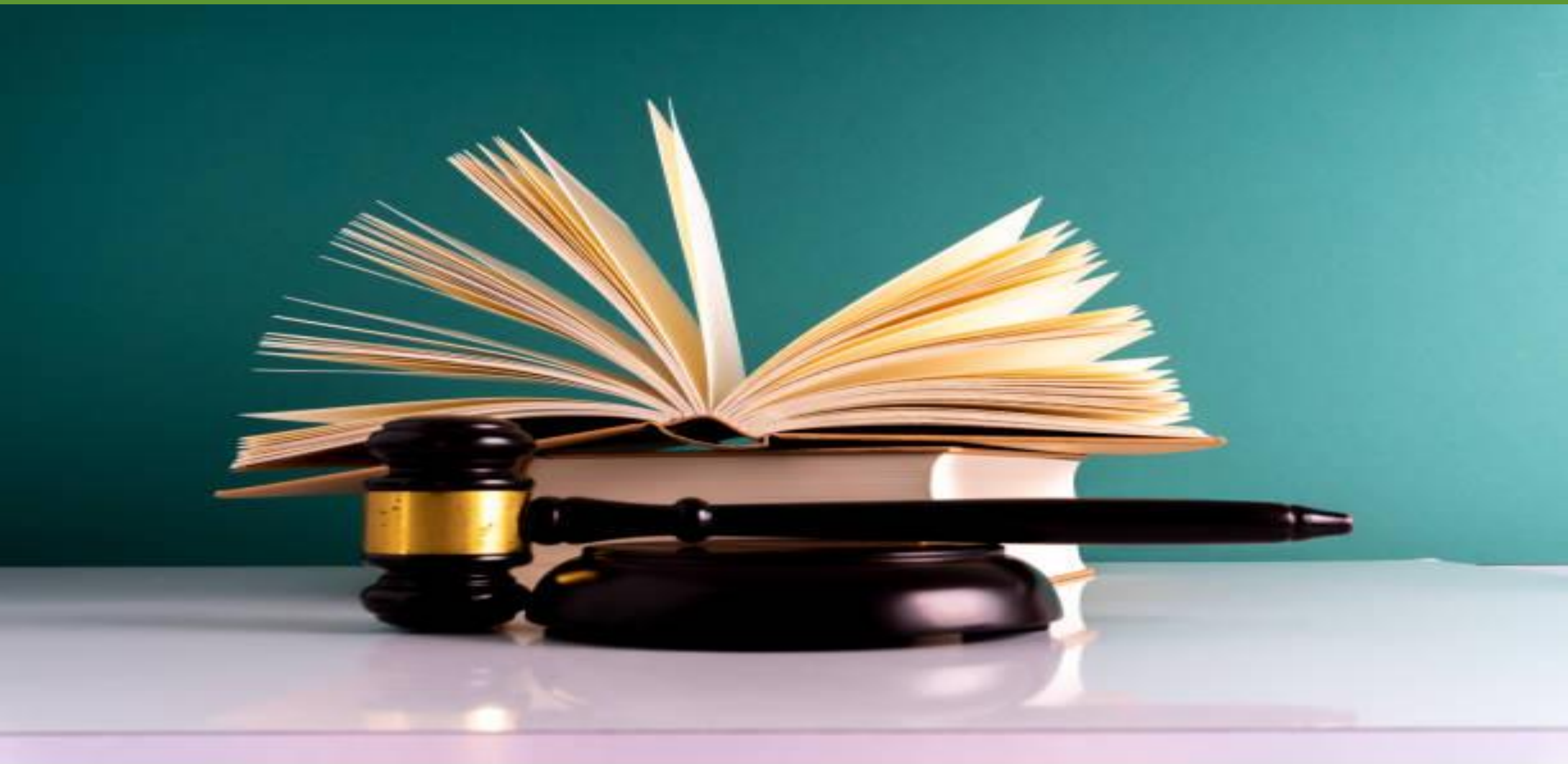
CRESTWOOD ADVISORS

Antitrust & Big Tech

Executive Summary

The Big Tech platforms, Alphabet, Amazon, Apple and Facebook, which make up about 17% of the weight of the S&P 500, are facing increasing antitrust scrutiny in the U.S. and abroad. The potential for regulatory action escalated last year after a series of investigations were initiated. So far, in the U.S. only Alphabet and Facebook have faced lawsuits, but further lawsuits are likely on the horizon and, given the backdrop of the pandemic, the stars may finally be aligned for bolder measures against these companies. Covid seems to have highlighted the economic consequences of Big Tech's clout as it wreaked havoc across many industries. Smaller businesses, never more challenged, seem even weaker to Big Tech's dominance. While the groundswell of recent activity may signal regulators are readied for synchronized action, the outcome of all this is still very uncertain, as is often the case in gauging regulatory risk. We will continue to monitor this evolving situation which may take several years to fully play out, as was the case with the antitrust suits against AT&T, IBM, and Microsoft. However, this could be an overhang on these companies for some time as it seems increasingly likely that they will not be able to dodge some level of antitrust action. Importantly, given that their massive market capitalizations dominate the S&P 500, headwinds to both their profitability and valuations could present a challenge to the overall market.



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Antitrust Perspective

The stage seems increasingly set for antitrust action against the Big Tech platforms, Alphabet, Amazon, Apple and Facebook, given growing bipartisan scrutiny in the U.S. and a pandemic that has spotlighted their dominance. These tech firms have grown to represent nearly 17% of the weight of the S&P 500 and about $5.5 trillion in aggregate market capitalization. The potential for regulatory action escalated last year after a series of investigations were initiated in the U.S. and abroad to determine whether these companies still really compete on their merits, or whether they are monopolies unfairly exerting their dominance. The risks are rising as addressing this has become a rare area of common ground for both political parties. In the near-term, before any concrete consequences materialize, the potential for antitrust enforcement could weigh on their valuations, distract management, and result in more conciliatory competitive behavior that impacts their margins or allows rivals to gain ground. Given that their massive market capitalizations dominate the S&P 500, headwinds to both their profitability and valuations could present a challenge to the overall market. However, all but Amazon have huge cash hoards, trade near market level free cash flow yields and have free cash flow margins more than twice the average of the S&P.

Rising Scrutiny

Last year, Big Tech saw escalating regulatory focus as the Department of Justice ("DOJ"), Federal Trade Commission ("FTC"), multiple state Attorneys General and the House Judiciary Subcommittee on Antitrust all initiated separate investigations into anticompetitive behavior. Since October there has been a flurry of activity with multiple lawsuits filed by state and federal regulators against Google (part of Alphabet) and Facebook. Further lawsuits are likely on the horizon.

