

Morgan Stanley Technology, Media & Telecom Conference

Company Participants

- Ruth Porat, CFO

Other Participants

- Brian Nowak, Analyst, Morgan Stanley

Presentation

Brian Nowak {BIO 16819013 <GO>}

Good afternoon. Hello, is this on? Good afternoon. Thank you, everyone, for joining us for another one of our keynotes. We're very happy to have Ms. Ruth Porat with us today. We have a lot of disclosures. So we'll go through those first.

Please note that important disclosures, including my personal holdings disclosure and Morgan Stanley disclosures, all appear as a handout available in the registration area and on the Morgan Stanley public website.

Some of the statements that Ms. Porat makes may be considered forward-looking. These statements involve a number of risks and uncertainties that could cause actual results to differ materially. Any forward-looking statements that Ms. Porat makes are based on assumptions as of today. And Alphabet undertakes no obligation to update them. Please refer to the Form 10-K for a discussion of the risk factors that may affect these results.

Glad that we're through that.

Ruth Porat is the CFO of Alphabet. Prior to joining Alphabet, she was the CFO of Morgan Stanley. We love the pedigree. She received her undergraduate degree from Stanford, a graduate degree from London School of Economics in political science. And an MBA from the Wharton School at the University of Pennsylvania.

We're very grateful. Thank you. So much for being here.

Ruth Porat {BIO 2536317 <GO>}

Great to be here.

Brian Nowak {BIO 16819013 <GO>}

A series of questions about the core Google business, the Other Bets and everything going on at Alphabet. You've been with Alphabet for about a year now. Can you talk to kind of what's surprised you most about the Company, as a whole. And what are the biggest challenges you've seen with the new role?

Ruth Porat {BIO 2536317 <GO>}

So what surprised me most is, I think I somewhat alluded to it on the various earnings calls. When I came in and immediately was able to go deep under the hood and go through diligence to get ready for the first earnings call, I think what really struck me is how early stage Google is, which is a staggering statement when you consider the size.

But if you just go through products, services, geography, it really led me to the position where I -- my biggest surprise was how early stage. You think about Internet penetration, how many people are online, 5 billion to go. But more than that, when you look at how we're using our handset today, it's so fundamentally different, the experience gets richer. We have these micro moments, the ability to act, transact, search when you need it, where you need it. It just continues to get enriched.

If you look at offline advertising still to move online and with the level of activity and time spent online, we're early stage there.

Look at what's going on in the enterprise and just the cloud opportunity for us. Machine learning, virtual reality, the list goes on. Next billion users is a big strategic priority for us.

Brian Nowak {BIO 16819013 <GO>}

Yes.

Ruth Porat {BIO 2536317 <GO>}

So that was really the biggest surprise for me in a positive way.

Brian Nowak {BIO 16819013 <GO>}

Ad the challenges?

Ruth Porat {BIO 2536317 <GO>}

Well that leads very naturally to the challenge. We just completed our 2016 budgeting process. And the challenge when you have that breadth of opportunity is prioritization, which is where we spent a lot of time.

Brian Nowak {BIO 16819013 <GO>}

Yes. And that was the next question, kind of a glimpse into a day in the life for yourself at Alphabet. What are you spending -- what's taking up most of your time nowadays? Is it budgeting, or what are you up to nowadays?

Ruth Porat {BIO 2536317 <GO>}

Well 2015 was about really launching Alphabet and then, as I just said, the 2016 budgeting. But those were both, actually, continuous dynamic processes.

It's -- neither are actually a once and done. So for example, on Alphabet, I spoke a bit about it on the Fourth Quarter call. The next phase of what we're doing is really focusing on capital structure efficiency, moving the debt from the Google level up to the Alphabet level. And that's a process that's ongoing.

And similarly, with budgeting, what was key in the budgeting process is this effort on prioritization across both Google and the Other Bets, making some tough choices. In a number of areas, we set up what we call gating, where we established technical or business milestones and looked at investments in business, products, or areas, through to hit those milestones, those technical or business milestones before the next leg of investments available.

So that's something we're continuing to focus on, work on, monitor and manage.

Brian Nowak {BIO 16819013 <GO>}

That's actually one of the most common questions, I think, that myself and my teams are asked. How do you balance that equation between the core Google growth, the core Google profitability. And then the Other Bets' investment? Is it that gating? Does that gating apply to both the Other Bets? And how do you think about investing in the core business versus letting it flow through?

