

Equity Research

**BUSINESS SERVICES:
MEDIA & MARKETING**

Interactive Media &
Marketing

October 19, 2007
Research Note

Ticker: GOOG
Market: NYSE
Price: \$639.62
52-week: (\$418-
\$641)

Stock Rating:
Outperform

Company Profile:
Aggressive Growth

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Google Inc.

Another Strong Quarter; Trends Remain Robust; Increasing Estimates

FINANCIAL SUMMARY

Fiscal Year Ends:	December	Dividend/Yield:	\$0.00/0.0%
Long-term EPS Growth Rate:	30%	Market Value (mil.):	\$199,096

ESTIMATES*

FYE	Q1	Q2	Q3	Q4	Annual	P/E
2006A	\$2.29	\$2.49	\$2.62	\$3.18	\$10.59	60.4x
2007E	\$3.68 A	\$3.56 A	\$3.91 A	\$4.54	\$15.69	40.8x
2008E	NA	NA	NA	NA	\$21.71	29.5x
Cal2008					\$21.71	29.5x
Cal2009					NA	NA

* Estimates do not reflect the adoption of FAS 123R.

- **Results:** Google reported another strong quarter that was ahead of expectations. Net revenue of \$3.01 billion increased 61.5% year-over-year, 3.1% ahead of our estimate, and up 10.0% sequentially in the seasonally slowest quarter. Pro forma EPS of \$3.91 exceeded the consensus by \$0.13 and surpassed our estimate by \$0.07.
- **Takeaways:** Google continues to gain market share with innovative new products and continuous improvement in the core search experience and in monetization, which is evidenced by 68% growth in Google sites revenue. Monetization gains remain impressive, as we estimate the company enjoyed double-digit gains in revenue per search.
- **Forecast:** We believe Google will continue to gain market share and benefit from its unmatched innovation, partnerships, and new product offerings. We are increasing our 2007 pro forma revenue and EPS estimates from \$11,440 million and \$15.41 to \$11,745 million and \$15.69, respectively, and our 2008 estimates from \$15,640 million and \$20.34 to \$16,861 million and \$21.71.
- **Investment Perspective:** We continue to recommend Google as one of our best picks in the media and marketing sector. Trading at 19.1 times our 2008 enterprise value to pro forma EBITDA estimate and 29.5 times our 2008 pro forma EPS estimate, we view valuation as reasonable, and we anticipate that modest multiple expansion, continued earnings growth, and upward earnings revisions will drive share appreciation.

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Quarterly Highlights

We characterize the third quarter as above expectations and the outlook as bright. There is no sign of a slowdown at Google as the company continued to extend its search market share lead to 57.0% according to comScore, and we remain confident that Google will continue to make meaningful changes to improve market share and monetization in a manner consistent with past quarters. Specifically, the introduction of video ads and gadget ads, international search quality improvements, and a new algorithm for the pricing and placement of sponsored listings may all be meaningfully positive to revenue and profitability.

Growth at network sites rebounded during the quarter as a result of a growing network of partnership including industry leaders such as MySpace. We will continue to keep an eye on operating expenses, as pro forma operating margins declined nearly 500 basis points versus last year, as expenses increased 4.6% sequentially and 81.5% year-over-year; however, we believe management is still appropriately focused on balancing revenue and expense growth. While revenue growth is decelerating as a result of the law of large numbers, the slowdown is occurring more gradually than anticipated and valuation of shares looks attractive, in our view.

Google, Inc.				
Valuation Summary				
	EPS	EBITDA	P/E	EV/ EBITDA
2005	\$5.64	\$2,602	113.4 x	72.8 x
2006	\$10.59	\$4,610	60.4 x	41.1 x
2007	\$15.69	\$7,010	40.8 x	27.0 x
2008	\$21.71	\$9,911	29.5 x	19.1 x
* Assumes a stock price of			\$639.62	
Valuation Summary - Including Stock Comp				
	EPS	EBITDA	P/E	EV/ EBITDA
2006	\$10.04	\$4,182	63.7 x	45.3 x
2007	\$13.50	\$6,177	47.4 x	30.7 x
2008	\$18.64	\$7,591	34.3 x	25.0 x

Monetization remains impressive. We believe Google is enjoying continued strong gains in monetization, as evidenced by 45% growth in paid clicks in the quarter. Gross revenue growth was 12% higher than paid clicks growth, which implies a 12% lift in revenue per click. Additional evidence of improved monetization is supported by data from comScore, which estimated that Google's paid clicks grew 48%, implying a 9% improvement in revenue per click.