Scrutiny is also rising abroad, most notably in the EU which has a track record for a more aggressive regulatory stance. The past efforts of the European Commission have focused heavily on fines and not yet slowed the dominance of Big Tech. Most recently, the EU announced two separate investigations into Amazon. Their most meaningful effort to reign in Big Tech may be just released draft legislation that looks to apply tougher standards to large "gatekeeper" tech companies than to budding rivals. Importantly, this is a preliminary draft. It would likely be 2024 before these rules are finalized, with the potential for significant revisions in the meantime.

Bipartisan House committee alleges monopoly abuse

The bipartisan House Subcommittee issued a report in September concluding that all four companies abuse their market power. It describes how these companies have become monopoly gatekeepers where their dominant positions in online retail, search, mobile computing, and social media leave them inescapably at the center of most digital commerce. They say the structure of digital markets helps form their power because they tend toward winner-take-all dynamics. This is driven by positive feedback loops from economies of scale, the self-reinforcing advantages of greater amounts of data and network effects, where each incremental user strengthens the value of the network. However, the report suggests their monopolies are built on more than just the natural outcome of such competitive dynamics. They allege that while their dominance may be due to the merit of their innovation and the quality of their user experience, that it is also a result of anticompetitive behavior. They cite numerous examples including acquisitions that should have been blocked, self-preferencing in areas where they compete with their customers, oppressive contract terms that would be impossible in a competitive market and predatory pricing. It also describes how they have deepened their monopoles through vertical integration and leveraged them into adjacent businesses, leaving their operations riddled with conflicts of interest and the ability to exert monopoly power increasingly outside of their core businesses.

Allegations against Amazon focus on them creating a consumer network on their marketplace through predatory pricing of products and services like Prime subscriptions and Echo devices, then abusing that power in their treatment of suppliers and third-party sellers. That includes onerous contract terms, like forced arbitration clauses and most-favored nation pricing policies, and weaponizing the "buy box" to essentially tie participating in their marketplace to "Fulfillment by Amazon" (FBA) services. It also included extracting higher fees from third-party sellers than would be possible in a competitive market and leveraging marketplace data to copy third-party products then self-preferencing their private label version. In addition to increasing FBA related fees, they considered Amazon's ad revenue to effectively be an additional fee levied on third-party sellers. Amazon was the only company cited for predatory pricing which is tied to their having the lowest margins of the group by far, specifically with their e-commerce segment.

