Finding Quality Companies

Lesson 201: Economic Moats

"To the question, What shall we do to be saved in this World? There is no other answer but this: Look to your Moat."—George Savile Halifax

In Workbook #1 of this series, we introduced the concept of an economic moat and the role it plays in identifying whether a business will stand the test of time. To define, an economic moat is a long-term competitive advantage that allows a company to earn oversized profits over time. Quite simply, companies with a wide moat will create value for themselves and their shareholders over the long haul, and these are the companies you should focus your attention on.

The term "moat" in regard to finance was coined by one of our favorite investors of all time, Warren Buffett, who realized that companies that reward investors over the long term most often have a durable competitive advantage. Assessing that advantage involves understanding what kind of defense, or competitive barrier, the company has been able to build for itself in its industry.

Moats are important from an investment perspective because any time a company develops a useful product or service, it isn't long before other firms try to capitalize on that opportunity by producing a similar—if not better—product. Basic economic theory says that in a perfectly competitive market, rivals will eventually eat up any excess profits earned by a successful business. In other words, competition makes it difficult for most firms to generate strong growth and profits over an extended period of time since any advantage is always at risk of imitation. The strength and sustainability of a company's economic moat will determine whether the firm will be able to prevent a competitor from taking business away or eroding its earnings.

How to Build a Moat

There are a number of ways a company can build a sustainable competitive advantage in its industry. Among the more qualitative measures commonly used to assess a firm's economic moat:

- Creating real or perceived product differentiation
- Driving costs down and being a low-cost leader
- Locking in customers by creating high switching costs
- Locking out competitors by creating high barriers to entry or high barriers to success

Thankfully we've been able to whittle down all of the types of advantages in the marketplace. In Workbook #1, we identified the four main types of economic moats, and below we provide a bit more detail, using examples. The more types of moats a company can build, the better.

Low-Cost Producer or Economies of Scale

Companies that can deliver their goods or services at a low cost, typically from economies of scale, have a distinct competitive advantage because they can undercut their rivals on price. Likewise, companies with low costs can price their products at the same level as competitors, but make a higher profit while doing so.

This type of moat creates a significant barrier to entry, since a prohibitively large amount of capital is often required to achieve a size needed to be competitive in a market.

Dell

Dell's success is due to the company's famous build-to-order direct-sales business model, which eliminates expensive middlemen, lowers working-capital investments, and provides real-time market information to management. The direct model's low-overhead advantage allows Dell to undercut rivals without sacrificing features or profitability.

The firm has consistently improved margins and increased revenue, in good times and bad, by replicating the model across several new markets. Most recently the firm has moved into consumer electronics, which is typically a lower-profit-margin market. But given Dell's low-cost structure, it may succeed here as well. Along the way, Dell's competitive advantage in building computers, servers, and notebooks at the lowest possible prices has made life extremely difficult for other manufacturers, particularly Gateway and HP Compaq. The cyclicality of the IT industry carries some risks, but Dell's robust cash flow and strong balance sheet help mitigate those risks.

Wal-Mart

Wal-Mart is perhaps the most salient example of a company benefiting from economies of scale, and for good reason. As a dominant player in retailing, the company's size provides it with enormous efficiencies that it uses to keep costs low. For example, its size allows Wal-Mart to do its own purchasing more efficiently since it has roughly 5,000 large stores worldwide. This gives the company tremendous bargaining power with its suppliers.

Not only does it get its products cheaper, but its size allows it more inexpensive distribution. In addition, it has an enormous amount of information concerning consumer likes and dislikes, and it can spread its best practices across its entire store base.

To see economies of scale in action, let's assume that Wal-Mart can acquire a DVD from a supplier for $5, while it costs one of Wal-Mart's smaller competitors $6. It also costs Wal-Mart $4 to distribute the DVD and pay for the overhead costs of the stores, while it costs the smaller competitor $5 to do the same. Wal-Mart can then sell the DVD for $9.50, and still make a $0.50 profit. The smaller competitor can't charge that little, because at a cost of $11 per DVD, it would be losing money.

