LESSONS FROM THE TRENCHES:

VALUE INVESTING, ENTREPRENEURSHIP & LIFE

BETTING ON THE BEST: ALPHABET AND FACEBOOK

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WHITNEY TILSON'S KASE LEARNING BOOTCAMP

ALPHABET

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THE BASICS

- Stock price (10/2/18 close): $1,207.64 (GOOGL)
- Market cap: $837 billion
- Cash & STI: $102 billion ($147/share)
- Debt: $4 billion
- Enterprise value: $739 billion
- 2018 est. EPS (normalized) and P/E: $46.53, 26.0x

Q2 ‘18 EARNINGS WERE EXCEPTIONAL

- Revenue up 26% (23% constant currency)
- Operating cash flow up 37%
- Aggregate paid clicks up 58%

GOOGLE WAS MY WORST CALL EVER

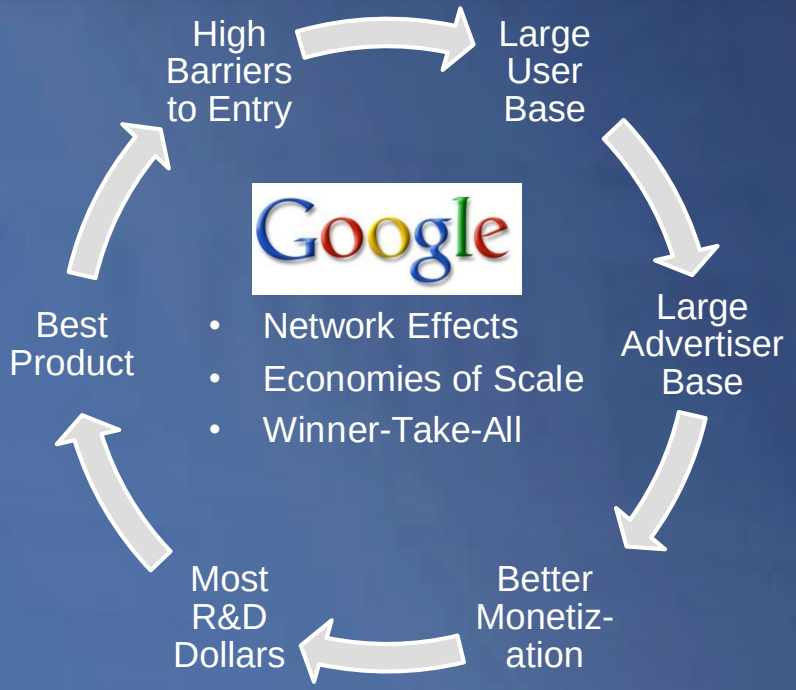
- In a column published on The Motley Fool website on July 30, 2004 entitled *The Tech Stock Opportunity*, I wrote:

  Just as Google came out of nowhere to unseat Yahoo! as the leading search engine, so might another company do this to Google. I admire Google and what it has accomplished -- and I'm a happy user -- but I am quite certain that there is only a fairly shallow, narrow moat around its business.

  Think about it. What are the odds that it is the leading search engine in five years (much less 20)? 50/50 at best, I suspect, and I'd wager that odds are at least 90% that its profit margins and growth rate will be materially lower five years from now. Yet investors appear ready to value this company at as much as $36 billion, nearly 200 times trailing earnings! Google with the same market cap of McDonald's (a stock I own)?! HA! I believe that it is virtually certain that Google's stock will be highly disappointing to investors foolish enough to participate in its overhyped offering -- you can hold me to that.