Google sites remarkably strong. The most impressive result in the quarter was the 68% growth (10% sequential) in Google sites revenue to \$2.73 billion, which exceeded our estimate by 2% and was down from 74% growth last quarter. Growth may be somewhat overstated, however, as toolbar distribution agreements that require traffic acquisition (TAC) payments are accounting for an increasing (albeit small) share of Google sites revenue. Growth in these TAC payments has exceeded growth in Google sites revenue, as \$105 million in distribution payments were made in the quarter up 21% from last quarter.

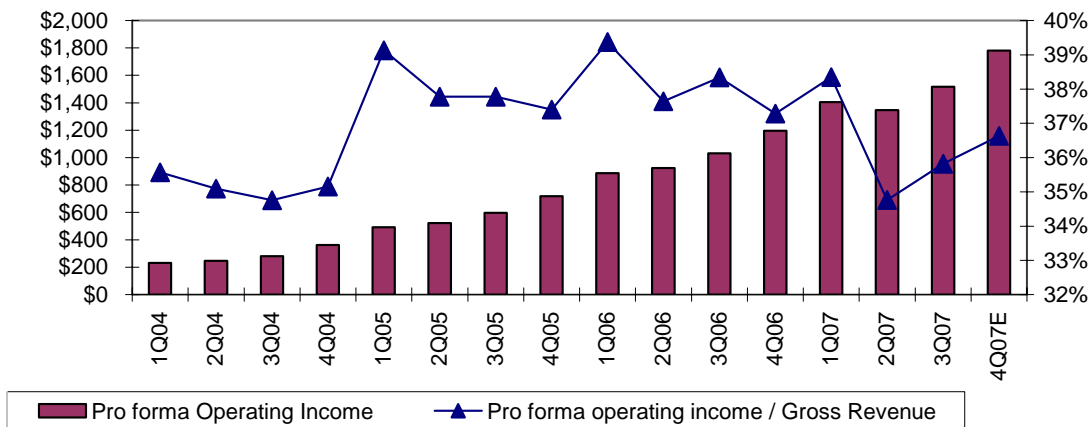
Network growth rebounded. The Google network grew 40% in the quarter, accelerating from 36% last quarter, after eight quarters of sequential decline. The improvement was driven by traffic growth and monetization improvements at its partners' sites, MySpace in particular. However, we remain concerned that slower growth and upward pressure on TAC may force the company to rely more heavily on proprietary properties for growth in the near term. Longer term, as Google further cements its lead in search, we see the potential for TAC to trend lower. With Google's search engine commanding greater than 50% market share in the United States and over 70% in Europe, there is a slight risk that revenue growth may slow more rapidly than expected among its network partners as the core Google.com site continues to gain market share.

Margins remain compressed but under control. Pro forma operating margin remained a concern, as expenses increased 4.6% sequentially and 81.5% year-over-year. As a result, pro forma operating margin was about 50 basis points below our estimate and declined nearly 500 basis points versus last year. A portion of this increase was driven by a 69.7% increase in headcount to a record 2,130 employees during the quarter; however, we view this investment as essential to maintaining the company’s robust growth over the long term. We also note that management reiterated its commitment to focus on headcount expansion and that this quarter’s growth was likely inflated by seasonal college recruitment and the Postini acquisition. Costs were high also due to expenses for data centers and equipment. While it is difficult to project the trajectory of expenses in the future, the quarter is not an indicator of a systemic deterioration in margins, in our view. We believe management is still appropriately focused on balancing revenue and expense growth, and we remain impressed by its unprecedented growth in revenue and profits at such substantial scale.

