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Human progress at a market multiple

We live in a technological golden age but in a monetary and fiscal dark age. While physicists discover the so-called God particle, governments print and borrow by the trillions. Science and technology may hurtle forward, but money and banking race backward.

Now under way is an attempt to resolve the investment tension between technological progress and financial retrogression. Google Inc. will stand in for progress, the short-dated government security of your choice for progress-in-reverse. In preview, *Grant's* is all for progress.

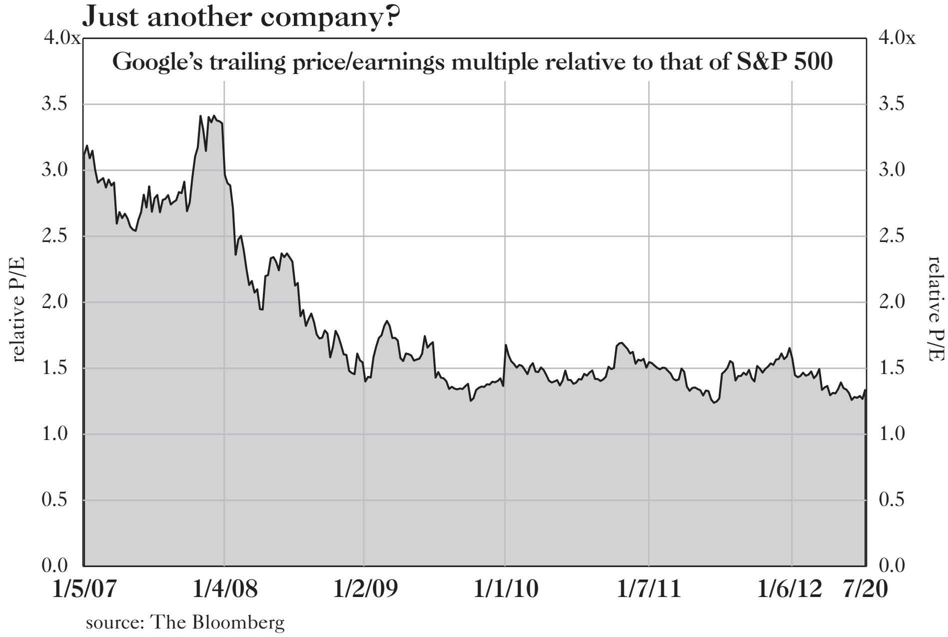
Crowding into sovereign debt yielding less than nothing, investors give wide berth to equities returning—or, rather, to be exact, undertaking to return—something more than nothing. For supposed security of principal, no current yield seems too low. But for a call on human progress, no earnings yield seems adequately high.

Safety is in a bubble, this publication continues to believe. Reciprocally, progress—capitalized progress—is in a bear market. At the end of last week, the two-year obligations of the governments of Austria, Denmark, Finland, Germany, the Netherlands and Switzerland each yielded less than nothing. Google traded at a market multiple, more or less—less after adjusting for surplus cash. We are not saying, let alone insisting, that ostensible safety can't get dearer or progress cheaper. Our point is rather that progress, at current prices, seems a better and safer bet for the long haul than claims on sovereign governments denominated in the very currencies that those governments are actively working to depreciate.

From time to time, your editor tries to imagine Benjamin Franklin brought back to life. "Dr. Franklin," someone would say, handing the pioneering electrical theorist a smartphone, "the entire store of human knowledge is yours to command on this small mobile device—no charge for the search." The inventor of the lightning rod would surely be flabbergasted. How could he not be? Larry Page, Google's CEO, can hardly stop raving about the leaps and bounds of digital progress—or could, before he lost his voice—and Page was born in 1973.

