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Darwin's Power and Porter's Missing Force – A Framework for Global Returns

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Shall Value Investing end with Warren Buffett? The question itself is an irony as he was one of few men who had the boldness, genius and audacity to extend the original ideas of the father of Value Investing as we know it. One of the keystones of innovation is that some people are able to connect what are seemingly unrelated ideas, and create what Charlie Munger calls 'Lollapalooza' effect – sum being greater than the parts, like the idea of 'Emergence' in science. Buffet's investing innovation was that he realised early on that key Graham ideas of 'margin of safety', 'the investor philosophy' etc. need not be applied just to 'cigar butt' and 'one foot in the grave' companies. The investing net could be casted much wider than just Graham's 'net-net', and having detailed knowledge of the companies in the portfolio offered much greater protection than that offered by the Statistical God's law of large numbers (of stocks). However every mortal genius has a flaw, which for a reason unknown to yours truly, the imitators, like moths to the flame, find it hard to resist. So, I won't invest in tech as Buffett just won't (historically)! But Buffett will score home runs in finance and insurance, and you won't – Were you offered to buy cut price Goldman warrants in the great panic of 2008? Hence imitation might be the sincerest flattery of a master, but inspiration from a master is what is likely to flatter our pocket books.

Standing on the shoulders of Value Investing Giants, can we develop a framework to see further, incorporating our knowledge, experiences, and above all our imagination? A case in point is the once famous money manager Bill Miller. His seminal contribution was that he extended the Value Investing framework to include Technology stocks. Value investors can now drive confidently in what was once Buffett's blind spot! So why did Miller fail? Imagine investors trying to tame the wild market Elephant in the dark. It is as if groping Graham found one leg that emphasised Elephant's strength and stability. Buffett got the awesome trunk which combined with his mentor's earlier knowledge of the powerful legs, gave him a sense of the awesome power of the beast. Miller landed the stylish ivory, which he correctly figured out to be hitherto unknown, but another offensive weapon in the arsenal. However as the Ancient Greek Hippocrates pointed out, "Life is short, and Art long; the crisis fleeting; experience perilous, and decision difficult", it is as if the mental flexibility of individual mortals can only take baby steps in improving the collective investing wisdom. A decade after the financial crisis, it is now clear that the ever perennial desire for corporate power, power pressures and the amoral incentives all played a central part in thwarting the then well-established Value Investing framework. One of the most well-read American Presidents, Richard Nixon, once wrote that leaders are not ordinary people. Underscoring the nature of brutal competition and the power of incentives on self-interest, he was of the view that if these less desirable traits appear benign in other domains apart from Sports and Politics, it is only because it is better concealed in those sectors. So US Subprime stocks looked cheap to investors on the eve of financial crisis, but unless you had understanding of the power dynamics of key players (I shall dance till the music stops – else I look stupid if the music plays on), incentives (Securitisation makes my low quality loans magically high quality, my meat today and may be someone else's poison tomorrow) and ethical short fuse (Heads I win, and tails you lose – an insider like me who has high business visibility can always unload at the peak for 'diversification' reasons), the subsequent events proved the limitations of a 'high on Quants and low on Poets' investing framework.

Darwin's Power:

Given that power is central to human interactions, how central is it in investments?? Investors have traditionally attributed excess returns in any company to a 'moat' – a kind of competitive advantage with new products, platforms, scale etc. that cannot be easily replicated by the competition. However, I would argue that power can manifest in many forms, and traditional moat is only one of the manifestations of broader corporate power. In other words, is it possible to build a multi-billion market cap business by providing just commodity services and without having any moat in the traditional sense?? If you said impossible, I would say, 'Him possible', i.e. possible with Darwin – 'Darwin's evolutionary Power'. In fact, stocks of precisely such companies have become 100 baggers in the US over the last 15 years. The services they provide are so plain vanilla that it can be easily replicated by your local realtor. They are brilliantly asset light, real estate fellas who don't like to own real estate. And when it comes to owning any fast depreciating hi-tech gadgetry, they would simply say 'no' & allow their customers take the technology risk on their sites. However their evolutionary Darwinian power is so strong that they are able to extract a big chunk of value from the Wireless ecosystem- the stomping ground of the mighty Telecom techies of America, the AT&Ts and the Verizons. In fact the largest of them is now about 30% of the market cap of Verizon – outstanding if you consider that this industry was established only in the mid-90s. Welcome to US towers – The lands of the American tower of Boston, Crown Castle of Houston and SBA of Boca Raton, Florida.

