Company Update BUY

Equity | United States | Internet/e-Commerce
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Bank of America Merrill Lynch

Changes to most valuable real estate on the Web

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Three changes that could drive better monetization

Summer (usually August) is when Google has introduced changes to the site to increase monetization, and this year is no exception. We have noted three changes this year that could serve to increase revenues on a sequential and y/y basis on Google.com: 1) moving text ads to the right side of the page closer toward free listings, 2) introducing product ads in sponsored search results (still in test mode), and 3) adding video trailers to sponsored search results (for movies). We see these initiatives as biggest potential YTD monetization changes in 2009. (Please see screen shots within this report for more detail.)

Should help with paid clicks, and potentially CPCs

Moving text ads closer to center of the page should increase paid click rates (one SEM said by 10% in an early test), and making product ads more appealing with pictures could do the same. Also, product ad pictures and video trailers have better branding value and offer consumers better product information up front, which could benefit conversions and CPCs. The product ads are still just being tested on a few searches, but we think have the most potential long-term impact.

Reiterate Buy, more confidence in our above Street ests.

We see ad changes as some of the biggest monetization steps Google has taken this year and could lead to q/q and y/y revenue improvement. We expect 5% y/y net revenue growth in 3Q ($70mn above street), and 12% growth in 4Q ($150mn above Street), driven by normal q/q search spending trends and FX. We believe the street is underestimating the revenue recovery potential in the model and any monetization improvements would be potential upside to our estimate. Each 1% improvement in 4Q search monetization could generate ~$40mn/$0.09 in additional 4Q rev/EPS, and we think the text ad movement could be worth a few hundred basis points, while the product ads have bigger long-term potential.

Stock Data

Price	US$445.28
Price Objective	US$510.00
Date Established	17-Jul-2009
Investment Opinion	C-1-9
Volatility Risk	HIGH
52-Week Range	US$247.30-510.00
Mrkt Val / Shares Out (mn)	US$140,920 / 316.5
ML Symbol / Exchange	GOOG / NAS
Bloomberg / Reuters	GOOG US / GOOG.OQ
ROE (2009E)	22.3%
Total Dbt to Cap (Dec-2007A)	0%
Est. 5-Yr EPS / DPS Growth	30.0% / NA

Estimates (Dec)

(US$)	2007A	2008A	2009E	2010E	2011E
EPS	15.59	19.49	22.09	25.32	28.22
GAAP EPS	13.29	13.49	19.14	21.73	24.24
EPS Change (YoY)	47.2%	25.0%	13.3%	14.6%	11.5%
Consensus EPS (Bloomberg)			21.72	24.73	28.20
Dividend Rate	0	0	0	0	0

Valuation (Dec)

	2007A	2008A	2009E	2010E	2011E
P/E	28.6x	22.8x	20.2x	17.6x	15.8x
GAAP P/E	33.5x	33.0x	23.3x	20.5x	18.4x
Dividend Yield	0%	0%	0%	0%	0%
EV / EBITDA*	18.3x	13.5x	11.8x	10.3x	9.4x
Free Cash Flow Yield*	2.4%	3.9%	5.3%	5.6%	6.1%

* For full definitions of *iQmethod* SM measures, see page 6.

Quarterly Earnings Estimates

	2008	2009
Q1	4.84A	5.16A
Q2	4.63A	5.36A
Q3	4.92A	5.45E
Q4	5.10A	6.12E

Refer to important disclosures on page 7 to 9. Analyst Certification on Page 5. Price Objective Basis/Risk on page 5. 10863778

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iQprofile SM Google Inc

iQmethod SM – Bus Performance*

(US$ Millions)	2007A	2008A	2009E	2010E	2011E
Return on Capital Employed	24.0%	21.4%	21.3%	19.9%	18.5%
Return on Equity	24.8%	24.3%	22.3%	20.8%	19.2%
Operating Margin	43.6%	42.4%	46.2%	46.1%	46.2%
Free Cash Flow	3,373	5,494	7,485	7,915	8,544

iQmethod SM – Quality of Earnings*

(US$ Millions)	2007A	2008A	2009E	2010E	2011E
Cash Realization Ratio	1.2x	1.3x	1.2x	1.2x	1.2x
Asset Replacement Ratio	2.5x	1.6x	0.7x	1.1x	1.5x
Tax Rate	25.9%	28.0%	23.2%	24.0%	24.0%
Net Debt-to-Equity Ratio	-26.8%	-30.7%	-45.4%	-55.5%	-61.9%
Interest Cover	NA	10.1x	NA	NA	NA