With Google the focus is on exclusionary contracts that underpin their search dominance and a series of acquisitions that made them the dominant digital advertising intermediary. They allege that vertical integration in the full digital advertising stack, bolstered by their search monopoly, enables them to reduce transparency and extract extraordinary rents.

Facebook is largely critiqued for acquisitions of competitive threats, particularly Instagram and WhatsApp. They were also criticized for misappropriation of user data aimed at identifying which budding rivals to "kill" by either acquiring or copying them. This is facilitated by acquisitions like Onavo, which Apple removed from their app store in 2018 following reports that Facebook was using it to track users and other apps. The FTC lawsuit just filed against Facebook asks for them to divest Instagram and WhatsApp. This is boldest antitrust move yet as it would undo previously approved acquisitions.

The primary focus of scrutiny for Apple is treatment of third-party developers on their app store, not on their hardware which accounts for the majority of their profitability and is the centerpiece of their moat. The report claims Apple's mobile operating system dominance with iOS (about 50% market share in the U.S. and about 25% globally) puts them in a gatekeeper position between software developers and consumers on their app store. They say Apple exploits that closed ecosystem by self-preferencing their own apps and charging exorbitant fees.

Bipartisan agreement on monopoly abuse but disagreement on new laws

While the recent lawsuits and investigations are obviously limited to application of current law, the House report was focused on whether new laws would be required and contained a series of far-reaching recommendations. Among the House Subcommittee, the findings of monopoly abuse had clear bipartisan support, while the suggested remedies fell on more partisan lines. The majority Democrat members advocated for sweeping new laws including Glass Steagall type rules for the internet to separate lines of business, like that legislation's separation of retail and investment banking. This would address conflicts of interest in areas where they compete with customers and act as a vital distribution channel. Suggested remedies also included a stricter approach to acquisitions to prevent their ability to gobble up any meaningful competition that emerges, and data portability and interoperability standards, which would help address "walled garden" strategies that prevent compatibility and bolster dominant platforms. Since Democrats lack a filibuster-proof 60 seats in the Senate, passage of broad new legislation would be difficult as it would require bipartisan agreement. However, there is still plenty of potential for action. While Republicans were wary of the risk of unintended consequences with overreaching regulation, they did offer some support for new laws of more limited scope saying that "potential changes need not be dramatic to be effective." So, there may be room for compromise on legislation. One further path for action is FTC rulemaking, which could create new guidelines of unfair competition without congressional support. This is more of an uncharted path but has recently been advocated by some existing and potential FTC members. Biden's FTC appointments will be a key indicator on this front. Additionally, one area where Democrats and Republicans do agree is that years of judicial interpretation have set precedents that make existing antitrust laws narrower and more difficult to enforce than originally intended. While new legislation would be the surest path of antitrust action, reining in the power of Big Tech might be possible under existing laws.

Historical precedent weakened current laws

The key antitrust legislation, The Sherman Antitrust Act, The Clayton Act and The FTC Act, were all enacted over a century ago. While these laws clearly could not contemplate the technology platform business models of today, it is argued that they were deliberately written to be vague enough to allow for the monopolies of the future. However, years of precedent may have weakened the laws and thus granted Big Tech immunity from antitrust scrutiny. Interpretation of these laws has evolved to include such high evidentiary burdens for challenging anticompetitive mergers that hundreds of acquisitions made by these four companies were cleared without scrutiny. Action under existing laws requires not just proof of a monopoly and anticompetitive behavior, but also proof of harm. At issue is the "Consumer Welfare" standard which has emerged as a key test of antitrust infringement that has historically hinged on higher consumer prices in establishing harm.