Ruth Porat {BIO 2536317 <GO>}

So we do focus on revenue growth and profitability. So I like the way you've set it up. And I tried in the various earnings calls, when I talked about expense management, to really start with something that's so key, which is that revenue growth remains the priority. It has been and remains the priority.

But as I've said on a couple of calls, that doesn't give us the pass on expenses. And we're similarly focused on expense management. But I think a very key philosophy is one articulated by Larry back in that 2013 founder's letter, which is that incrementalism leads to irrelevance, in particular in technology, where change tends to be revolutionary, not evolutionary.

And so, with that in mind, we're very focused on revenue growth and investing to have long-term revenue growth. And then, what's the expense growth that's needed. And how do we make sure that we are getting the right balance there.

Within Google, I think one of the benefits of segment reporting has been the opportunity to see what is the profitability within Google. That being said -- like we've emphasized that some of our biggest bets are in Google. So we're clearly investing meaningfully there, as well.

Then I would say on the Other Bets side, a key focus has been this effort on prioritization. Part of it is gating. It's figuring where we may want to double down, where we're pulling back some, how to establish gating as we go through a number of the businesses. And so, again, a keen lens on making sure we have a managed approach to expenses there.

I would say the other thing worth noting as we look more inward to 2016, I emphasized on the Fourth Quarter call that we're investing across the business. And that's not just CapEx. That's OpEx, as well. Headcount continues to be important. Talent is what drives that revenue growth. And so, just as a reminder, we have the senior exec equity refreshes come every other year. This is one of those years. That's a First Quarter item. FICA and 401(k) that's a First Quarter item.

So when you're thinking about some of the near-term budgeting things that we've looked at, I'd say the other thing that's -- that is relevant near term is mobile growth continues to be something we talked about in the third and Fourth Quarter call, in particular. That has with it higher TAC. So, that's something we're looking at as well as it relates to margins.

Brian Nowak {BIO 16819013 <GO>}

Yes. Talent drives the engine ultimately.

Ruth Porat {BIO 2536317 <GO>}

Absolutely.

Brian Nowak {BIO 16819013 <GO>}

I think the change in the disclosure between the core Google and the Other Bets, that's probably one of the biggest changes that's happened since you've gotten there. Can you talk a little bit more about the motivation? behind the new segments? And how do you think about potentially further separating those businesses into separate operating units or maybe even separate trading entities?

Ruth Porat {BIO 2536317 <GO>}

So the -- the move to Alphabet started with a very deeply held view that we did need to make sure that our organizational structure mirrored what I just went through about driving long-term revenue growth. And the view, very strongly, was that with this organizational structure, we increased the level of focus within Google, as well as really driving the ability to have innovation into new areas, whether it's life sciences or driverless cars. But areas that can continue to build revenue growth over the longer term.

I kind of envision it as these cresting waves -- or cresting waves, I guess. And what we wanted was a structure that provided that level of focus and enabled us to drive expenses down to the business levels. And have a much greater sense of what resources we're using around each business. It provided a level of clarity internally and, I would say, externally, as we move to segment reporting.

But the real driver was the strategic one. And once you have an organizational structure, disclosure follows that. And that enabled us, then, to move to this segment reporting, which, as I said, gave us more visibility internally and, hopefully, externally.

Brian Nowak {BIO 16819013 <GO>}

Yes. No. I think that's right.

You're having a lot of discussion around the 70/20/10 philosophy. I think some of those 20s and 10s are in Other Bets. Internally, now that you have kind of the new disclosure and the real focus on gating investment, which of the 20s and 10s are most exciting internally at this point?

Ruth Porat {BIO 2536317 <GO>}

Well when I described the 70/20/10 on the various earnings calls, I talked about 70/20/10 applying within Google and across Alphabet. And I think one of the things that is very exciting and Sundar and I both spoke about it on the earnings call and I think I addressed it in your first question is that many of our biggest bets are in Google. And to us, that's exciting, the sheer opportunity there.

Again, whether it's cloud or what we're doing in Google for Work, the apps side, or machine learning or virtual reality, or you can go on. So the bets that we're making in Google we were -- we've tried to make it really clear, some of the biggest bets are in Google. And to us, that's exciting and talks, really, to the point that Google is still in early stages.

I would say on the Other Bets side what's so key is that we have this breadth of opportunity and there's not a monolithic approach to growing these businesses or assessing the appropriate level of resources within the business. And I think for me it's this -- the discipline that's being applied to go through them, assess the appropriate level of resources needed. In some, we want gating.