Income Statement Data (Dec)

(US$ Millions)	2007A	2008A	2009E	2010E	2011E
Sales	11,660	15,858	17,127	19,339	21,769
% Change	59.8%	36.0%	8.0%	12.9%	12.6%
Gross Profit	9,967	13,215	14,412	16,301	18,334
% Change	55.8%	32.6%	9.1%	13.1%	12.5%
EBITDA	6,921	9,347	10,730	12,272	13,483
% Change	50.8%	35.1%	14.8%	14.4%	9.9%
Net Interest & Other Income	590	(778)	33	295	395
Net Income (Adjusted)	4,929	6,189	7,037	8,152	9,254
% Change	50.4%	25.6%	13.7%	15.9%	13.5%

Free Cash Flow Data (Dec)

(US$ Millions)	2007A	2008A	2009E	2010E	2011E
Net Income from Cont Operations (GAAP)	4,203	4,283	6,097	6,997	7,949
Depreciation & Amortization	968	1,500	1,614	1,898	1,766
Change in Working Capital	319	232	(207)	(99)	(230)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	286	1,838	1,105	1,179	1,634
Capital Expenditure	(2,403)	(2,358)	(1,124)	(2,060)	(2,576)
Free Cash Flow	3,373	5,494	7,485	7,915	8,544
% Change	101.1%	62.9%	36.2%	5.7%	7.9%

Balance Sheet Data (Dec)

(US$ Millions)	2007A	2008A	2009E	2010E	2011E
Cash & Equivalents	6,082	8,657	15,841	24,130	32,692
Trade Receivables	2,163	2,642	3,000	3,379	3,790
Other Current Assets	9,045	8,879	9,275	9,385	9,515
Property, Plant & Equipment	4,039	5,234	5,091	5,387	6,013
Other Non-Current Assets	4,007	6,356	5,780	5,780	5,780
Total Assets	25,336	31,768	38,987	48,061	57,790
Short-Term Debt	0	0	0	0	0
Other Current Liabilities	2,036	2,302	2,546	2,969	3,314
Long-Term Debt	0	0	0	0	0
Other Non-Current Liabilities	611	1,227	1,569	1,614	1,659
Total Liabilities	2,646	3,529	4,115	4,583	4,973
Total Equity	22,690	28,239	34,871	43,478	52,817
Total Equity & Liabilities	25,336	31,768	38,987	48,061	57,790

* For full definitions of *iQmethod* SM measures, see page 6.

Company Description

Google (GOOG), a well-branded search engine, was founded in 1998 by Larry Page and Sergey Brin. Google quickly became a top search engine via word of mouth and went public on August 18, 2004 at $85/sh. The company generates over 98% of its revenues from online search advertising and is the industry leader in this form of online advertising. The company's mission is to enable web users to find the world's information on the Internet.

Investment Thesis

Google is a leader in Online advertising, and is gaining share, which should drive a premium valuation. We see share appreciation in opportunities afforded by its emerging display network business, YouTube monetization, and a potential reacceleration of core growth if/when the macro-environment improves. Google should begin to generate significant revenues from alternative sources beyond search this year with display advertising and YouTube monetization the biggest near-term opportunities.

Stock Data

Average Daily Volume	3,000,791

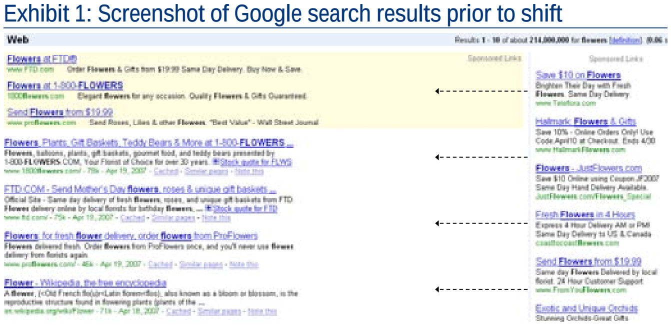
Three changes that may improve monetization

The summer period (August) is when Google usually introduces changes to the site to increase monetization, and this year appears to be no exception. We have noted three changes that could serve to increase monetization on a sequential and y/y basis on Google.com: 1) shifting sponsored links from the right side of the page closer in towards the center of the page, 2) introducing product ads within sponsored search links (still in test mode), and 3) adding movie trailers to sponsored search links. We see ad changes as some of the biggest monetization steps Google has taken this year and could lead to q/q and y/y revenue improvements in 4Q.

