MOI GLOBAL

Members Share Their Insights into Moats

We recently invited our members to share their thoughts on identifying companies with sustainable competitive advantages. Please enjoy the selected responses below.

ETHAN BERG, CHIEF INVESTMENT OFFICER, G4 PARTNERSHIP

While there are numerous potential sources of advantage, what strikes me is how genuinely rare it is to find sustainable competitive advantage. A company may have good products, a good reputation, significant market share, and high returns on capital, but each one of these is susceptible to erosion. By themselves, none of those factors indicates sustainable competitive advantage. The latter exists only when a firm clearly understands customer needs and uniquely and decisively configures their own assets and activities to deliver against those needs better than any other firm— an advantage so great that it is not replicable no matter how much a competitor spends. The advantage should almost seem unfair. Otherwise, if the opportunity is good enough, other firms will build the capabilities, and the advantage will not endure.

The three most important things to look at in searching for competitive advantage are 1) customer's needs, 2) a company's assets and activities, and 3) the fit between those two things relative to other firms.

For commodity products, the need is almost always price. Low prices can only be maintained over time if the company in question has a lower cost structure. As Ken Peak correctly pointed out in his Contango [MCF] roadshow when he discussed their core beliefs since inception, "The only competitive advantage in the natural gas and oil business is to be among the lowest cost producers." He configured the company to be a low-cost producer. Helpfully, he would detail the full costs of production for him and others in his industry. He was focused on the one thing that mattered in his business.

In non-commodity businesses the needs vary, but the analysis is the same. Good strategy in non-commodity businesses begins with an understanding of who the customers are and what their needs are. I live a few minutes from Tanglewood, the summer home of the Boston Symphony Orchestra. My wife and I occasionally host chamber music concerts. We have in our living room a piano made by Steinway [LVB]. One hundred years, ago, Steinway had strong market share amongst concert pianists. Today, it has strong market share amongst concert pianists. While they are still short of Buffett's preferred holding period of forever, they remain a candidate.

There are quite explicit reasons their advantage has endured and will continue to endure. Generally speaking, within the piano market, there are four primary segments: professional/serious players, institutions, furniture buyers (!), and families. Each segment has specific needs. Focusing on the concert pianists, the need is what is called the "voice", which is Steinway's legendary sound. (For institutions, it is durability. For furniture buyers, it is type of wood and size. For families, it is primarily price.) Regarding voice, the underlying assets and activities are technical excellence (more than 100 piano-related patents), 12,000 parts, craftsmen with 20+ years of experience, the "concert bank," master piano technicians, know-how in wood selection, etc. There just isn't any easy way for this system of assets and activities to be replicated for this part of the market. While there could be questions about size of the market, the collection of individual advantages results in sustainable advantage.

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ANTHONY CAMBEIRO, PRESIDENT, ANTHOLOGY CAPITAL

To find a firm with a sustainable competitive advantage, you first have to find a firm that actually has a competitive advantage. One primary way of identifying a firm with competitive advantage is to look at the historical returns on invested capital. A long history of high ROIC is usually indicative of some kind of sustainable competitive advantage. There are many ways to measure this. Our preferred measure is [EBIT / (total assets – current liabilities + short term debt – excess cash)]. Another favorite method is to ask a CEO a variation on these questions: Which one of your peers do you most admire and respect? If you could put a silver bullet in the head of one of your competitors, who would it be and why? If you could pick one other company in your industry to own/run, which would it be and why? If you ask enough players in the space these questions, you'll end up with a pretty good view of the market.

Let's say you find a company that has generated high ROIC. Start looking to see why they generate these returns and if the reasons are sustainable or temporary. A more difficult challenge is to find a company whose financials do not yet demonstrate competitive advantage. Finding a situation like that is every investors dream since the stock is likely to be mispriced by a wider margin.

To determine the question of sustainability of returns and thus sustainability of competitive advantage, it requires a deeper understanding of the business model and the reasons those returns exist. This requires a lot of reading (SEC documents, transcripts, presentations, industry research) on the company in question and all the other companies in the ecosystem (competitors, customers, suppliers). Additionally, it can help to speak with industry participants to deepen your understanding of the advantages a company may have.

