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BIG TECH: ASSESSING THE THREATS ON THE HORIZON

Key points

- Apple, Amazon, Facebook and Alphabet/Google ('Big Tech') make up nearly 20% of the entire US market capitalisation by now. As a result, clouds may gather on the horizon for Big Tech in the shape of anti-trust prosecutions, increased regulation, and the prospect of adverse tax policies.
- Anti-trust prosecutions, in particular in the United States, probably represent the most high-profile threat. However, previous enforcement actions over the past century suggest that shareholder value need not necessarily be impaired.
- Increased regulatory oversight looms on the horizon, too, even though in the case of IBM and Microsoft in the US these measures have failed to dent corporate profitability. In Europe, however, regulations are developing that are potentially more targeted and may pose a medium-term risk for investors.
- Changing tax policies in the US and Europe pose perhaps the most misunderstood threat to Big Tech's asset-light business model. That said, the political appetite to pursue such measures, especially in 2021, appears low.
- On one hand, the 'move fast and break things' business model is under threat, potentially limiting tech companies in their ability to use M&A to sustain high rates of growth over the forecast horizon. However, as Apple and Microsoft have shown, high free cash flow generation combined with unlevered balance sheets allow them to invest and transform their businesses while at the same time driving shareholder value via dividends and share buybacks.
- For investors, this suggests that pivoting exposure to include companies and segments still in the midst of their growth phase can boost returns when paired with more mature segments in the growth spectrum.

Global Investment Committee

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The Rise of Big Tech Dominance

With Netflix shaping our entertainment choices and Zoom putting faces to our conversations during this extended period of social distancing, the mobile digital revolution that began with four companies in the early days of the 21st century has acquired new players.

The century began with the retail disruption of Amazon.com that accelerated rapidly once Apple's launch of the iPhone in 2007 put a computer in everyone's pocket.

Google's introduction of the Android operating system arguably succeeded in spreading this concept globally and across socio-economic strata, overtaking traditional media with its internet-based advertising model.

With a computer in everyone's pocket, Facebook's success effectively connected large swaths of the world via social media.

Thus, over the first 20 years of the 21st century, 'Big Tech' – Amazon, Apple, Facebook and Google (Alphabet) – have steadily seized a growing share of the global economy and global financial markets as well.

Indeed, while Apple used the mobile digital revolution to reinvent itself from a beleaguered personal computer maker in the 1990s, the dominant player in the original digital revolution, Microsoft, has similarly used it to transform itself, moving from PCs to the 'cloud'.

It is this perceived dominance of Big Tech that has attracted the attention of regulators and tax authorities around the world.

Anti-Trust Prosecutions: A Threat or an Opportunity?

Since the US Department of Justice, the Federal Trade Commission and a slew of US States Attorneys General filed anti-trust or anti-competition suits against Facebook and Google in recent months, concern that these prosecutions may hamper them commercially has understandably grown.

Indeed, two high profile anti-trust prosecutions in the technology realm have coincided with poor stock market performance. This was the case for IBM in 1981, the dominant mainframe computer provider of the time, and Microsoft in 1999, the leading source of operating systems for the personal computer market.

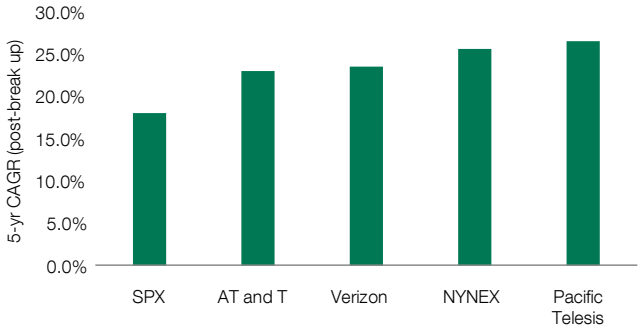
However, those correlations were likely more coincidences than the cause of the poor performance of either former market leader. Instead, the timing of these prosecutions came at the height of each company's market dominance, but more importantly it happened as the industry was going through a transformational shift – from mainframes to PCs for IBM and from desktop to mobile for Microsoft – for which both companies were ill-equipped.