1) Shifting sponsored links inward

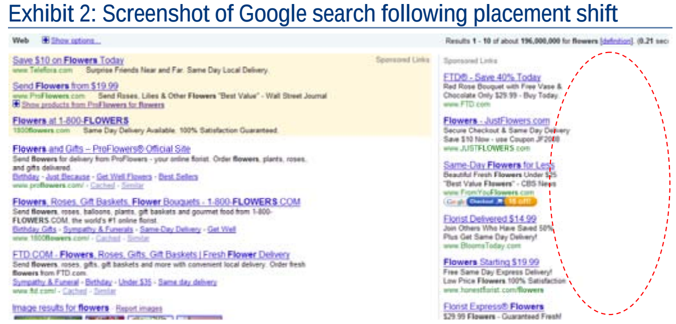
Google shifted the area containing sponsored links inward slightly, effectively decreasing the amount of blank space between organic search results and sponsored links (see Exhibit 1). The downside is that the integrity of fee (organic) results could be affected, with the upside being more paid clicks. One SEM (The Search Agency) reported that it was seeing an early 10% lift in click-through rates on sponsored ads, although we wouldn't expect this rate of improvement to be sustainable.

Exhibit 1: Screenshot of Google search results prior to shift



Source: google.com

Exhibit 2: Screenshot of Google search following placement shift

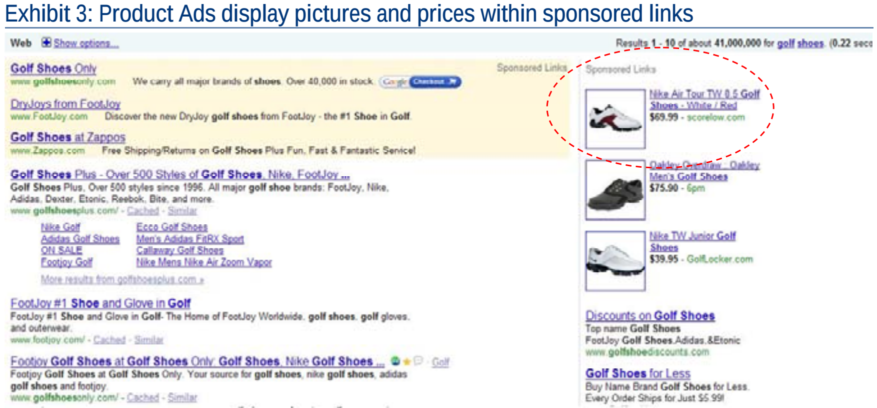


Source: google.com

2) Product ads in search results

Google is testing a new ad format called Product Ads which will display both pictures and prices of products within sponsored search links on the right side of the search results page. These images could get higher click-throughs and command a higher CPM if conversion rates increase, and we see this change as having biggest long-term potential for Google to increase value of advertising.

Exhibit 3: Product Ads display pictures and prices within sponsored links

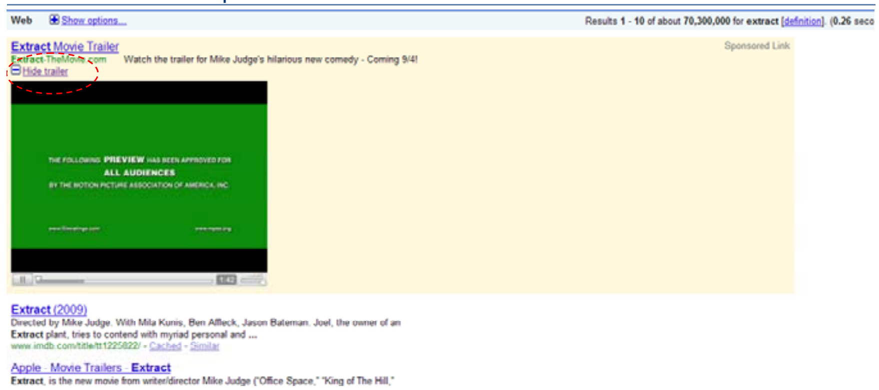


Source: google.com

3) Video clips in movie search results

Google is enabling advertisers to include video clips such as movie trailers within sponsored ads. Users can click the ad to expand a video player. Although limited to a few verticals, we think video ads in search results have much higher value to advertisers and could driver higher CPCs.

