THE TEXAS HEDGE REPORT

Steven McIntyre and Todd J. Stein, CFA
www.texashedge.com

GRUDGE MATCH: GOOGLE VERSUS CHEVRON

We watched in amazement the other day as Google (ticker: GOOG) shares notched a new all-time high of 488 bucks and the company's market capitalization zoomed to over $150 billion. This made us ponder that there might be significantly better ways to spend $150 billion these days. This then led us to think about the possibility of putting on a "$150 billion market cap pairs trade".

Is there a pairing in the U.S. stock market whereby we could effectively short Google at a $150 billion market cap and go long a more reasonably priced asset with a roughly equivalent $150 billion market cap? This could of course also be accomplished by going long a basket of stocks whose market caps add up to $150 billion, but for simplicity's sake in tracking performance over the years, we wanted to choose just one long.

There are a number of quality $150 billion-ish market cap companies to choose from; but Chevron Corp. (ticker: CVX) has, at the time of this writing, nearly the exact same market cap as Google and couldn't represent a more stark contrast in terms of business and level of profits.

Our short search engine (GOOG) vs. long oil wells (CVX) pairs is set as of 11/14/06. We plan on revisiting the results of this pairs trade each year around this time to see if a clear victor emerges. Our guess is that one will.

Let us state our biases upfront:

- We use search engines daily. Google is the most used search engine around the office and at home, but we will step out with Yahoo! search and Clusty.com from time to time

- Chevron has the closest gas station to the office so it probably gets the majority of our refueling business. That said, when convenient, we will buy gas from Exxon, Shell, Valero, or any other variety that offers "pay at the pump"

- We are neither long nor short Google or Chevron and have no current plans to be

- We tend to hate tech stocks; though we are from Texas we are usually not big fans of energy stocks either; however, our value bias would certainly push us more towards owning Chevron than Google

- We think there is a not insignificant chance that Microsoft may make Google into a Netscape-like casualty over time

- Though not in the "Peak Oil" camp, we do believe that the low hanging fruit in terms of oil production has already been picked – this likely means that the days of cheap oil ($20-$30 per barrel) are behind us

With our biases laid out, we have constructed a "tale of the tape" for our two opponents below. From this tale of the tape we can see that Google has age on its side at only 10 years old versus feeble old man Chevron at 95 years young. However, Chevron has a definite weight advantage as Google's employee base is fewer than 10,000 (though growing rapidly) and Chevron's is some 59,000 strong. Given recent stock market performance, Google is the reigning champ with Chevron the journeyman challenger.

Tale of the Tape

	Reigning Champ	***vs.***	***Challenger***
Name	**Google Inc.**		**Chevron Corp.**
Ticker	GOOG		CVX
Hometown	Mountain View, CA		San Ramon, CA
Year of Birth	1996		1911
Age	10		95
Employees	9,378		59,000
Reach	Global		Global
Shares	Issuing		Buying Back
(billions)			
Market Cap	$151.6		$154.0
Trailing Sales	$9.3		$202.9
Trailing EBITDA	$4.1		$40.1
Trailing OI	$3.1		$33.1
Trailing NI	**$2.4**		**$17.5**
Trailng OCF	$3.3		$24.5
Trailng FCF	$1.5		$11.7
Dividend Yield	0.0%		3.0%
Earnings Yield	1.6%		11.4%
Price/Sales	16.3		0.76
Price/EBITDA	37.4		3.8
Price/OI	49.6		4.7
P/E ttm	62.6		8.8
P/E forward est.	35.8		9.3
Price/FCF	98.0		13.2
Cash & Inv.	$8.0		$12.3
Debt	$0.0		$10.4
Net Cash	$8.0		$1.9
Tangible BV	$9.1		$64.9
Price/ Tang. BV	16.6		2.4
ROA	17.76%		15.84%
ROE	20.86%		26.98%

The most staggering stats from above are without a doubt the sheer size difference in these two companies. Chevron has $17.5 billion in trailing net income to Google's $2.4 billion. For roughly the same market cap, Chevron pays out annually nearly twice Google's net income in dividends alone! Google certainly has earnings growth momentum on its side, but keep in mind just how much growing Google has to do to increase earnings over 7x to match Chevron.

If we were to give you the following choices without labeling the specific company, which would most rational people choose?

$150 billion cost – Pick choice A or B:

a) **Old Economy Company**

This company has been around for 95 years, employs nearly 60,000 people all over the world and has one of the top 3 or 4 brands in the upstream and downstream operations of oil and natural gas in the U.S. **The company has $203 billion (that is billion with "b") in trailing sales, $33.1 billion in operating income, $24.5 billion in operating cash flow, and $17.5 billion in net income.**

Income Statement (mil)		
Year	Sales	EBIT
2001	$ 104,409	$ 8,291
2002	$ 98,340	$ 4,100
2003	$ 119,575	$ 12,676
2004	$ 150,865	$ 20,551
2005	$ 193,641	$ 25,197
2006 - ytd 9 mo.	$ 164,372	$ 25,772
LTM	**$ 202,880**	**$ 33,100**

The company is profitable nearly every year (even in poor years like 2001-2002) and is currently paying out $4.5 billion to shareholders in dividends each year. It is relatively certain that absent a tremendous sustained spike in oil (which would be a medium term boon to the company) that it will maintain its leadership status in the energy industry for many years to come. The company's sheer size and established physical footprint provides a significant moat around its business. The emerging markets' demand for oil, particularly Asian, should continue to grow rapidly over the next decade, though there will likely be the occasional set-back from time to time when places like India and China get overextended. Global supply for black gold and natural gas also appears fairly constrained over the coming years. The company has about $2 billion in net cash, a huge free cash flow stream, and is actively buying back its shares in the open market and reducing share count.

or

b) **Rapidly Growing Tech Company**

Since the company first started generating revenues of any meaningful sort in 1999, it has grown like wildfire. It has established itself as by far the leading brand in Internet search and is rapidly trying to expand its offering of news, stock quotes, maps, and other content to become the leading traffic generator on the web. The balance sheet is pristine with $8 billion of net cash as of the latest quarter. Management has eschewed the quarterly guidance non-sense - which we like. However, they are selling stock hand over fist in the open market and seem to have a taste for company party planes and other wastes of money whether it is shareholders' or their own. A recent acquisition though of an interesting nature is likely to bring a slew of lawsuits.

