

Company Update — December 12, 2023

Internet

Alphabet Inc. (GOOGL)

GOOGL: Assessing Risks to Play Store Economics from Epic Games Trial

Our Call

Federal jury sides with Epic Games in Google app store antitrust challenge. Remedy trial to begin in early '24 with potential risk to Play Store profits. With DOJ Search trial decision expected in 3Q24, regulatory risks rising for GOOGL in '24.

Federal jury decides Google's Android app store benefits from anti-competitive barriers in the Epic v. Google anti-trust case. See risks for transactions to move outside of Play Store or potential concessions on take rate. Remedy trial to begin in Jan '24, per Epic CEO Tim Sweeney. US District Judge James Donato to decide whether Google must make accessible payment and app distribution methods outside its own app store.

We estimate ~\$10.3B in '23 Play Store revs from app sales and in-app purchases generating OI of \$7.2B, 8% of Google consolidated OI, and \$0.49 of '23 EPS. By our forecast, every 5pts of Play Store fee rate decrease results in a ~\$1.3B and \$0.09/share impact on Google OI and EPS, respectively. We forecast \$38.5B in total Play Store billings in '23—expect a ~\$0.9B and \$0.06/share impact on Google OI and EPS, respectively, for each \$5B (~13%) decrease in Play Store billings. See Exhibits 2 and 3.

This ruling stands in contrast with the previous Epic v. Apple outcome in Sept. '23, where only Apple's anti-steering provisions were proved to be anti-competitive, but not its app ecosystem. We note MTCH dropped its closely-watched antitrust lawsuit against Google in October and reached a settlement, entering into a new partnership agreement and agreeing to implement the company's User Choice Billing program in return for a 4pts reduction in Play Store fee rate by March 31, 2024.

See MTCH & BMBL as the most meaningful potential beneficiaries of app store fee reductions in our coverage universe. Estimate MTCH & BMBL 2023 app store fees (iOS & Play Store) will represent \$680M & \$265M of cost of revenue, respectively, relative to \$1.2B & \$276M EBITDA. While ruling doesn't necessarily suggest immediate term benefit, expect market to begin underwriting fee relief. Every 5pts reduction in app store fees represents 10% & 20% of EBITDA accretion to MTCH & BMBL, respectively.

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Rating	Equal Weight
Ticker	GOOGL
Price Target/Prior:	\$129.00/NC
Upside/(Downside) to Target	(3.2)%
Price (12/11/2023)	\$133.29
52 Week Range	\$84.86 - 141.22
Shares Outstanding	12,516,000,000
Market Cap (MM)	\$1,668,258
Enterprise Value (MM)	\$1,563,631
Average Daily Volume	31,089,571
Average Daily Value (MM)	\$4,144
Dividend (NTM)	\$0.00
Dividend Yield	0.0%
Net Debt (MM) - last reported	\$(104,627)
ROIC - Current year est.	32%
3 Yr EPS CAGR from current year (unless otherwise noted)	15%

	2022A	2023E	2023E	2024E	2024E
\$					
EPS		Curr.	Prior	Curr.	Prior
Q1 (Mar)	1.23 A	1.17 A	NC	1.65 E	NC
Q2 (Jun)	1.21 A	1.44 A	NC	1.79 E	NC
Q3 (Sep)	1.06 A	1.55 A	NC	1.80 E	NC
Q4 (Dec)	1.05 A	1.70 E	NC	1.93 E	NC
FY	4.56 A	5.86 E	NC	7.17 E	NC
P/E	29.2x	22.7x		18.6x	

Source: Company Data, Wells Fargo Securities estimates, and Refinitiv.
NA = Not Available, Volatility = Historical trading volatility

Wells Fargo Express Takeaways

Alphabet Inc. (GOOGL) | Rating: Equal Weight | Price Target: \$129.00

Analyst: Ken Gawrelski

Financials

FY (Dec)	2022A	2023E	2024E
\$			
ESTIMATES			
EPS			
Q1	1.23 A	1.17 A	1.65 E
Q2	1.21 A	1.44 A	1.79 E
Q3	1.06 A	1.55 A	1.80 E
Q4	1.05 A	1.70 E	1.93 E
AN	4.56 A	5.86 E	7.17 E
Rev. (MM)	282,836.0 A	306,721.0 E	342,048.0 E
EBIT (MM)	74,842.0 A	85,210.0 E	102,401.0 E