Looking at the prosecutions of Standard Oil (1911) and AT&T (1982) may provide an alternative and likely more relevant parallel for the threats facing Big Tech. While both companies were eventually broken up, contrary to Microsoft and IBM, they actually prospered following the judgements against them.

The progeny of Standard Oil, including Exxon-Mobil and Chevron continued to dominate the energy sector for decades to follow. Indeed, as energy intensity grew in the United States post-WWII, these companies remained among the largest American companies in terms of revenues and profits into the 21st century.

Similarly, following the breakup of the AT&T monopoly in 1982, the 'Baby Bells' that were spawned benefited from the telecom revolution that laid the foundations for cable, internet and wireless telecom solutions in the decades to follow. Even immediately after the break-up of the telecom monopoly, AT&T descendants outperformed the broader market handily in the years that followed.

AT&T's 1984 break-up was beneficial for shareholders



Sources: Standard & Poor's; Bloomberg Finance L.P. and UBP
(1) post-break up AT&T which focused on carriage of long-distance traffic

Thus, the four high-profile examples of anti-trust prosecutions suggest that industry maturity may be a more important consideration than the prosecution itself. For mature industries subject to disruption – like mainframes and PCs – the prosecutions coincided with the industry's peak and eventual decline.

In the case of Standard Oil and AT&T, the firms that were created out of their break-up benefitted from supportive industry dynamics in the wider economy allowing the resulting companies to perform well for shareholders as they were forced to manage and deploy free cash flow more efficiently than their predecessors, who could simply exploit their monopolistic power.

US regulatory risk: Historically ineffective…

Prior to the anti-trust prosecutions of IBM and Microsoft, both had been subject to 'consent decrees' in which they voluntarily curtailed their activities in certain arenas in an attempt to limit their market power. For IBM, the first consent decree – restraining its room to manoeuvre in the server market – was issued as far back as 1956, well before the 1980 prosecution. Microsoft agreed to a consent degree in 1994, again well before its 1999 prosecution which limited its ability to tie products to the sale of its market-leading operating system, Windows.

Indeed, since 2012, Google has been subject to a series of consent decrees that sought to constrain its power. However, given the recent anti-trust filings, like with IBM and Microsoft before, it appears that these regulatory steps will hardly disrupt the growth in Big Tech's dominance in their existing business lines.

Admittedly, recent legislation introduced in the US Senate seeks to widen the grounds that can preclude companies, and Big Tech in particular, from pursuing acquisitions that 'block others from a fair chance to compete even before a monopoly results'.

Though doing little to target the outsized profits earned, the bill appears to seek to limit the ability of Big Tech (and others, admittedly) from deploying that free cash flow in a manner that limits future competition, perhaps even in nascent industries in which companies are investing. In the long-term, this may limit their growth trajectory driven by acquisitions (e.g. Facebook and Instagram) and force them to pivot to innovation-focused growth drivers, much as Apple and Microsoft were forced to do as their core businesses reached saturation.

Regulatory headwinds are likely to show up as revenue growth headwinds because rising data protection results in more restrictions on how consumer data can be monetised. This could put downward pressure on ad pricing.

Indeed, during its Q4 2020 earnings call, Facebook talked about its business facing "significant uncertainty" in the second half of 2021 due to the "evolving regulatory landscape" and Apple's recent changes in its privacy policy. The lower visibility due to increased regulatory pressure could reduce valuation multiples, as Facebook has seen in recent years.

EU/UK regulatory risk: Potentially a bigger concern

US regulatory efforts have been, at best, able to slow but not derail the growth trajectories of actual and perceived monopolies, while EU and UK regulatory efforts have been more targeted and arguably more effective.

Historical approaches by the EU anti-competition regulator and new proposals by both the EU and UK regulators can provide investors with context as to the direction of regulatory efforts looming in Europe.