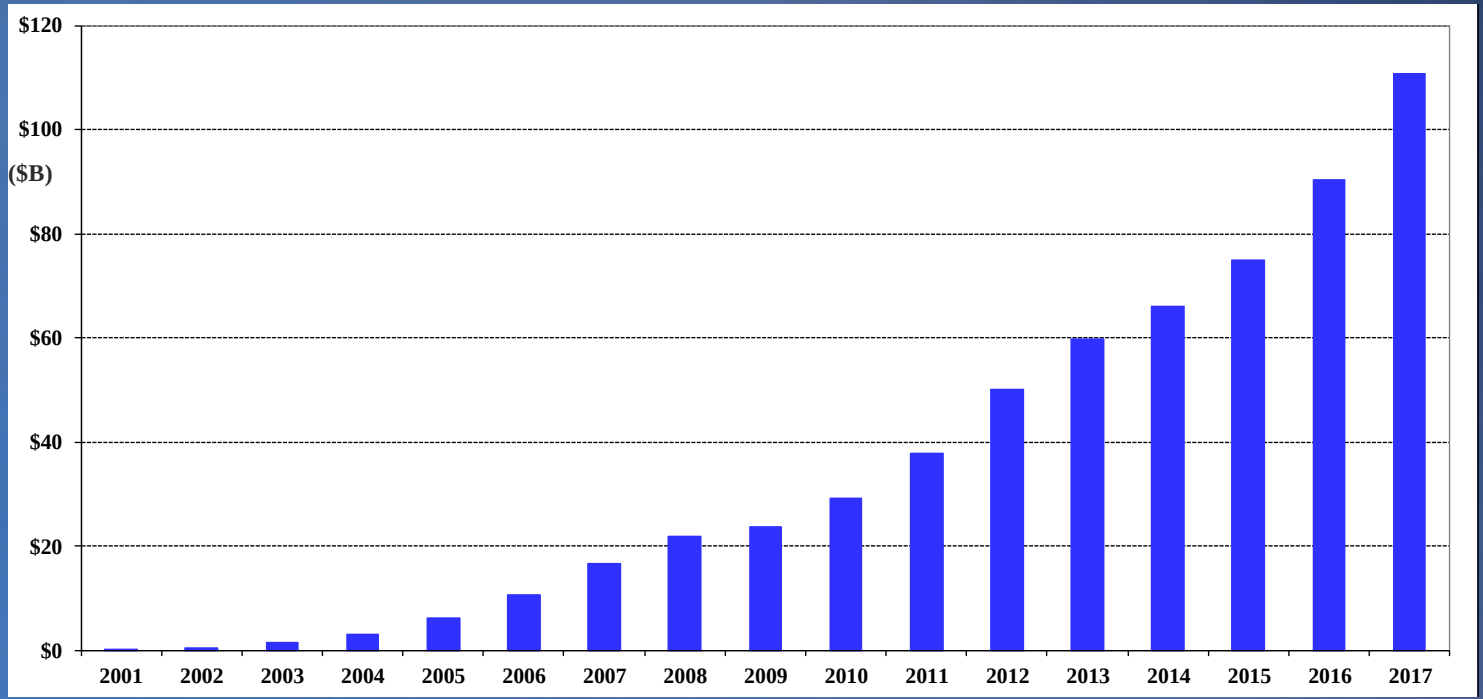
WHAT DID I MISS?

- Google is in enormous, rapidly growing markets
- It has expanded from desktop search into many other areas: Gmail, mobile search, Chrome, app store, YouTube, Google maps, Android, etc.
- I was completely wrong that Google has “only a fairly shallow, narrow moat around its business”; in fact, Google has a very powerful virtuous cycle at work, that leads to a huge moat:



