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Michael Porter identifies two ways a company can create a competitive advantage: lower cost or differentiation. The presence of one or both of these factors is the key to the company earning excess returns on capital and creating value.

When selecting investments, I devote my energy to analyzing company operations in order to identify the source and sustainability of a competitive advantage. In Porter's framework, the advantage is derived from attribute(s), such as *resources, market position, or skills,* that allow an organization to outperform its competition. Each of these attributes can take various forms, but I believe they are captured in the following categories.

Asset-based competitive advantage usually leads to lower cost than the competition and is especially relevant in commodity type industries.

PP&E – Companies, such as refiners, with a significant asset base that is either uneconomical or impossible to replicate. Building a new refinery requires navigating a nearly impossible web of local regulation and making heroic assumptions on future demand for the product. That is why the last major greenfield refinery in the U.S. was commissioned in 1977.[1]

Natural Resources – Companies with access to a superior resource that allow them to produce at a cost below that of the marginal producer. As an example, oil companies in Russia and Kazakhstan **(Lukoil, GazpromNeft, etc…)** extract oil at below $10 per barrel while marginal producers (e.g. shale, tar sands) need prices in the $50 to $80 range to break even.

Distribution – In this case advantage comes from the scale that took years to build up. Amazon's domination comes from their ability to offer same-day and two-day shipping at a price that is lower than any other company. They can do that due to tremendous purchasing power and the network of warehouses located close to population centers all over the S.

Competitive advantage that is based on intellectual property can take on many forms and will often lead to differentiation that allows for excess returns on capital.

Patents – Probably the first thing that comes to mind when thinking of IP based advantages. Long period of patent protection is the key to the pricing power that drug companies enjoy, which usually translates to gross margins of 90% or higher. It is important to keep in mind that patents based competitive advantage are not sustainable since they expire.

Trademarks – This competitive advantage is usually associated with brands such as Coca-Cola, Gillette, Brand based competitive advantages are considered to be under threat due to changing consumer preferences, but it is going to be a long time before people will be willing to pay as much for RC Cola as they do for Pepsi or Coke.

Content – The best example of a content-rich company is Disney, which owns the rights to some of the more marketable media assets, including Marvel superheroes and Star Wars characters. These assets are exploited or created via feature films and are monetized via licensing deals and theme parks. Content advantage can also come from cumulative R&D spend for a technically complicated product (microprocessors, industrial robots, etc.)

Regulation – A general increase in regulatory burden and complexity is almost as certain as death and taxes. The Dodd-Frank law is 23 times longer than the Glass-Steagall act that followed the 1929 Wall Street crash.[2] While regulation increases costs on incumbents, it also creates an often unsurmountable moat for new entrants. As an example, all the fintech companies trying to disrupt the industry still rely on traditional banks for AML and KYC infrastructure.

Know-How – Any process, whether retail, manufacturing, or distribution, benefits from incremental knowledge acquired through day-to-day operations. As an example, Walmart is constantly sourcing ideas from its 2.1 million employees on how to improve sales or costs. Unlike other intellectual property, "know-how's" competitive advantage is expressed through lower costs instead of pricing power.

The last category of competitive advantage comes from customer captivity acquired through either brand affinity or learning. These types of competitive advantages usually lead to pricing power and require low amounts of capital to upkeep.

Brand Affinity – The adage of "nobody got fired for buying IBM" applies to many companies that are known for providing quality, reliable, mission-critical products or services. A good example is Verisign, which is licensed by ICANN to make sure that every .com and .net address leads users to the appropriate website. While the contract comes up for renewal every five years, the likelihood of ICANN taking a chance on another provider is low, owing to inherent execution risk. As a result, Verisign has pricing power, which allows it to raise prices by 3% per annum on average.

Customer Learning – Anyone who has taken the time to integrate a spreadsheet into a Bloomberg knows how difficult it is to wean oneself from a service provider. A less obvious example of captivity that comes from customer learning are dental offices that have been set up by either Patterson or Henry Schein. Suppliers set up offices for dentists and automatically provide them with supplies. There is little price discovery in the process, which allows for reasonable price escalations as long as a reasonable service level is maintained.

A good company will have one of the competitive advantages mentioned above, but a great one will have several and will benefit from both lower cost and differentiation. I believe that **Harley Davidson (HOG)** has an advantage on the cost side owing to its scale, and an advantage on the differentiation side owing to a strong *brand affinity* for its product. There are very few companies that can boast 50%+ market share (*scale*) despite being 20% to 30% more expensive than the competition. There are even fewe that can claim that their brand name is the one which people are most willing to tattoo on their bodies[3].

Thanks to its pricing power, Harley Davidson routinely generates returns on invested capital in the 20 to 30% range[4] – well above peers and other manufacturing companies. These returns are protected via $150 to $175 million annual R&D spend *(content)*, proprietary network of almost 1,500 dealerships (*distribution*) and finance company (HDFC) that finances 60% of Harley Davidson motorcycles sold. HDFC is a wholly owned subsidiary of Harley and is worth approximately 40% of company's current market cap.

Harley Davidson has everything that I look for in a company, but for the last few years has been missing a supportive market environment. In North America, the number of new large (601cc+) motorcycle registrations went down by 13% in last two years and is down by 47% since 2006. While most analysts are attributing the decline to a permanent change in consumer preferences, I believe the devil is in the details, and the current weakness presents an attractive buying opportunity.

Since 2008, the number of new registrations as a percentage of total touring and cruiser (larger bikes) registrations went down from 10% to 5.4% and the average age of motorcycles on the road went up from 8.8 to 11.8.[5] In fact, the total number of 601cc+ motorcycle registrations has been going up both in absolute terms and as a percentage of the US population between ages of 35 and 55. The data on the average motorcycle usage is unreliable, but best estimates[6] suggest that current average age of a bike is well above normal life expectancy of a motorcycle engine. Another interesting piece of data is the look at the relevant population itself. The cohort of 35 to 55-year-olds has been shrinking for the last few years, but is about to start growing again as the millennials age. Combining the above factors, I believe that the current North American new large motorcycle sales are approximately 20 to 25% below normalized levels.

In addition to being a great business, Harley Davidson is also an excellent capital allocator. Even in the current sluggish sales environment for its motorcycles, it generates enough free cash after CapX to yield approximately 10% to the current market price. Most of this cash is returned to shareholders in dividends and buybacks, and the number of shares outstanding is down by 28% in last eight years. Since 2009, Operating cash flow per share has grown from $2.61 to $5.98, an 11% CAGR.

I believe that Harley Davidson is a rare combination of quality and value available in the market at a reasonable price. While it is possible that the market for large motorcycles is permanently challenged, levels of engagement, average age, and demographic trends suggest otherwise. Thanks to its dominant market share and pricing power, I expect that Harley will continue to generate significant free cash flows and reduce shares outstanding. Its market should turn in the next year or two, and the coiled spring effect will generate excess returns to those shareholders willing to keep the faith.

Listen to Steve's in-depth presentation on Harley Davidson.

Footnotes:
[1] Source
[2] Source
[3] Source
[4] Source
[5] Motorcycle registered in the United States 2002-2017 – IIHS
[6] Source