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Greetings from Kansas City, where things are heating up on many fronts (triple digits the entire week!). On Thursday, we started the second quarter earnings season with Google's earnings. It represented the first quarter under the CEO leadership of co-founder Larry Page, who sounded like he's been in the job for years. At the end of his opening remarks, he presented a vision for Google that epitomizes the depth of thought at the company:

*All of us at Google will want to create services that people in the world use twice a day just like toothbrush [sic]. And we strive to make those services beautiful, simple and easy to use. That way we can provide huge benefit to the world. We've made a good start, but we're only at 1% of what's possible. Google is just getting started, and that's why I'm here, working hard to lead the company in the next level.*

Since [The Sunday Brief began](#) (we will celebrate the 100<sup>th</sup> SB published next weekend), we have talked about the effect of Google's products on the mobile and telecom worlds. Unlike the traditional multi-year depreciable lives of fiber and switching, the world of Google measures time by release, usually months. They are a software company which specializes in organizing and indexing billions of web addresses, and, in the process, determining your next move so they can provide this profile to advertisers.

Like telecom, however, garages around the Silicon Valley do not spawn new search algorithms to compete with Google overnight. And even if they could, they would have to apply these formulas to well-developed profiles which wouldn't exist for months if not years. Google's sustainable advantage is in the size of its search experience database. It knows your next move better than Apple, LinkedIn, and Facebook combined. If that makes you uncomfortable, just stop using the Internet.

However, to watch the coverage of Google's earnings, one might have thought that the advent of a new CEO ushered in a new profit spigot. It didn't, as we will show below. Google was strong in 2009 and 2010, and it's continuing that strength. Their comments on global growth give as much insight into the prospects for a second half worldwide recovery as any economist's conjectures. Projections on the final score of the Facebook vs. Google "Social Super Bowl" were rampant after Thursday night (and we're only in the first minute of the game), and this discussion, in large part, sent Google's stock price soaring (although they are trading slightly below their beginning of year price). One interesting note – until Friday, Google's year-to-date return was worse than Microsoft's (gasp!) – that's a badge no Silicon Valley company wants to wear.

**Google's earnings can be summed up as follows: Powerful and consistently growing.** They got better, as they always do. Let's have a look at their 10-quarter chart:

(\$millions)	31-Mar-09	30-Jun-09	30-Sep-09	31-Dec-09	31-Mar-10	30-Jun-10	30-Sep-10	31-Dec-10	31-Mar-11	30-Jun-11
<b>Revenues</b>	\$ 5,509	\$ 5,523	\$ 5,945	\$ 6,674	\$ 6,775	\$ 6,820	\$ 7,286	\$ 8,440	\$ 8,575	\$ 9,026
Revenue growth					\$ 1,266	\$ 1,297	\$ 1,341	\$ 1,766	\$ 1,800	\$ 2,206
Driven by foreign exchange					\$ 242	\$ 24	\$ (169)	\$ (132)	\$ 23	\$ 417
% driven by foreign exchange					19.1%	1.9%	-12.6%	-7.5%	1.3%	18.9%
<b>Costs and expenses</b>										
Cost of revenues	\$ 2,102	\$ 2,108	\$ 2,226	\$ 2,408	\$ 2,452	\$ 2,467	\$ 2,552	\$ 2,946	\$ 2,936	\$ 3,172
Research and development	\$ 642	\$ 708	\$ 758	\$ 736	\$ 818	\$ 898	\$ 994	\$ 1,051	\$ 1,226	\$ 1,234
Sales and marketing	\$ 434	\$ 469	\$ 498	\$ 583	\$ 607	\$ 629	\$ 661	\$ 902	\$ 1,026	\$ 1,091
General and administrative	\$ 447	\$ 364	\$ 389	\$ 466	\$ 410	\$ 461	\$ 532	\$ 559	\$ 591	\$ 648
<b>Total costs and expenses</b>	\$ 3,625	\$ 3,649	\$ 3,871	\$ 4,193	\$ 4,287	\$ 4,455	\$ 4,739	\$ 5,458	\$ 5,779	\$ 6,145
<b>Income from operations</b>	\$ 1,884	\$ 1,874	\$ 2,074	\$ 2,481	\$ 2,488	\$ 2,365	\$ 2,547	\$ 2,982	\$ 2,796	\$ 2,881
Interest and other income (expense), net	\$ 6	\$ (18)	\$ (7)	\$ 88	\$ 18	\$ 69	\$ 167	\$ 160	\$ 96	\$ 204
Income before income taxes	\$ 1,890	\$ 1,856	\$ 2,067	\$ 2,569	\$ 2,506	\$ 2,434	\$ 2,714	\$ 3,142	\$ 2,892	\$ 3,085
Provision for income taxes	\$ 467	\$ 371	\$ 428	\$ 595	\$ 551	\$ 594	\$ 547	\$ 599	\$ 594	\$ 580
<b>Net income</b>	\$ 1,423	\$ 1,485	\$ 1,639	\$ 1,974	\$ 1,955	\$ 1,840	\$ 2,167	\$ 2,543	\$ 2,298	\$ 2,505
<b>Annual Revenue Growth (%):</b>					23.0%	23.5%	22.6%	26.5%	26.6%	32.3%
Gross Margin:	61.8%	61.8%	62.6%	63.9%	63.8%	63.8%	65.0%	65.1%	65.8%	64.9%
Operating Margin:	34.2%	33.9%	34.9%	37.2%	36.7%	34.7%	35.0%	35.3%	32.6%	31.9%