Results Summary

Google reported a very robust quarter with continued strong revenue and profit growth. Gross revenue reached \$4.23 billion—growing 57.3% versus last year, up 9.3% on a quarter-over-quarter basis and 3.6% ahead of our estimate. Net revenue of \$3.01 billion increased 61.5% year-over-year, 10.5% sequentially, and exceeded our estimate by 3.1%. Operating margins declined due to an increase in payroll expense and investments in data centers, equipment, and other facilities, but improved sequentially as highlighted in the nearby chart.

Google, Inc.
Pro forma Operating Income & Operating Margin
 (\$ in millions, % of gross revenue)



Source: Google and William Blair & Company, L.L.C.

The increase in payroll expense was caused by the record hiring of 2,130 employees, driven by new graduate hires, the Postini acquisition, and international expansion. TAC declined to 83.9% after five sequential increases due to the revenue mix from partners, but remained well above the 79.0% averaged over the past several years. While a lower TAC rate is better, we view the retention of the relationships as key to helping Google maintain a significant marketplace advantage. Google’s dominant network of search and content providers serves two key purposes: providing more scale for its advertisers and to block potential competition from attempting to rival the critical mass of Google’s advertising platforms. Management’s new metric paid clicks grew 45%, compared with 47% last quarter and 52% reported in the first quarter.

The key drivers behind the company’s performance in the quarter were international strength, as well as strong traffic growth and continued improvements in monetization. International revenue not

including the United Kingdom increased 80.2%, outpacing the rapid growth in the United States and United Kingdom of 46.0% and 56.5%, respectively.

Growth in operating costs (up 81.5%) and capital expenditures of \$553 million continue to pay dividends in the form of growth at scale. Cost of revenue grew 98.2% versus last year and was 5.7% above our estimate due to investments in content, data centers, and equipment. Sales and marketing also grew faster than anticipated, up 82.5% versus last year and 7.2% above our estimate, likely due to the payroll expense associated with employee growth. Rising expenses during the quarter were evident in pro forma operating margins (calculated using net revenue), which declined 497 basis points versus last year and were 46 basis points lower than our estimate. Despite the margin contraction, pro forma operating income increased 47.0% versus last year. Pro forma EPS of \$3.91 exceeded our estimate of \$3.84 and the consensus of \$3.78; GAAP EPS were \$3.38 for the quarter, \$0.05 above our estimate and 43.1% higher than last year.

Google, Inc.
3Q 2007 Earnings Review
(\$ in thousands, except EPS)