In others, for example, in Verily, the life sciences business, it's a great example of where we've brought in strategic partners, because our view is we could accelerate not only our time to market. But the improved -- overall outcome for stakeholders by partnering with best-in-class players, whether it's Sanofi, Novartis, J&J. And so, again, that goes to the notion there's no monolithic approach.

Let's be disciplined in our approach. We've pushed the expenses down, assess where we want to really rein in expenses, where we want to expand what we're doing and to me, that's the part that is exciting.

Brian Nowak {BIO 16819013 <GO>}

Yes. Yes. We're not letting anybody off the stage this week without asking them about macro. So can you just tell us what you're seeing from a macro perspective and kind of if anything changing with the advertiser conversations going into 2016 budgeting around macro?

Ruth Porat {BIO 2536317 <GO>}

So in terms of macro the biggest impact for us -- and I'd be interested in your summary of everybody -- when you're done with the conference.

Brian Nowak {BIO 16819013 <GO>}

Yes, I'm sure.

Ruth Porat {BIO 2536317 <GO>}

Yes, let's cut a YouTube video. So the biggest impact -- no surprise -- is the dollar headwind. And if you just look at revenue growth year over year, in 2015 it was 20% excluding the impact of the dollar, 14% with the impact of the dollar. And the dollar, obviously, remains strong.

So that remains a headwind, the other element is our -- most of our R&D is done here in the US, which means more expenses are weighted here in the US. And so, again, there are margin implications on the stronger dollar.

But the main -- the main point beyond kind of the dollar headwind, because we do think, looking through the impact of the dollar, gives one the best measure of the health of the business. So beyond that, I think what's positive is we're riding secular change. And having those kind of tailwinds is a benefit.

You'd certainly rather be in a healthier environment than not. But having the benefit of some important secular trends is the main thing that we keep coming back to. So that means I'm going to leave it to you to forecast.

Brian Nowak {BIO 16819013 <GO>}

Yes. We'll exactly -- we'll do what we can.

Moving to capital allocation, something I know you're familiar with from your old days and now your new days, the buyback has been pretty well received since you've come to Alphabet. Can you talk about how we should think about the size and the cadence of the buybacks, going forward?

Ruth Porat {BIO 2536317 <GO>}

So in the Third Quarter that we announced that we would commence a share repurchase, I tried to walk through the framework that we used to look -- to answer the question, which I really think is a key one, how much is too much. And how much is too little.

And as I described then, what we did is a real bottoms-up build with the business leaders and what CapEx, what could CapEx be over a multi-year period, what kind of investment cadence do we think is possible. And try and layer in M&A there based on historic patterns. And then build in something for a liquidity risk buffer. And from that, our view was that announcing this square foot root of 26, share repurchase program was something that was reasonable.

It was, as I said, a look over a multi-year period. And so, it was with that multi-year outlook that we came up with this \$5 billion-ish number. We're about a third of the way through it. There's some detail in the K on that. And so, I'm glad to have it. But it's in that context.

Brian Nowak {BIO 16819013 <GO>}

Multi-year period. You have a background in kind of capital markets and optimal capital structure. Some might argue that there could be debt capacity at Google, at Alphabet. How do you think about the potential of kind of increased debt capacity or maybe pay a recurring dividend as kind of the next weapon in capital allocation?

Ruth Porat {BIO 2536317 <GO>}

So we've previously stated that we don't intend to initiate a dividend in the foreseeable future. In terms of debt, as I mentioned, we're in the process of moving debt from what was the holding company, Google, up to the holding company, Alphabet. It's something we talked about on the Fourth Quarter call. We think that builds in a level of efficiency that's helpful. This gives us flexibility if and when it makes sense to use. But overall, we've been very conservative in the way we've used our balance sheet. And so, this gives us a level of flexibility, again, to support the business if it makes sense. But we've been conservative on balance sheet.

Brian Nowak {BIO 16819013 <GO>}

On the core Google business. And you mentioned the cresting wave, which I think is a great way to describe the business over a multi-year period. Since you've arrived,

we've seen very strong core Google websites growth. And even accelerating growth, to an extent.

Could you talk about some of the drivers of that last year and how shall we think about those drivers kind of going into 2016? What's driving Google websites right now?

Ruth Porat {BIO 2536317 <GO>}

There are quite a number of things. We talked about product strength, geographic strength. But I would say the main thing is one of the other wonderful things to see close up is the culture of innovation at Google. And really continuing to try and focus on new ways to do things that help users and advertisers.

