

Alphabet Inc Class C GOOG ★★★

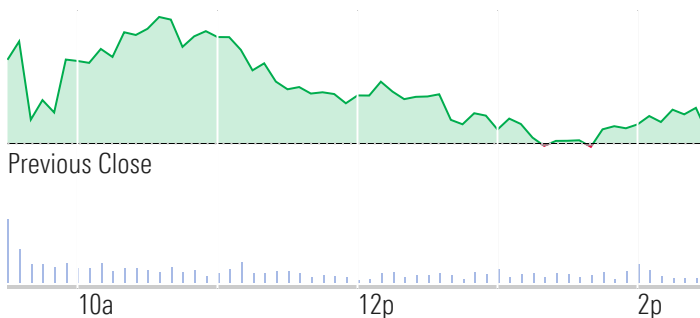
Rating as of Jul 28, 2021

Quote Stock Analysis News Price vs Fair Value Sustainability Trailing Returns Financials Valuation Operating

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Quote Key Ratios Short Interest

\$2,727.63 ↓ **8.30** | **0.30%**
 2,730.00x



USD | NASDAQ |
 Last close prices updated as of Jul 28, 2021, 4:00 PM EST |
 BATS BZX Real-Time Price

Ask/Size 2,735.00x1	Day Range 2,727.00 – 2,793.52	Volume / Avg 3.9 / 1.3 Mil
Year Range 1,406.55 – 2,800.22	Forward Div Yield —	Market Cap 1.8280 Tril
Price/Sales 13.72	Beta (5-Year) 1.01	Investment Style Large Growth
	Consensus Forward P/E 31.35	Price/Book 7.66

Morningstar's Analysis ⓘ

Summary Competitors Bulls Say/Bears Say

Valuation Jul 28, 2021
 Currency in USD

GOOG is trading within a range we consider fairly valued.

Fair Value
3,200.00
Uncertainty: High

Last Close
2,727.63

1-Star Price
> 4,960.00

Alphabet's Google Advertising and Cloud Performed Exceptionally Well in Q2; Raising FVE to \$3,200

Ali Mogharabi
 Senior Equity Analyst

Analyst Note | by Ali Mogharabi [Updated Jul 28, 2021](#)

We are increasing Alphabet's fair value estimate to \$3,200 from \$2,925 as the firm's second-quarter results not only beat expectations but were also indicative of faster and more sustainable digital advertising growth than we previously expected. An impressive increase in search ad revenue was accompanied by continuing growth in YouTube advertising and subscription revenue, combined with Google gaining further

Economic Moat

Wide

Trend: Stable

5-Star Price

< 1,920.00

Capital Allocation

Standard

traction in the cloud market. We continue to believe the stock is attractive.

Alphabet reported total revenue of \$61.9 billion, up 62% from the pandemic-ridden second quarter of last year. Google Services revenue increased 63% year over year to \$57.1 billion, due to 68% and 84% growth in search and YouTube, respectively, which not only drove total advertising revenue 69% higher year over year but also 55% above the second quarter of 2019. Demand for search ads remained high from the retail sector, while the economic recession and reduced travel, similar to what we were expecting (see our report of July 26) shows that the 30-day average of 2019 levels, up from 52% at the end of the second quarter, which is when net advertising revenue increased.

On the YouTube side, we were not surprised by the increase in advertising demand, driven by the economic recovery and more than 2 billion users. In addition, direct response offerings (which show up in our analysis of medium-size businesses) that increase the likelihood of making video ads actionable by viewers. YouTube Shorts, which is Google's version of TikTok, rolled out globally and could represent additional revenue in the long run. Management stated that YouTube Shorts, which was launched initially only in India during third quarter 2020, already has over 15 billion daily viewers.

Business Strategy and Outlook | by Ali Mogharabi [Updated Apr 09, 2021](#)

Alphabet dominates the online search market with Google's global share above 80%, via which it generates strong revenue growth and cash flow. We expect continuing growth in the firm's cash flow, as we remain confident that Google will maintain its leadership in the search market. We foresee YouTube contributing more to the firm's top and bottom lines, and we view investments of some of that cash in moonshots as attractive. Whether they will generate positive returns remains to be seen, but they do present significant upside.