	Reported	Estimate	Last Quarter	Last Year	vs. Estimate	vs. Last Quarter	vs. Last Year
Revenue:							
Google web sites	2,734,756	2,685,193	2,486,290	1,625,977	1.8%	10.0%	68.2%
Google network sites - gross	1,454,721	1,365,572	1,352,051	1,037,022	6.5%	7.6%	40.3%
Licensing and other	41,874	34,653	33,644	26,674	20.8%	24.5%	57.0%
Gross revenues	4,231,351	4,085,418	3,871,985	2,689,673	3.6%	9.3%	57.3%
Less: Traffic acquisition costs	(1,220,000)	(1,163,467)	(1,147,900)	(825,300)	NM	NM	NM
Total net revenues	\$3,011,351	\$2,921,951	\$2,724,085	\$1,864,373	3.1%	10.5%	61.5%
Costs and expenses:							
Cost of revenues	438,548	414,917	404,696	221,279	5.7%	8.4%	98.2%
Research and development	418,057	409,073	375,123	250,918	2.2%	11.4%	66.6%
Sales and marketing	350,902	327,259	319,219	192,299	7.2%	9.9%	82.5%
General and administrative	288,046	286,351	278,908	168,686	0.6%	3.3%	70.8%
Stock-based compensation	197,956	200,000	241,524	99,860	-1.0%	-18.0%	98.2%
Total costs and expenses	1,693,509	1,637,600	1,619,470	933,042	3.4%	4.6%	81.5%
Income from operations	1,317,842	1,284,351	1,104,615	931,331	2.6%	19.3%	41.5%
Interest income, other	154,428	140,130	137,130	108,180	10.2%	12.6%	42.8%
Income before taxes	1,472,270	1,424,481	1,241,745	1,039,511	3.4%	18.6%	41.6%
Income taxes	402,281	370,365	372,524	306,150	8.6%	8.0%	31.4%
Net income	\$1,069,989	\$1,054,116	\$925,120	\$733,361	1.5%	15.7%	45.9%
Pro-forma operating income	\$1,515,798	\$1,484,351	\$1,346,139	\$1,031,191	2.1%	12.6%	47.0%
Pro forma net income	\$1,236,934	\$1,214,116	\$1,123,647	\$812,283	1.9%	10.1%	52.3%
Diluted GAAP EPS	\$3.38	\$3.33	\$2.93	\$2.36	\$0.05	\$0.45	\$1.02
Pro-forma diluted EPS	\$3.91	\$3.84	\$3.56	\$2.62	\$0.07	\$0.35	\$1.29
Diluted shares	316,576	316,100	315,469	310,574	0.2%	0.4%	1.9%
Adjusted EBITDA	\$1,765,173	\$1,742,275	\$1,569,494	\$1,176,501	1.3%	12.5%	50.0%
CAPEX	\$552,640	\$575,098	\$575,098	\$492,222	-3.9%	-3.9%	12.3%
Margin Analysis (net revenue)							
TAC	83.9%	85.2%	84.9%	79.6%	-134 bps	-104 bps	428 bps
Cost of revenues	14.6%	14.2%	14.9%	11.9%	36 bps	-29 bps	269 bps
Research and development	13.9%	14.0%	13.8%	13.5%	-12 bps	11 bps	42 bps
Sales and marketing	11.7%	11.2%	11.7%	10.3%	45 bps	-7 bps	134 bps
General and administrative	9.6%	9.8%	10.2%	9.0%	-23 bps	-67 bps	52 bps
Stock-based compensation	6.6%	6.8%	8.9%	5.4%	-27 bps	-229 bps	122 bps
Income from operations, GAAP	43.8%	44.0%	40.5%	50.0%	-19 bps	321 bps	-619 bps
Income from ops, pro-forma	50.3%	50.8%	49.4%	55.3%	-46 bps	92 bps	-497 bps
Effective tax rate	27.3%	26.0%	25.5%	29.5%	132 bps	183 bps	-213 bps
Net income	35.5%	36.1%	34.0%	39.3%	-54 bps	157 bps	-380 bps
EBITDA	58.6%	59.6%	57.6%	63.1%	-101 bps	100 bps	-449 bps
Margin Analysis (gross revenue)							
Research and development	9.9%	10.0%	9.7%	9.3%	-13 bps	19 bps	55 bps
Sales and marketing	8.3%	8.0%	8.2%	7.1%	28 bps	5 bps	114 bps
General and administrative	6.8%	7.0%	7.2%	6.3%	-20 bps	-40 bps	54 bps
Income from ops, pro-forma	35.8%	36.3%	34.8%	38.3%	-51 bps	106 bps	-252 bps

International markets remained robust, with particular strength in France, Italy, Spain, Portugal, Belgium, Korea, Brazil, and China. The United Kingdom also exhibited strength, growing 10.5% quarter-over-quarter. Currency effects were positive this quarter; a constant currency comparison to first quarter 2007 would have yielded revenue \$24 million lower this quarter, and a comparison to second quarter 2006 would have yielded revenue \$121 million lower this quarter.

Google's tax rate remained a wildcard, coming in 130 basis points above our estimate at 26.0%. The tax rate has fluctuated historically, typically a source of upside surprise, from a high of 41.8% in fourth quarter 2005 to a low of 13.0% in fourth quarter 2006. The company has attributed the fluctuations to the fact that Google is a rapidly growing company transacting business across an increasing number of tax jurisdictions.

Outlook and Estimates

We remain confident that Google will continue to make meaningful changes to improve market share and monetization in a manner consistent with past quarters. Specifically, the introduction of video ads and gadget ads, international search quality improvements, and a new algorithm for the pricing and placement of the sponsored listings may all be meaningfully positive to revenue and profitability.