REVENUE GROWTH HAS BEEN REMARKABLE

UP 35x SINCE 2004



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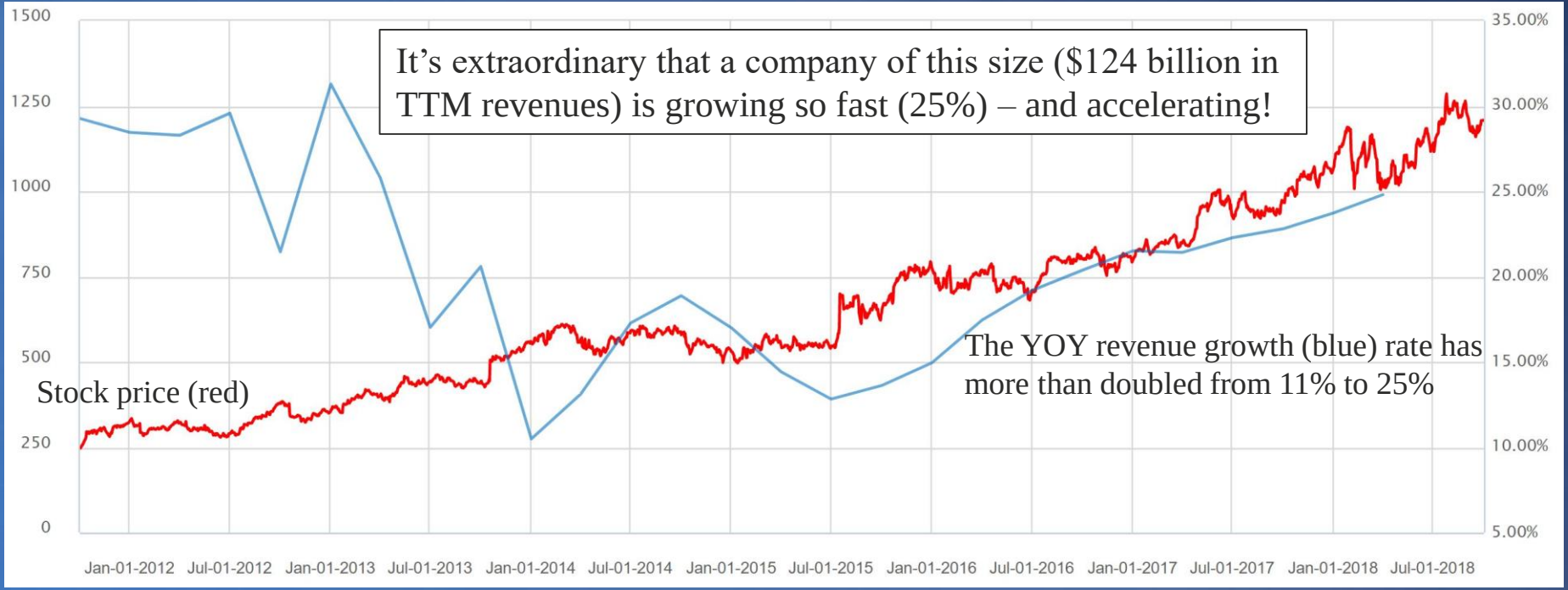
ALPHABET'S REVENUE GROWTH RATE IS ACCELERATING DESPITE ITS SIZE