Exhibit 4: Users can expand search results to view movie trailers

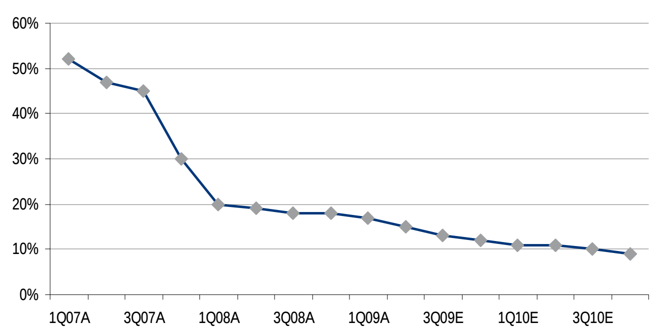


Source: google.com

Changes should help with paid clicks, and potentially CPCs

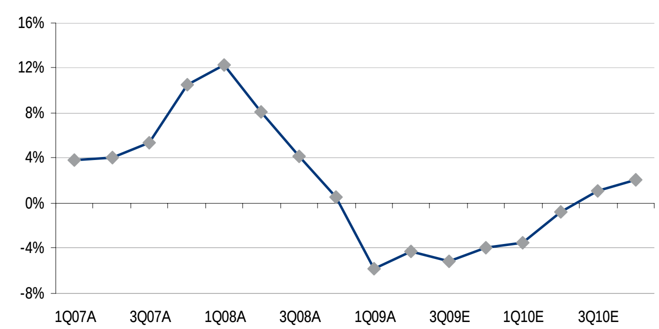
Moving text ads closer to center of the page should increase paid clicks, and making product ads more appealing with pictures could do the same. Also, product ad pictures and video trailers have better branding value and offer consumers better product information up front, which should benefit conversions and CPCs. We see the changes potentially benefiting our 12% paid click growth estimate for 4Q, and we also see upside to the 4% decline in CPCs (ex-currency and hedging) we expect in 4Q. CPC comps get much easier in 2010.

Chart 1: Y/Y Paid Click Growth



Source: Banc of America securities – Merrill Lynch research estimates, company reports

Chart 2: Y/Y Change in CPCs (Ex-FX and hedging)



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Reiterate Buy, more confidence in our above street ests.

We see ad changes as some of the biggest monetization steps Google has taken this year and could lead to q/q and y/y revenue improvement. We expect 5% y/y growth in 3Q ($70mn above street for net revenue), and 12% growth in 4Q ($150mn above street), driven by normal q/q consumer spending trends and FX. We believe the street is underestimating the revenue recovery potential in the model and any monetization improvements would be potential upside to our estimate. Each 1% improvement in 4Q search monetization could generate ~$40mn/$0.09 in additional 4Q rev/EPS, and we think the text ad movement could be worth a few hundred basis points, while the product ads have big long-term potential.

For 2009 we are at adjusted EPS of $22.09 vs. Street at $21.71, and for 2010 we are at $25.32 vs. Street at $24.70.

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Price objective basis & risk

Google (GOOG)

Our price objective is $510, representing 20x our PF 10E EPS estimate of $25.32. We believe a 20x multiple is reasonable, representing a 1.3x P/E/G relative to our 16% 3-year CAGR assumption, within the historical trading range of premier large cap. technology companies. Additionally, we believe some multiple expansion is possible as Google starts comping against the worst of the recession in 4Q and 1Q10, and confidence in a reacceleration as the economy recovers grows. Risks to our PO are 1) revenue growth pressure from competitor initiatives, saturation of key markets, and consumer cyclicality, and 2) margin pressure from increased investment spending, and 3) competitive efforts by Microsoft. The stock has been subject to heavy volatility in the past based on revenue growth trends and this volatility could increase due to economic uncertainty.

