comments led me to ask myself why, if Buffett and Munger admit they "failed" shareholders and "blew it" by not buying Alphabet's stock in the past, they didn't fix the mistake by buying Alphabet now?
- The simple answer, perhaps, is that Alphabet was cheaper then, whereas they don't think it's cheap enough to buy today
- But I think there's more to it than that. If Buffett had bought $10.8 billion of Alphabet stock instead of IBM's in 2011 and was sitting on a huge gain (Alphabet's stock has tripled since then), I highly doubt he would be thinking about trimming, much less exiting, this position (even if there were no tax consequences). Rather, I think he'd be delighted to own nearly $40 billion of Alphabet stock right now and would view this as one of Berkshire's permanent stock holdings, like Coca-Cola, Wells Fargo and American Express
- Triggered by this realization, I decided to take a fresh look at Alphabet and a handful of similar companies

My Conclusion: Alphabet Is One of the Greatest Businesses on Earth

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- I've been following Alphabet for years, so it didn't take long to confirm my long-held belief that it is among the greatest businesses on earth: it dominates its sectors globally, is growing rapidly, has enormous, sustainable competitive advantages in the form of brands, habits, and network effects, and has a low-capital-intensive, high-margin business models that generates gobs of free cash flow
- It has seven products with more than one billion monthly average users: Search, Android, Maps, Chrome, YouTube, Google Play and Gmail
- Google Search has 90% share of search in most countries, Android has ~90% share of smartphones globally (vs. 5% in 2010), and YouTube serves ~20% (and growing) of all video consumed on the internet
- Alphabet currently captures 14-15% of global advertising spending

One Additional Data Point

- I gathered one important additional data point at the Berkshire Hathaway meeting when I had the opportunity to speak for 20 minutes with Martin Sorrell, the CEO of the largest advertising agency in the world, WPP Group, and he confirmed a story I'd read that 100% of the incremental ad spending in the world is going to Alphabet and Facebook
- Stop and think about that for a second: countless companies are competing for a share of this huge and rapidly growing pie (according to one study, "global internet advertising expenditure will grow 13% to reach $205 billion in 2017 and will attract 36.9% of all advertising expenditure, up from 34.0% in 2016. This will be the first year in which more money will be spent on internet advertising than advertising on traditional television."), yet only two companies are taking all of the global growth, leaving every other company to compete in a zero-sum game. This is simply astonishing…

Alphabet Has Plenty of Room for Growth

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- Enormous trend of advertising moving from traditional media to online
- Only ~12% of U.S. commerce is online today
- Smartphone penetration is only ~31% globally
- YouTube has enormous potential:
  - The world's second-most visited website (after Google.com), 80% outside of the U.S.
  - Video appears to be at an inflection point, and Alphabet has arguably the most valuable video platform in the world, as users watch 1.3 billion hours/day (5 billion videos/day) and upload 300 hours of video every minute
  - The average mobile viewing session lasts more than 40 minutes, up with more than 50% year-over-year
  - Video is currently ~15% of Alphabet gross advertising revenue, growing at twice Alphabet's overall rate
  - Opportunity to increase monetization, as YouTube serves ~20% of the web's videos, yet only ~10% of the web's video ads
  - In the U.S. YouTube currently monetizes at 60-70% the level of TV despite significantly better targeting
  - Annual revenue/user is slightly below Twitter despite having nearly 3x time spent/user
- If Alphabet spun off YouTube, how would the market value it?
  - How it's currently valued within Alphabet: $17 billion ($12 billion in revenue * 4% net margin * 35x) = $25/share
  - How it could be valued: $190 billion (assuming 40 cents/hour viewed, half of what cable companies are valued at) = $270/share (source: Bill Nygren, VII, 5/17)

Alphabet's "Other Bets" Depress Reported Profitability

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- Alphabet's "Other Bets" segment includes Waymo (autonomous vehicles), Nest (thermostats), Verily (life sciences & healthcare), Access, Calico, CapitalG, GV, and X
- In 2017, Other Bets generated revenues of $1.2 billion (up 49% YOY) and operating losses of $3.4 billion (down 6% YOY)
- Alphabet's operating income in 2017 was $26.1 billion, so excluding Other Bets, it would have been $29.5 billion or 13% higher
- Alphabet has invested ~$25/share into Other Bets; a conservative estimate is that this could be worth ~$50/share or 4% of Alphabet's value

But What About Valuation?

- It's hard to argue that Alphabet is misunderstood, with 40 analysts following the company, and equally hard to argue that its stock is cheap, at 28x and 15x 2018 EPS and EBITDA estimates, respectively
- But those multiples aren't crazy either, in light of the quality and growth prospects of Alphabet's core businesses
- They're even less crazy if you adjust for various factors:
  - If you subtract cash ($141/share) and the value of Other Bets ($50/share), and add $2.7 billion ($3.89/share) to net income for after-tax losses on Other Bets, Alphabet is trading at 21x 2018 earnings estimates – not far above the average for the S&P 500, for a company that is *vastly superior* to the average large U.S. corporation
  - If you think YouTube adds $255/share of extra value, the P/E drops to 15x
- If revenues continue to grow at ~20% annually and margins and multiples remain steady, then the stock will also grow at ~20% annually
- If you asked me to name 10 stocks that I think are most likely to outperform the S&P 500 over the next five and ten years, Alphabet would be on the list (after Berkshire Hathaway and Howard Hughes, to be sure), so I've made a bit of room for it in my portfolio