This article is excerpted from a client call transcript featuring MOI Global instructor Sean Stannard-Stockton, president and chief investment officer of Ensemble Capital.

I'm going to talk about our investment in Alphabet, the holding company that controls Google. While the company has moved into a lot of areas outside of just search advertisements, 20 years after its founding the core of the Google profit machine is still its ad business. As Larry Ellison first put it all the way back in 2006, Google is "a one-trick pony, but it's a hell of a trick." What's amazing is how steady the growth of Google's ad business has been even in the face of massive changes to the internet, most importantly the shift to mobile computing. We believe the key metric for investors to track Google's ad business is to look at the rate of growth of currency neutral ad revenue net of traffic acquisition costs. This is basically the amount of money Google collects from all of their ad products after subtracting the amount they pay to acquire traffic on their sites. For instance, when you search for something on your iPhone the results you get are Google results. This is because Google pays Apple to make them the default search engine on Apple's iPhones. Amazingly, since 2016, the company has reported average growth in this key metric of 20% with every quarterly report showing growth of between 17% and 23%. In fact, over half of all quarterly reports have seen this metric increase by within 1% above or below the 20% average.

High growth companies aren't supposed to exhibit this sort of stability. But think about what drives growth for Google. The most important demand driver is the time people spend online. While many tech companies offer discretionary products that see variable demand and can see abrupt declines when the economy weakens, we would posit that time spent online is more of a consumer staple type behavior. In good times and bad, people around the world are turning to Google products to answer their questions. The persistent nature of this high level of growth is remarkable and has been instrumental in driving up the intrinsic value of Alphabet.

That growth is partly being driven by YouTube. With over 5 billion YouTube videos viewed every day and growing, the ad opportunity is huge. Depending on your own use of YouTube, you may not fully appreciate the power of this platform. While famous for viral cat videos and the like, YouTube is effectively the default global video platform for non-TV type content. With more and more time spent online consuming video, YouTube is in the pole position to benefit. While paid subscription products like Netflix may be a better business model for curated quality content such as TV and movies, the ad-supported YouTube format is far superior for short form, non-narrative content.

Interestingly Google does not break out the standalone financials of YouTube, leaving the investment community to guess at how profitable it currently is. Many investors believe that YouTube is currently less profitable than Google overall and yet as they grow, they will become more profitable, leading to longer, faster profit growth than might be apparent at first glance. While we are somewhat ambivalent about the validity of this thesis, primarily because we think YouTube fueled profit growth is needed to offset other parts of Google's business slowing and so is not strictly additive to corporate growth, we do think that the breaking out of YouTube's financials is going to occur before too long and it may have a dramatic positive impact to investors understanding of Google’s long-term prospects.

YouTube isn’t the only part of Alphabet that may have more value than generally appreciated. When they formed Alphabet, they created two subsegments, Google and what they refer to as Other Bets. The Other Bets group contains what Google historically called Moonshots, such as Waymo, their self-driving car business, Fiber and Loon, their internet access businesses and Verily, their health sciences business. Today, the Other Bets segment is losing approximately $4 billion a year. But when I say “losing” I mean they are burning this amount of cash as they seek to build profitable businesses. Today, the existence of Other Bets inside of Alphabet reduces the company’s reported earnings by about 10%.

So, Alphabet could boost current earnings by 10% by simply shutting down Other Bets. Of course, that would be a mistake. Any reasonable investor knows that Waymo in particular, but the other parts of Other Bets as well, have significant value. So, in thinking about the value of Alphabet, you need to remove the currently money losing Other Bets segment, value Google as a standalone business without the Other Bets losses and then add to that whatever you think the value of Other Bets is.

Of course, the value of Other Bets is highly uncertain. We’ve seen some investors talk about the value of Alphabet in relation to a PE multiple it should trade at. But given the negative earnings of Other Bets, this methodology implicitly values Other Bets as a liability. Believe me, there is a wide range of venture capitalists who would happily take ownership of Other Bets and so it is clearly not a liability. We’re also seen some analysts attribute as much as a $100 billion of value to Waymo alone. While Waymo is very valuable, in our view, on a probabilistic basis, $100 billion is way too high of an estimate. It could be worth that much, but it could be worth much less. In fact, Waymo could even end up failing without ever earning a dollar of profit.

We estimate that after removing Other Bets’ losses and removing the excess cash that Google has on its balance sheet (not all of its cash, just that amount we believe is not required to run the company), Alphabet is trading at around 20x what we expect them to earn in 2019. Given the company’s growth rate and its strong returns on invested capital, we think the stock will perform well from these levels.

That being said, we do have two concerns about the company’s management. In general, we evaluate corporate management primarily on their ability to create value and their abilities in allocating excess cash flow. On the first question, Google excels. It is amazing that they have become one of the most valuable companies the world has ever seen just 20 years after they were founded. As I mentioned earlier, their services have become a required part of modern life, almost a form of oxygen for internet connected populations.

But in allocating their excess capital we have been less enthusiastic. While Google has been criticized in the past for the M&A they engage in, YouTube and DoubleClick are two hugely successful acquisitions with YouTube ranking as one of the smartest acquisitions in the internet age. But Google has now built such a war chest of cash that they clearly have more than they will ever need, and we think shareholders would be better served if the company began to pay a dividend, bought back stock and used more debt in their capital structure to finance more return of capital. We had hoped that Ruth Porat, the CFO they brought in from Morgan Stanley, would be instrumental in improving capital allocation. But after some initial positive signs, it seems that for whatever reason, Porat is no longer focused on making this happen.

The other management issue we're tracking is the company's relations with their employee base. For pretty much all of their history Google has been considered one of the very best places to work. They have pioneered much of what we think of as modern Silicon Valley corporate culture with an employee base that has been raving fans of the company. But last year, employee concerns around the company's work with the military and issues of gender equality and sexual harassment became flashpoints between management and employees. Of particular note to us was the various reports on the company paying large severance packages to key senior employees who were forced out after accusations of sexual harassment.

In our view, Google management's handling of these cases has not been good. We believe for the short-term health of their corporate culture and their long-term ability to attract the best and brightest employees, they must do better. By "do better" we mean behave in a way that satisfies their employee base and preserves the belief that Google is one of the best places to work for the smartest, most technically savvy people in the world. To the extent that the company is not able to manage employee relations constructively, our confidence in the long term success of the business would deteriorate and should we decide to exit our position, something we are not currently contemplating, it would be due to our assessment of the long-term health of the business, which is very much a function of the company maintaining a positive corporate culture.

Read the full transcript.

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