Analyst Certification

I, Justin Post, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

US-Internet Coverage Cluster

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	Digital River, Inc.	DRIV	DRIV US	Nat Schindler
	Electronic Arts	ERTS	ERTS US	Justin Post
	Expedia	EXPE	EXPE US	Justin Post
	Google	GOOG	GOOG US	Justin Post
	GSI Commerce, Inc.	GSIC	GSIC US	Nat Schindler
	priceline.com	PCLN	PCLN US	Justin Post
NEUTRAL				
	Amazon.com	AMZN	AMZN US	Justin Post
	eBay	EBAY	EBAY US	Justin Post
	eHealth	EHTH	EHTH US	Justin Post
	OpenTable, Inc.	OPEN	OPEN US	Justin Post
	Take-Two Interactive	TTWO	TTWO US	Justin Post
	Yahoo!	YHOO	YHOO US	Justin Post
UNDERPERFORM				
	IAC InterActive	IACI	IACI US	Justin Post
	Netflix, Inc.	NFLX	NFLX US	Nat Schindler
	Overstock.com	OSTK	OSTK US	Justin Post
	THQ Inc	THQI	THQI US	Justin Post

iQmethod SM Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	NOPAT = (EBIT + Interest Income) * (1 - Tax Rate) + Goodwill Amortization	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	EV = Current Share Price * Current Shares + Minority Equity + Net Debt + Other LT Liabilities	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

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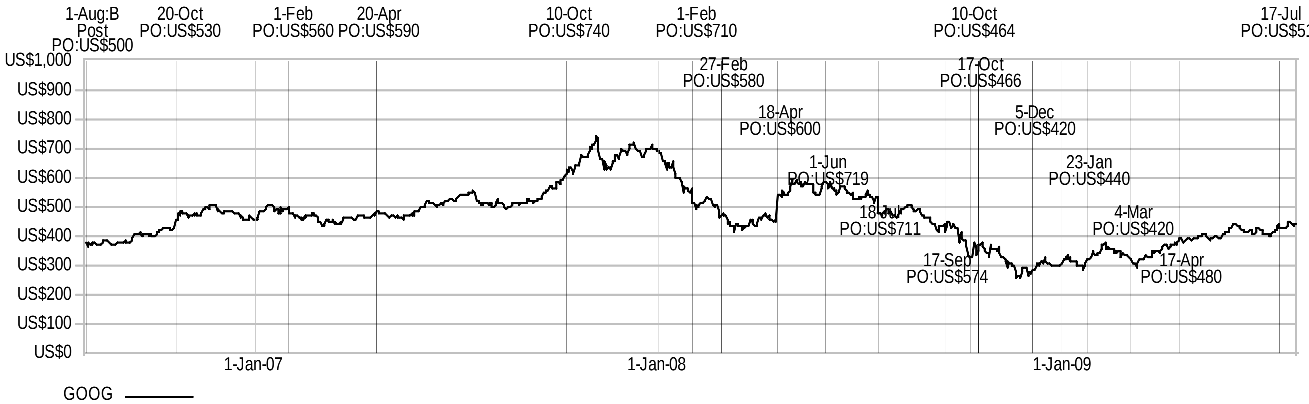
GOOG Price Chart



B : Buy, N : Neutral, S : Sell, U : Underperform, PO : Price objective, NA : No longer valid

"Prior to May 31, 2008, the investment opinion system included Buy, Neutral and Sell. As of May 31, 2008, the investment opinion system includes Buy, Neutral and Underperform. Dark Grey shading indicates that a security is restricted with the opinion suspended. Light grey shading indicates that a security is under review with the opinion withdrawn. The current investment opinion key is contained at the end of the report. Chart is current as of July 31, 2009 or such later date as indicated. BAS-ML price charts do not reflect analysts' coverage of the stock at prior firms. Historical price charts relating to companies covered as of July 31, 2009 by former Banc of America Securities LLC (BAS) analysts are available to BAS clients on the BAS website."

Investment Rating Distribution: Technology Group (as of 01 Jun 2009)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	85	39.53%	Buy	43	55.84%
Neutral	45	20.93%	Neutral	26	66.67%
Sell	85	39.53%	Sell	30	38.46%

Investment Rating Distribution: Global Group (as of 01 Jun 2009)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1303	40.83%	Buy	602	51.10%
Neutral	807	25.29%	Neutral	362	51.49%
Sell	1081	33.88%	Sell	394	39.96%

* Companies in respect of which MLPF&S or an affiliate has received compensation for investment banking services within the past 12 months. For purposes of this distribution, a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

* Ratings dispersions may vary from time to time where BAS-ML Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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