The problem with applying this test to these companies is that many of their key products are "free" to consumers, like access to social media and Google's search engine. Moreover, it largely ignores harm to workers and other businesses. Like harm to the third-party sellers and software developers that access consumers through Amazon's marketplace and Apple's app store. In each case, these companies can build two-sided networks through a service, that may be free or below cost to consumers, then leverage their position as the gatekeeper to that network in an anticompetitive way against other businesses. Past precedent has left that kind of harm out of reach by "following a web of jurisprudence instead of following congressional intent." The 2018 Ohio v. Amex lawsuit is a specific example of this. That suit concluded the need to show harm on both sides of a two-sided market, which many viewed as key protection for Big Tech. As a result, the House report argues for a broader view of consumer harm. They say all four can lower quality, stifle innovation, charge exorbitant fees to businesses that rely on them to reach consumers and degrade privacy on their platforms without consequence. So, moving away from a limited view of harm could be crucial in policing Big Tech. The lawsuits recently filed by federal and state regulators against Google and Facebook challenge these precedents.

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Current lawsuits may be just the beginning…

Efforts to return to the original intent of these statutes could be an important turning point in challenging these platforms, as none of their hundreds of acquisitions have been blocked, a previous FTC investigation into Google fizzled and accusations against Apple for price-fixing with eBooks resulted in a nominal fine. The risks vary by company and while the valuations of these companies are not as lofty as those during the tech bubble, their growth and their margins have certainly benefited from this lack of antitrust action. Recalibrating the high evidentiary bar to block mergers could help regulators unwind previous acquisitions like the Facebook acquisitions just challenged by the FTC or Google's acquisition of DoubleClick. For Facebook, their ability to use monopoly profits for acquisitions has been key to protecting their platform from consumers migrating to new forms of social media that can quickly siphon attention. The FTC lawsuit against them also employs a broader interpretation of harm in challenging Facebook's lack of interoperability with third parties like Twitter which does not raise prices for consumers but does limit innovation. For Amazon, challenges to their treatment of third-party sellers in their dual role as marketplace and retailer could impact their ability to improve profitability in that segment, which is key to their valuation. Their cloud business provides most of their profitability but only underpins roughly a third of their valuation; advertising and their retail business, with expectations of improved margins, drives the rest. With Apple, challenges to treatment of third-party developers could lead to lower app store fees which would be a headwind to growth in their high margin services business. However, the long-term drivers mitigating this is their growing ecosystem of devices, including wearables, and the evolving utility of applications that continually progress with new technologies. For example, as computing power in mobile devices increases and 5G delivers better connectivity we should have the ability to use their products in enhanced ways like apps that take advantage of augmented reality and Internet of Things (IoT) related technologies. Moreover, improvement in the economics to developers could spur innovation and lead to greater availability of higher quality apps.

Finally, it is important to note that Section 5 of the FTC Act gives that agency broader interpretation in gauging monopoly behavior, allowing them to reach "other practices that harm competition that may not fit neatly into categories of conduct formally prohibited" by the Sherman Act and Clayton Act. Since it is the FTC that filed the lawsuit against Facebook and that is investigating Amazon, those two companies could be subjected to a different standard.

Too Early to think the worst...

Given the backdrop of the pandemic, the stars may finally be aligned for bolder measures against these companies. Covid seems to have highlighted the economic consequences of Big Tech's clout as it wreaked havoc across many industries. Smaller businesses, never more challenged, seem even weaker to Big Tech's dominance. While the groundswell of recent activity may signal regulators are readied for synchronized action, the outcome of all this is still very uncertain, as is often the case in gauging regulatory risk. Will the result of all this be quashed monopolies, unleashing rising competition and a broadening of the market? Or could it ultimately prove to be more of a stumbling block for Google, Facebook, Amazon and Apple, than an existential threat? Action against any one of these companies could have unintended consequences that strengthen their position. For instance, the current focus on Section 230 highlights the difficulty in gauging the ramifications of regulation. Calls for platforms to become liable for user generated content on their site risks strengthening the dominance of the incumbents, in part, by raising the cost to compete with companies like Facebook. Efforts to be more stringent in blocking acquisitions could reduce venture capital funding of startups because take-outs can be viewed as a key exit path. If that exit path is limited, capital could dry up in certain areas where these companies compete, limiting innovation and potential competition. Finally, regulation could thwart some facet of their "monopoly," but still leave behind a profitable company with an enviable moat and solid growth prospects as these companies are buffered by secular tailwinds and strong free cash flow margins. Microsoft's antitrust case weighed on their operations, but ultimately the company continued to flourish. We will continue to monitor this evolving situation which may take several years to fully play out, as was the case with the antitrust suits against AT&T, IBM and Microsoft. However, this could be an overhang on these companies for some time as it seems increasingly likely that they will not be able to dodge some level of antitrust action.

