

Hyperion Asset Management

Company Profile

Alphabet Inc. Class A

Main Business Activities

Alphabet Inc's (Alphabet) primary business activity is offering a free to use search engine, Google, allowing consumers to search the world's information, including webpages, images and videos. Google is the dominant search engine globally and is used by the majority of the world's internet population. Google allows businesses to advertise on the results page of consumers' search intentions. Google, in return, receive advertising dollars from search on a cost per click basis from desktop and mobile devices. Google also provides the ability to advertise on the Google Display Network, providing access to over two million websites that reach 90% of internet users globally.

Alphabet also owns Youtube, an online video platform where users and businesses can post their original content and receive a share of the advertising dollars. Similarly to search, the platform is free and monetised through display and search advertising. There is over 2 billion users that visit Youtube on a monthly basis.

Alphabet has a strong growing cloud business which includes their Google Cloud Platform (GCP) as well as GSuite, their office productivity tools. GCP allows businesses to move their IT infrastructure from an on-premise environment to a cloud environment. GSuite is Alphabet's Microsoft Office equivalent and provides productivity tools for knowledge and first line workers.

In addition, Alphabet operates the Google Play App Platform and Hardware as well as owning numerous businesses with minimal financial contribution, contained in the other bets segment.

Alphabet generates advertising revenue across its own sites as well as from third parties within Google Networks. Advertising revenue makes up approximately 80% of total revenue. Additional revenue comes from Google Other Revenue, comprised of Google Play, Hardware and subscription revenue (approximately 10% of revenue) and Google Cloud revenue, comprised of the Google Cloud Platform and GSuite (approximately 7% of revenue). Other Bets revenue makes up the remaining revenue, which is Alphabet's investment in a number of promising, early stage businesses such as Nest, Calico and Verily.

Key Value Proposition to Customers

Alphabet's value proposition to consumers is offering fast and accurate results for users searching online. Google benefits from networks effects in that the more searching that is done via Google properties, the superior the search results are. The value proposition for Youtube is offering either free or paid ad-free video content.

Alphabet's value proposition to advertisers is providing access to the largest number of consumers globally across Google's properties, including Search and Youtube. Google Search reaches the majority of the world's internet population while Youtube has over 2 billion monthly active users. Google and Youtube are the two most visited sites globally each day. Consumers who are using Google Search show very high commercial intent, and are more likely to respond favourably to an advertisement as they are actively searching for that product or service. Ads are therefore useful and relevant rather than intrusive and annoying. The more ads can be matched to the right consumer, the greater the return on investment which also increases the price paid to Facebook. Facebook offers advertisers a scaleable ad platform which has the capacity to consume a large proportion of advertisers' budgets without large declines in return on investment. Advertising is crucial for the ability of businesses to communicate their product with consumers and drive their sales.

Alphabet provides a strong value proposition to small businesses, allowing them to compete on a level playing field with large corporations. With 35% of small businesses before the COVID-19 pandemic having no web presence, Alphabet provides a compelling and easy to use solution for these businesses to increase their digital presence.

The value proposition for Google Cloud is that it enables companies to shift their workloads into the cloud. Corporates are able to reduce costs (less internal IT staff and lack of infrastructure required), increase productivity with variable processing and storage capacity immediately available, and also have the most up to date technology. The value proposition for GSuite is providing productivity tools (equivalent to Microsoft Office) at a lower cost though this comes with lighter functionality.

Sustainable Competitive Advantages and Outlook

Alphabet has a diverse and market leading product set with nine platforms with over 1 billion users, including Search, Youtube, Google Play, Chrome, Android, Maps, Google Photos and Gmail. The company's breadth of assets and the ability to leverage Android and its hardware assets to improve the reach of their apps is a key advantage.

Search remains the dominant way information is discovered online and Hyperion believes it is difficult to see how this could be replaced at this point in time. Google search dominates the market for paid search with a market share of approximately 80%. It is very difficult to disrupt market incumbents that benefit from network effects, particularly when the service is free. Google Search continues to improve as more queries are made, which increases their competitive advantage. Breaking consumer habit is very difficult, particularly when the substitute product offers a worse experience. The main competitor in the U.S. is Bing (owned by Microsoft) however the offering is inferior from both a user perspective (the effectiveness of search results) and from an advertiser perspective (with a smaller audience).

Youtube is the dominant platform for free and paid video and music content. There are strong network effects on the platform where users want to post content to attract advertising dollars and the greater the amount of content drives additional users. There are no threats in terms direct competitors for Youtube however it does compete for time spent against other video platforms.

Alphabet's competitive advantage in Cloud computing is through leveraging its expertise in high performance computing and Artificial Intelligence and Machine Learning. It also has strong Software-as-a-Service (SaaS) based products such as BigQuery. Google is a distant third in the cloud computing market, however the industry has high barriers to entry and is early on in the transition to the cloud (with an 20% estimated penetration). Google Cloud can compete effectively in the cloud computing market and should take a meaningful share of the market long term.

Overall Company Growth Options

Hyperion believe search (and display) advertising should continue to grow at double digit rates of growth over the long term with the continued migration of advertising dollars online as well as increased advertising from small to medium enterprises, which were previously restricted from advertising heavily on traditional media. The continued shift to e-commerce will also result in growth in advertising dollars as businesses shift their presence online.

Youtube is a heavily undermonetised asset and should be a strong growth driver for Alphabet. Youtube has over 2 billion MAUs yet only has revenue of approximately US\$20 billion. This equates to an average revenue per user of less than \$10 which is significantly less than peers.

Google's cloud computing business is another growth driver for Alphabet, which has a significant addressable market. Alphabet will likely be the third player in this market behind Amazon and Microsoft, however the long term addressable market is likely to be in excess of US\$1 trillion. The transition from on-premise computing to the cloud is at an early stage, with an estimated penetration of 20%.

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