WELLS FARGO vs. CONSENSUS

Consensus Estimate	4.56 A	5.77 E	6.76 E
Difference from Consensus		1.6%	6.1%

VALUATION

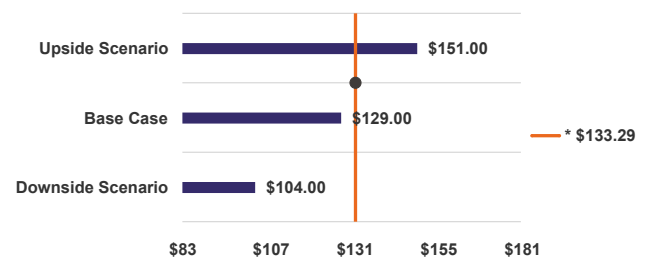
P/E	29.2x	22.7x	18.6x
EV/Revenue	5.5x	5.1x	4.6x
EV/EBIT	20.9x	18.4x	15.3x

Consensus Estimate: Consensus EPS Estimate; Source: VisibleAlpha
Source: Company Data, Wells Fargo Securities estimates, and Refinitiv.
NA = Not Available, NE = No Estimate

Investment Thesis

We rate GOOGL EW. We believe that the upcoming format transition to conversation search brings significant uncertainty to the search market. We expect disruption with the format change, which will likely drive headwinds to medium-term search growth. Competitors are likely to bid aggressively for Google's search distribution partnerships, driving profitability lower. Even if Google maintains search leadership, we do not expect the company to replicate its prior prosperity in the next decade.

Risk vs. Reward – Upside/Downside Price Target Scenarios



*As of 12/11/23

Source: Wells Fargo Securities, LLC estimates and Refinitiv.

Base Case | \$129.00

- Our PT of \$129 is based on an 18x multiple on our 2024 EPS estimate.
- Our multiple assumption is in line with the median multiple for GOOGL since 4Q21, as well as the company's median trading premium versus the S&P 500 during the same period.
- For reference, the median multiple during the same period for S&P 500 was ~17x.

Upside Scenario | \$151.00

- Upside price target is \$151, which applies a 20x multiple to a higher 2024E EPS estimate of \$7.53.
- Upside to our PT would be driven by faster-than-expected revenue growth, and
- Lower TAC payments to distribution partners.

Downside Scenario | \$104.00

- Downside price target is \$104, which applies a 16x multiple to a lower 2024 EPS estimate of \$6.52.
- Downside to our PT would be driven by slower-than-expected revenue growth, and
- Higher TAC payments to distribution partners.

Upcoming Catalysts

- Existing Google Search distribution partners potentially announcing agreements with competing search engine providers.
- An increase in reported Google traffic acquisition cost.
- New AI-driven search product releases by Google and competitors, e.g., Microsoft Bing.

Company Description

Alphabet Inc. is the holding co. owner of Google Inc., a global technology company with a stated mission to "organize the world's information and make it universally accessible and useful." Founded in 1998, Google operates the world's leading search engine platform and has led the development of Android, the world's leading mobile operating system. Other products include YouTube, Chrome OS and browser, Google Docs, Gmail, and Google Playstore. Alphabet is headquartered in Mountain View, CA.

Exhibit 1 - WFS Google Play Store '23 Operating Profit Contribution

	2023E	Memo
WFS Google Play Total Billings (3P Apps)	38,468	WFS based on SensorTower data
(x) Take Rate %	26.8%	WFS based on 15% fee for subscription and first \$1M in billings; 30% fee for the rest
(=) WFS Google Play Revenue From App Sales	10,291	
WFS Google Play Revenue	10,291	
(x) 1 - COGS	90.0%	Assume 10% COGS includes ~4% in payment processing and ~6% in other costs
(=) Google Play Gross Profit	9,262	
Google Play Gross Profit	9,262	
(-) Play Operating Expenses	(2,058)	
% of Google Play Revenue	20.0%	
(=) Google Play Operating Profit	7,204	
% of Google Play Revenue	70.0%	Based on Epic v. Google trial disclosure per FT, Play Store Op. Margin @ ~70% in '21
Google Play Operating Profit	7,204	
(x) 1 - Tax Rate	85.7%	WFS
(/) '23 Google Diluted Shares Outstanding	12,724	WFS
(=) Play Store App Sales Contribution to EPS	\$0.49	

