Wagner Road Capital Management

Investing Through Antitrust Challenges

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One of the biggest stories of the past few years has been the ongoing antitrust investigations of major technology companies like Google, Amazon, Facebook, and Apple. This type of attention is widely considered to be bad for business. At best, it's an interruption. At worst, it's devastation. But outside the effect of an individual case, there are two general rules about any business that grows large enough to attract the attention of antitrust regulators:

1. It was probably an excellent investment over the previous 10 to 20 years.
2. It might not be able to grow any bigger.

As investors, we can always hope to identify *future* antitrust targets—industry giants before they become giants—but we are most likely to find the companies that have already won. This is where regulatory risk becomes a real concern. What happens next? It may be similar to what has happened in the past.

While each decade has a different level of antitrust intensity, the historical record of major antitrust cases can provide some ideas on how current antitrust lawsuits may affect potential returns. Modern antitrust cases are generally more "preventative" with different regulators probing every deal, but the scary kind of antitrust aims to break up a company after it has already grown too powerful. And that's what we're looking at here.

We're not considering the merits of the case or why either side won or lost—our interest is more in the effects on the business, because that's where we decide how to invest. If a company can lose the case and still end up with excellent returns, then that can still be a win for investors, because some businesses are worth more after they break up. From this perspective, the four most prominent antitrust cases are Standard Oil, AT&T, IBM, and Microsoft. Each one has its own conclusions.

Standard Oil

In 1911, after a five year antitrust case, Standard Oil was split up into 34 separate companies. The original shareholders were awarded shares in each of the new companies. Whatever effect this may have had on the business practices of the separated companies, the parts were worth more than the whole—shares mostly doubled, and each individual company continued to create value over several decades.

The ever-growing popularity of the automobile (and later chemicals and plastics) ensured that the industry would remain healthy, even with more competition.

Over time, the industry consolidated, and parts of Standard Oil still exist as Chevron and ExxonMobil.[1]

AT&T

In 1982, after a 7-year antitrust case, AT&T agreed to break up into separate companies. The breakup, which was completed in 1984, created 7 "Baby Bell" companies, each with regional monopolies.[2] For every 10 AT&T shares that an investor owned, they received one share in each of the new companies.

In 1996, someone did the math—an investor who bought AT&T right before the split, and held all of their shares, would average about 16% each year, or more than 600% over 12 years. The market return for that same time period was 14.5% per year.

The telephone networks, which became the infrastructure for internet communication in the 90s, transitioned into wireless networks, and continued to create value. Like the Standard Oil companies, AT&T has slowly merged back together, and major parts of it still exist as AT&T and Verizon.

IBM

On the same day in 1982 that the US Government settled its antitrust case with AT&T, it dropped a 13-year antitrust case against IBM. The objective was the same—to break up the company—but the result was different. Regulators decided that the initial reasons for bringing the suit were no longer valid, and the case was not strong enough to win (13 years is an eternity in technology).

An investor who owned IBM during that 13-year antitrust case would have done just fine. IBM's stock performance during that time was not significantly different from the overall market return. But the case was a distraction for the company. It is often credited as one of the reasons that IBM began to lose ground in the 80s and 90s with personal computers, and the IBM of today is a shell of its former self.[3]

With IBM, it is clear that the *fear* of antitrust regulation can affect the way that a company does business. It does not have the ability to be as aggressive as any potential competitors. And maybe IBM investors would have been better off if the

[1] Visual Capitalist, NES Fircroft, and TheWayAhead all have good summaries of the Standard Oil story.
[2] Cybertelecom provides a very detailed look at the history of AT&T since the 1960s. Investopedia has a much quicker summary.
[3] There were obviously many other reasons that IBM became uncompetitive, but the antitrust case is a major contributor.

company lost the case and was forced to break up into pieces. It eventually sold off major pieces on its own.

Microsoft

The result of Microsoft's antitrust case is more complicated. The company lost its 2-year case in 2000 and it was ordered to be broken up. The case was then appealed by Microsoft, where a higher court agreed that Microsoft had violated antitrust laws, but ruled that it did not need to be broken up. The company settled with the US government in 2002, agreeing to a range of competitive restrictions and independent oversight. These restrictions and oversight ended in 2011.

Any review of the results for Microsoft investors is also more complicated. The case happened at the height of the Dot-com bubble, a time when it is widely agreed (in hindsight) that the company's stock price was much higher than it should have been. But the initial effect on the business was similar to IBM—the company became more cautious in its approach, sometimes described as a "too late" kind of competitor, missing important markets like mobile phones. Microsoft also lost its position in the Internet browser market that generated the original antitrust lawsuits.

It's impossible to say how much might have changed without the antitrust case, but the company did see a major revival in the decade since it was freed from strict oversight. Most of that revival came with a new CEO, so it's still hard to make any conclusions, but Microsoft has successfully transformed its image into a friendly tech giant. The company no longer provokes regulators.

Today's Antitrust

Antitrust regulators are getting more aggressive. From what I have heard in presentations from antitrust experts, the modern way of looking at antitrust concerns is becoming broader than past cases. For a long time, "consumer harm" has been the standard for antitrust. But now there is more consideration for the entire industry and the rest of society. I am not sure what that will mean other than antitrust cases becoming more common.

What matters for investors are the effects on the businesses that are targeted by antitrust. And antitrust lawsuits represent a unique problem—they show up when a company is *too* successful. This is a good problem for anyone who can identify these companies years or decades in advance, but it's not always a bad thing for a relatively new investment. Big companies can become slow, complacent, and uncompetitive without enough outside market forces. Antitrust scrutiny can make these problems worse, but they can also force a business to focus.

As a long-term investor, I would not be worried about failed mergers, but the experience of IBM and Microsoft are signals of what could come from antitrust cases against companies like Google, Amazon, Facebook, and Apple. The fear of antitrust alone could be enough to slow their future long-term growth, opening the door for potential competitors. But a breakup is not always bad, and a good business can still recover. Microsoft learned from its mistakes, and other companies can too.

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