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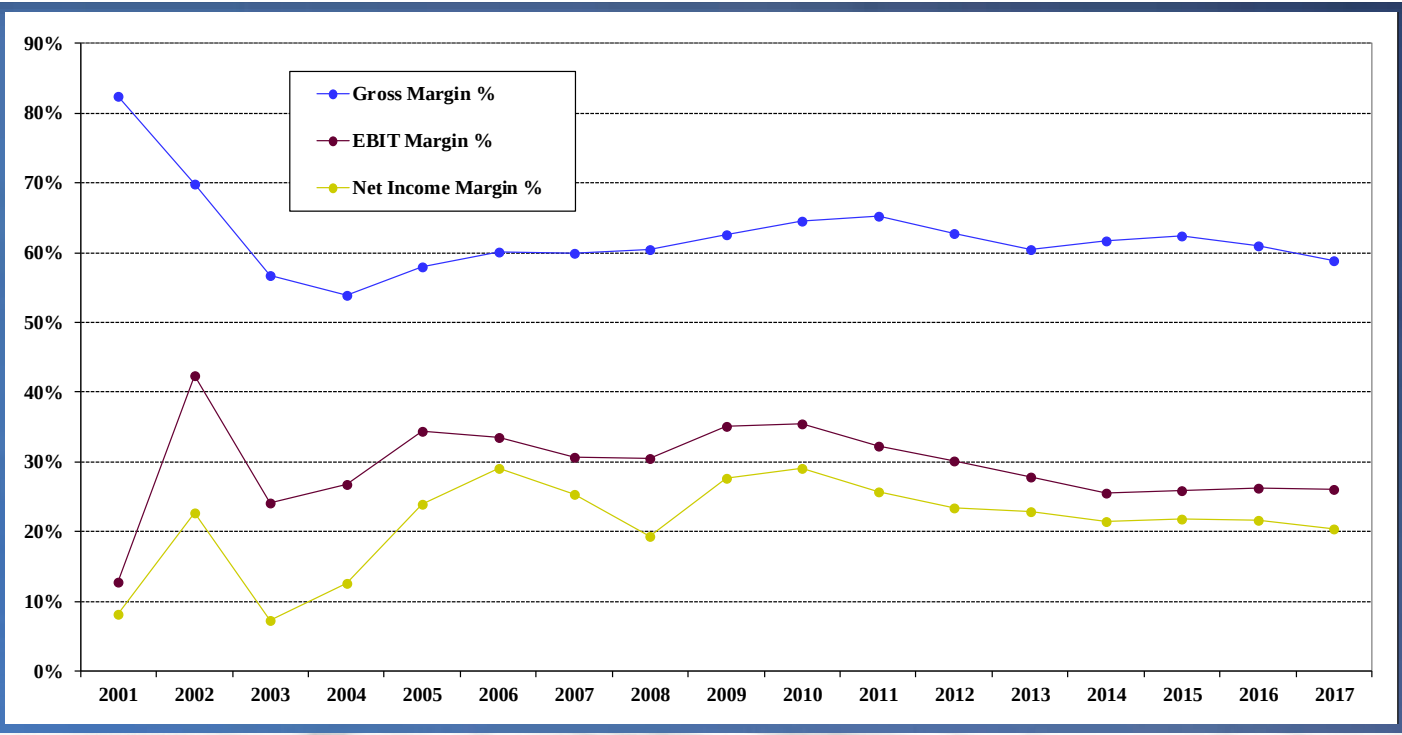
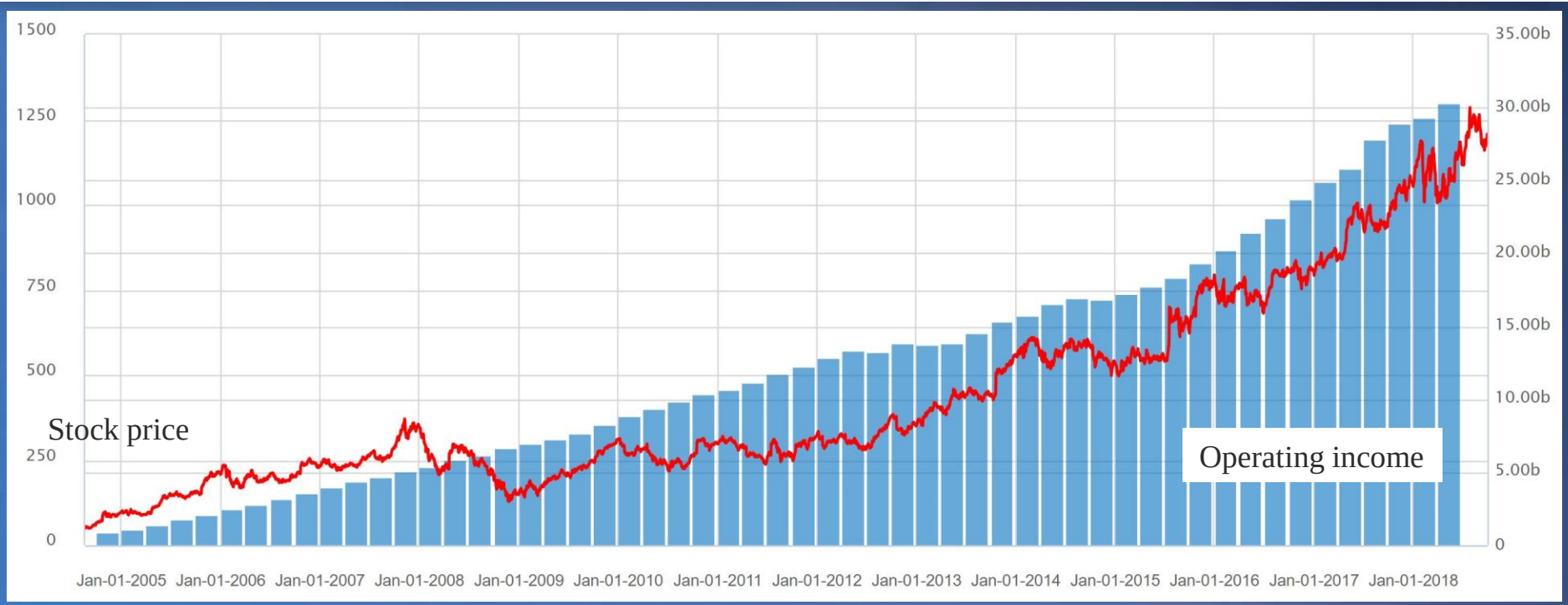
MARGINS ARE HIGH AND STABLE



PROFIT GROWTH HAS BEEN EXTRAORDINARY

The stock has been a 25-bagger since its IPO 14 years ago



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ALPHABET IS THE GREATEST BUSINESS ON EARTH

- It dominates its sectors globally, is growing rapidly, has enormous, sustainable competitive advantages in the form of brands, habits, and network effects, and has a low-capital-intensive, high-margin business model that generates gobs of free cash flow
- It has seven products with more than one billion monthly average users: Search, Android, Maps, Chrome, YouTube, Google Play and Gmail
- Google Search has 90% share of search in most countries, Android has ~90% share of smartphones globally (vs. 5% in 2010), and YouTube serves ~20% (and growing) of all video consumed on the internet
- Alphabet currently captures 14-15% of global advertising spending
- 100% of the incremental ad spending in the world is going to Alphabet and Facebook
- There is plenty of room for growth:
  - Enormous trend of advertising moving from traditional media to online
  - Only ~12% of U.S. commerce is online today
  - Smartphone penetration is only ~32% globally

