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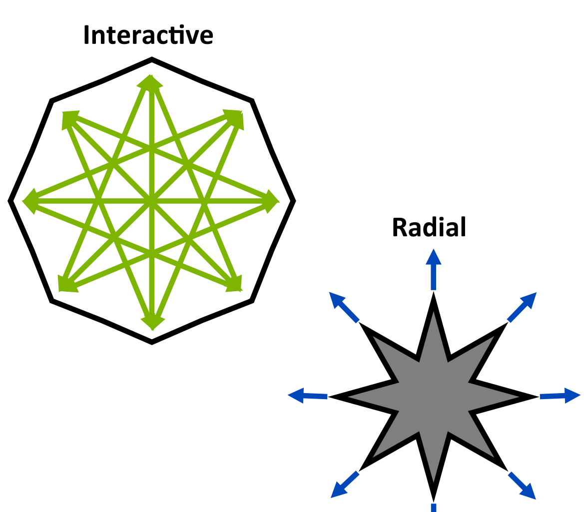
How Far Will Regulators Go With Big Tech?

From the internet to eCommerce to the iPhone, technology has become indispensable in how we consume content, purchase goods and services, and interact with one another. Have you binged the newest streaming series? Or, used an online platform to have this week's groceries dropped at your doorstep? Or liked the latest post from your second cousin you haven't spoken to in years? Technological developments over the last twenty years have delivered incredible services which have revolutionized our lives in many positive ways, and broadly changed the ways in which our society operates.

As well as being transformative, tech-oriented industries can often mature into winner-take-all scenarios. Factors such as network effects (Exhibit 1), the aggregation of consumers (and/or suppliers), cost advantages, and switching costs are common sources of sustained economic outperformance. Today we see a handful of dominant tech companies that have become so successful, and so able to grow and expand into adjacent industries, that

Exhibit 1: Interactive Networks Make For Stronger Network Effects than Radial Network



Source: United Capital Seattle

Source: mitsloan.mit.edu

the typical forces of competition are not driving down their profitability as is typical as companies mature.

While the arguments differ for each company, large technology companies today have incredibly high profitability, market power, are likely stifling the level of competition in various industries, and have wide-ranging influence on society as well. Along with the positive innovations, technology has also introduced completely new risks and challenges for both societies and individuals. Whereas you may no longer have to attend your family reunion to keep up with that odd cousin, you now have to worry about the security and encryption of emails you send. Privacy and data rights are topics separate from antitrust, but are just as important and top of mind. Ultimately, if these companies really are as powerful as they seem, some might take the view that "big tech" is in need of greater regulation.

That said, it's essential that any reimagining of tech regulation is based on evidence and a thoughtful discourse in Washington D.C. Both the topic generally, as well as criticisms of particular companies, have been politicized with unknown consequences. For instance, President Trump has been weighing in heavily (and likely driving policy) regarding how social networks police hate speech and "fake news." Additionally, he has inserted himself into the ongoing process to award the $10B Joint Enterprise Defense Infrastructure (JEDI) contract to one of the large cloud computing companies.[1,2] Unfortunately, it's likely too much to expect the tech industry to regulate itself. We worry that, despite sound thinking from some regulators, both Congress and the President could end up being impediments to effective future policies in this critically important area, by allowing a lack of objectivity to cloud policy implementation.

Tech Regulation Is Coming...

… and change is already afoot. Today there is a cacophony of declarations from pundits and presidential hopefuls that, with near uniformity, conclude that "something" must be done. Generally, politicians across the political spectrum widely agree that technology needs greater regulation. Driven by this backdrop, both the Department of Justice (DOJ) and Federal Trade Commission (FTC) have formally announced proceedings to investigate antitrust and anti-consumer behavior amongst the tech giants. The FTC's Bureau of Competition announced in February that it was creating a new task force dedicated to "monitoring competition in U.S. technology markets, investigating any potential anticompetitive conduct in those markets, and taking enforcement actions when warranted."[3] Along with the FTC, the DOJ has antitrust jurisdiction as well. The DOJ's antitrust head, Makan Delrahim, has made it clear that he believes antitrust action in digital spaces is not only the right thing to do, but that it's also important to spurring innovation.[4]

We would take the position that most often competition either resolves market concentration issues on its own, or regulatory intervention takes so long that it's no longer effective by the time it's put in place. For example, in US vs. Microsoft it took years for the DOJ to file its lawsuit, courts to order the breakup of the company, the appeals court to reverse that decision, and to finally see the DOJ and the company reach a settlement that changed some business practices.[5]

Whether or not Delrahim's claim that regulators can promote innovation is true, with the process started, we consider it very likely that at least some of the major tech companies will receive Civil Investigative Demands (CIDs), which initiate formal antitrust investigations. What actually results from those antitrust investigations is another story. According to Cowen & Co., only about 25% of CIDs have historically resulted in DOJ/FTC enforcement actions.[6] In sum, we think these events (along with mounting political pressure) will inevitably lead toward some sort of enforcement action, but likely nothing critically large.

