Alphabet Inc. (a.k.a. Google): A Case Study in Spotting Value Creation

On June 22, 2015, Tom Gayner, Co-Chief Executive Officer of specialty insurance underwriter, Markel Corporation, gave a presentation titled, *The Evolution of a Value Investor* during the lunch hour to the employees of Google, the world's largest internet company. Mr. Gayner began his presentation by summarizing his business background as a Certified Public Accountant and security analyst before taking a position as an Investment Officer for Markel Corporation in 1990. Tom's fifty eight minute presentation may be viewed on YouTube and, in my opinion, is most insightful and well worth the time.

Tom acknowledged that his initial approach to investing had a quantitative bias that utilized fundamental metrics to analyze common stocks. He mentioned that these fundamental metrics worked well for Benjamin Graham, and other value oriented investors, in the post depression years when securities were grossly mispriced relative to net assets and earnings. Conversely, Tom's experience using only the quantitative approach was less than satisfactory in stating that, "the pond has gotten a little overfished. The quantitative approach is good for *spotting value*. It is a snapshot or picture in time of a business, but it does not provide enough information to determine the future prospects and success of a business."

His investment approach then evolved to one that was more qualitative and focused on *spotting the creation of value*. Instead of a snapshot or picture, he began to analyze a business as if it was a movie and how the reel is going to unfurl so as to better understand the valuation of the business over an extended period of time. He became more interested in determining what the business valuation would be five and ten years in the future as opposed to one specific period in time and whether value was increasing, static or deteriorating.

Tom's investment philosophy focuses on four points of view with the following characteristics:

1. Businesses that have a demonstrated record of profitability and the ability to earn high rates of return on capital with little or no leverage (debt).
2. Management that has integrity and ability because "one without the other is worthless."
3. The reinvestment dynamics of the business allow it to reinvest and compound its profits at high rates of return, which lead to an increased valuation.
4. The price paid for the business in relation to its long term value creation potential is attractive.

Albert Einstein stated, "Compound interest is the most powerful force in the universe. Those who understand compound interest earn it and those who don't pay it." It is for this reason that Tom Gayner believes the reinvestment or compounding dynamics of a business is the most important criteria in determining the attractiveness of an investment. Determining whether the business will be more or less valuable in the future is the key component to building wealth with common stocks.

At the conclusion of his presentation, Tom was asked by a Google employee what he thought of Google as an investment opportunity. He confirmed that he uses the Google search engine twenty times each day and owns a small amount of shares of Google stock. That said, he felt he had missed much of the opportunity and has been challenged to understand how senior management compensation is determined and what Google intends to accomplish for its shareholders over time. He went on to say that he is more inclined to learn and think more deeply about a business if he owns a small amount of shares because, "things you don't know, you should learn something about." Tom's admission that analyzing businesses that are rapidly changing is much harder than those that do not change rapidly is consistent with Ben Graham's observation that growth for a business is extremely important yet hard to calculate.

If we view Google using Tom Gayner's four point perspective, we can summarize it in the following way:

1. Google has demonstrated a consistent record of profitability and high rates of return on capital since its public offering in August of 2004. Operating income has grown at a compounded rate of more than 30% since 2004 and rates of return on capital have been greater than 10%. The debt to equity ratio for Google

has declined from 12.6% in 2010 to 6% in 2016. Leverage is negligible due to the extensive amount of cash flow that is generated by the business.

2. At the time of the public offering in 2004, Co-Founders Larry Page and Sergey Brin, along with Senior Executive, Eric Schmidt, all agreed to work together at Google for twenty years, until the end of 2024. Not only do all three executives together embody a shareholder ownership mentality by controlling 60% of the company's voting power, but their skill and talent is amply demonstrated by the more than 1750% increase in Google's share price since 2004, which equates to a compounded rate of return of more than 27.5% annually.
3. Since 2004 Google has retained more than $90 billion worth of profit and reinvested that capital in businesses that together account for returns on total capital greater than 10% and operating profit margins in excess of 25%. Recently, Google announced a $5 billion share buyback of its Class C stock and that it is discontinuing investment in and operations of offerings that have not gain sufficient traction in order to enhance and develop the company's next generation of internet search, advertising and video businesses.
4. Historically, especially in the post IPO period, Google shares have typically been priced at a premium to its earnings and cash flow. It is interesting to note that although Google is currently selling for more than 30 times trailing twelve month earnings, the company's shares have not sold for less than 22 times earnings since 2006. Google has never paid a dividend to shareholders because management prefers to reinvest profits to look for new ways to serve customers and expand their businesses. If viewed from a ten year perspective, a $10,000 investment in shares of Google in June of 2006 is worth more than $78,500. In 2006 an investor had to pay close to 60 times earnings to own shares of Google. Granted, the company has grown its revenues and market share significantly in the past ten years to become one of the largest publicly traded companies in the world. Nonetheless, Google dominates the online search market with a global market share greater than 80%, with more than 3 to 4 times as many search requests as Bing (Microsoft) and Yahoo. In addition, its YouTube video business, with 15 times more viewers than Netflix, has the potential to double its revenue per viewer in the next five years, possibly making it twice as a valuable as Netflix if it were listed as a separately traded company.

In the *2005 Markel Corporation Annual Report*, the following excerpt appeared in the Market Review section, "Technology stocks, and in particular Google, also rose dramatically in 2005. While these companies continue to delight us as consumers and we enthusiastically applaud the productivity and efficiency gains these companies create for society, the businesses remain volatile and only minimally predictable over time."

It is most refreshing to hear an investment executive, such as Tom Gayner, candidly admit that he regrets not having purchased Google at earlier date by stating, "How could I have missed Google!" He likened it to his regret of not having purchased shares of Berkshire Hathaway in 1984 at $380 per share only to reconsider after Steve Markel prodded him into buying shares at $5,750 more than ten years later. It should not come as a surprise that since Tom's presentation at Google in June of 2015, Markel has increased its ownership of Google shares by a small amount so as to provide Tom with a "library card" to learn and think more deeply about the business.