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Google, Inc. GOOG

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by Larry Witt, CFA

Analyst Note 04-17-2009

Google GOOG reported solid first-quarter results April 16. Revenue increased 6% (12% excluding currency effects) from the year-ago quarter. Even though this is a marked deceleration from the past, this rate is impressive considering the weak advertising environment. However, we expect Google's growth rate to remain challenged as the weak economy leads to a reduction in overall ad spending.

Advertising revenue on Google-owned Web sites (67% of revenue) increased a 9%, as the company continued to gain market share in Internet search. Revenue from selling ads on partner sites (30% of revenue) declined 3% because of pressure on ad pricing and the company's ongoing initiative to shed low-quality partners. Historically, Google had guaranteed revenue to some of its partners. Because it had trouble selling some of this inventory, the share of revenue that Google remitted to its partners had been increasing for several quarters. Due to these quality-control initiatives, the percentage of revenue paid out has finally stabilized.

Despite the weak revenue growth, there are signs for optimism. Google continues to take market share of Internet search, and search continues to take share from other forms of advertising. Therefore, we think Google is in good position to benefit when the economy recovers. In addition, management has made cost controls a priority, evidenced by the expansion in the operating margin to 34% from 30% a year ago. In addition, the company converted 36% of its revenue into free cash flow during the quarter (compared with 21% for all of 2008) because of cost controls and a steep decline in capital expenditures. Although we don't expect capital expenditures to remain at these low levels, we remain impressed with the company's profitability in recent quarters.

Thesis 01-27-2009

Google's dominance in Internet search has led to meteoric revenue growth and fantastic profits. This profitability has allowed the company to enter additional advertising markets and new industries, including software as a service and the mobile industry. Though we're not convinced the firm will replicate its current success in these new markets, its profits from search advertising should allow the company to generate copious cash flow for many years.

Attracted by its measurability and effectiveness, marketers have allocated more funds to paid search every year. Although the U.S. search market has started to mature, we think there is plenty of growth left in many international markets. These growth opportunities bode well for all industry participants, especially Google, which had 62% global market share compared with just 13% for second-place Yahoo YHOO as of December 2007, according to ComScore. And we think Google is poised to remain the leader for a few reasons. First, the fact that "Google it" has become synonymous with Internet search is a testament to

Morningstar Rating
★★★

Stock Price
As of 04-17-2009
$392.24

Fair Value Estimate
$500.00

Consider Buying
$250.00

Consider Selling
$1,000.00

Fair Value Uncertainty
High

Economic Moat
Wide

Stewardship Grade
C

Bulls Say

- Online advertising is growing very quickly as large advertisers are increasingly attracted by its measurability and its high returns on investment.
- Because of its effectiveness and measurability, we think paid search would be the least affected, though not immune, form of advertising in an economic downturn.
- Google has a superior technical staff that will continue to innovate faster and better than the competition.
- Google's brand strength should help attract customers to try its new products like online software, Google Checkout, and its mobile platform.
- Google's massive cash position, profitability, and corporate image allow the company to outbid competitors when it comes to acquiring hot technologies and key personnel.

Bears Say

- Other than brand strength, there are very few switching costs in Internet search. Google would suffer if a competitor could develop a superior search engine and gain marketing buzz.

Google's brand strength. Second, the firm has the financial resources and engineering prowess to ensure its search engine remains the best in the industry. Third, Google's massive scale of search queries and clicks gives the company unparalleled insights into which search results are most popular with users. This data intelligence can be used to further tweak its algorithms, leading to more relevant search results and an even better user experience. For these reasons, we think the company has a wide economic moat.

Paid search, which represents 90% of net revenue, generates substantial cash flow for Google. The firm has pursued new business lines into which it can deploy this capital, including placing ads on third-party Web sites, video ads on YouTube, and setting up a platform for the buying and selling of radio and television ad space. Unlike paid search, Google has to share the vast majority of any revenue it receives in these markets with the content owner, leading to lower profit margins. Therefore, relative to paid search, we think the opportunity for Google to earn significant profits through these other ad platforms is limited.

Google is also investing in emerging industries outside advertising. For example, it has launched Google Apps, a Web-based suite of office productivity applications aimed at small businesses, to compete with Microsoft Office and Outlook. Google has also developed an operating system for cell phones, hoping it can own the dominant platform in the mobile industry.