**NOTE: The above analysis does not include the one-time charge of \$500 million for the DOJ investigation that Google took in Q1 2011.**

The headline was 32% growth, but, in the earnings release, Google discloses that:

*Revenues from outside of the United States totaled \$4.87 billion, representing 54% of total revenues in the second quarter of 2011, compared to 53% in the first quarter of 2011 and 52% in the second quarter of 2010. Excluding gains related to our foreign exchange risk management program, had foreign exchange rates remained constant from the first quarter of 2011 through the second quarter of 2011, our revenues in the second quarter of 2011 would have been \$167 million lower. Excluding gains related to our foreign exchange risk management program, had foreign exchange rates remained constant from the second quarter of 2010 through the second quarter of 2011, our revenues in the second quarter of 2011 would have been \$417 million lower.*

The above comment means little unless it's viewed in context of the longer revenue and earnings growth picture. **Google's earnings are not only driven through their individual profile quality** (what we will do next), **but also by the quality of the dollar** (what the foreign exchange markets will do next). Look at the net effect of revenue growth less foreign exchange over the past three quarters – it's pretty flat if not down at \$1.8 to \$1.9 billion (remember, this is not a pro forma statement so growth also includes the effect of the 100+ acquisitions Google completed in 2010). Twenty-five percent growth on a normalized basis is terrific, and Google should be recognized for that growth, not only in 2Q but in previous quarters.

The costs of revenue are the greater concern. Google's costs (TAC) are paid on a global basis – this is what drove up their costs of revenue by 29% annually and a whopping 8% sequentially. If the dollar continues to weaken, it becomes more difficult to control/ hedge third-party advertising expenditures. For example, here's the **5-yr chart** for the US \$ vs. the British pound:

1 USD = 0.6203 GBP +0.00031 (0.050%)

Jul 15, 8:00PM GMT+00:00



Until the financial crisis of 2008, the dollar was headed lower. Then came the restructuring of the banking system, large fiscal stimulus packages across the globe, and a stronger dollar. Google should have received more credit in 2009 and 2010 for effectively managing their international currency exposure, and analysts should adjust their gross margin growth expectations based on the international revenue/ cost mix.

Gross margins for Google are lower, but still terrific. Operating margins are also lower (nearly 300 basis points). While both grew (gross profits grew 34% and op income grew 22%), net income grew faster (36%). Why? Here's a chart that shows the growth of "below the [operating income] line" for Google:

(\$millions)	31-Mar-09	30-Jun-09	30-Sep-09	31-Dec-09	31-Mar-10	30-Jun-10	30-Sep-10	31-Dec-10	31-Mar-11	30-Jun-11
Spread between income bef. Taxes, Op. income	0.3%	-1.0%	-0.3%	3.5%	0.7%	2.9%	6.6%	5.4%	3.4%	7.1%
Total income bef. Taxes growth					\$ 616	\$ 578	\$ 647	\$ 573	\$ 386	\$ 651
Total growth driven by interest income, other					\$ 12	\$ 87	\$ 174	\$ 72	\$ 78	\$ 135
Percentage of income growth driven by interest/ other					1.9%	15.1%	26.9%	12.6%	20.2%	20.7%

Yes, 21% of Google's net income growth occurred because they earned a return on their trove of \$39 billion in cash and marketable securities. The spread between their operating margin and their profit before taxes margin is over 7%. Google is becoming a better banker. **And \$39 billion in the bank provides enough minty-fresh toothpaste to make any product "toothbrush" a hit.**

The hits keep coming for Google – 50 million Android mobile operating system activations in the quarter (550,000/ day), 10 million active Google+ users in a few short weeks, and a 160 million Chrome user base all have a lot of room to grow. No doubt Google + will hit 100 million users, but can it match G-Mail's user base?

Google's on a groove. It's been on one since the end of last year. Can it manage to integrate each of their burgeoning bases? That's what their customers and shareholders expect. More on the Android impact on Verizon and AT&T in our earnings analysis next Sunday.

Now for 5 you may have missed:

1. Where are developers spending their time? The new report from Flurry suggests it's Apple's iOS platform, not Android. [More here](#) in the article from Ars Technica.
2. 4G Network interoperability? Not with Verizon's network, according to this [new report from PC Magazine](#).
3. In the personnel camp, [Sam Howe left Time Warner Cable very abruptly last week](#), and his CMO replacement will be Jeff Hirsch. More from Multichannel News. Best wishes to both.
4. The former CFO of Sprint, Bob Brust, is joining the Board of [Smith and Wesson](#), well known for its weaponry. More in the [announcement](#). (Add your own caption).
5. Virgin Mobile appears ready to duplicate T-Mobile's data throttling practice, according to this recent article from the [Wall Street Journal](#). Beyond Talk is still the best value for basic users in the telecom space.

Got a few headlines ready for Mobile Symmetry as well. Don't forget to download our new Android app (search on Mobile Symmetry or Mobsym). Also, I am on Google + as James Patterson if you are looking for someone to connect to (or need an invitation). Stay cool this week!

Jim

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