Alphabet Inc. (A) (GOOGL)
Expect Solid Q1 Results; Margins + Cloud Platform in Focus

Expect solid revenue growth in line or better than consensus expectations. Our checks with advertisers and marketing partners throughout Q1 indicated healthy and stable search advertising trends in the quarter, with core search growth declining slightly vs. Q4, but consistent with our revenue build (Baird $37.6B vs. consensus $37.1B). While Alphabet guided to moderating headcount growth through the year, we still expect overall platform investments to remain a drag on margins. Maintain Outperform rating.

- Alphabet will report Q1 results next Monday (April 29) AMC. Shares are up 8% since the last reporting date, slightly outperforming the S&P's 6% gain.
- Growth likely to decelerate slightly on a tougher comp, but checks suggest core trends remain solid. We expect revenue growth of roughly 20% Y/Y (vs. consensus of +19%), with our field checks implying largely stable search trends (growth rate declining slightly from Q4) and steady e-commerce growth (a positive for Google Shopping). We note that most third-party data points indicate Google search spend increased low-to-mid double digits vs. mid-high double digits in Q4. Additionally, feedback suggests that the ramp in Amazon advertising is having limited impact on core Google search spend, despite negative media headlines to the contrary.
- Key areas of investor focus include: 1) GCP growth strategy and traction under new leadership; 2) impact of increasing search competition (e.g., Amazon); 3) impact from cookie blockers; 4) Investment spending priorities/margin outlook; 5) YouTube growth, safety concerns; 6) potential new regulations; 7) early Stadia reception and overall hardware strategy; 8) Waymo roll-out.
- Margin pressure reflects investments in growth. As with most of our other large cap Internet companies, Alphabet is prioritizing platform investment over harvesting earnings, and we expect technology, product, and headcount will continue to outgrow revenues. We note that significant opportunities still remain across cloud, video, hardware, and even core search (e.g., voice, visual search.) In Q1, we still expect moderating TAC growth.
- Recent announcements shows Google eager to leverage its Cloud. Google's upcoming video game streaming platform marks an important step for the company, and is an example of Google leveraging its vast cloud/ML platform, furthering YouTube engagement, and driving device sales (e.g., Chromecast,) Just as important, Google continues to make strides to commercialize its enterprise cloud platform (GCP), and we expect improving momentum as the company updates its go-to-market strategy with improved sales and support.

Google is the world's dominant web search engine, leading online advertising platform, and media company.
Details

Figure 1. 1Q19 Currency FX Impact

<table>
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<tr>
<th>Exchange Rate</th>
<th>Intraquarter Average</th>
<th>Exchange Rate</th>
<th>February 4 - March 31</th>
<th>Intraquarter Average Local Currency Appreciation/Depreciation</th>
<th>2019E Currency Share of Revenue</th>
<th>Ba r A r B i l l R e v i e W C o n t r i b u t i o n B a s e d o n P u b l i s h e d E s t</th>
<th>I m p l i e d R e v e n u e U s i n g I n t r a q u a r t e r 1 Q F X R a t e</th>
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<td>Dollars</td>
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<td>$30,256</td>
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</table>

Source: Factset, R.W. Baird estimates

Investment Thesis

- **We have an Outperform rating**, based upon Alphabet's unparalleled technology platform and opportunities in multiple compelling growth verticals. Google, an Alphabet subsidiary, is the dominant leader in the online advertising market and is poised to benefit from the ongoing secular growth tailwinds in search and display advertising as well as the explosion of mobile. Based on reported advertising-related revenues, Google is the largest media company, having single-handedly driven search advertising to the mainstream, and in our view poised to benefit even further from secular growth tailwinds, a healthy Search business, the rapid rise of the company's programmatic display ad platform, and leading market share on mobile devices. We estimate that directly and indirectly Google drives roughly 50% of overall online advertising with annual growth in the 15% range expected over the next 3-5 years. As such, we believe Google remains uniquely positioned to grow in excess of the overall market, on the back of continuous innovation and a more aggressive push into nascent markets.

- **Valuation.** Our $1380 price target is based on 15x 2020E EV/EBITDA and 25x 2020E P/E, in line with to slightly above comparable multiples of 10-22x and 18-30x, respectively, largely due to Alphabet's scale, market share penetration, and long-term growth trajectory.

Risks & Caveats

- **Competitive threats.** In search, Google's biggest competitor is Bing (owned by Microsoft) but also faces various regional search competitors in Russia, China, South Korea and Japan, where Google lags.

- **Anti-trust and other regulatory risks.** As Google's dominance has grown in Search and other areas of digital media, the DOJ and EC anti-trust regulators have increased scrutiny of the company's activities. This may hamper Google's competitiveness in the future.

- **Facebook and social networking-related risks.** Facebook's portfolio of social networks constitute an increasing and significant part of the web that is walled off from Google's search engine. This could pose an increasing blind spot for search. Facebook may also, over time, compete in search, by using its social network data to augment a search index compiled of public web data.

- **Facebook and display advertising threats.** Facebook is also one of the largest display advertising platforms.

- **Patent risk.** Apple and Microsoft, among others, have actively been filing patent infringement lawsuits against Android OEMs, in an attempt to slow the growth of Android.
- Mobile and Voice-related platform risks. Apple's iOS platform competes with Android and could take significant share, while Amazon's Alexa is already the leading voice-based Internet platform.

Company Description

Alphabet is both the largest global online advertising company as well as the leading media company, as measured by top-line revenues. Alphabet (Google) dominates Search and Paid Search advertising (AdWords) in most markets, excluding China, Russia and South Korea. In addition to search on its own sites, Google operates third-party advertising networks that outsource advertising, or monetization, of their properties to Google, in return for a fee. Google is operationally structured around six key products: Search, Display, YouTube, Enterprise, Play, and Hardware (Nest/Chrome/Pixel/Home).
Appendix - Important Disclosures and Analyst Certification

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Covered Companies Mentioned
All stock prices below are the 04/22/2019 closing price.

Facebook, Inc. (FB - $181.44 - Outperform)
Twitter, Inc. (TWTR - $34.39 - Neutral)
Yelp, Inc. (YELP - $36.95 - Neutral)
(See recent research reports for more information)
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