One of the greatest business models in the world is just a simple ***'Pole in the hole'*** *tower business. Tower companies leases spaces on towers primarily to Wireless carriers. Multiple tenants can sit on each tower, as seen in the picture above.*

So, why is the rise of US towers, a prime example of Darwin's evolutionary power in action? Historically almost all the wireless towers were owned by the Carriers (AT&T, Verizon, Sprint, T-Mobile etc. or their predecessors). They were primarily built for the individual carrier's coverage needs only (i.e. no sharing of towers with competitors). This was also because some US carriers led by Verizon and Sprint, moved towards Qualcomm derived CDMA standard, whereas others such as AT&T and T-Mobile chose GSM, which was the main mobile standard globally. Having two different standards with differing frequencies and signal propagation also changed the coverage requirement at individual sites. This dichotomy in chosen standards proved to be a major Darwinian evolutionary move which later proved to be a cornerstone of tower power. In the mid-90s, the Carriers bogged down by rising capex requirements and the corporate fashion to focus on 'core competence' (real estate haggler, who me AT&T!), starting selling their tower portfolios to tower companies. This move proved to be such a high step function in Darwinian iteration that for the first time majority of the wireless towers came in the hands of independent American entrepreneurs. Moreover, American entrepreneur, that innovation superman, invented a secret sauce that turbo charged the tower returns – multi tenant tower leasing. Like China's Deng Xiaoping, who once famously commented, 'The colour of the cat doesn't matter as long as it catches the mice', the tower entrepreneur decided that he would invite all US carriers to sit on his towers, a bait which if successful could give him windfall profits. This proved to be a great business model innovation as with one tenant on your tower, you can only cover your costs, but a second and third tenant could give you exploding profit growth with close to 90% profit margins on incremental tenancies – the way to profits is to subdivide the land in sky!! Now all they had to do was to consolidate and execute the age old land grab! And boy! They did woo & marry, and by early to mid-2000s consolidated primarily into three tower giants – a set up that continues to this day.

'The die is cast' said Julius Caesar as he crossed the Rubicon river with his troops against the wishes of the senate. The die was also cast against the US Carriers as the minnow towers merged into towering giants, but little did the Carriers realise at the time! When the carriers woke up from their real estate slumber, they suddenly discovered biblical John 14:6 (…No one comes to the Father except through Me.), for the carrier gateway to the customer heaven was now routed through the Big 3 tower companies. Moreover, with strict zoning rules in US it was now impossible to do a large scale build out of new towers to rival the existing network. The 'tower negotiators' at the carriers finally realised that Darwin's evolutionary power follows you like your shadow, and they will have to pay a heavy price now, for their expedient actions of the past. Inflation busting rental escalators with long term contracts that will soon escalate to a mighty sum over time, no discounts even as a second or third carrier at lower heights on towers, homage to tower cos every time carriers add more equipment (amendment revenues), and even having to pay to strengthen the towers so they can charge Carriers to sit on their towers (re-development capex), all pointed to how the power equation evolved to favour the tower men of America. The carrier's response has been

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their own version of the classic WWII Battle of the Bulge – sell their last remaining towers to the Big 3 at as much value as possible, for they realise they are now playing for pride, and need to salvage at least some value, even as the broader war has been lost and their once servants have become their new masters!!! As always, America loves the winner, and the young tower stocks became the 'Wow Jones' of America and the ageing carrier stocks the 'Dud Jonesses' of Americana!!