YOUTUBE HAS ENORMOUS POTENTIAL

- The world's second-most visited website (after Google.com), 80% outside of the U.S.
- Video appears to be at an inflection point, and Alphabet has arguably the most valuable video platform in the world, as users watch 1.3 billion hours/day (5 billion videos/day) and upload 300 hours of video every minute
- The average mobile viewing session lasts more than 40 minutes, up with more than 50% year-over-year
- Video is currently ~15% of Alphabet gross advertising revenue, growing at twice Alphabet's overall rate
- Opportunity to increase monetization, as YouTube serves ~20% of the web's videos, yet only ~10% of the web's video ads
- In the U.S. YouTube currently monetizes at 60-70% the level of TV despite significantly better targeting
- Annual revenue/user is slightly below Twitter despite having nearly 3x time spent/user
- If Alphabet spun off YouTube, how would the market value it?
  - How it's currently valued within Alphabet: $17 billion (est. $12 billion in revenue * ~4% net margin * 24x) = $12/share
  - How it could be valued: $190 billion (assuming 40 cents/hour viewed, half of what cable companies are valued at) = $270/share (source: Bill Nygren, VII, 5/17)

“OTHER BETS” DEPRESS REPORTED PROFITABILITY

- Alphabet’s “Other Bets” segment includes Waymo (autonomous vehicles), Nest (thermostats), Verily (life sciences & healthcare), Access, Calico, CapitalG, GV, and X
- In 2017, Other Bets generated revenues of $1.2 billion (up 49% YOY) and operating losses of $3.4 billion (down 6% YOY; down 19% in Q1 ‘18)
- Alphabet’s operating income in 2017 was $26.1 billion, so excluding Other Bets, it would have been $29.5 billion or 13% higher
- Alphabet has invested ~$25/share into Other Bets; a conservative estimate is that this could be worth ~$50/share or 4% of Alphabet’s value

BUT WHAT ABOUT VALUATION?

- It's hard to argue that Alphabet is misunderstood, with 40 analysts following the company
- But the stock looks reasonably valued, at 28x next 12-month EPS estimates
- This multiple isn't crazy in light of the quality and growth prospects of Alphabet's core businesses
- They're even less crazy if you adjust for various factors:
  - If you subtract net cash ($141/share) and the value of Other Bets ($50/share), and add $2.7 billion ($3.89/share) to net income for after-tax losses on Other Bets, Alphabet is trading at 21x NTM earnings estimates – not far above the average for the S&P 500, for a company that is vastly superior to the average large U.S. corporation
  - If you think YouTube adds ~$250/share of extra value, the P/E drops to 16x
- If revenues continue to grow at ~20% annually and margins and multiples remain steady, then the stock will also grow at ~20% annually

FACEBOOK

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THE BASICS

- Stock price (10/2/18 close): $159.33
- Market cap: $460 billion
- Cash & STI: $42 billion ($15/share)
- Debt: $0
- Enterprise value: $418 billion
- 2018 est. EPS and P/E: $7.18, 22.2x
- 2019 est. EPS and P/E: $8.33, 19.1x

Q2 ‘18 EARNINGS WERE EXCEPTIONAL

- Revenue up 42%
- EPS up 32%
- Monthly active users at 2.2 *billion* (!), up 11% YOY
  - 2/3 are daily active users (1.47 billion)
  - Massive potential to further monetize users, as Average Revenue Per User is $25.91 in the U.S. and only $8.76 in Europe, $2.62 in Asia/Pacific, and $1.91 in the rest of the world
- However, guidance was weak and the stock tumbled

FACEBOOK IS THE 2ND-GREATEST BUSINESS ON EARTH

- It pays nothing for content – users provide it
- It knows more about you than anyone – even Alphabet
- Huge network effects
- Astronomical margins and growth
- It's only 1/3 the size of Alphabet, so more room to grow
- 100% of the incremental ad spending in the world is going to Alphabet and Facebook
- There is plenty of room for growth:
  - Enormous trend of advertising moving from traditional media to online
  - Smartphone penetration is only ~32% globally