A company with durable competitive advantage is Carmax [KMX]. I learned about Carmax KMX at my former firm. We were the largest shareholders in the KMX tracking stock in the early 2000s. I'm quite certain we were the first (in 2003) to figure out how to scrape the company's website every night and estimate the number of cars sold to within 100 cars out of 70,000. Carmax was once thought to be a terrible business. In the late 1990s and early 2000s, they found themselves in a land grab war with AutoNation [AN]. The company spent millions of dollars building huge superstores all across America, racking up huge losses. The stock fell nearly 90% from its IPO price. AutoNation eventually cried uncle and gave up. That day KMX shares hit an all-time low. However, this was the best possible news for KMX. The primary competitor who had forced them into a land-grab strategy had decided to quit. This allowed KMX to stop expanding and focus on optimizing the business.

What they developed over the coming years was a differentiated and unique business. There are hundreds of little advantages which combine to create an enduring and significant advantage. KMX has created something that has never existed in the used car market—a brand associated with trust. The long-term value of that brand association in the used car market is and will continue to be incredibly high, and no other company is close to building something similar. Here are a handful of the advantages we see KMX possessing:

Economies of scale. KMX sells over 500 cars per location while other dealerships average is closer to 40. This huge volume advantage allows the employees to become more efficient and allows the company to leverage fixed overhead and spend more on advertising to build a national brand.

Footprint of superstores in single-store markets. KMX has opened over 100 locations, and many are superstores in markets the company believes only support a single store of that size. This serves as a deterrent for a potential entrant since the prospective returns on capital would not look attractive.

Appraisal lane and wholesale market. KMX will purchase any car a customer brings into their stores. They have huge economies of scale, buying over 400,000 cars per year from their customer base. The margins on cars purchased through this appraisal lane are better than cars bought at auction. KMX can only buy at scale if they have an outlet for the cars they don't want. And so they run their own auctions for other dealers to come buy the cars KMX does not want to retail. You can only get dealers to come to your own auctions if you have enough volume to make it worth their while. Another benefit from this is that one of the first things a customer does before they buy a car is figure out how much they can get for their old car. Studies show that a large percentage of customers who purchase a car will do so from the first place they visit. Getting them to start at KMX thanks to the appraisal lane is a big advantage.

Brand. KMX has built a brand consumers can trust. The company stands behind the quality of their cars and the consumer offer—no-haggle pricing, à la carte offering of finance and extended warranties, and fixed commissions for salesmen, incentivizing them to put you in the car best for you.

Systems. Huge investment in systems has allowed KMX to know how to manage inventory and adjust quickly to changing market environments.

History in ABS market. KMX has a 15-year history in the securitization market. The proven history of their paper allows them to continue to securitize at rates far better than a new participant. This allows them to earn a better margin and keep accessing the market in tighter environments. This is not easily replicated.

There are other advantages as well, but this should give you a flavor of what makes the advantages of KMX durable. My experience with investing in KMX is that despite the long-term advantages, the stock market can still be overly concerned with near-term issues. KMX stock has been quite volatile, which is great for the longer-term investor since you can continue to buy stock during periods of weakness. Only by having conviction in the long-term advantages are you able to buy with both hands when the market is giving it to you.

JOHN GILBERT, CIO, GENERAL RE–NEW ENGLAND ASSET MANAGEMENT

Sustainable competitive advantage has become more appreciated, but not more persistent. The investing challenge of finding it at a discount has gotten harder.

Occasionally it comes our way. Mead Johnson [MJN] was the infant formula spinoff from Bristol-Myers [BMY]. It has all the things we like — an oligopolistic industry structure with high shares for the participants, a well-known and longstanding brand name in Enfamil, and unusually large exposure to emerging market economies, where infant nutrition and safety can be even bigger issues than in developed markets. Beyond the industry structure issues, however, MJN has an advantage most businesses crave but do not possess — price-inelastic customers. A baby is the most important thing in the world to young parents. What MJN is really marketing isn't a liquid, it is trust. Price is never irrelevant, but in this product is secondary. MJN and its small cohort of competitors have pricing flexibility and the margins and ROIC that go with it.