We talked about on the Third Quarter call, as an example, changing the ad format on mobile handset. And the fact that that was helpful for users and advertisers and benefited the Third Quarter and called it out again on the Fourth Quarter.

Although beyond that, we've seen YouTube strength, as we talked about. Desktop has remained healthy. We break out, obviously, on a geographic basis, as we've seen the breadth there. So it's really a combination of things.

Brian Nowak {BIO 16819013 <GO>}

You mentioned desktop. I think one of the things that continues to surprise us in a good way is the resiliency of desktop. Kind of based on your comments, it almost seems like it's still growing or contributing to growth in some ways. Could you talk about what continues to drive that positive desktop paid search growth, even as we see all the data and more and more people are transitioning to mobile, yet desktop continues to grow really nicely and contribute.

Ruth Porat {BIO 2536317 <GO>}

Right. I think we start with a -- there's obviously a large base of desktop users still out there. And if you go back to my comment that we're focused on innovation and trying to make the user experience a better experience, there's still a number of areas with high commercial intent and complex query, high commercial intent where we particularly focus. A good example is travel. And what you find is, for certain queries, you continue to see real stickiness with users on desktop. And so, when you take the sheer number and some of the moves that are being made, have been made, that results in what we call healthy revenue growth there.

Brian Nowak {BIO 16819013 <GO>}

So the vertical-specific initiatives like travel that are really kind of driving that, travel and retail, I would imagine, is strong, as well.

A couple on YouTube. You mentioned it earlier. It seems like 2015 was a pretty big year for YouTube. You mentioned ad spending with top clients was up double digits. You doubled your watching time spent in living rooms.

What drove this seemingly sea change in advertiser sentiment to spend on YouTube in 2015?

Ruth Porat {BIO 2536317 <GO>}

We think that, as I said, it's still early days on YouTube. And we're just beginning to see advertisers moving budgets from offline to online. And there are a number of factors. One is we're quite focused, as are others, on measures, on analytic tools for advertisers, the ability to measure the effectiveness of ads. That's an important element of it. And one where I think engagement is an important measure. But continuing to look at analytics and what does it mean for advertisers.

But I think our view is, it continues to be early days. We're seeing watch time -- the watch time statistics underscore this is where users are going. And I think that we're continuing to see advertisers, looking at that, responding to it.

Brian Nowak {BIO 16819013 <GO>}

You called out the strength in YouTube International on the Fourth Quarter call. Are the advertising dollars following based on regions or different zones, kind of how advertisers are using YouTube domestically versus internationally?

Ruth Porat {BIO 2536317 <GO>}

I would say overall our main point is that it's still early days when you just look at the sheer volume of time spent online. We called it out in one of the earlier calls, kind of the amount of time, 18 to 49. And the number of 18 to 49-year-olds watching YouTube video on mobile versus any cable network would suggest you would see more of those ad dollars globally following.

Brian Nowak {BIO 16819013 <GO>}

Yes. And you've made some great strides with these advertisers on YouTube. Talk about how YouTube thinks about investing in more content and kind of improving the quality of the content on YouTube just to drive more time spent.

Ruth Porat {BIO 2536317 <GO>}

We're really proud of our YouTube stars. We talked about it last year. There was a Variety survey that looked at top stars. Eight of the 10 top stars are YouTube stars. And as much as traditional media has expressed interest in a number of stars, their audiences are with us.

And so, we're continuing to invest in our YouTube stars. And the ability to build around them. We launched four new programs in the last couple of weeks, which hopefully you've been watching very closely.

Brian Nowak {BIO 16819013 <GO>}

Yes.

Ruth Porat {BIO 2536317 <GO>}

And so, again, we think that's a differentiated area and one that we're really proud of.

Brian Nowak {BIO 16819013 <GO>}

Got it. More originals to come.

Ruth Porat {BIO 2536317 <GO>}

More originals. Exactly.

Brian Nowak {BIO 16819013 <GO>}

The other piece of the core Google story is around programmatic. You did some calling out in the past couple of quarters. Can you just talk to the big drivers of strength in the programmatic business? What's causing the dollars to continue to shift towards Google or other players in programmatic.

Ruth Porat {BIO 2536317 <GO>}

So one of the things I have said on a number of calls is that we were really early in building this end-to-end ad tech stack. And we think that's serving us well. So DBM and Ad Exchange are a really important part of the overall experience. It's a positive. It's useful for publishers.