Google's ecosystem strengthens as its products are adopted by more users, making its online advertising services more attractive to advertisers and publishers and resulting in increased online ad revenue

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which we think will continue to grow at double-digit rates after the pandemic and during the next five years. The firm utilizes technological innovation to improve the user experience in nearly all its Google offerings, while making the sale and purchase of ads efficient for publishers and advertisers. Adoption and usage of mobile devices has been increasing. The online advertising market has taken notice and is following its target audience onto the mobile platform. We have seen Google partake in this on the back of its Android mobile operating system's growing market share, helping it drive revenue growth and maintain its leadership in the space.

Among the firm's investment areas, we particularly applaud the efforts to gain a stronger foothold in the fast-growing public cloud market. Google has quickly leveraged the technological expertise it applied to creating and maintaining its private cloud platform to increase its market share in this space, driving additional revenue growth, creating more operating leverage, which we expect will continue. Regarding Alphabet's more futuristic projects, although most are not yet generating revenue, the upside is attractive if they succeed, as the firm is targeting newer markets. Alphabet's autonomous car technology business, Waymo, is a good example: Based on various studies, it may tap into a market valued in the tens of billions of dollars within the next 10-15 years.

Economic Moat | by Ali Mogharabi [Updated Apr 09, 2021](#)

We assign Alphabet a wide moat rating, thanks to sustainable competitive advantages derived from the company's intangible assets, as well as the network effect.

We believe Alphabet holds significant intangible assets related to overall technological expertise in search algorithms and machine learning, as well as access to and accumulation of data that is deemed valuable to advertisers. We also believe that Google's brand is a significant asset, as "Google it" has become eponymous with searching, and regardless of actual technological competency, the firm's search engine is perceived as being the most advanced in the industry.

In our opinion, Alphabet's network effects are derived mainly through its Google products such as search, Android, Maps, Gmail, YouTube, and more. Ultimately, we view Google's network as heterogeneous. On the

one side, all the aforementioned products have provided Google with a massive consumer base that allows the company to collect data. On the other side, via its rich collection of data and large user base, Google can offer the best return on investment for advertisers and build a growing network of advertising customers. The addition of each new ad and advertiser improves the efficiency of Google's programmatic advertising offerings, allowing the firm to better monetize the network.

In search, Google has successfully and consistently has monetized many of its technology-based intangible assets, from the original algorithms behind search to the current machine-learning ones, which are also being applied to nearly every product. The company was recognized first for its "extremely relevant results" by PC Magazine in December 1998. From that point, it grew into the world's most popular online search engine and has maintained its leadership. Google processes more than 3 times and 4 times as many search requests as Bing (Microsoft) and Yahoo, respectively. Google Search's success stems from the relevance of its results to its users and the likelihood that this relevance will improve as more data is gathered and analyzed, assumptions are generated, and predictions are created. Google has used machine-learning technology to improve the user experience.

The company has applied machine learning to its Google App (speech recognition), Gmail (Smart Reply), Google Photos, Maps, and many other products, including its cloud offerings. As technological advancements improve the user experience for each product, the likelihood of further usage increases.

With more usage, more data about users' behavioral interests is gathered, analyzed, and applied to rank ads more accurately based on their relevance and click-through-rate probability. The monetization of, and higher ROI on, machine learning stems from the fact that the technology increases the volume and click-through rates of ads, resulting in more ad revenue. Google's continuing investment in machine learning should help increase the effectiveness of ad rankings and placements, resulting in higher ROI for advertisers and increased revenue for Google.

We believe Google's investment in machine-learning technology will also enhance the efficiency of its DoubleClick programmatic advertising

offerings, which consist of not only real-time bidding that the technology adjusts in real time based on the various search trends it recognizes, but also programmatic direct, where ad impressions (or inventory) can be purchased in advance. Programmatic advertising, and more specifically programmatic video ad spending, is expected to grow at a healthy rate.

Based initially on its technology, Google has successfully increased its users' dependence on its products to keep transforming the usage of those products into something habitual. We have seen that with online search, as most people around the world continue to "Google it." It has strengthened its brand, which we think has longevity. We view the Google brand as a significant driver of user growth for YouTube, Maps, Gmail, and Chrome. Again, an expanding user base helps the company collect more data, which is monetized when applied to online ads.