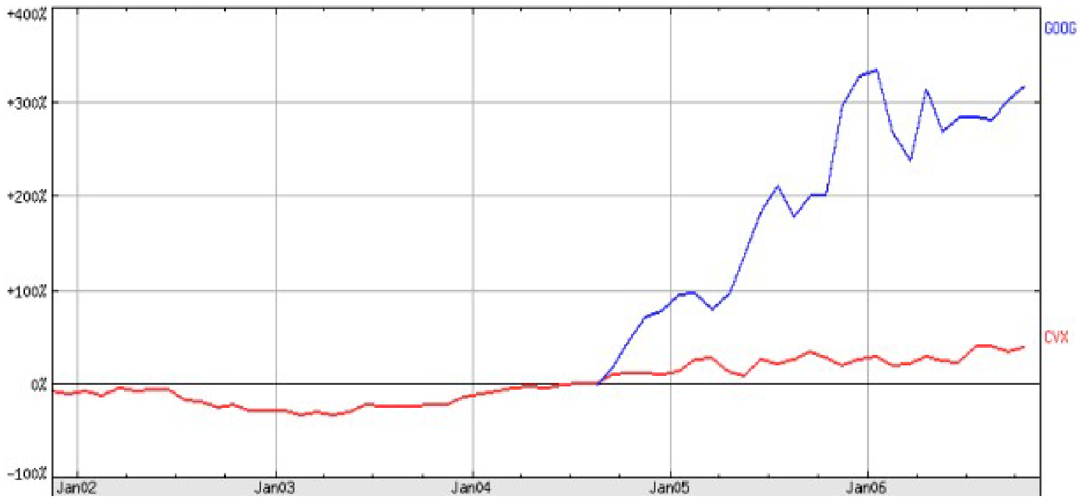
The company's financials are impressive. Though not of nearly the size in choice A, they do offer much higher growth off a smaller base. **Trailing sales register $9.3 billion, trailing operating income $3.1 billion, trailing operating cash flow of $3.3 billion, and trailing net income of $2.4 billion.** The company's margins are very strong and getting better.

Income Statement (mil)		
Year	Sales	EBIT
1998	n/a	n/a
1999	$ 0.2	$ (6.1)
2000	$ 19.1	$ (14.7)
2001	$ 86.4	$ (10.1)
2002	$ 439.5	$ 184.9
2003	$ 1,465.9	$ 346.7
2004	$ 3,189.2	$ 650.2
2005	$ 6,138.6	$ 2,141.7
2006 - ytd 9 mo.	$ 7,399.4	$ 2,489.4
LTM	**$ 9,320.0**	**$ 3,059.0**

Competition and the moat around this company's business is perhaps the hardest aspect to ascertain. One could make an intelligent argument that the company has a sort of "first mover" advantage in search and has created a dominant brand in Internet search and that Internet traffic on their site will continue to grow rapidly for many years to come driving advertising revenues to new heights and enabling the company to further expand its web footprint and garner a larger share of people's eyeballs in multitude of applications while computing. However, one could make an equally intelligent argument that Internet search leaders have already changed rapidly since the dawning of the relatively new industry and that the stickiness of customers (in what is largely a commoditized product) is weak. A company like Microsoft may be able to leverage its monopoly on the PC operating system and web browser to direct traffic to their internet searches, maps, and other goodies simply because of no other fact than convenience and that they are in a position to control default destinations. Oh, and Microsoft has one of the largest cash hoards and free cash flow streams on the planet to win over Internet search loyalty. Microsoft is attempting to destroy this company as they have basically implied it as unspoken goal. Picking a fight with the toughest kid on the block may not be wise.

Despite $8 billion in net cash, the company has on several recent occasions issued more shares and has a not insignificant stock option overhang to deal with as well. If you have the greatest thing since sliced bread as a company, do you really keep piling on the dilution? We will also mention again that management is rapidly monetizing portions of their stake in the company.

Only in the manic depressive stock market would this even be a contest. Imagine if you will a billionaire with 150 billion bucks burning a whole in his pocket. He could buy all of a company A above or all of company B. The only stipulation is that given the size of his investment and tax implications, he is unlikely to sell for at least 10 years. We think choice A would be selected by the overwhelming majority of private market investors if not all. However, as you can see from the chart below, for the better part of the last two years, stock market investors are illogically choosing choice B.



We think this temporary insanity is just that – temporary. Google trades at 50x operating profits and Chevron trades at less than 5x! Google trades at 63x trailing net income and Chevron 9x. Google trades at 36x forward earnings and Chevron is again 9x. Google is diluting shareholders constantly and pays no dividend. Chevron pays a 3% dividend and is buying back shares. **But most importantly, Google's competitive position appears far more tenuous than Chevron's.** We want relative certainty when making an investment decisions. We are relatively certain that 5 and 10 years from now we will be filling up at Chevron gas stations that are pumped with Chevron explored, discovered, pipelined, and refined oil. We are however not certain at all who, if anyone, will be making money off internet search and news services several years out. The price for Google is simply too steep and we think that before all is said and done, a $50 to $100 billion divergence in Google and Chevron's market cap is not out of the question.