Whereas the US has typically sought breakup as a remedy, Europe's approach has been instead to regulate the exercise of monopoly power.

In the telecom space, identifying collusion and the exercise of monopoly power in the pricing of telecom roaming fees on the continent, the EU passed legislation effectively to undermine carrier monopoly power, first by regulating the fees and then by eliminating roaming fees in the EU altogether.

Similarly, the EU has capped credit card interchange fees (fees retailers pay to accept a credit card transaction) to stymie the market power of the dominant card issuers, Visa and Mastercard. The move has limited fees to 0.2%/0.3% for debit/credit transactions compared to the 1.5-2.0% in the US currently.

In the digital economy, where the consumer is typically the product and pricing power is exercised at the wholesale rather than retail level, the EU Digital Markets Act and mooted UK Digital Markets Unit have begun discussions proposing to:

- ban rules about selling prices and terms set by their business customers (EU)
- give customers and end-users the right to "data portability" and "real-time access" (EU)
- regulate the sharing and exchange of data between dominant services and smaller rivals (UK)

While still in draft form, the measures appear to seek to constrain wholesale pricing power (similar to credit card regulations) and introduce data portability (similar to number portability that helped spur competition in the mobile telecom segment).

Though well intentioned, both measures may end up spurring activity, thereby increasing the pie for shareholders, even if the share of the pie held by Big Tech declines.

Together with the Digital Markets Act, the EU is also proposing the Digital Services Act which would likely impose additional operating and compliance costs on "gatekeepers" responsible for the content on their platforms. It also raises the risk of fines being levied for non-compliance. Companies deemed non-compliant with their new obligations risk fines of up to 6% of their annual turnover.

The current proposed definition includes any platform with over 45 million monthly active users in Europe. Facebook, Google, Twitter and TikTok, the only non-US company, currently meet that threshold.

Shifting tax regimes: A threat on the horizon

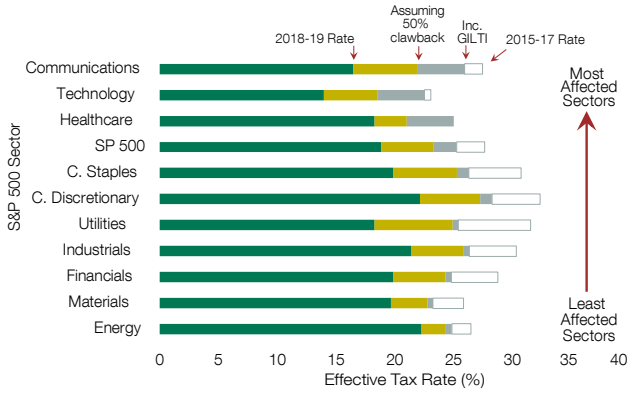
Big Tech not only represents a substantial share of the global equity market capitalisation but also earns a significant share of global corporate profits just when governments are chasing tax revenues to fight the global pandemic. Thus, it comes as little surprise that governments around the world are keen to increase the tax take from Big Tech. Indeed, during his campaign, US President Joe Biden proposed a new tax regime for the United States.

While most observers focus on the clawback of part of the 2017 tax cuts that benefitted technology and communications companies disproportionately, there is a proposal to increase taxes on income earned by foreign affiliates of US companies from intangible assets such as patents, trademarks, and copyrights.

Many companies that rely on intellectual property (technology and healthcare in particular) shelter income associated with that IP. These measures aim to increase the government take on this income.

If implemented, these measures could increase the tax burden of technology and communications companies by 350-450 bps.

Increased GILTI* taxes would disproportionately hit technology and communications companies



Sources: Credit Suisse, Goldman Sachs, and UBP

*Global Intangible, Low Taxed Income (GILTI) – Income earned by foreign affiliates of US companies from intangible assets such as patents, trademarks, and copyrights.

Moreover, with a comparatively small technology/communications sector, Europe has been seeking to create a global corporate tax framework under the auspices of the OECD.