Google has the world's most widely used search engine, and such a large and growing user base has created a network difficult to replicate, in our view. We believe that an additional search on Google's search engine creates value for other users, as well as for advertisers and businesses. With Google's machine-learning technology, more requests made by current and/or new users improve relevancy of search results, creating value for users. More relevant results also decrease the likelihood of users jumping to another search engine, creating somewhat of a barrier to exit.

For advertisers, value is created mainly through growth of the large user base to target and from behavioral data compiled and analyzed. As users and search requests grow and more data is gathered, advertisers' demands for ads increase, helping Google to further monetize the network.

As with Google search, we see network effects from large and growing user bases of other products, such as Maps, Gmail, and Chrome, all of which create value for users and advertisers. As more consumers use Maps, more data regarding traffic, commuting tendencies, and so forth is gathered, helping Google generate more accurate results (in terms of locations, travel times, and route suggestions). Google also utilizes such data to provide faster routes (via Maps and the Waze app). All of this creates more value for users. As in search, increasing users and data

create value for advertisers, which Google monetizes effectively. Businesses and advertisers pay Google to place their search ads, targeted based on users' locations and previous searches, within Maps' search results list and directly on the map.

Although an additional Gmail user does not necessarily create more value for other Gmail users, the growing network does become more valuable for advertisers, creating additional opportunities to place target ads, resulting in more revenue generated from the network.

Usage of Google's Chrome browser is also continuing to grow. According to Net Applications, Chrome browser usage on mobile devices nearly doubled year over year in 2015. It trailed only Apple's Safari, which declined in 2015. On desktops, Chrome usage was also ranked second in 2015, trailing Microsoft's Internet Explorer. However, Chrome was the only browser with higher year-over-year usage share. In our opinion, growth in Chrome browser usage helps increase the network effect for Google; again, the network is monetized via sales of various online ads. With more users, more data is gathered and analyzed, helping advertisers target the large user base more effectively with online ads.

By launching Android in 2007, Google positioned itself well in the faster-growing mobile ad market, maintaining its online search dominance and strengthening its network effect. With Google's Chrome browser on Android phones, more mobile searches are conducted using Google. In addition, more Google apps such as Maps, Gmail, and Google Play are used by consumers on Android-powered devices, further driving ad and other revenue growth. According to IDC, Google's Android OS powers more than 85% of smartphones around the world, compared with Apple iOS' slightly below 15%. We think it is likely that the two smartphone operating systems will continue to power nearly every smartphone around the world in the long run, with Google's apps not only on Android devices, but also among the top apps used by iOS customers.

In the expanding mobile market, we believe Google will not only maintain but expand its user base, positively affecting the network effect as it becomes more valuable to advertisers, resulting in more digital mobile ad revenue growth. Similarly, Android's network effect also creates more value for users. As the number of Android-powered

smartphones increases, more developers will create more apps to be made available on Google Play and run on those smartphones, creating additional value for Android smartphone users.

We think YouTube is also valuable, as it benefits from a network effect that creates value for users, content creators, and advertisers. With more viewers on the site today, more content creators will look to YouTube for content distribution. Continuing growth of YouTube's content library drives further viewer growth. YouTube's video platform has more viewers than other online video properties, making it attractive for advertisers. We believe growth in content library and in viewers on YouTube will drive growth in Google online video ad revenue, a market that is expected to grow at a strong double-digit compound annual growth rate. While Google has also begun to monetize YouTube via the subscription model (YouTube Red and YouTube TV), we expect the majority of YouTube revenue to remain generated through online ads on desktops and mobile devices.

We also expect Google to gain a foothold in the growing enterprise cloud market, but we do not think its cloud offerings create a network effect. Although Amazon is clearly the leader in this space, we expect Google to gain some traction and trail only Amazon's AWS and Microsoft's Azure in market share. Ultimately, we believe Google can leverage the technological expertise it applied to creating and maintaining its private cloud platform to build and maintain public cloud platforms for many businesses.

Regarding other potential sources of moat, we do not believe Alphabet has a sustainable cost advantage when compared with its peers. Alphabet's size allows the firm to invest heavily in Maps and YouTube, and perhaps in more capital-intensive businesses like enterprise cloud or Google Fiber. However, we don't see an inherent cost advantage in Alphabet that other tech titans like Apple and Amazon can't replicate, especially since cloud hardware is becoming increasingly commodified.