We line up with Page and the imagined Franklin. Glass half-full people from way back, we stand in awe of a cash-spinning company that, among other things, holds the keys to the driverless car and the digital contact lens (for the record, your editor owns GOOG and uses the technology, including—though only rarely while in the office—YouTube). "Google is not a conventional company. We do not intend to become one." Those ringing sentences, the opening lines of the 2004 Founders' IPO Letter, set a tone that early carried GOOG aloft. As recently as 2007, the shares commanded a P/E multiple more than twice that of the S&P 500—37 vs. 16, by the respective forward estimates. Better still from the value-seeker's perspective is today's valuation: 14.3 times the estimate, fol-

Just another company?



source: The Bloomberg

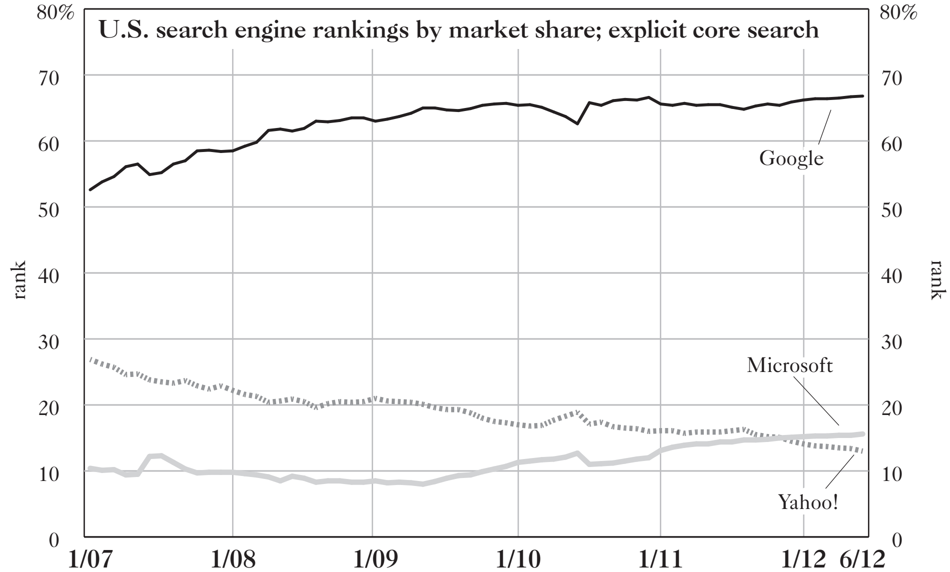
lowing slightly better-than-expected second-quarter earnings, compared to the S&P's 13 times forward multiple. Adjust for Google's immense cash hoard, however, and the forward P/E drops to just over 12.8 times. Apple, another mighty engine of digital progress, trades cheaper (on Tuesday, it reported much worse-than-expected fiscal third-quarter earnings).

Why does Google, for all its growth and brainpower, command a mere market multiple? A skeptic can cite many possible reasons, starting with the valuation of the S&P itself. Maybe it's too high. Maybe, considering Spain and China, Stockton, Calif., and the fiscal cliff, Libor and Dodd-Frank, Obama and Romney, Google is, in fact, properly valued; it's the rest of the market that should, and will, adjust to the downside.

Then there are Google's innumerable warts, a skeptic might observe. "For starters," colleague Charley Grant notes, "for all of the company's marvelous engineering feats, Google earns 96% of its revenue (2011 total, $37.9 billion; $22.9 billion in 2012 so far) from advertising. Advertising, of course, is a cyclical business. As the Internet-connected world transitions away from the personal computer to tablets and mobile devices, ad revenues fall. Claire Cain Miller, writing in last Friday's *New York Times*, neatly summed up the predicament: 'People have long described the price difference between print and Web ads as moving from analog dollars to digital dimes. Cellphone ads could be described as trading those dimes for mobile pennies.' The cost per click for an ad you see on a cellphone is 53% cheaper than the cost per click of an ad on a personal computer, according to the Rimm-Kaufman Group. Google expects that mobile ads will generate higher revenues over time, but time will tell."