A focus on the lawsuits against Google…

Since October, three lawsuits have been filed against Google by federal and state regulators, all of which challenge the established Consumer Welfare standard. Regulators are essentially contesting behavior that they have largely ignored in the past. The lawsuits focus on Google's search advertising business and their position as a digital advertising intermediary. Google is accused of having a monopoly position in search that is maintained through a series of unlawful agreements giving them a self-reinforcing data and scale advantage. Through distribution agreements and ownership of Chrome and Android, Google has locked up the devices, operating systems and browsers that are the access points for nearly 80% of the general search queries in the U.S. They give away their Android operating system, which has made it the most popular mobile operating system in the world, but through tying agreements, they ensure that Google is the default search engine on those phones. They also have a default search engine deal with Apple. These two companies have a duopoly in mobile operating systems, together capturing nearly all mobile devices globally. On desktop, Google's Chrome is the leading internet browser and Google has distribution agreements with the other major browsers including Apple's Safari browser and Mozilla's Firefox browser. So, these agreements collectively cement Google's search dominance by securing the vast majority of desktop and mobile search access points, thus blocking out rivals. As a result, Google's U.S. search share is 94% on mobile and 82% on desktop. Search engine algorithms thrive on data, so locking up market share improves their search engine giving them a self-reinforcing advantage. Google's key defense with these allegations, however, is that consumers can change their default search engine and are not forced to use Google.

Instead of focusing on higher consumer prices as a source of harm with Google's search monopoly, regulators allege that through exclusionary contracts, Google stifles innovation and choice and would be able to thrive with a lower quality product. They essentially argue that the vast amounts of consumer data they monetize through advertising is achieved by degrading privacy which is tantamount to raising prices and lowering quality. Google's default search engine deal with Apple and their Android "anti-forking" agreements are specifically cited as anticompetitive. Their anti-forking agreements condition access to Google's app store on making their search engine the default and on not altering Android's open-source code. So, handset makers like Samsung are dissuaded from customizing Android because giving consumers access to Google's vast app store is essential to sell devices. Regulators allege that those agreements reduce innovation in operating systems because they prevent an alternate operating system from emerging that could be a path to market for a competing search engine.

In addition to their search business, where Google makes money by serving relevant ads alongside search results, they dominate the display advertising market, where they own key advertising properties and have dominant market share in each stage of the complex value chain that matches supply and demand between advertisers and publishers. With Google's own properties, they are accused of using their search monopoly to preference higher margin display advertising on their sites, like YouTube. As a digital advertising intermediary, Google's position is bolstered by their search monopoly as their massive data advantage enables them to facilitate better targeted advertising. Regulators argue that Google's dominant position in the ad tech stack allows them to charge monopoly rents that reduce ad revenue to website publishers, which can harm the quality and availability of publisher content, like journalism. They also argue that Google is able to "set advertising prices above the level that would prevail in a competitive market," which could be argued to ultimately raise the price of goods to consumers.

Implications for Google

At this point, no remedy is ruled out, including structural remedies. Prohibiting Google's agreements with companies like Facebook and Apple, could erode their market share in the ad tech stack or in search. Losing meaningful share of search would be the most damaging to Google but would take time and could be counteracted, at least in the short-term, by billions in disallowed fees to distributors, like Apple. Potential margin enhancement in search could help offset any impact to their advertising intermediary margins. Additionally, the only other general search engine in the U.S. that crawls and indexes the internet at scale is Microsoft's Bing, but with single-digit market share they likely lack the click-and-query data to quickly produce a competitive search product. DuckDuckGo, another competing search engine, relies heavily on Bing as its source. For a competitor to rival Google's quality would likely be a gradual process. So, in the near-term, Google could continue to maintain market share without having to "buy" it. One of the most severe remedies would be a "structural" remedy like forcing them to divest Chrome, Android or YouTube. While this would weaken their moat, spinning out their pieces could show that Alphabet's current valuation is a discount to the sum of its parts. Their financial statements lack the transparency to value the pieces of their business separately which arguably penalizes their multiple. Finally, these lawsuits could take multiple years and are decided in courts, which may not agree with the evolving viewpoint of regulators and lawmakers. If these lawsuits prevail, meaningful impact the economics of Google's business could take years, particularly with search which dominates their profitability. In the meantime, their business is reinforced by burgeoning secular growth drivers like their cloud business and leadership in artificial intelligence.