High Switching Costs

Switching costs are those one-time inconveniences or expenses a customer incurs in order to switch over from one product to another, and they can make for a very powerful moat. Companies that make it tough for customers to switch to a competitor are in a position to increase prices year after year to deliver hefty profits. Companies aim to create high switching costs in order to “lock in” customers. The more customers are locked in, the more likely a company can pass along added costs to them without risking customer loss to a competitor.

Autodesk

Autodesk dominates architecture and construction-design software with its market-leading AutoCAD product. With roughly 6 million loyal users, it has a wide economic moat—high switching costs make it tough for customers to get comparable products elsewhere or do their jobs without the help of Autodesk. Because customers are essentially required to understand its software to be successful in their careers, it is nearly impossible for competitors to take meaningful market share from Autodesk.

Autodesk’s software is also relatively affordable, making it somewhat immune when the economy turns south. While some software costs millions of dollars, Autodesk’s products cost much less; the initial price of AutoCAD is only a few thousand dollars. This makes the company less susceptible to cutbacks in information-technology spending. In addition, using its software reduces expenses by shortening the design and manufacturing processes. The firm has also incorporated subscription sales, which add more predictability to its business model and further “lock in” its customers. As with many technology companies, uncertainty remains regarding its new product development cycle and adoption of new products, but Autodesk’s committed customer base give the firm a wide economic moat.

Citigroup

If you've ever taken the time to move all of your account information from one bank to another, you know what a hassle it can be. Even if another bank is offering the same services for $1 less per month or maybe a slightly higher interest rate on deposits, is all the extra effort needed to switch really worth it?

You may also want to look at your wallet and think about your credit cards. How long have you had some of those cards, and why do you keep them? Surely a better deal could be had elsewhere. But perhaps you have built up frequent-flier miles on your cards, have your utility bills automatically charged, or enjoy the familiarity that having the same account for a long time offers.

Clearly, banks and credit card companies enjoy the benefits of the high switching costs their customers would incur by leaving. As the largest credit card issuer in the world, Citigroup is one of the beneficiaries. It is also worth noting that Citigroup enjoys switching costs across a large number of its other financial services businesses, making for an impressive firmwide moat.

The Network Effect

The network effect occurs when the value of a particular good or service increases for both new and existing users as more people use that good or service. It can also occur when other firms design products that complement an existing product, thereby enhancing that product's value. The network effect is arguably one of the most potent competitive advantages, and it can also quickly catapult firms to the lead in new industries.

Adobe

Like Autodesk, Adobe actually enjoys two economic moats. The firm's Acrobat software has become the standard for reading and creating documents electronically. Because customers, such as graphic designers, are trained early in their careers to use products like Photoshop and Illustrator, it's nearly impossible for competitors to take meaningful market share. High switching costs make it tough for customers to get comparable products elsewhere or do their job without Adobe.

As if switching costs weren't enough, Adobe also benefits from the network effect. With more than 500 million copies downloaded, Acrobat has a foothold on computer desktops everywhere. As its network effect increases, and more designers and readers use Adobe's software, its position as a standard-bearer grows.

eBay

When the online auction market was just getting started, eBay was the largest. As the site with the most sellers, it had the widest selection of products. This attracted the most buyers. Because it had the most buyers, it attracted more sellers.

The cycle just continued to feed on itself, and now eBay is essentially the only real online auction site of size. It was able to capture this position even though some large, well-known, and well-financed Internet companies such as Yahoo and Amazon tried to make a frontal assault on eBay in the late 1990s with very little success.

Intangible Assets

This category incorporates several types of competitive advantages including intellectual property rights (patents, trademarks, and copyrights), government approvals, brand names, a unique company culture, or a geographic advantage. It may be difficult to assess the durability of some of these advantages, so be sure you have a grasp of how long this type of competitive advantage might last. Brand equity, for example, can be damaged or slowly erode over time, while government approval can be revoked. Try to understand how susceptible a firm might be should this kind of advantage be disrupted.

Moody's

Moody's plays an important role in the capital markets by evaluating the risk associated with borrowers and debt instruments. The rating process is hardly ever easy. The federal government has created a designation—nationally recognized statistical rating organization—that a company must acquire before moving into the market. Achieving this designation is very challenging, meaning that the rating business is basically a government-sanctioned oligopoly with a limited number of competitors.

