September 14, 2021

SKBA Market Update

The Wrath of Khan

Since when has such a progressive candidate been appointed to such a high profile position with so little partisan vitriol and fanfare? Ms. Lina Khan, for those still wondering, assumed her role as chair of the Federal Trade Commission (FTC) in June 2021 after being appointed by President Joe Biden. Chairing the FTC is no small task as Ms. Khan will be responsible for ensuring that no single company exerts undue and unfair power over its constituents. How might constituents be defined, one might ask? Constituents typically include customers, suppliers, employees, owners, regulators and communities. However, let us not forget that shareholders are also constituents. The FTC is largely concerned with consumers but must also considers the others. In past administrations, FTC chairs appointed by both Republican and Democrat presidents predictably avowed being for and defending “the little guy.” The evidence strongly suggests otherwise, at least as far as some of today’s largest industries are concerned.

Over the last few decades, the concentration of power and market share, often defined by the Herfindahl-Hirschman Index (HHI), has increased meaningfully across many industries. The HHI scores the concentration among participants in any particular industry; the higher the number, the more potentially problematic, or concentrated, the industry. The calculation considers differences between concentrated industries where large players generally have equal share as well as industries where one among many large players exerts excessive share.

“Acceptable” Monopolies…

The differences between the categories are not subtle. Let us look at few different examples of industry concentration that are not considered to be as much of a “problem”:

- **Automobiles** | Today, there are many large manufacturers and brands yet not one car company dominates. Ford, GM, Chrysler, Volkswagen, Toyota and others all have reasonably equitable market shares. Some more so depending on the region but none has an uneven balance of power. The auto industry is one in which the HHI is therefore low and not worrisome.

- **U.S. Wireless Providers** | Formerly known as the telecoms, the industry is concentrated among very few large players. That oligopolistic landscape explains why the recent merger between T-Mobile and Sprint was fraught with complications that delayed its completion for years and required several attempts. Nevertheless, while the number of players is small, no single company exerts dominance. In addition, as consumers increasingly purchase content in different forms the industry has spawned additional players. Competition is very high, resulting in the industry not being viewed with significant concern.

“Bad” Monopolies worth questioning…

In contrast, where has product or service concentration led to either or both monopoly-like pricing power (at the expense of consumers) or uncompetitive behavior?

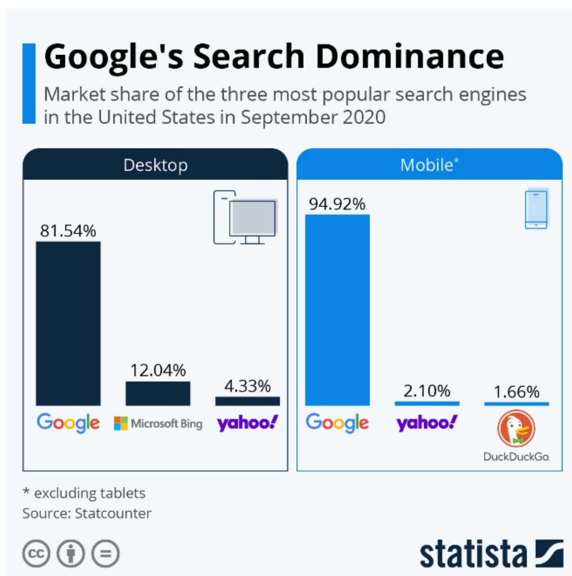
- **Railroads** | There are currently seven railroads in North America. As recently as 1975 there were over fifty! Concentration in this industry has increased significantly as a result of deregulation in the 1970s and in 1980 (the Railroad Revitalization and Regulatory Reform Act and the Staggers Rail Act). Deregulation was deemed necessary due to the number of railroads in bankruptcy. It also enabled this industry to subsequently thrive.

  Today, none of the remaining seven railroads has excessive market share from a geographic standpoint. Is that then a satisfactory test of adequate competition? In this case, it clearly isn't. Railroads maintain their own networks as opposed to trucking and air transport which use public highways, roads and infrastructure systems. As a result, railroads need to spend to upgrade their private networks and keep them as efficient as possible, or let them deteriorate and suffer the consequences.

  North American railroads are divided among Canadian, American West (of the Mississippi) and American East (of the Mississippi). Kansas City Southern stands alone with a mostly North-South rail network and happens to be in process of being acquired by Canadian Pacific. We will soon see whether the FTC considers this to be anti-competitive; it will offer useful insight into the government's change in viewpoint, if any. Antitrust concerns in the case of railroads comes from the fact that many shippers (retailers, farmers, consumers, etc.) frequently have no other options to transport their products. Customers cannot simply ship their products with competitor B if they don't like competitor A's terms. As a result of deregulation, railroads have been able to raise prices more quickly than they might have otherwise even though they have been understood to provide vital—or utility like—services.

