EQUITIES

The False Dawn of Big Tech Regulation?

BARINGS INSIGHTS

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Calls for increased regulation of tech giants have indeed grown—but will they have the desired impact? In our opinion, the focus on "big is bad" is simply ineffective in a digital world.

The clarion calls for increased regulation of Big Tech have reached deafening levels in recent months. As we have written previously, this has gone hand in hand with growing concerns that the valuations of tech giants are too expensive—with some even fearing that we could be in bubble territory—even as a closer inspection of tech valuations reveals them to have contracted on the back of strong earnings revisions.

The sources of these calls for drastic action are uniform across the globe—from companies that have lost market share to Big Tech, to politicians that have seen opposing viewpoints spread virally on social media, to regulators that inherently believe that "big is bad". But missing from this list is the consumer. And it is the consumer who may prove to be the most important stakeholder of all.

Big is Not Necessarily Bad

It's worth remembering that the world's largest tech platforms are indeed meeting the needs of millions (perhaps even billions) of consumers every day, offering solutions to the inevitable hassles and frictions in communicating and transacting online—enabling consumers to benefit from economies of scale and cut through the noise in a digital world with endless choice.

Ultimately, we believe there is a major roadblock to effective regulation going forward—which is that any real leveling of the playing field requires millions of consumers to stop shopping on Alibaba and Amazon, stop searching on Google, stop sharing on Facebook and stop ordering food on Meituan.

In our view, changing engrained consumer behavior is incredibly difficult. Indeed, consumers continue to engage with these platforms on a daily basis, despite the negative headlines surrounding these businesses. As such, we find it unsurprising that Google's shares, for example, have performed strongly since the U.S. Department of Justice (DoJ) lawsuit was announced in October last year, suggesting that markets continue to believe that the regulatory bark is worse than the bite.

And while negative headlines continue to flood our smartphones and Bloomberg terminals, it still is not a given that the largest and most successful tech companies broke laws or actively behaved anti-competitively to get to where they are now. However, the efforts continue, with varying degrees of concern for investors. The most significant are explored below.

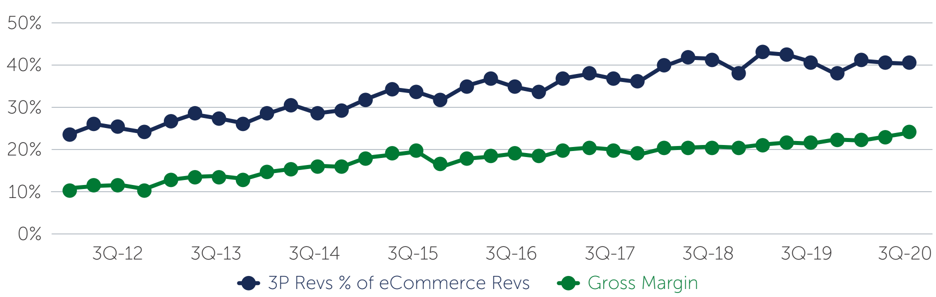
1. Conflict of Interest

There is an assumption that an owner of an e-commerce marketplace that sells its own products alongside third-party merchants (3P) will abuse their superior access to customer data, and ultimately undercut 3P merchants.

Regulators in India, Europe and now China are making moves to explicitly prevent this abuse of market power. In our view, these efforts have failed to comprehend the underlying economic incentive for an e-commerce marketplace—to help 3P merchants thrive, rather than the other way around. For example, Amazon's margins tend to rise as 3P merchants take share from their 1P business. In fact, 3P merchants now make up well over 50% share of Amazon's total gross merchandise volume on Amazon.com **(FIGURE 1)**.

While regulators will most likely target the few cases where errant employees have abused their position, we believe it is unlikely to alter the direction of travel for the largest online marketplaces.

FIGURE 1: Amazon.com Total Gross Margins



SOURCES: Amazon.com; Barings. As of October 31, 2020.

2. Exclusivity

There are some businesses, including Alibaba and Apple, which already have hundreds of millions of users—yet insist on exclusive supply contracts with merchants or developers to use their platforms. While such behavior can understandably be interpreted as the abuse of market position—and we don't necessarily disagree with this—we would argue that their large scale has already reached escape velocity, such that if they were prevented from exercising their monopoly powers, there would be little incremental impact.

Indeed, the benefits of scale and focus on meeting customer needs would make up for any headwinds from removing such clauses, in our view. Ultimately, merchants need access to such platforms' vast number of users, which is their key advantage.