Antitrust Frameworks Aren't Static

While antitrust authorities have been much more aggressive in Europe, doling out large fines and restrictions on various business practices for abusing market dominance, these actions have been based on a much broader European definition of antitrust.[7,8] Antitrust law in the United States has historically been driven by the "consumer welfare standard."[9,10] This standard focuses on market prices to determine the health of a market, and means that if consolidation results in enhanced products and equal prices, it is less problematic than if a company raised prices as a result. Within that framework, it's generally harder to regulate a service such as search, which undeniably delivers an incredible service to consumers for no (direct) cost. We believe that it cannot be anyone's goal that consumers pay higher prices for inferior products and services.

Additionally, establishing that these businesses are monopolies depends on how you define the market they're monopolizing. Regardless of actual market power (which could be substantial), a company may, for example, have 50+% of online retail share that equates to just 6% of retail share in total. (See Exhibit 2.) If the market is defined as all of retail, the arguments which follow from defining the company as monopolistic in online retail disappear. In the end, these companies have power because people love what they do, not because consumers lack choice.

We think it follows, then, that the legal cases against big tech could be difficult to prove in court. Regardless, Delrahim made it clear in a recent speech that "price effects are not the sole measure of harm to competition under the U.S. antitrust laws." He continues by saying:

"The Antitrust Division does not take a myopic view of competition. Many recent calls for antitrust reform, or more radical change, are premised on the incorrect notion that antitrust policy is only concerned with keeping prices low. It is well-settled, however, that competition has price and non-price dimensions.

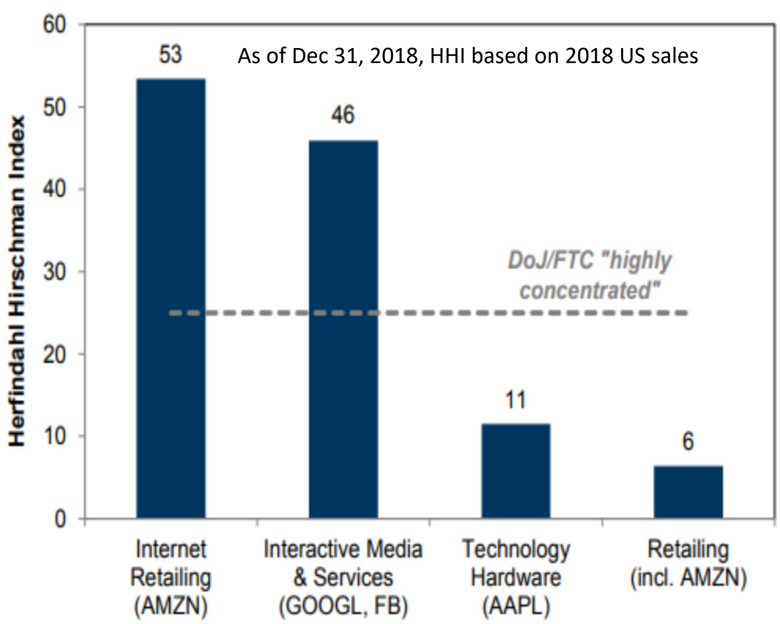
Price effects alone do not provide a complete picture of market dynamics, especially in digital markets in which the profit-maximizing price is zero. As the journalist Franklin Foer recently said, 'Who can complain about the price that Google is charging you? Or who can complain about Amazon's prices; they are simply lower than the competition's.' Harm to innovation is also an important dimension of competition that can have far-reaching effects. Consider, for example, a product that never reaches the market or is withdrawn from the market due to an unlawful acquisition. The antitrust laws should protect the competition that would be lost in that scenario as well."[11]

It appears that the DOJ of today is thoughtfully reviewing the ways in which technology needs to be scrutinized, believes in taking a holistic view of the topic, and sees the unique characteristics of each digital market. After reading this speech, it's hard not to conclude that the odds of some antitrust action being brought against one or more of the big tech companies appear quite likely.