The government protection Moody's enjoys is virtually priceless. Operating profit margins have been higher than 50% over the past couple of years, thanks to growth in international and structured finance, where pricing is especially sweet. These high margins lead to excellent cash flow from operations. The company requires very little in the way of capital investment, so its leverage is low and free cash flow is strong.

Harley-Davidson

Anytime people are willing to tattoo a company's logo onto their arms, it is a surefire sign of a powerful brand. The firm, the only continuous survivor from the original American motorcycle industry, is more than 100 years old. The brand built over this time has allowed Harley dealers to sell motorcycles at or above manufacturer's suggested retail price for years. Despite selling essentially the same steel, chrome, and rubber as its competitors, it can charge premium prices for its products. And as we'll see later in this workbook, Harley's brand has translated into solid financial results for the company.

Brand Doesn't Always Equal Moat

Just because a company possesses a well-known brand does not necessarily mean that company has an economic moat. We've all heard of United Airlines, Chevrolet, and Ford, but the companies with those brands have had a difficult time competing. As such, the stocks of those companies have been terrible investments. In later lessons, we'll demonstrate how to read financial statements to determine if a company has a moat or not.

The Bottom Line

While having these four types of moats, or competitive advantages, as guidelines is helpful, there is still a lot of art to determining whether a firm has a moat. At the heart of it, the harder it is for a firm's advantage to be imitated, the more likely it is to have a barrier to entry in its industry and a defensible source of profit.

Investor's Checklist

- Economic moats are long-term competitive advantages that allow companies to earn oversized profits over time. These are the companies you should focus your attention on.
- There are four main types of economic moats:
  - Low-Cost Producer or Economies of Scale
  - High Switching Costs
  - Network Effect
  - Intangible Assets
- The more types of economic moats a company has, the better.
- The longer a firm can sustain its competitive advantage, the wider its economic moat.

Quiz

Answers to this quiz can be found on page 189

1 Harley-Davidson has what type of economic moat?

a	Economies of scale.
b	Switching costs.
c	Intangible assets.

2 Which type of moat benefits from making life difficult for its customers?

a	Economies of scale.
b	Switching costs.
c	Intangible assets.

3 What type of moat are you likely to find in a commodity industry?

a	Low-cost producer.
b	Network effect.
c	Intangible assets.

4 If a company is able to price its products lower than its competition and still make a profit while its competition is in the red, it has what type of moat?

a	Low-cost producer.
b	Network effect.
c	Intangible assets.

5 When a company tries to differentiate its product from those of its competition by spending money on marketing, it is attempting to create what type of moat?

a	Low-cost producer.
b	Switching costs.
c	Intangible assets.

Worksheet

Answers to this worksheet can be found on page 199

1 Write down the four types of economic moats a company can create for itself. Then beside each type of moat, write down the name of a company not mentioned in this lesson that you believe has that type of moat.

Type of Moat	Company

2 Match the four types of moats with each of the following company characteristics.

- Low-Cost Producer or Economies of Scale
- High Switching Costs
- Network Effect
- Intangible Assets

Patent protection on a product:
Inexpensive product distribution:
Possession of one of only a few government licenses:
Ability to negotiate strongly with suppliers:
Ability to raise prices without losing many customers:
Existing customers attract other customers:
Ability to charge premium prices due to branding:
Ability to undercut competition on price:

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3 Beside each of the following characteristics, check "Moat" if you think a company that possesses that characteristic likely has a moat, or "No Moat" if you think it does not.

	Moat	No Moat
Number of customers keeps growing, despite large price increases	◯	◯
Small price increase sends customers to rivals	◯	◯
Suppliers have the upper hand and negotiate tough terms with company	◯	◯
Company had very strong profits last year, but is near break-even this year	◯	◯
Company has product that will be nearly impossible for competitors to replicate	◯	◯
Strong labor union demands, and receives, much larger portion of profits each and every year	◯	◯
Brand allows company to charge premium prices for an average product	◯	◯
Lowest overhead costs among industry peers in commodity market	◯	◯