3. Transparency

Social media companies realize that properly identifying the source of posts on their platform, be they advertisements, misinformation about vaccines or emotive political messages, will lessen the pressure on them to take greater control of what is published—and therefore avoid becoming liable for any harm caused by posts made by third parties.

The revenues for platforms come from advertisers looking to connect with consumers—but the types of posts causing the problems for platforms are anathema to these advertisers, and make for an unhealthy ecosystem. Ultimately, this will likely damage platforms' revenue growth—which in turn suggests that failures to police their own platforms are driven by the scale of the problem they face from harmful posts, rather than any malicious intent on the part of the platforms to sway opinion towards their own political desires, or to profit from such posts going viral.

The dangers of over-regulation are first to limit free speech, and the different interpretations that hold around the world, and also to raise entry barriers for new competitive platforms that lack the financial and technical resources to police the millions—if not billions—of posts that occur on a growing social media platform. And this would likely further entrench the position of the largest incumbents able to invest in the artificial intelligence and human intervention required. Trade-offs and changes in how the platforms police posts on their sites seem inevitable now, but ultimately will be aimed at creating healthier ecosystems for users to engage with—which should boost the sustainability of the platforms in the long term.

4. M&A

The case laid out by the U.S. Justice Department against Visa and their intention to acquire Plaid is one of a number of complaints against anti-competitive acquisitions. As Plaid has the potential to create a payments network that disrupts Visa's debit card business, the complaints are therefore suggesting that Visa is hoping to buy Plaid to quash the potential competitive threat. This is similar to the case of Facebook buying Instagram when it was still an up-and-coming photo app, yet showed signs at the time—to Facebook if not the Federal Trade Commission (FTC)—that it could potentially become a large-scale competitor. Regardless, the deal was approved by the FTC.

Anti-trust law doesn't do an effective job of guidance on such deals, given that the acquired companies are often little more than rapidly growing websites or apps—but with little or no revenues. However, there is a strong case that large platforms should be prevented from making horizontal acquisitions that bring in additional users, or that close off other routes to market for competing products.

With that in mind, it came as no surprise that the FTC sued Facebook for anti-trust following 16 months of investigations into the acquisitions of Instagram and WhatsApp, even if the precedent or technical mechanisms to unwind these deals remain very unclear.

It also came as no surprise to see Visa ultimately step away from the Plaid acquisition, and see M&A likely playing a far smaller role in the strategy playbook of large tech platforms. Focus on internal R&D and agility to pivot into new markets will therefore be ever more critical for investors when it comes to finding sustainable growth opportunities in the large tech space. Given the significant cash generation at most of these companies, it also fuels the notion that shareholder returns are likely to become a bigger feature in capital allocation policies going forward, in lieu of large-scale acquisitions.

Big Tech: One Step Ahead?

Time and time again, we witness that the pace of the legislative processes in the U.S. and Europe, in particular, are painfully slow. Even the lengthy DoJ investigation into Google, which led to a very narrow lawsuit, will likely take years to see remedies turn into action—and this highlights how tech companies are able to navigate the choppy regulatory seas adeptly.

By offering what some see as sacrificial lambs and nuancing business models, these companies may be providing regulators a 'win', while at the same time—intentionally or not—building new competitive moats, as we have seen with the GDPR standards. All the while, the attractions of the large tech platforms for consumers—scale, security, price—continue to grow.

Key Takeaway

The focus on size and trying to relate this alone to the abuse of monopoly power is simply ineffective in a digital world, in our opinion. Size is a consequence of building a service that is in great demand from consumers. Trying to build a sustainable and fair digital economy has to reflect this reality—focusing more on the fairness of contracts and the amount of transparency around behaviors, as well as the profitability of the various stakeholders on platforms where conflicts of interest can emerge. We believe that by fixing these specific issues, the activities offered by platforms can improve.

From an investment perspective, this means that we continue to find a number of attractive, long-term investments within the large-cap tech universe. As well as assessing the earnings risks in our standard 5-year horizon, we assess the long-dated risks associated with anti-trust investigations within our integrated environmental, social and governance (ESG) framework, penalizing those companies within the space where we feel their governance and businesses practices fall short.

Ultimately, we believe the genuine grievances are narrow in scope and as such will likely attract fines and minor tweaks to behaviors—but these are unlikely to change the fact that, if the companies have over a billion engaged users, the game is theirs to lose.

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**As of September 30, 2020*

21-1482055