We also believe that customer switching costs provide Alphabet with only a negligible competitive advantage. Alphabet's Google offerings, such as search, YouTube, Android, Maps, and Gmail, have some switching costs associated with time and effort needed to learn a new user interface, move content to another platform (YouTube) and notify

contacts of an email change (Gmail), but such costs are not so prohibitive that these customers are locked in forever.

Our narrow-moat thesis for Apple is based on modest, but not insurmountable, switching costs around the iOS ecosystem. Android may also benefit from switching costs, as apps purchased on Google Play would have to be replicated on iOS, but we also do not see such costs as overwhelming.

Finally, while Alphabet generates economic profit through Google, which we think will continue, this profit would be higher were it not for Alphabet's strategy of remaining a step ahead in terms of innovation. In its other bets segment, Alphabet is betting on (or investing in) smart homes (Nest), using technology to enhance health (Verily), providing significantly faster Internet access to homes (Google Fiber), self-driving cars (Waymo), and much more.

Some of these wagers may not bring in any winnings, and we believe it is too early to consider these businesses as contributors to Alphabet's economic moat, either in terms of intangible assets or network effects. However, the assets and continuing investments may give Alphabet an early edge as a first mover, although the sustainability of that competitive advantage will be determined over time. In our opinion, these bets demonstrate the company's objective of remaining a leader and one of the main players in the Internet technology space. A hit with any of these bets could put Alphabet further ahead of the technology pack.

Fair Value and Profit Drivers | by Ali Mogharabi [Updated Jul 28, 2021](#)

Our fair value estimate is \$3,200 per share, equivalent to a 2021 enterprise value/EBITDA ratio of 20. We expect revenue growth to accelerate in 2021 as the economy recovers from the COVID-19 pandemic, helped by greater revenue contribution from YouTube and cloud and the acquisition of Fitbit. While new offerings will pressure gross margin, we look for operating leverage improvement during the next five years. Our model represents a five-year compound annual growth rate of nearly 20% for total revenue and a five-year average operating margin of 27%.

We expect advertising revenue to represent over 70% of Alphabet's total revenue, driven by continuing growth in overall digital ad spending, more specifically in search, video, and mobile. We model 32% ad revenue growth for 2021 due to the economic recovery, which will be accompanied by higher ad spending across verticals, including travel. We have estimated total Google ad revenue of \$194 billion and \$225 billion in 2021 and 2022, respectively. We think YouTube will contribute about 15% of Google's advertising revenue in 2021, up from 13% in 2020. Outsize growth at YouTube should stem from its impressive reach and frequency, plus its video-only content format, which is attractive to brand advertisers.

We believe Google will continue to gain traction in the cloud market (32% annual revenue growth through 2025), and when combined with non-ad YouTube revenue, Google Play, and sales of hardware products, we see Google's other revenue growing 42% to over \$49 billion in 2021. For 2022, we expect 33% growth in other revenue.

Although Alphabet does not break out revenue for its other bets segment, we assume Fiber and Verily generate most of this revenue, as commercialization of Waymo is in its early stages. Our total other bets revenue estimates for 2021 and 2022 are \$781 million and \$868 million.

We model 55% and 53.1% gross margins for 2021 and 2022, respectively, compared with nearly 54% in 2020, due to the higher cost of YouTube content. We expect the average gross margin through 2025 to be comparable to 2020. Combined with strong revenue growth, we expect deceleration of growth in other operating expenses to increase operating leverage for Alphabet through 2025.

Risk and Uncertainty | by Ali Mogharabi [Updated Apr 09, 2021](#)

Our uncertainty rating for Alphabet is high, the result of high dependency on continuing growth in the online advertising space, along with questions as to whether the company's moonshot investments will bear fruit. While we remain confident that Google will maintain its dominant position in the search market, a long-lasting downturn in online ad spending could have a negative impact on Alphabet's revenue and cash flow, resulting in a lower fair value estimate. While Alphabet is facing a decline in online ad spending due to the COVID-19 pandemic, we think the impact will be for only 12-18

months, after which the firm will again benefit from the growing online ad market. On the other hand, positive returns on Alphabet's investments in moonshots could increase the company's fair value estimate considerably. These two factors support our high uncertainty rating.