Under the heading of warts, one could also mention management's exasperating vagueness about where, exactly, the money comes from. The front office will say only that 45.6% is sourced from the United States, 10.7% from the U.K. and 43.6% from that dark region known as "rest of the world." Nor is management much more forthcoming about the status of its 39-year-old CEO—Page has "lost his voice" is the full medical report—or about the deeper meaning of the looming two-for-one stock split by which holders will receive a new Class C share for every Class A share. Voting control is vested in the Class B shares, which are largely held by founders Page and Sergey Brin, and by the executive chairman, Eric Schmidt. The decision to issue the C shares—which have no voting rights and will cement control with the ruling troika—is one the *Financial Times* termed "unusual" in its news columns, "depressing" on its editorial page.

Look no further



source: comScore

Google's very success constitutes another kind of flaw, since it overstimulates the social envy glands. Antitrust authorities on three continents, at least, have their knives out for the worldwide leader in search and digital advertising. Then there's Google's astounding cash pile—$44.2 billion, even following the recent acquisition of Motorola Mobility for the round sum of $12.5 billion. Will the Google oligarchy consent to return even small change to the owners? It appears that Page et al. will not, but will rather continue acquiring new businesses at the customary rate of a company a week. "More than half the purchase price of Google's 79 acquisitions in 2011 was allocated to goodwill," Grant observes, "rather than to the intangible assets themselves. Such a ratio is high enough to set you wondering whether the company is spending wisely—it will be interesting to see how much goodwill is assigned to the acquisition of the lavishly unprofitable Motorola unit."

Then, too, a skeptic may reasonably wonder, as Google's technology has laid low the analog competition, might Google itself not one day fall victim to a new, new thing not of its devising? Or might Google's single-minded search for the next world-shaking innovation—it spent $5.2 billion on R&D in 2011—prove a distracting and costly hunt for a technological will-o'-the wisp? Prowl around on the tech blogs and you'll read complaints that Google is delivering fuzzier, less relevant search results. (If so, the data don't reflect it, as Google's share of American searches inched up to 66.8% in June from 66.2% in January, and from 52.6% in January 2007, according to comScore.)

All these doubts and more figure in Google's valuation, which is neither better nor worse than the kind of company that innovates a little and grows a little but holds out no claim—as Page and Brin have done since Google's inception—of getting filthy rich while transforming human life. "We have always tried to concentrate on the long term," wrote Page this year, "and to place bets on technology we believe will have a significant impact over time. It's hard to imagine now, but when we started Google most people thought search was a solved problem and that there was no money to be made apart from some banner advertising. We felt the exact opposite: that search quality was very poor, and that awesome user experiences would clearly make money."

And making money is what Google does do. It has returned no less than 16.6% on common equity in any year since its going-public year of 2004; last year's ROE was 18.7%, reflecting free cash flow of $11.1 billion. (Apple, valued at 12.8 times the fiscal 2012 estimate before Tuesday's blowup, returned 41.7% on equity in 2011). Though the second-quarter balance sheet has not yet been unveiled, the first period's EBIT coverage ratio, 169.5:1, is a figure out of the Balance Sheet Hall of Fame (Apple is debt-free).

It almost goes without saying that if there were an Innovation Hall of Fame, Google would long ago have been an inductee, along with rivals Apple, Amazon and Microsoft. Judges might have waved Google through solely on the strength of its timely acquisition and masterful nurturing of the Android operating system. Acquired in 2005 for an undisclosed sum, Android, at last report, powered 56.1% of the world's smartphones, compared to a 22.9% share for the Apple IOS, according to Gartner Inc. Among the newest Android features is one that automatically (or, in the spirit of Franklin's ghost, miraculously) delivers workaday information at the moment one needs it, e.g., commuting time, flight updates, driving instructions, weather, the choicest nearby bistro. This feature, Google Now, was a mere footnote in the company's enumeration of second-quarter achievements, but it brings to mind the fact that even Google's near hits and near misses—never mind its consequential successes—engage the lives of millions. Thus, Google+, hailed by management as "the social spine that is starting to connect everything across Google" but regarded outside Google as a bit of a dud, is a miss that has nonetheless garnered a quarter-billion users.