- **Social Media** | Until recently, a number of players competed for market share. Does anybody remember Myspace? Today, it is clear that Facebook dominates social media with its Facebook, Messenger, Instagram and WhatsApp applications. No other company comes close in the United States and in many parts of the world. There are a handful of newer entrants, TikTok figuring prominently, and the space is rapidly changing.

- **Internet Search** | A number of companies, large and small, participate in this industry—Google, Microsoft, Apple, Yahoo, DuckDuckGo, Qwant and others but only one truly dominates (over 80%! in the U.S.)—Google. When many companies participate but one clearly dominates, the HHI becomes elevated, a negative from regulators' standpoint.



Source: Statista (https://www.statista.com/chart/23250/search-market-share-in-the-united-states/)

Differences between the first three examples above and the latter two highlight the old versus the new economy, the importance of tangible versus intangible assets and high fixed cost structures versus low fixed cost structures. Many of today's behemoths—Facebook, Google, Apple, Microsoft and Amazon—operate with mostly intangible asset balance sheets. They have employees and facilities to account for but the majority of the firm value comes from their intangible networks. They are digital companies.

The May 1998 case against Microsoft was early in attempting to deal with antitrust concerns of an intangible and digital nature. While the trial failed to prove wrongdoing, it provided an impetus to look at the concentration of power through a different lens, a digital lens. The shift from tangible asset-driven businesses to intangible asset-driven businesses is a critical reason behind the Department of Justice (DOJ) and FTC needing to look at the rules from another vantage point. We strongly believe that rules and laws will ultimately have to be rewritten to address the changes in, and sources of, corporate profit generation. The old rules simply lose some of their relevance in the same manner when a business' value resides digitally. We do indeed live in a new world.

The Next Standard Oil or American Tobacco for a new century?

Returning to the antitrust discussion, the nature of anti-competitive behavior is an important issue the FTC will struggle with. Whether it is a railroad, a search company, online retailer or a social media platform, does the end-consumer really have a true choice or alternative? If not, is any harm being inflicted? In the case of railroads, it comes pretty clearly down to pricing. If consumers have no choice but to accept terms, harm is being done.

In the case of social media and internet advertising, it may be privacy. It may also be that what is considered choice is actually a false choice. Let's look at one of the constituents—customers. Not the customers one might at first think of like you and me, but advertisers. Within search (i.e. Google), I may think I am the customer as I search for, say, a particular brand of laundry detergent. But I am not a customer in the traditional form. I am not paying Google anything to obtain search results. Or am I? In fact, I am. My expectation is that I am presented with ads to make up for the convenience of the service, akin to broadcast television and the commercials we're all familiar with. Yet it is not that simple. In reality, everything about me is being mined digitally for the benefit of Google and its ability to target me, whether I want to or not, whether I know it or not. My data, my information, is being bought, sold and traded; all for Google's benefit and profit.

The story does not end there; rather we're just getting warmed up. Google gets paid by advertisers like Tide or Surf as the case may be from our earlier example. As internet advertising has surpassed television advertising, does Tide have an option to advertise elsewhere? That is another false choice. While Tide can advertise on traditional television networks such as ABC, CBS, Fox or NBC equally easily and with generally comparable results, the supposition that there is a choice on the internet is mostly false. One advertises with Google or faces irrelevance. Technology changes rapidly and such a blanket statement is arguable and impermanent but the point remains. Where else might Tide advertise? It might choose Facebook with its social network dominance, and it might choose Amazon with its e-commerce dominance.

Reinforcing the government's concerns there is a common thread. All mentioned companies are of significant size. And within all of these industries, one company has overwhelming influence and market share. The combination of both of those elements is invariably a negative for the promotion of fair competition; think HHI.

In addition, any time a legitimate competitive threat has surfaced, Big Tech has attempted to acquire its way to the elimination of that threat. "If you can't beat 'em, join 'em", in full force. When Amazon proved unable to sell diapers competitively, it acquired Diapers.com for terms that the latter couldn't refuse. When Facebook saw a looming threat from WhatsApp and Instagram, it acquired them. When it comes to buying its way to market dominance, Big Tech is unrivaled.