While the brand may resonate with consumers, we don't think Google has superior competitive advantages outside of Internet search. Therefore, the company will have to invest heavily to succeed in what we think are inherently lower-margin businesses. While this may lead to lower overall returns on capital, we think Google's core search business will allow the company to remain very profitable.

Valuation

We are lowering our fair value estimate to $500 per share from $575; our $500 estimate includes $50 per share (or $16 billion) in cash. Although we think Internet search marketing will continue to take share from traditional media advertising, we think the economic slowdown will force companies to trim their overall advertising budgets and will lead to slower revenue growth for Google. We now forecast revenue to grow at an average annual clip of 15% (compared with our prior forecast of 18%) over the next five years, driven by a slowdown in 2009. While we forecast that the majority of this revenue growth will come from paid search, we also expect Google to increase revenue from other business lines, including third-party ad sales and online software.

Due to offsetting factors, we expect the operating margin to remain relatively flat over our forecast period, and project an operating margin of 31% in 2013 compared with 30% in 2008. The main drag on margins will be Google's investments outside of its core business, search. The company's other business lines are inherently less profitable, as they do not enjoy the economies of scale of Google's search platform. Therefore, we expect Google's expenditures on personnel and technology to continue growing faster than revenue, which would imply lower operating margins. However, Google's lowest-margin business is selling ads on third-party sites because in addition to incurring operating costs, the majority of this revenue must be paid to the content owner. These payments are called TAC, or traffic acquisition costs. Because we project this business to grow much slower than the rest of the company, TAC expenditures will decline as a percentage of sales, offsetting increased expenditures on operating expenses.

Risk

- New business lines for Google will be less profitable, and any significant investment may ultimately destroy shareholder value.
- Large, expensive efforts like Google Earth digital mapping software may enhance Google's image but will do little to generate additional revenue for the company.
- Now that many key employees are financially independent, long-term employee retention may become more difficult.
- After acquiring YouTube, Google may be constantly distracted by lawsuits claiming digital copyright infringement.

Switching costs are relatively low in Internet search, and fickle consumers may move to a competitor that is able to establish a stronger brand or a more useful experience. Google is investing in new businesses where it is less competitive, which may lead to a deterioration in its operating margin and return on capital. Finally, the stock options of many early employees have now vested. Therefore, employee retention may become more difficult.

Close Competitors	TTM Sales $Mil	Market Cap $Mil
Google, Inc.	**22,118**	**130,925**
* Yahoo, Inc.	6,971	20,837
* IAC/InterActiveCorp	1,406	2,368
* Microsoft Corporation	61,175	199,265

* Morningstar Analyst Report Available

Data as of 03-31-09

Strategy

Using behavioral insights, demographic data, and geographic targeting, Google wants to provide highly relevant advertising across a variety of media; the more relevant the advertising, the more advertisers are willing to pay. Google is also trying to leverage its brand strength and massive financial resources to enter new markets outside of advertising.

Management & Stewardship

Larry Page and Sergey Brin founded Google in 1998 and now lead the company as a triumvirate with Eric Schmidt, who has been CEO since 2001. Schmidt had previously been CEO of Novell NOVL and chief technology officer of Sun Microsystems JAVA. Many have heralded the unorthodox decision-making led by this three-person committee, but we question its sustainability, particularly if Schmidt were to leave. We believe Schmidt plays a critical role in the success of the company that highlights the talents of each of the leaders. Page, Brin, and Schmidt have two thirds of the equity voting rights as of the last proxy filing, thanks to a dual-class structure. This disproportionate voting power is a significant risk for the remaining equity shareholders. We believe management could be more forthcoming with regard to its long-term strategy and operating metrics of the business.

Profile

Google provides a free search engine for users around the world and generates revenue whenever a user clicks on a text ad displayed alongside the search results. This represents 90% of the company's net revenue. The remaining 10% of net revenue is derived from ads sold on third-party sites and online software. Google is also investing in new business lines including traditional media advertising, the mobile industry, and online software.

Growth

Annual revenue growth has averaged an astounding 120% per year since 2001 as the company helped define the paid search industry and built the largest syndicate of advertisers and content partners.

Profitability

Paid search is highly profitable and scalable. However, investment in new businesses has led to a decline in the operating margin to 30% in 2008 from 34% in 2006.

Financial Health

The balance sheet is rock-solid, with $16 billion of cash and no debt.

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