Source: Wells Fargo Securities, LLC Estimates, Financial Times, SensorTower

Exhibit 2 - Sensitivity Analysis - Play Store Impact on '23 OI

\$ Impact on Google Total '23 OI (\$MM)

		Play Store Fee Rate					
		27%	22%	17%	12%	7%	2%
Play 3P Billings (\$B)	23.5	(2,809)	(3,630)	(4,452)	(5,273)	(6,094)	(6,916)
	28.5	(1,873)	(2,869)	(3,865)	(4,862)	(5,858)	(6,855)
	33.5	(936)	(2,108)	(3,279)	(4,450)	(5,622)	(6,793)
	38.5	-	(1,346)	(2,693)	(4,039)	(5,386)	(6,732)
	43.5	936	(585)	(2,106)	(3,628)	(5,149)	(6,671)
	48.5	1,873	176	(1,520)	(3,217)	(4,913)	(6,609)
	53.5	2,809	938	(934)	(2,805)	(4,677)	(6,548)

% Impact on Google Total '23 OI

		Play Store Fee Rate					
		27%	22%	17%	12%	7%	2%
Play 3P Billings (\$B)	23.5	-3.3%	-4.3%	-5.2%	-6.2%	-7.2%	-8.1%
	28.5	-2.2%	-3.4%	-4.5%	-5.7%	-6.9%	-8.0%
	33.5	-1.1%	-2.5%	-3.8%	-5.2%	-6.6%	-8.0%
	38.5	0.0%	-1.6%	-3.2%	-4.7%	-6.3%	-7.9%
	43.5	1.1%	-0.7%	-2.5%	-4.3%	-6.0%	-7.8%
	48.5	2.2%	0.2%	-1.8%	-3.8%	-5.8%	-7.8%
	53.5	3.3%	1.1%	-1.1%	-3.3%	-5.5%	-7.7%

 Current '23 WFS

Source: Wells Fargo Securities, LLC Estimates

Exhibit 3 - Sensitivity Analysis - Play Store Impact on '23 EPS

\$ Impact on Google Total '23 EPS (\$ / Share)

		Play Store Fee Rate					
		27%	22%	17%	12%	7%	2%
Play 3P Billings (\$B)	23.5	(\$0.19)	(\$0.24)	(\$0.30)	(\$0.36)	(\$0.41)	(\$0.47)
	28.5	(\$0.13)	(\$0.19)	(\$0.26)	(\$0.33)	(\$0.39)	(\$0.46)
	33.5	(\$0.06)	(\$0.14)	(\$0.22)	(\$0.30)	(\$0.38)	(\$0.46)
	38.5	\$0.00	(\$0.09)	(\$0.18)	(\$0.27)	(\$0.36)	(\$0.45)
	43.5	\$0.06	(\$0.04)	(\$0.14)	(\$0.24)	(\$0.35)	(\$0.45)
	48.5	\$0.13	\$0.01	(\$0.10)	(\$0.22)	(\$0.33)	(\$0.45)
	53.5	\$0.19	\$0.06	(\$0.06)	(\$0.19)	(\$0.32)	(\$0.44)

% Impact on Google Total '23 EPS

		Play Store Fee Rate					
		27%	22%	17%	12%	7%	2%
Play 3P Billings (\$B)	23.5	-3.2%	-4.2%	-5.1%	-6.1%	-7.0%	-8.0%
	28.5	-2.2%	-3.3%	-4.4%	-5.6%	-6.7%	-7.9%
	33.5	-1.1%	-2.4%	-3.8%	-5.1%	-6.5%	-7.8%
	38.5	0.0%	-1.5%	-3.1%	-4.6%	-6.2%	-7.7%
	43.5	1.1%	-0.7%	-2.4%	-4.2%	-5.9%	-7.7%
	48.5	2.2%	0.2%	-1.7%	-3.7%	-5.7%	-7.6%
	53.5	3.2%	1.1%	-1.1%	-3.2%	-5.4%	-7.5%

 Current '23 WFS

Source: Wells Fargo Securities, LLC Estimates

Investment Thesis, Valuation and Risks

Alphabet Inc. (GOOGL)

Investment Thesis

We rate GOOGL EW. We believe that the upcoming format transition to conversation search brings significant uncertainty to the search market. We expect disruption with the format change, which will likely drive headwinds to medium-term search growth. Competitors are likely to bid aggressively for Google's search distribution partnerships, driving profitability lower. Even if Google maintains search leadership, we do not expect the company to replicate its prior prosperity in the next decade.