We are updating our estimates to reflect slightly stronger than anticipated revenue. Our estimates are outlined in the following table:

Google, Inc.						
3Q 2007 Estimate Revisions						
	1Q 2007A	2Q 2007A	3Q 2007A	4Q 2007	FY 2007	FY 2008
Gross Revenue (\$ millions)						
Old	\$3,664	\$3,872	\$4,085	\$4,504	\$16,126	\$21,195
New	\$3,664	\$3,872	\$4,231	\$4,859	\$16,627	\$23,259
Difference	\$0	\$0	\$146	\$355	\$501	\$2,063
Net Revenue - Ex Tac (\$ millions)						
Old	\$2,539	\$2,724	\$2,922	\$3,255	\$11,440	\$15,640
New	\$2,539	\$2,724	\$3,011	\$3,470	\$11,745	\$16,861
Difference	\$0	\$0	\$89	\$215	\$305	\$1,222
Non GAAP Operating Profit						
Old	\$1,405	\$1,346	\$1,484	\$1,699	\$5,935	\$8,006
New	\$1,405	\$1,346	\$1,516	\$1,780	\$6,047	\$8,569
Difference	\$0	\$0	\$31	\$81	\$113	N/A
EBITDA - Pro forma (\$ in millions)						
Old	\$1,610	\$1,569	\$1,742	\$1,995	\$6,917	\$9,402
New	\$1,610	\$1,569	\$1,765	\$2,066	\$7,010	\$9,911
Difference	\$0	\$0	\$23	\$70	\$93	N/A
EPS - Pro Forma						
Old	\$3.68	\$3.56	\$3.84	\$4.32	\$15.41	\$20.34
New	\$3.68	\$3.56	\$3.91	\$4.54	\$15.69	\$21.71
Difference	\$0.00	\$0.00	\$0.07	\$0.21	\$0.28	\$1.37
EPS - GAAP						
Old	\$3.18	\$2.93	\$3.33	\$3.79	\$13.24	\$17.27
New	\$3.18	\$2.93	\$3.38	\$4.01	\$13.50	\$18.64
Difference	\$0.00	\$0.00	\$0.05	\$0.22	\$0.26	\$1.38

Google, Inc.
Abbreviated Model
(in millions except per share values)

	2006	1Q07	2Q07	3Q07	4Q07E	2007E	2008E
Revenue:							
Google web sites	\$6,335	\$2,282	\$2,486	\$2,735	\$3,172	\$10,675	\$15,690
Google network sites - gross	4,159	1,345	1,352	1,455	1,644	5,796	7,383
Licensing and other	110	37	34	42	43	155	186
Gross Revenue	\$10,605	\$3,664	\$3,872	\$4,231	\$4,859	\$16,627	\$23,259
Less: Traffic acquisition costs	(3,309)	(1,125)	(1,148)	(1,220)	(1,389)	(4,882)	(6,398)
Net Revenue	\$7,296	\$2,539	\$2,724	\$3,011	\$3,470	\$11,745	\$16,861
Operating Costs	3,258	1,134	1,378	1,496	1,690	5,697	8,292
Pro Forma Operating Profit	4,038	1,405	1,346	1,516	1,780	6,047	8,569
Adjusted EBITDA	4,610	1,610	1,569	1,765	2,066	7,010	9,911
GAAP Net Income	3,107	1,002	925	1,070	1,271	4,268	5,959
Pro-Forma Net Income	3,279	1,159	1,124	1,237	1,439	4,958	6,939
Pro-Forma EPS	\$10.59	\$3.68	\$3.56	\$3.91	\$4.54	\$15.69	\$21.71
GAAP EPS	\$10.04	\$3.18	\$2.93	\$3.38	\$4.01	\$13.50	\$18.64
Share Count	310	315	315	317	317	316	320

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Additional information is available upon request.



Current Rating Distribution (as of 10/1/2007)

Coverage Universe	Percent	Inv. Banking Relationships*	Percent
Outperform (Buy)	60	Outperform (Buy)	12
Market Perform (Hold)	39	Market Perform (Hold)	5
Underperform (Sell)	1	Underperform (Sell)	1

*Percentage of companies in each rating category that are investment banking clients, defined as companies for which William Blair has received compensation for investment banking services within the past 12 months.

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