As for Motorola Mobility, which registered an operating loss of $233 million during the few short weeks in the second quarter in which Google owned it, the company said it was buying patents, "which will enable us to better protect Android from anti-competitive threats from Microsoft, Apple and other companies." The Motorola acquisition is said to have delivered 17,000 patents, as well as 7,500 more under Patent Office review, not to mention 20,300 employees, which brings the number of full-time employees—"Googlers," as the front office calls them—to 54,600.

To hear management tell it, the answer to the Google capital allocation question is as simple as the progression, "70%, 20%, 10%." That is, to quote Page, "70% of our resources [go] to search and advertising. We debate where we should classify our apps (Gmail, Docs, etc.) products, but they currently fall into the 20% of resources we devote to related businesses. We use the remaining 10% of our resources on areas that are farther afield but have huge potential, such as Android. We strongly believe allocating modest resources to new areas is crucial to innovate."

When fretting about Motorola or the next leg down in Europe and China, an investor might spare a thought for YouTube, for which Google in 2006 paid what seemed the very full price of $1.65 billion. That investment is overturning the video news and entertainment business. "I think it was in 2007. . .when newspapers frequently said YouTube is groping for an effective business model," Nikesh Arora, Google's chief business officer, reminded dialers-in on the second-quarter earnings call last week. "I think we can declare that we found our model. YouTube now unites the world through video, from the human rights channel launched this quarter to a Pew study confirming YouTube as a major global news platform, and, for the first time, YouTube will be powering NBC's live streaming of the Olympics in the U.S., while also live-streaming the games in London to 64 territories around the world. Daily account sign-ups have doubled year over year, and users are uploading over 72 hours of video every minute. This quarter, we released a new YouTube app for Android, helping users find videos and follow channels from a mobile or tablet device. We believe YouTube is now a proven winner for the whole video ecosystem."

"Who would have thought in 1998 that anyone could get for free a high-resolution picture of their house from above, and even from the street?" Page and Brin asked in their 2009 Founders' Letter. Who indeed? We ourselves, having been floored by the fax machine, are still trying to grasp the fact that one can talk into a Google-equipped smartphone in English and be heard in, say, German (convenient for future conversations with the Bundesbank about the restoration of the Deutschemark).

"Physics of the Future," a new book by Michio Kaku, professor of theoretical physics at the City University of New York, is catnip for the Google fan. Self-driving autos and Internet-connected eyewear will be commercial realities by 2030, the author predicts, and he quotes, among other authorities, a member of the Google X

Google Inc.
(in $ millions)

	first half of 2012	2011	2010	2009	2008	2007	CAGR (2007-2011)
Revenue	$22,859	$37,905	$29,321	$23,651	$21,796	$16,594	18.0%
EBIT	6,592	11,742	10,381	8,312	6,632	5,084	18.2
Operating margin	28.8%	31.0%	35.4%	35.2%	30.4%	30.6%	—
Net income	$5,675	$9,737	$8,505	$6,520	$4,227	$4,204	18.3
Return on equity	17.5%	18.7%	20.6%	20.3%	16.6%	21.2%	—
Research and development expense	$3,026	$5,162	$3,762	$2,843	$2,793	$2,120	19.5
Cash from operations	7,946	14,565	11,081	9,315	7,853	5,775	20.3
Free cash flow	6,565	11,127	7,063	8,506	5,494	3,373	27.0
Current assets	53,857	52,758	41,562	29,167	20,178	17,289	25.0
Current liabilities	14,028	8,913	9,996	2,747	2,302	2,036	34.4
Shareholders' equity	64,721	58,145	46,241	36,004	28,239	22,690	20.7
Employees	54,604	32,467	24,400	19,835	20,222	16,805	14.1

source: The Bloomberg, company reports

team, Babik A. Parviz, a University of Washington professor of electrical engineering. Right off the bat, Internet-connected eyewear will help diabetics regulate their glucose levels, Parviz tells the author. But by and by, the vistas will be limitless. "Parviz envisions the day," Kaku writes, "when we will be able to download any movie, song, Web site or piece of information off the Internet into our contact lens. . . . From the comfort of the beach, we will be able to teleconference to the office by blinking."