And again, we just come back to the overall ecosystem that has been built. You look on the network side and AdMob, we think that the in-app market is one that similarly has a lot of room to grow and is positive for the entire ecosystem.

So there are a couple of pieces to it. But it starts with very early investments.

Brian Nowak {BIO 16819013 <GO>}

There have been a lot of changes in the network the past couple years, some cleanup, the moving of some lower-quality partners. Is that a continuing process or are we at a point where that might slow down?

Ruth Porat {BIO 2536317 <GO>}

It's a great question. And you'd think that it would at some point. You kind of clear it out. But I think that what we have seen is it is a continual process. And we continue to try and make changes and we keep talking about these policy changes. They're a priority for us. We want the user experience to be a really positive user experience. And keeping the bar high is important.

Brian Nowak {BIO 16819013 <GO>}

Yes. A couple of the Other Bets we get a lot of questions around, around fiber and driverless cars.

Let's start with fiber. I know you talked about it quite a bit in the Fourth Quarter call. Just talk about kind of the go-to-market with fiber the next couple years. And what are the key factors that you're watching internally assess the capital allocation there?

Ruth Porat {BIO 2536317 <GO>}

So with the fiber business one of the points I tried to stress in the Fourth Quarter call is, that 2015 was an important year for us. We spent a lot of time really continuing to enhance the way we work with cities, as well as our construction partners.

And so, we've announced a number of cities but have been very deliberate in our execution. We haven't -- the reason I tried to emphasize on the Fourth Quarter call is that with the cities that we've announced, as we start executing against them, that would suggest CapEx will follow. And so, that's something we're looking at for 2016. But I think, bigger picture, if you're asking how do we look at the business, we look at the business and analyze it on a stand-alone basis. We look at it over an extended period of time, the returns opportunity in the fiber business.

It is a heavy up-front CapEx. But our view is that what you're -- what we're building is, then, a cash flow annuity over the longer term.

Brian Nowak {BIO 16819013 <GO>}

Yes. Driverless cars really same -- autonomous cars, same question. What are the critical factors that you watch there, sort of assess whether or not it's going to be an asset-heavy or asset-light model?

Ruth Porat {BIO 2536317 <GO>}

So the main focus within the driverless car business has been, really, building the technology. We've got an extraordinary team. They've been there quite an extended period of time. At this point, we've driven over 1.3 million miles, which has been critical to getting safety data and utility data. And the view of the driverless car business internally is we're solving two really big problems.

One is a safety issue. We believe that when you have driverless cars, we're going to be saving lives.

And second, you can think about how cities can be re-imagined when we don't need to use this kind of space for cars and we can use resources substantially more efficiently.

But it starts with safety. And so, at this point, we're continuing to do the tests. We're really pleased with the progress we've had. And I think one of the things that's also gratifying is we're seeing regulators looking at this market and appreciating the impact, both on safety and what it means for their cities. And seeing more communities interested in having us come there and use their cities as the model for implementation of whatever we're doing with driverless cars.

Brian Nowak {BIO 16819013 <GO>}

Yes. You mentioned fiber being a stand-alone business. Which of the other businesses within the Other Bets do you view as being stand alone. Do Nest and robotics fall into that, as well? How is that thought about internally?

Ruth Porat {BIO 2536317 <GO>}

So for -- what I was trying to convey on fiber is when we look at it, does it benefit the experience of consumers? Of course, intuitively, it does. And one of the early catalysts for us getting involved here is that you look at what the experience is like in the US relative to many other markets. And it was clear there was an opportunity for something better.

But when we analyze the financials, we look at it on a stand-alone basis. And the view is, let's look over an extended period of time to the returns available within fiber without looking at what are the theoretical benefits or the clear benefits to some of the other parts of the business, which you could argue could be done elsewhere.

So to us, there's a financial discipline around this, which I think is really valuable. And that's what I was trying to convey in the way we look at it. I think for each of the Other Bets what we're trying to do is really understand the financial profile. and that goes back to this notion that expenses are pushed down to the business and, again, my comment there's no monolithic approach to looking at them or how we think about resourcing them. And Verily being the poster child for where there's been a real benefit, we think, to the business in bringing in some of these best-in-class partners.

Brian Nowak {BIO 16819013 <GO>}

Got it. All right, Ruth, thank you very much.

Ruth Porat {BIO 2536317 <GO>}

Great to be here. Thank you.

Brian Nowak {BIO 16819013 <GO>}

Thanks.

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