This is different from suggesting that the largest companies are not innovative. They are. But they are by way of acquiring their way to that end. At its core, such companies have made it nearly impossible to compete as there is no level playing field. Once constituents no longer have a choice, is a free market still free? When Diapers.com has no choice but to sell, that appears anti-competitive. When Amazon collects information on its vendors and then undercuts them with similar in-house products at lower prices, that appears anti-competitive. When Tide can only realistically advertise on two digital platforms, that is a false choice. When those two digital platforms, Facebook and Google, are accused of colluding by a number of state attorneys general, their behavior appears anti-competitive. When internet giants track consumer behavior in ways unrivaled by anyone else to compound their already massive advantage and subsequently sell it to any bidder for their benefit, that begs looking into. That is the digital world, and it is time for the rules of engagement to, at a minimum, be reconsidered.

It may come as no surprise then that Facebook and Amazon are looking at ways to shield themselves from the scrutiny of the FTC. That both have petitioned for Ms. Khan to recuse herself from antitrust cases filed against them should be clear. It is no secret that the newly appointed FTC chair has been a vocal challenger towards some of these giants' conduct. Her *Yale Law Journal* article on Amazon four years ago is widely quoted as evidence of her bias against Big Tech. Yet voicing one's opinion does not necessarily invalidate claims that may or should be brought forth in the future. Facebook and Amazon are clearly doing what is in their best interest. As the two largest corporate spenders on Washington lobbyists in 2020, it is not surprising to see them do so. Massive spending on lobbying efforts is not new or unique to Big Tech; nor is it likely to end anytime soon. The DOJ and the FTC nevertheless need to do what is in all their constituents' best interest.

And that is why Ms. Khan was appointed with little political fanfare. Because antitrust shouldn't be a partisan issue. Both sides of the aisle need to appreciate that the long-term success of the U.S. economy depends on the preservation of choice for all market constituents. It also depends on a more level playing field from an opportunity standpoint. Big corporations should be allowed to prosper but they should not become black holes in our capitalistic galaxy—vacuuming everything within their orbit in order to stifle competition.

We are not, by any means, suggesting all large companies be broken up. Capitalism rewards success and the goal of the administration is a difficult one in that it needs to balance both objectives, which at the onset appear to be in conflict with one another. Because this Digital Age is new territory, however, the health of the American capitalistic system is dependent on a current assessment and re-evaluation of the rules of engagement. It is unclear if or when this new paradigm favoring the largest of the large companies may shift, but investors do not appear to be discounting the chance for disruption from the FTC and DOJ. Market imbalances have typically found a way to unwind one way or another.

This time around we should embrace the wrath of Khan, not fear it, as did the crew of the Enterprise in the Star Trek episode of decades ago.

Nota bene

1. The brevity of this newsletter fails to do justice to most aspects of the discussion nor does it sufficiently delve into the details in a manner that it deserves. It is a short opinion piece and is liable to have some inaccuracies.

2. It is noteworthy, however, that constituents, shareholders included, have not always suffered as a result of government mandated break-ups. Teddy Roosevelt's trustbusting, to which the current regulatory regime is sometimes compared, resulted in years of subsequent wealth creation and innovation. His Republican successor was in fact responsible for many more antitrust lawsuits. Perhaps the most dramatic example is that of Standard Oil in 1911, which Roosevelt was vehemently against and used the Sherman Antitrust Act of 1890 to break it up. Shareholders in the broken up company ended up owning Chevron, Texaco, Mobil, Exxon, Marathon and Amoco among many others and were amply rewarded for owning the remaining pieces in subsequent decades as oil became an increasingly dominant resource globally. AT&T's breakup in 1982 also resulted in significant wealth accretion and democratization of telecommunications. It spawned more competition, not less. Sprint and MCI were borne of the breakup. Competition increased as a result of more fair rules of engagement.

3. Nothing suggests that today's quasi-monopolistic tech giants would fail in what will continue to be a fabulous century for technological advancements. For example, a break-up of Amazon along business lines would result in a number of spawned companies, each eventually worth multiple hundreds of billions of dollars.

Each one individually would remain among the largest publicly traded companies. That is an outstanding feat. Whether any of them would lose much or any of their market power is debatable.

4. We tend to agree with the recent judicial decision to dismiss the FTC's lawsuit against Facebook. Importantly, the FTC tried to reverse the acquisitions of Instagram and WhatsApp by Facebook. In our opinion, the time to have prevented such acquisitions from being completed was at the time of purchase, not years later. The judge's decision should serve as a warning to regulatory bodies not to bring cases until and unless grounds have been exhaustively vetted. We believe the FTC will file an amended complaint against Facebook and that such claims will be much stronger this go-around but time is running short. We are interested spectators in the developing situation.

5. As value investors we place stringent controls around valuations. Currently, we see the valuations of these modern monopolists as expensive and at risk of producing significant negative returns. Over time, should any of these companies fall back to what we would believe to be more reasonable valuation levels, and of fundamental interest to us, we would be delighted to consider them for investment. Just as we have done with other "fallen growth angels" in the past.

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