Samsung & Google

Gorilla war

- There is no money in Android…it is all in the ecosystem.
- Samsung's ecosystem aims to preserve margins…but competes with Google.
- Google must preserve its ecosystem at all cost. Conflict with Samsung ensues.
- Google benefits from civil war inside Samsung to deliver a crushing victory.
- Samsung's profits will now decline while Google's continue to grow.
- Samsung unattractive. Google looking good.

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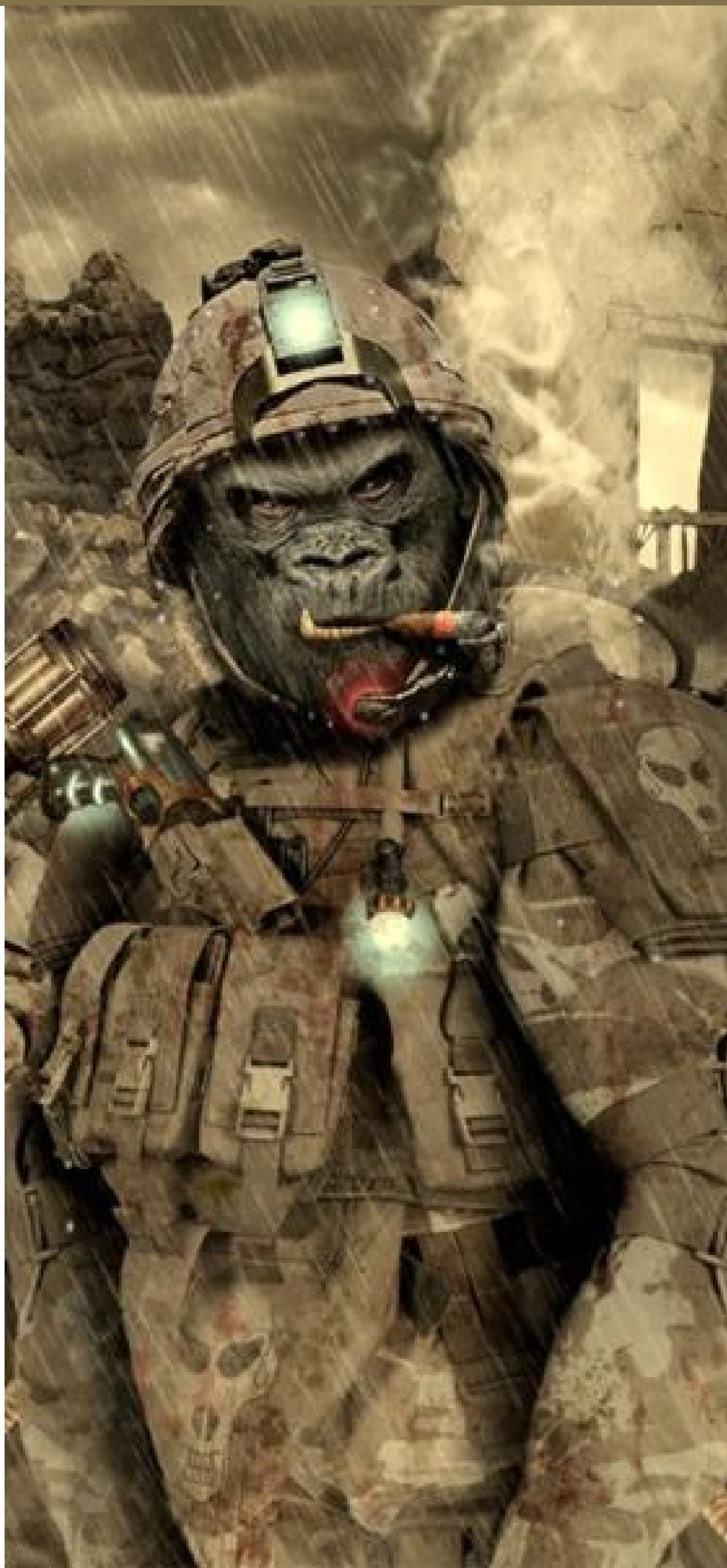
27th May 2014



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There is no money in Android. The value is in the ecosystems that sit on top of it. Samsung has mistakenly assumed that it can maintain its 18% handset margins by focusing on hardware. Consequently, it has been willing to cede complete control of the ecosystem to Google. This has ensured that Google will grow nicely driven by mobile advertising revenues while Samsung experiences declining earnings. RFM believes that holdings in Google should be increased, financed by holdings in Samsung.

- **Android**. No one except for Samsung makes good money in Android devices. Samsung has hardware differentiation, scale and brand but commoditisation will take its toll. Without scale or an edge in components or the ecosystem, an Android handset maker can hope for 3-5% EBIT margins in the best instance.
- **Gorillas** The two Gorillas in Android have been squaring off against each other for some time. Samsung's move to customise the Android user experience and to offer its own Digital Life services in competition to Google puts Google's revenues at risk. At the same time, Samsung has to move in this direction in order preserve handset differentiation from where a good part of its profits are derived.
- **Guerrillas.** The result has been a deteriorating relationship between the two over the last year. Recently, Google has been able to take advantage of indecision and conflict within Samsung to ensure its long term goals. The agreement of 27th January 2014 was really about the ecosystem and in the clandestine war; Google has by skill or by luck won a crushing victory against Samsung.
- **Samsung.** Samsung is a great company. It holds global leadership positions in handsets, memory, TVs and display panels. Handsets earn 18% EBIT margins and make up 70% of group EBIT. Ceding the ecosystem to Google and getting virtually nothing in return has all but guaranteed handset margins will decline over the next 4 years. Handset EBIT is so big that its decline will overwhelm growth elsewhere, leading to a contraction of earnings in the medium term. This is why RFM believes that there is 16% downside to the share price.
- **Google.** Mobile is the engine of growth at Google which is why it had to be secured at all costs. With Samsung out of its ecosystem, Google should now grow steadily over the medium term. Even with a hefty discount applied for shortcomings in corporate governance, RFM still sees 15% upside in Google shares.