Porter's missing force:

Harvard's Michael Porter developed a famous five forces framework to analyse the competitive advantage of companies. His key forces, which is now the staple diet of most Business School Strategy classes, were the 'Threat of new entry', 'Supplier power', 'Buyer power', 'Threat of substitution', and 'Competitive rivalry'. While Porter approximated any change in moat power to the first derivative of these five forces, is there another 'missing force' that often creates brand new competitive advantage, or destructs the advantage created by the five forces?? Enter 'Politics'. Generally we could see Porter's missing force in action in two arenas – Corporate and Government. On the corporate level, unlike in Europe, the US Carrier aversion to active network sharing means that all US carriers are duplicating their tower and tower equipment needs. The is especially irrational from the point of view of Carrier shareholders, especially considering that US is a mature wireless market with network quality ceasing to be a competitive advantage, and also as all the carriers have now moved to the same LTE standard for 4G. However, given that big network sharing would involve heavy job losses, would you expect the political managerial machines within these carriers to cheerfully vote for the proposal (classical agency problem in economics, but created by politics)?? Another area where you can see Porter's missing force is in the errors of omission – lack of tower acquisitions by Carriers. If a large US carrier can acquire one of the big 3 tower companies, they can re-balance the power structure and change the pricing power for the whole industry. But who will bell the Aesop's cat?? Which Ivy League MBA en route to tech corner office would want to be the sacrificial lamb and build a career in the more earthly, hustling, haggling and bluffing business?? An area where corporate politics can create shareholder value is in the tower poker games around MLAs (Master lease agreements) and in estimating equipment demand with new technologies (4G/5G etc.). In comparison to the PhD heavy Carriers, tower cos's limited knowledge of technology complexity means that they will have to make political choices between locking in carriers for long duration on sweetheart a la Carte terms or to price their sites to perfection, especially if they could anticipate large equipment deployment. Tower companies know that carriers will try to low-ball the equipment weight and tower demand, and so their job is another example of a Keynesian beauty contest – not the prettiest girl, but who will the crowd think to be the prettiest? Finally, there is another political knowledge arbitrage game with the owners of tower land. In the US, most of the lands under towers are leased on long term contracts mostly from mom and pop or other small landlords. Do they benefit as tower cos add the second or third tenant? Of course not!! And as the late William J Baumol of NYU often pointed out, clever ruses, brilliant innovations, charisma are all stuffs with which outstanding entrepreneurship is made!!

Finally, Porter's missing force in Wireless takes us to the mother lode of political moves – Uncle Sam! Carriers know that they can reduce their aggregate tower demand by merging and reducing duplicate towers, and also by convincing FCC (Federal Communication Commission) to release more Wireless Spectrum. Not for their lack of trying though – AT&T lost about $6bn in their failed attempt to buy T-Mobile. Sprint was only recently silently rebuffed by the Democrat controlled FCC for its audacity to approach them with T-Mobile marriage proposal. And the latest attempt by Sprint to 'Make Telecoms Great Again' in the Trump world, by merging with T-Mobile, fell through because of their own internal political power manoeuvring! This is a classic dilemma made famous by Machiavelli – You know what to do, but are prevented from doing it! Yes, mergers will make both Sprint and T-Mobile more competitive & will be a bonanza for our shareholders, but we can't do this as our (and our target's) political jockeying for posh jobs just won't stop!! And tower companies have also made their own political moves by locking-in the weakest and smallest carriers on non-cancellable long term contracts by offering sweeteners, extending their own lives and passing the risk on to the potential acquisitor of the weakest wireless links. Hence the view that Politics is one of the key forces in the creation, distribution and destruction of the Shareholder Value pie.

In my MOI Global presentation, we shall see how we could extend this framework beyond US and into Asia, where we will analyse another tower company, which I reckon has won the power struggle and is set for strong upside. If you have any comments, please feel free to send it to george_kurian@hotmail.com. For more information, please see my LinkedIn articles below:
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