BANYAN CAPITAL MANAGEMENT

July 27, 2018

Banyan's equity composite was up 3.00% for the first six months of 2018 while the S&P 500 was up 2.65%.

In other news, we are pleased to report AT&T completed its acquisition of Time Warner (TWX) in the second quarter. On June 12th, Judge Leon issued a favorable opinion, and his scolding of the Department of Justice (DOJ) was unrelenting. The DOJ lost badly, to put it mildly, and the merger was approved with no conditions.

To recap, the DOJ opposed the AT&T/TWX merger, and, after failing to reach a settlement, it took the unusual step of suing to block the transaction. This shocked many in the business community. Vertical mergers (i.e. transactions involving companies in separate links of the value chain) are rarely disputed, much less litigated. In fact, this was the first antitrust litigation involving a vertical merger in over forty years.

The reason vertical mergers are rarely disputed is simple. They rarely harm consumers, which is the crux of any antitrust argument, because they rarely inhibit competition. Unlike a "horizontal merger" between two businesses competing for the same consumers, no competitor is eliminated. A vertical merger simply consolidates two links of the production process under one roof. Generally speaking, therefore, consumer choice and value is unchanged by vertical mergers.

There are exceptions, however. A valid argument can be made against a vertical merger if a particular set of criteria are met. If the combined company will have "substantial market power" (i.e. monopoly power) in its upstream market, it may be incentivized to "foreclose" competitors from its upstream output to monopolize the downstream market. For instance, AT&T might refuse to sell TWX's content to Comcast in an attempt to poach Comcast's video subscribers.

That was largely the DOJ's argument against the AT&T/TWX transaction, but there is a problem. As we noted in the thesis we distributed in the first quarter, doing so makes no economic sense. Even if TWX has "substantial market power," and it almost certainly does *not*, foreclosing its content from AT&T's competitors (e.g. Comcast) would be suicidal. Far more value would be destroyed upstream than created downstream.

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Judge Leon agreed. To quote his opinion directly,

> "[TWX] would lose over $100 million per month during a post-merger blackout with a large distributor. As a result, . . . [TWX] would not be incentivized to *actually* engage in a long-term blackout with a distributor. . . . In view of that evidence . . . , the lynchpin of [the DOJ's argument] . . . is the *assumption* that a post-merger [TWX] would gain increased leverage by wielding a blackout threat that will only be somewhat less incredible. That does not make sense as a matter of logic . . . ."

The transaction closed two days after Judge Leon issued his opinion. We received $100.51 of fair market value ($53.75 of cash and 1.437 shares of AT&T at $32.54 per share) for each of our TWX shares. Including the 40¢ dividend we received, our annualized return on TWX was roughly 19.8%. Not too shabby.

But there is a catch. We now own AT&T, but it is not a company we would like to own for long. Its two largest businesses, wireless and satellite television, are troubled. The first is subject to brutal price competition, and the second is in secular decline. Furthermore, we question management's willingness to operate the business in owners' best interest rather than their own, which is an unpardonable sin as far as we're concerned.

Nevertheless, even a subpar business can be an attractive investment at the right price. Various factors, including selling by other TWX owners, have driven AT&T's price way down. As of this writing, AT&T's pro forma "earnings power yield" is almost 10%, and its dividend yield rounds to 6.5%. That is far too generous. We believe there will be a better day to part ways with the stock.

Unfortunately, we may have to wait awhile. The DOJ, undeterred by the tongue lashing received at the hand of Judge Leon, filed a Notice of Appeal on July 12th. That means at least one more round of litigation, which will take months. This case may even reach the Supreme Court. If so, this issue may take a year or more to resolve. Stay tuned.

As Warren Buffett is widely credited as saying, "The stock market is a device for transferring money from the impatient to the patient." We were taking notes. Although AT&T comprises less than 2.5% of our composite, every penny matters. Therefore, we have no problem being patient, and patience is key to **<u>building permanent wealth</u>**.

Sincerely,

Gary L. Watkins
President

Drew D. Estes
Portfolio Manager