This All Could Turn Out Well… In The End

We think it's early to expect breakups or material divestitures of businesses, but it's not too early to think about what those outcomes might mean for investors. Recent research titled "Tech Reg: A Case Study Approach to Examining the Impact of Government Intervention," Scott Helfstein and Sean O'Loughlin examined past US regulatory actions. They write: "A striking pattern emerges. Regulatory actions aimed at promoting competition actually had a series of tertiary repercussions that ultimately helped the existing entrenched players." Essentially, they found that government actions often have unintended consequences when rules which increase the costs of compliance ultimately constrain smaller companies which cannot afford to comply. For example,there are some who believe that the European Union General Data Protection Regulation (GDPR) actually hurt local competition. Mark Read, CEO of advertising giant WPP PLC said that "GDPR has tended to hand power to the big platforms because they have the ability to collect and process the data."[12] Most concerning, he continues, GDPR, "entrenched the interests of the incumbent, and made it harder for smaller ad-tech companies, who ironically tend to be European." In total, regulation often results in less competition and incumbents more able to raise prices, which, if you're paying attention, is exactly the opposite of the outcome these regulations are intending to provide. Heed Sir John Templeton's wisdom, "the four most dangerous words in investing are: *This time it's different.*"[13]

Exhibit 2: Current US Equity Market Industry Concentration



Source: Compustat, Goldman Sachs Global Investment Research

These Issues Are Reflected In Market Prices of Key Stocks

Holding large-cap tech stocks, which have outperformed broader indexes, has been very good to investors over the past decade.[14] While there are significant risks for sure, and we are sympathetic

MARKET STATS

S&P 500	2926
DOW JONES	26403
10 YR T-BOND	1.50%

As of 08/31/2019
Source: Bloomberg

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to these concerns and criticisms, we're not ready to conclude that these companies should be sold on the basis of coming regulation.

First, given that none of this is a surprise, these fears have been leaking into market prices for some time. Second, given the dominance of these companies, their cash flows, growth rates, and leadership, it's likely that most of those factors will largely continue unabated. Third, when considering these fundamental factors, we would argue that for the most part the companies in question are under-priced relative to their fundamentals. They're amazingly profitable and fast growing despite their size. Lastly, as we said above, a number of potential resulting scenarios such as a breakup could be positive or even unlock value by bringing attention to the stand alone businesses, resulting in even higher market values. We doubt that a wholesale breakup of big tech is likely.

While this story is in the early innings, we hold out hope that the regulation which comes about is good for competition, data rights, privacy, and the well-being of our society as a whole. It's possible that D.C. comes up with regulations which are both smart and limited. Yes, there will be twists and turns which will apply to each company in their own unique way, and we will be monitoring these stories closely. Regardless, we see a number of scenarios which would actually be beneficial to large-cap tech. The point is not that antitrust is a good thing, but companies with good profitability and a strong competitive position tend to do well over the long-term, even if constrained.

Footnotes:

1 https://www.nytimes.com/2019/08/02/us/politics/amazon-pentagon-contract-trump.html?searchResultPosition=2
2 https://www.cnn.com/2019/07/26/politics/oracle-trump-amazon-defense-contract-conspiracy/index.html
3 https://www.ftc.gov/news-events/press-releases/2019/02/ftcs-bureau-competition-launches-task-force-monitor-technology
4 https://www.justice.gov/opa/speech/assistant-attorney-general-makan-delrahim-delivers-remarks-antitrust-new-frontiers
5 Goldman Sachs, *Concentration, competition, and regulation: "Superstar" firms and the specter of antitrust scrutiny: July 11, 2019*
6 Cowen & Co, *Is D.C. Breaking Up With Big Tech?: June 4, 2019*
7 https://www.vox.com/policy-and-politics/2018/9/21/17887008/amazon-europe-antitrust-laws
8 https://www.mercatus.org/bridge/commentary/does-ftc-need-new-big-tech-task-force
9 https://stratechery.com/2019/where-warrens-wrong/
10 https://www.mercatus.org/bridge/commentary/does-ftc-need-new-big-tech-task-force
11 https://www.justice.gov/opa/speech/assistant-attorney-general-makan-delrahim-delivers-remarks-antitrust-new-frontiers
12 https://www.techdirt.com/articles/20190620/23360242441/another-report-shows-gdpr-benefited-google-facebook-hurt-everyone-else.shtml
13 https://www.investopedia.com/financial-edge/0511/the-top-17-investing-quotes-of-all-time.aspx
14 According to Bloomberg, for the decade ending August 31st, 2019, the S&P 500 Information Technology Sector GICS Level 1 Index returned 377.92% while the S&P 500 Index returned 240.12%.