Target Price Valuation for GOOGL: \$129.00 from NC

- Our PT of \$129 is based on an 18x multiple on our 2024 EPS estimate.
- Our multiple assumption is in line with the median multiple for GOOGL since 4Q21, as well as the company's median trading premium versus the S&P 500 during the same period.
- For reference, the median multiple during the same period for S&P 500 was ~17x.

Risks to Our Price Target and Rating for GOOGL

Upside risks: 1) Better-than-expected adoption and advancement of Google's conversational search products; 2) Minimal pricing headwinds associated with the new conversational search product

Downside risks: 1) major distribution partners (MDPs) significantly increase the contractual rev share % in their agreements with Google; 2) MDPs decline to renew existing agreements with Google; 3) rising efficiency of conversational searches drastically decreases the # of Google's traditional search queries.

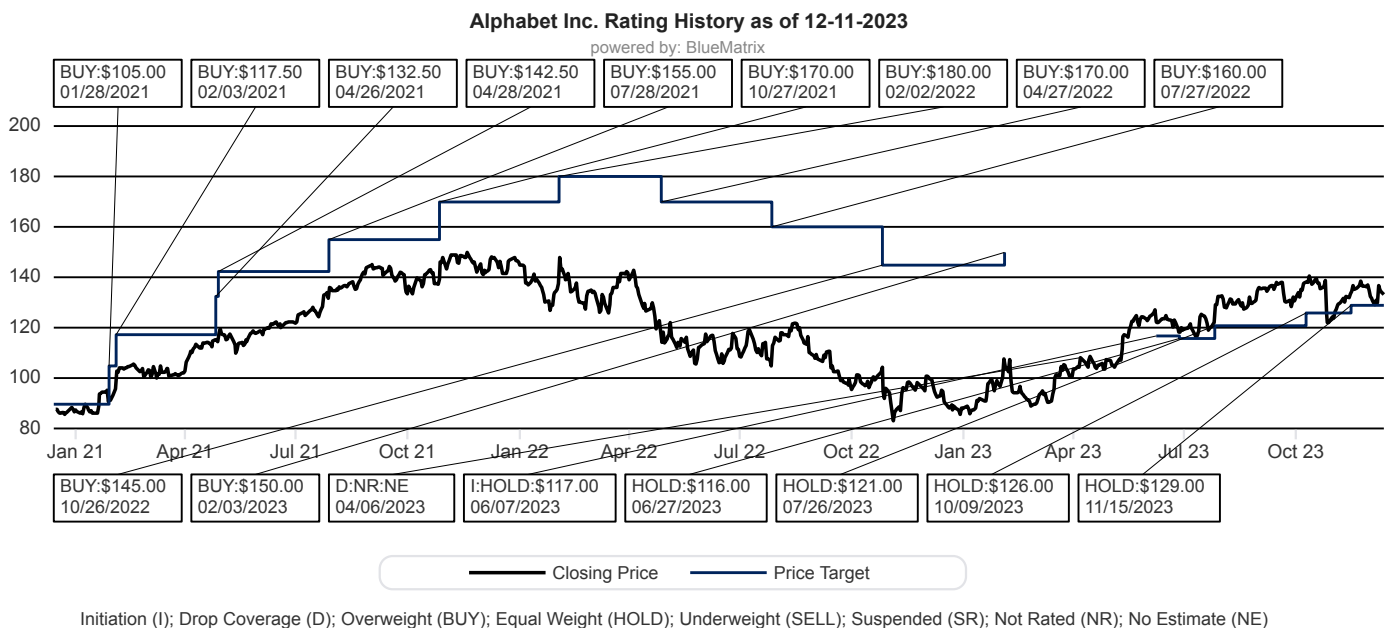
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