FACEBOOK'S REVENUE GROWTH HAS NEVER BEEN BELOW 35%

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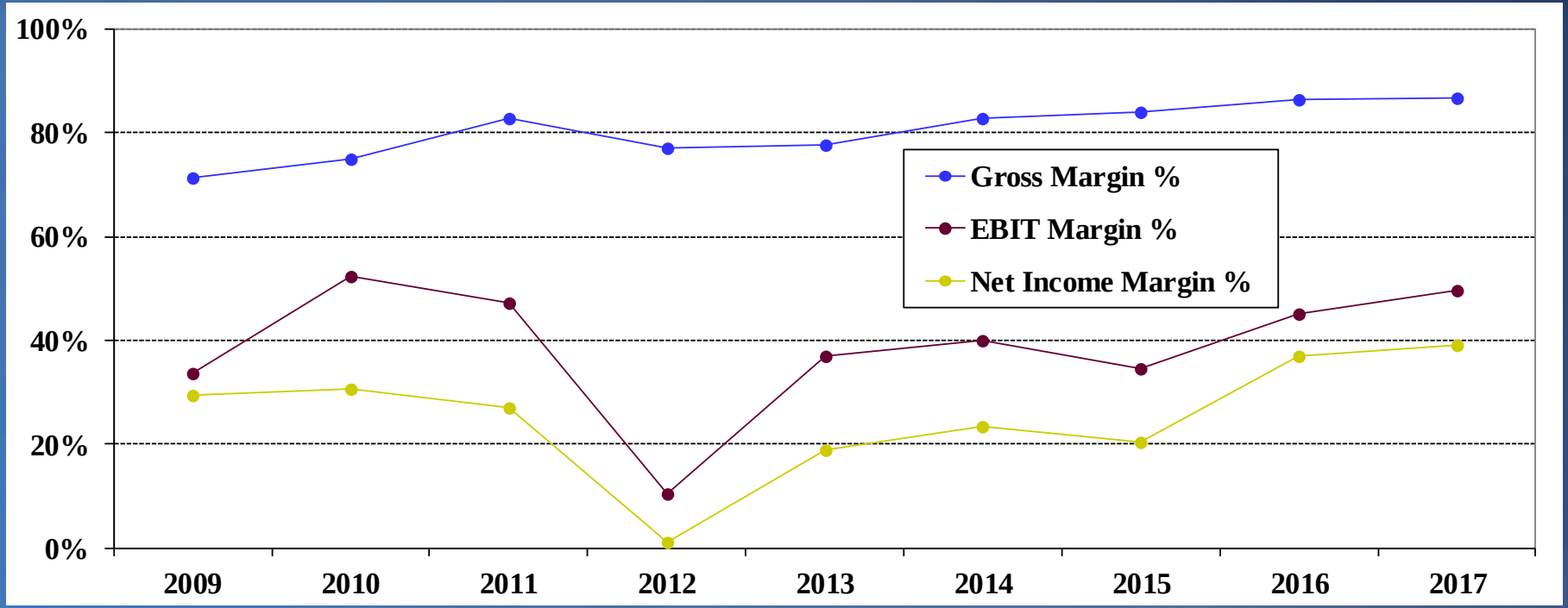
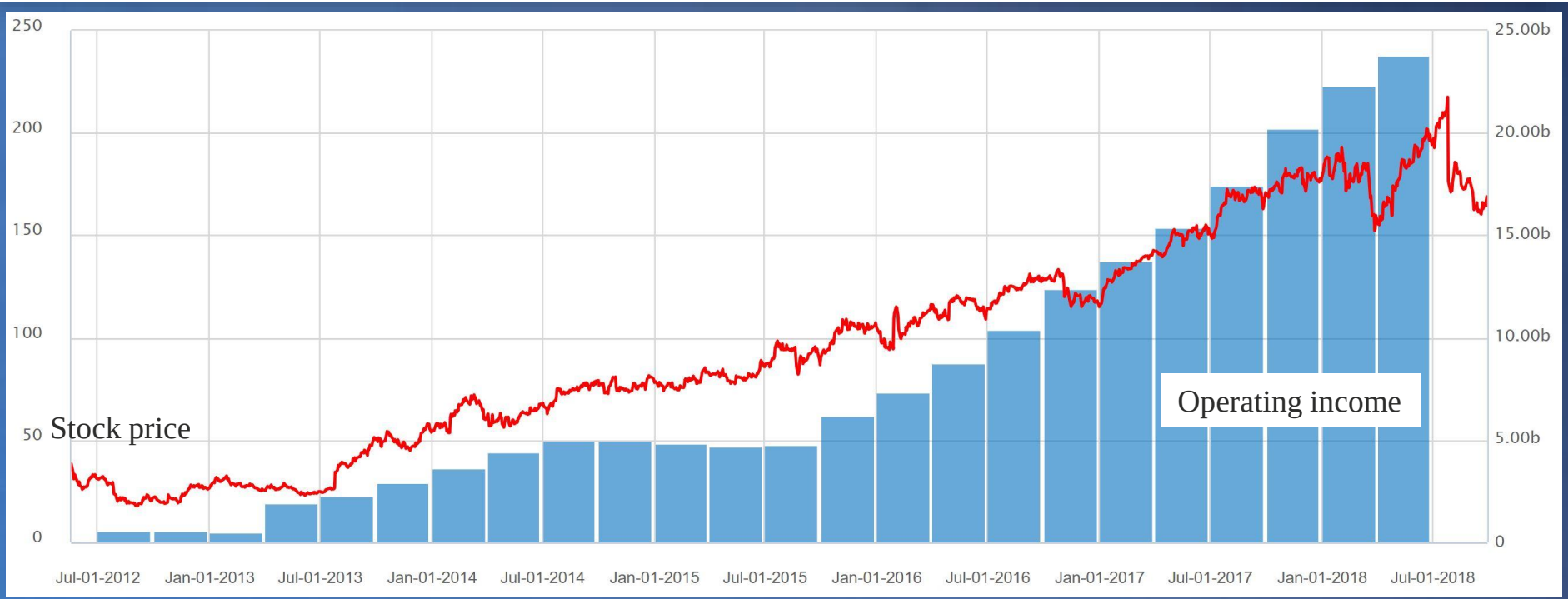
MARGINS ARE ASTRONOMICAL, NEARLY DOUBLE ALPHABET'S



