GMO

FOCUSED EQUITY INSIGHTS

ALPHABET AND THE DOJ

Focused Equity Team | July 2019

Summary

Shares in Alphabet have come under a good deal of pressure over the last year as investors process the implications of increasing regulatory scrutiny, culminating in reports this month that the U.S. Department of Justice (DOJ) is preparing for an antitrust probe into big tech. In this short piece, we explain why we believe Alphabet is appropriate for our Quality Strategy as an extraordinary company under a temporary cloud. Markets hate uncertainty; we believe that today's price discounts the loss of an antitrust case and that this presents us with a long-term opportunity.

Background

The advertising industry has been through one of its periodic bouts of transformation over the last two decades as marketers followed media consumption onto the internet. The digitalisation of advertising has led to explosive growth in revenues for the internet properties that offer a combination of user numbers and user knowledge. Alphabet has carved an enormous market share in recent years; in 2017, Alphabet accounted for about 50% of the global market for digital advertising.[1] Alphabet's revenue growth has decelerated to a degree, but digital advertising remains a growth opportunity, even as others enter the space.

While it is tech companies' knowledge of their users that makes them so attractive to advertisers, they shoulder a good deal of responsibility to use that data ethically. At the same time, the sheer volume of online content brings political baggage and the ability for bad actors to participate in the market for minds. Repeated blunders at Facebook in particular have brought the sector into the political crosshairs.

At the beginning of June, the Wall Street Journal broke the news that the Federal Trade Commission (FTC) and the DOJ had agreed to carve up oversight of the tech giants between them. It is understood that the FTC will cover Facebook and Amazon while the DOJ studies Google and Apple. Investors are fretting over the possibility of antitrust probes on the sector, and shares of Alphabet at the time of writing were 16% below their recent peak.

GMO's Quality Strategy has a preference for good companies where a temporary cloud has led to a lower than warranted share price. The challenge is separating the temporary clouds from permanent impairment and doing so in real time. Alphabet is an interesting case study.

Methodology

How worried should Alphabet's investors be at this point? Of course, the absence of an antitrust probe is better than the threat of one, but investment is a probabilities game. We suggest several reasons why the outcome for Alphabet may not be as bad as implied by the stock market.

1 Data for digital advertising spend, global (ex-China). Source: IPG Mediabrands, GMO.

1. The decision for DOJ oversight does not guarantee that Alphabet will suffer an antitrust probe. It is likely that a complaint has been made and at least one of the companies will be probed, but this is not a certainty.

2. Proving anticompetitive behavior for Alphabet is not likely to be straightforward for the DOJ. To bring a case against Alphabet, the DOJ would need to conclude that the company was getting in the way of economic competition by hindering the setting of prices, the quality of products available to the market, or innovation by others. Proving any of these is not trivial; European cases against Alphabet – under a different competition framework – have covered browser pre-installation, Adsense advertising contracts, and search results. On the last of these, the FTC already gave the company a clean bill of health in 2013.

3. A fine is unlikely. The fines levied on Alphabet in Europe (€9.2bn, under appeal) are not relevant to U.S. antitrust cases. In civil – as opposed to criminal – antitrust cases, fines do not normally feature and there is no suggestion of criminal behavior by Alphabet.

4. Most antitrust cases do not end up in court. The objective of the DOJ is generally not to punish shareholders but to ensure that economic competition can flourish. Practically, few cases go to court – between October 2010 and April 2016, only 6 out of 50 civil antitrust cases did. The other 44 reached negotiated settlements that specified constraints on behavior.

5. If the case does get litigated, the conclusion is years away and so should be discounted accordingly. The timeline of an antitrust probe itself is likely one to two years (subpoenas, negotiations around documentation, interviews, reviews, commissioners' meetings). If the case were to go to court, another year might elapse before the trial with judgment months later while appeals can run for years. The famous antitrust cases of AT&T and Microsoft (see more below) each took more than a decade from start to finish.

In addition, we might add that Alphabet's experience of the 2013 FTC antitrust probe and recent clashes with the European Union's competition commissioner mean that the company is, for better or for worse, well-equipped to respond to antitrust issues.

We note that in the most high-profile American antitrust cases across the decades, equity investors fared reasonably well with a long enough time frame in mind:

- In 1954, Kodak was found to have used anticompetitive practices by bundling film and film development. The enforced unbundling coincided with a quintupling of Kodak stock over the next 10 years (performance twice that of the S&P 500).
- Shares in the successor companies to AT&T after its enforced break-up outperformed the market by about 20% over the next 13 or so years.[2]
- Investors in Microsoft saw returns of more than 3000% in the decade following the initiation of the FTC's antitrust probe in 1990, and modestly outperformed the S&P 500 in the decade following its 2000 break-up order (subsequently revoked), even in the face of the deflating dot.com bubble.

The point is not that antitrust cases are positive for the companies, but that companies with strong market power tend to make good long-term returns for their shareholders, even when some of that power has been constrained.

2
The calculation was painstakingly undertaken in an article for Knight-Ridder in May 1996. See http://www.spokesman.com/stories/1996/may/25/att-rewards-steady-investors-shares-held-since/

Conclusion

Alphabet has lost about $150 billion in value since its peak just a month ago. We believe that Alphabet's shares are priced as though an antitrust case is certain and will be lost. We suspect that the probabilities are not so clear-cut. We believe Alphabet remains an extraordinary, growing business with a powerful value proposition for advertisers, from mom and pop businesses to global enterprises, and yet the stock is priced today like any ordinary business, with a forward multiple in the high teens (ex-cash). We think this combination of fundamental strength with some short-term uncertainty puts Alphabet squarely in the wheelhouse of GMO's Quality Strategy.

Focused Equity Team

The GMO Quality Strategy is managed by the Focused Equity team. The experienced team includes ten investment professionals and four partners of the firm, with members located in Boston and London. Tom Hancock, Ty Cobb and Anthony Hene, portfolio managers for the Quality Strategy, oversee idea generation, research, and portfolio positioning.

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