The proposal aims to allow governments to tax profits based on sales made in their jurisdictions. In the case of tech, a digital tax would help avoid the concentration of tax revenues in low tax jurisdictions, as is the case today.

The OECD also wants to establish a minimum global tax rate to prevent companies from arbitraging tax differentials and to stifle tax competition between countries when they try to attract foreign investment.

These proposals were opposed by the Trump administration on the basis that they would disproportionately affect US companies. Then-Treasury Secretary Mnuchin even threated to levy tariffs on countries imposing these measures.

However, the new US Treasury Secretary, Janet Yellen has expressed support for the minimum global tax rate stating during her confirmation hearings that:

> *…in the context of the OECD negotiations on global taxation, we have much greater leverage to keep our American firms competitive if we avoid a race to the bottom in corporate taxation more globally."*

On the OECD digital services tax (DST) proposal, Secretary Yellen similarly spoke constructively,

> '…(while) DSTs differ across jurisdictions, many have been designed in a way that unfairly singles out a few large US digital platform companies.'

The OECD estimates that, once implemented, these measures could increase corporate taxes by as much as USD 100 billion or 4% in total, providing a much-needed influx into national coffers suffering from the fallout of the global pandemic.

What appears clear is that the direction of travel for corporates generally, but for Big Tech in particular, is towards higher rather than lower tax burdens. In the midst of the pandemic, it does not appear that the political will is strong enough, certainly not in the US, to pursue increased corporate taxes or GILTI taxes in 2021.

Looking into 2022, the picture becomes more opaque, as higher corporate taxes and potentially the OECD global minimum tax rate could become more likely. Moreover, even though the political hurdles are high, a rise in digital services or US GILTI taxes to help pay down fiscal deficits represents a growing risk in 2022 and beyond for Big Tech.

Strategies for investors looking ahead

In spite of this proliferation of threats for Big Tech, the most serious of these, namely tax changes or new EU regulations, are unlikely to be imminent.

Rather, while enhanced oversight or an outright break-up from US regulators may result in near-term volatility, like in the case of Microsoft in the 1990s, we do not think these measures will necessarily derail their future earnings growth.

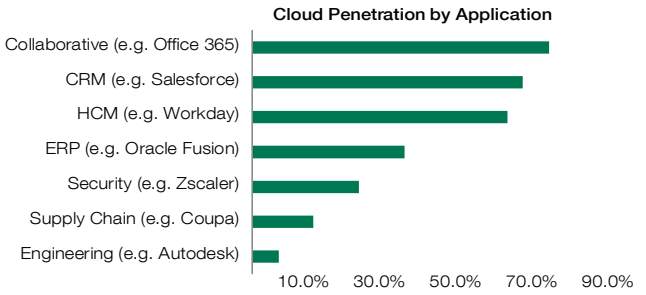
Indeed, should regulatory action raise concerns about longer-term growth prospects, the unlevered balance sheets and strong free cash flow generation of Big Tech firms allow them to replicate the measures taken by Apple in recent years via dividends and share buybacks to keep their stock prices up, mitigating the potential for a compression in earnings multiples in a period of regulatory uncertainty.

As with Apple and Microsoft, free cash flow generation should allow Big Tech to keep investing and innovating in order to remain on their growth trajectories.

For investors, it would be premature to divest out of Big Tech because of these threats. However, a degree of diversification away from established players towards earlier stage technologies or segments may well represent a prudent form of protection and at the same time present an opportunity to benefit from future transformative trends that may reshape the global economy.

The cloud computing transformation offers such an opportunity. While certain segments have made significant progress migrating to the cloud in the midst of the global pandemic, the engineering software segment remains at an early stage of adoption, allowing investors to maintain an attractive growth trajectory within the overall cloud computing thematic.

Even within the Cloud Computing transformation, there are comparatively mature and early-stage segments



Sources: IDC and UBP

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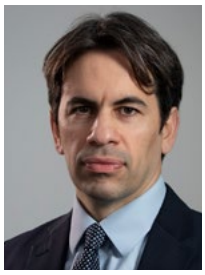

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