PROFIT GROWTH HAS BEEN EXTRAORDINARY

Earnings continue to soar, but the stock is down 27% in the past three months



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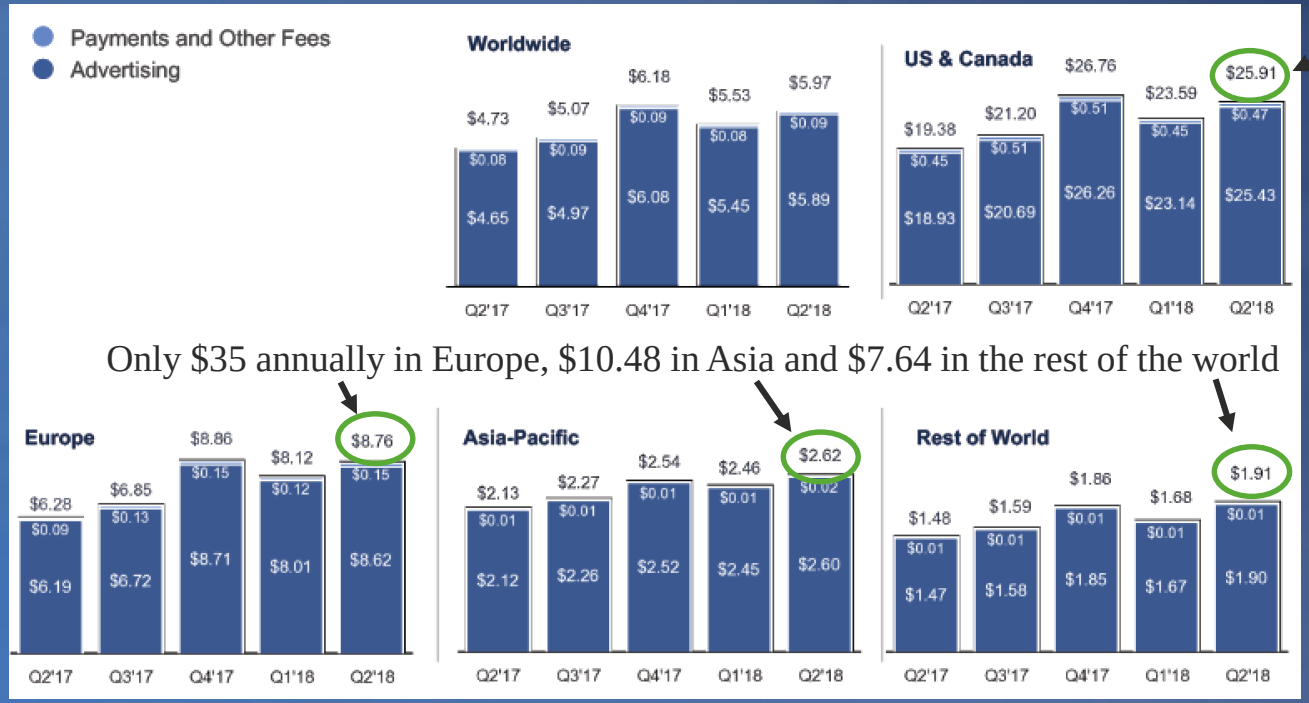
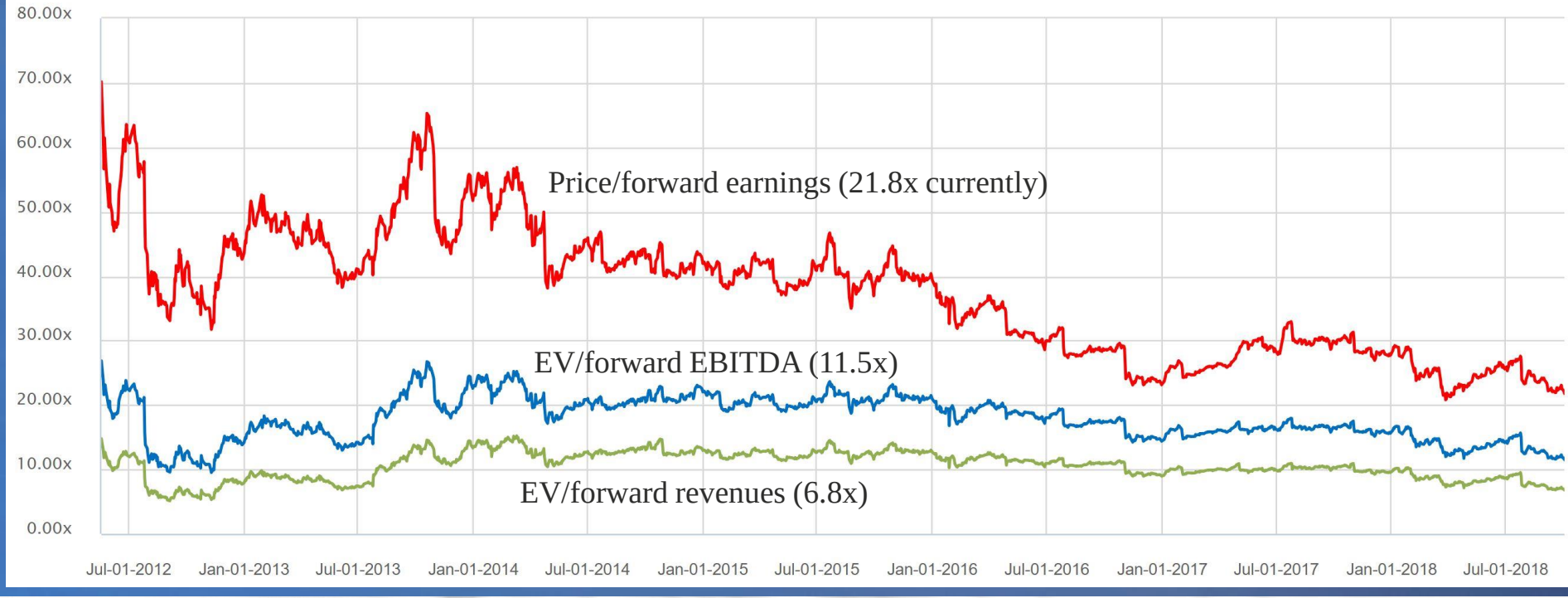
FACEBOOK HAS VAST OPPORTUNITY TO MONETIZE FOREIGN USERS



$104 annually in the U.S. & Canada

Only $35 annually in Europe, $10.48 in Asia and $7.64 in the rest of the world

THE STOCK IS AT ALL-TIME LOW VALUTION METRICS



SUMMARY

- Despite all of the bad press this year, revenue growth was still 42%
- It appears unlikely that regulators will take action that meaningfully crimps growth or margins
  - In fact, certain proposed regulations, ironically, might further entrench Facebook (and Google)
- There is massive potential to further monetize users
- The stock is trading at it lowest valuation multiples ever
- If the company can continue to grow at even half of its historical rates, the stock will do very well from here