Although the moat sources of intangible assets and network effect will help Alphabet's Google retain its competitive advantages, minimal switching cost to utilize a rival search engine remains a risk for the company. This risk is discounted as Microsoft's Bing, the nearest competitor to Google's search engine, currently does not have significant presence in the mobile market, which is one of the main growth drivers of the search ad market.

The rapid adoption rate of additional online ad platforms, such as Facebook's social network, could lower Alphabet's revenue growth, eliminating operating leverage and creating pressure on operating margin.

In addition, Alphabet's Google faces antitrust pressure and various claims and investigations brought on by different companies and regulatory agencies regarding search bias and its overall market dominance in online advertising.

Capital Allocation | by Ali Mogharabi [Updated Feb 09, 2021](#)

We assess the stewardship of Alphabet as Standard. This assessment was conducted using our prior stewardship methodology. We will be transitioning our assessment mechanism for Alphabet, and the balance of our stock coverage, to the Capital Allocation methodology by the end of September 2021.

We assign a Standard stewardship rating to Alphabet's management. It appears that management aims to remain ahead of the pack by acquiring valuable assets to utilize and build upon, as it did with Android, YouTube, DoubleClick, Motorola Mobility, and more recently, Looker. In addition, Alphabet continues to invest in R&D and various high-risk and high-reward projects, which if successful could generate significant returns for the company. Investment in autonomous vehicle technology (Waymo), is just one example. Given the large amount of cash and low debt on Alphabet's balance sheet, it appears that

management continues to make the right decisions regarding capital allocation, as it is more likely to continue making acquisitions and investments in futuristic projects.

In late 2015, Alphabet became a holding company, with Google one of its wholly owned subsidiaries. Alphabet is also the parent company of other businesses, mostly moonshots, which are grouped into the other bets segment that includes Waymo. This structure has provided slightly more transparency to shareholders, as the company's mature cash-generating business, Google, is managed separately. In our opinion, such a move may indicate that management is considering some form of redistribution of cash generated by Google to shareholders a few years down the road.

Under this structure, Larry Page, who cofounded Google and is a director, was the CEO of parent company Alphabet. Sergey Brin, the other cofounder of Google and a director of Alphabet, was the president of the firm. In December 2019, Page and Brin left their roles (but remained on the board) and Sundar Pichai, the CEO of Google, also became the CEO of Alphabet. Pichai joined Google in 2004 and was its product chief before becoming CEO in 2015. Susan Wojcicki, who has been with Google since 1999 and convinced Google to acquire YouTube, became CEO of YouTube in 2014. Thomas Kurian, former president of Oracle's product development group, became the CEO of Google Cloud in 2019, a position held by Diane Greene for the previous four years. Ruth Porat is CFO of Alphabet and Google. She was CFO at Morgan Stanley before coming to Alphabet in 2015.

Although management's decisions have generated exceptional returns for shareholders in the past, and are likely to continue doing so, we remain watchful regarding the high concentration of voting power. At the end of 2019, Page, Brin, and former CEO and former executive chairman Eric E. Schmidt had more than 55% voting power. In addition, given Alphabet's multiclass share structure, it appears that this high concentration of power will remain intact in the long run, which could result in significant conflict of interest if the cofounders and Schmidt, who is now the company's technical advisor, make too many high-risk wagers on futuristic projects. However, we have not seen any indications of this.

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Company Profile

Business Description

Alphabet is a holding company, with Google, the Internet media giant, as a wholly owned subsidiary. Google generates 99% of Alphabet revenue, of which more than 85% is from online ads. Google's other revenue is from sales of apps and content on Google Play and YouTube, as well as cloud service fees and other licensing revenue. Sales of hardware such as Chromebooks, the Pixel smartphone, and smart homes products, which include Nest and Google Home, also contribute to other revenue. Alphabet's moonshot investments are in its other bets segment, where it bets on technology to enhance health (Verily), faster Internet access to homes (Google Fiber), self-driving cars (Waymo), and more. Alphabet's operating margin has been 25%-30%, with Google at 30% and other bets operating at a loss.

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Stock Type

Aggressive Growth

Employees

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