Good for some people, a skeptic will retort. Besides, the future usually looks rosy. The outlook was glorious in 1913 and 1929. Nasdaq couldn't miss in March 2000, and Chester Carlson was quite possibly counting his money on the day he invented xerography in 1938 (the Xerox 914 model copier didn't appear until 1959). As for the auto-auto, artists' renderings of that anticipated marvel were published in magazines like the *Saturday Evening Post* in the 1950s. The *Post* is long gone, but we 21st-century motorists are still sitting behind the wheel and not facing backward on a swiveling bucket seat playing a board game with our happy children, as the magazine pictured life in the not-so-distant future.

"What we do not say," analyst Grant concludes, "is that such long shots as the driverless car and the digitized lens are sure to pay off, only that they might and that the cost of laying them a bullish bet is reasonably low." At the *Grant's* Conference in New York early in 2011, Michael Harkins, a Google bull and a Bloomberg customer, invited the audience to imagine the day when "Larry Page gets out of bed and says, 'I wonder if there's anything more in the financial space for us to do?' About two hours later," said Harkins, "the Bloomberg will look like a Quotron did 20 years ago." That a thrust at Wall Street is not beyond the realm of imagining is implicit in the Google approach to innovation. Quoth Page and Brin in 2009: "Finding important technological areas where progress is currently slow, but could be made fast, is what Google is all about."

Every investment requires a modicum of trust. An investment in Google requires an almost devout belief in the judgment of the founders. "New investors will fully share in Google's long-term economic future but will have little ability to influence its strategic decisions through their voting rights," Page served fair notice in 2004. And he added for emphasis, "By investing in Google, you are placing an unusual long-term bet on the team, especially Sergey and me."

Oligarchs and despots and the self-perpetuating executives of American mutual savings banks have also asked for unimpeded freedom of action, of course. Page and Brin, at least, are proven miracle workers, not just aspiring ones. Still, Google's owners will sink or swim with the technological and capital-allocation decisions of the people who serve at their own discretion and who work not because they have to but because they want to. Nor will there be any help for the shareholders of Google from the market in corporate control. No Bill Ackman is going to show up demanding a special dividend financed by the halving of the Google X R&D budget—or else. Given the Google ownership structure, Page and Brin may remain entrenched for as long as they choose. The essential Google value proposition takes the simple form that the resident geniuses will discover the next great idea, that they will render it commercially valuable, foiling the antitrust police in the process, and that they themselves will somehow avoid being devoured by the very revolution they have helped to uncork.

Investment in government securities at prevailing low yields requires a different kind of trust. The bond bulls repose their faith in paper money and the stewards thereof, in Murphy's Law and in the long life of the interest-rate downtrend that began 31 years ago. However, with yields near zero, there is no margin of safety. Everything must go wrong for the bond trade to go right. A spark of hope in hiring, a flash of economic growth or an intimation of political compromise in debt and deficit reduction—in Europe, a commitment by the ECB to more QE—could send government securities prices reeling.

Last week in Europe, €4.2 billion of German two-year notes—"schatz" bonds to the initiates—were hammered down at a yield to maturity of minus six basis points. The news, however, is not that Germany is regarded as a safe haven but that so many other dubious European sovereigns have come to share the same magnetic power for timid money.

"Although German government bonds have been one of the favored investments of investors seeking shelter from the eurozone crisis," the *Financial Times* reports, "continually pushing yields across the curve to record lows this year, the low or negligible yields on offer have spurred investors into Europe's 'soft core' in recent weeks. . . . Even Belgium, one of the continent's more indebted countries, which has often been paralysed by political wrangling, can now borrow for about 0.25% for two years. Belgium and the European Stability Facility, one of the eurozone rescue funds, sold shorter-term bills at a negative yield for the first time on Tuesday."

The investment choice is hardly limited to Belgian bills vs. Google common, or Larry Page vs. Ben Bernanke, or Sergey Brin vs. Mario Draghi, or technological success vs. monetary and fiscal failure. However, if those are the choices, we'll take Google. The central bankers we leave to others.

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