Long Term Global Growth

Reflections

June 2021

We sold Alphabet from LTGG clients' portfolios in June 2021 after a 13-year holding period. Before we delve into our reasons for parting ways with the company, we first invite you to cast your mind back to January 2008 when we initially took a holding.

Back then, Google had emerged as the world's dominant search engine, sailing past Yahoo and Microsoft. Already standing at a market capitalisation of $175bn, our investment thesis hinged on the company's ability to spearhead what we felt might be one of the great transitions of the next decade. Writing at the time, we suggested that Google could play "a pivotal role in the migration of advertising dollars from traditional sources to the Internet." Two years later, global advertising spend on search engines surpassed that on radio. By 2014, it had surpassed newspapers, and even TV ad spend was about to crumble from its historic peak. That year Google's market capitalisation reached over $800bn.

Fast-forward to today. Valued at $1.6trn at time of writing, the company is a veritable global giant. And it's still growing. Google has reached 80-90 per cent global market share in search and its advertising-fuelled sales growth rumbles on at circa 15 per cent year-on-year. Its sister businesses, now housed under the Alphabet holding company, include YouTube, which has over 2 billion users and well over 10 per cent (and rising) of total ad revenues. Beyond ads, Google Cloud is growing revenues over 50 per cent year-on-year, making it the third largest provider globally; Android is operating over 2.5 billion devices; and self-driving car business Waymo already has cars on the road with no one sitting in the driving seat. The list of other businesses goes on, in verticals such as healthcare (e.g. Verily), consumer hardware (e.g. phones, laptops, smart home devices), gaming (e.g. Stadia) and artificial intelligence applications.

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It's plausible that Alphabet might go on to double in value from here. Such a scenario might involve ad revenues continuing to compound at 10–15 per cent per annum over the next five years (resulting in an additional $150bn of revenues), while Google Cloud's growth rate might reasonably fade to 30 per cent year-on-year (another $50bn in revenues), and a further $50bn in sales could be reaped from consumer services such as entertainment subscriptions and associated hardware. A 35x earnings multiple for one of the most cash-rich companies in the world would put Alphabet on a circa $3.2trn market capitalisation by 2026. This is just one way to arrive at a doubling and it doesn't even include the potential for Waymo, Verily and anything else Alphabet comes up with.

However, even for us 'blue sky' thinkers, the outlier case for Alphabet to more than quintuple in value from here over the next decade feels much harder to construct. Getting anywhere near to an $8trn valuation would require greatly amplifying the inputs to our doubling scenario above, plus a bold hypothesis that Waymo would become the leading operating system for transportation. Whilst not impossible, we don't feel there is sufficient probability of such an outlier scenario bearing out.

We might have been able to gain more confidence were it not for the lack of a close relationship with senior management. Typically, we gain excellent access to the leaders of our LTGG holdings over time to really kick the tyres, but by 2011 we noted that "the company remains frustratingly opaque."

More concerningly, this aloofness appeared to be entrenched in the corporate culture. Alphabet's increasingly evident cultural blind spots (such as its standoffishness with regulators) led us to posit, in 2018, that "the biggest threat to Alphabet is Alphabet." Today, we think culture is the main obstacle to its expansion in new growth categories. Whilst its employees thrive on solving the world's hardest problems, commercial success in areas such as cloud, hardware and autonomous driving requires more than just intellectual prowess – it requires working collaboratively with suppliers, distributors, and other stakeholders.

Our conviction in Alphabet's outlier potential thus started to wane in recent years. This, coupled with intense competition for capital in the portfolio, led us to eventually sell the holding.

Have we sold too soon? After all, missed opportunity is our top concern. We'll certainly continue to monitor the company's businesses and nascent high-end technology bets such as quantum computing. But we have since invested in holdings that we believe have a higher probability of extreme payoffs from here – such as Coupang, Peloton and The Trade Desk. As for the latter, we are excited about The Trade Desk's prospects in taking advertising share in the open internet, beyond Google's walled garden. We're as energised as ever to discover the next generation giants of the decade to come.

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CM15924 LTGG Reflections Jun21 IC 0721
Ref: 53442 INS AR 0848