On lack of sustainable competitive advantage: Technological change has been poison for many legacy businesses that at one time appeared bulletproof. Newspapers are an obvious example. Another is Pitney Bowes [PBI], which had 80% share of the mailroom equipment market. A good business — until email became the dominant written form of communication. It was clear to us several years ago that attrition was inevitable in their client base. We eliminated any holdings and have not regretted that decision.

HEWITT HEISERMAN JR., AUTHOR, THE CHECKLIST INVESTOR

In my book *It's Earnings That Count* I describe a three-step test to find bargain growth companies:

authentic earnings power, durable competitive advantage, and low price to intrinsic value.

Morningstar says there are five types of durable competitive advantages: cost leadership, intangibles, switching costs, network effect, and efficient scale. I would add a sixth criterion: ecosystem (e.g., Apple's iOS platform). Companies with authentic earnings power, which I define as rising levels of GAAP net income, confirmed by steady increases in FCF and EVA, tend to enjoy competitive advantage. The more durable the moat, the more valuable the business. (Some firms enjoy multiple advantages, as Morningstar points out.)

To estimate competitive advantage durability, I used to compare my target to other companies that offered a similar product — a "left-right" landscape analysis. When I bought video retailer Blockbuster because "entertainment" is a perpetual want, and because the stores have convenient locations, I identified other companies that also distributed movies via physical locations, like Coinstar [CSTR] and their Redbox vending machines. I preferred Blockbuster, which offered a broader selection. That was a competitive advantage, I thought. Due to the rise of the Internet, I have learned to consider non-traditional substitutes. With its mail-deliver distribution model, Netflix [NFLX] was even more convenient than Blockbuster. Lots of other consumers realized the same, to Blockbuster's detriment. Selling for over $18 in 2002, Blockbuster declared bankruptcy in 2010, and shares last traded for $0.07. Lesson? When assessing the durability of a moat, think two-dimensionally. Don't just look at traditional substitutes (left-right), also consider alternate substitutes (up-down).

ARKO KADAJANE, PORTFOLIO MANAGER, AMBIENT SOUND INVESTMENTS

We don't have any good quantitative metrics for finding companies with a sustainable competitive advantage. It's rather easy to find companies which currently have a wide-moat business. Return on equity or return on invested capital gives you some sort of a preliminary understanding that the company should enjoy some edge over competitors. The problem is that in most sectors it's impossible to predict which companies that will have sustainable competitive advantage and high returns on capital in the future.

The main questions for me is how sticky the product or service is, and if the company have the ability to raise prices. If those two qualities aren't met there should be a scale advantage or some other low-cost operator advantage. I always like to think about the service or product as a customer, although sometimes this approach has a bias risk.

DAVE SATHER, PRESIDENT, SATHER FINANCIAL GROUP

We are happy to find oligopolies. Monopolies are either governmental partners, or the government will break up the monopoly. Either way, this presents a risk to an investment thesis. As such, a few strong competitors will provide very good returns — while keeping new competitors at arm's-length.

Having an oligopoly alone does not assure a good investment. However, an oligopoly with wise management can be fantastic. This will quickly show up in the numbers — high return on equity, high return on capital, high free cash flow. If the return on capital is too high, it can show a vulnerability for new competitors to come in. Obviously, being a low-cost producer is always good. Wal-Mart [WMT] is a great example. They are certainly not an oligopoly — but it is extremely difficult to compete against them.

Fannie Mae and Freddie Mac both were oligopolies that turned out to be bad investments because of a change in credit policy and poor management. These were also ones in which the negative influence of government or politics caused the management to do foolish things. In the end, the wide moat collapsed.

Cemex [CX] is an example where the moat was challenged. In our assessment, the moat was still there since a geographical monopoly arises around a cement plant due to transportation costs. Unfortunately, the incurrence of too much debt — and the stacking of the debt in a few maturities — greatly hurt Cemex.

Furniture Brands [FBN] appeared to have a moat. They had a great reputation and brand names. Unfortunately, once Asian markets decided to mass-market competitors, Furniture Brands could not compete due to their high labor costs.

FABIAN SCHILCHER, PRIVATE INVESTOR

As to finding moats in general, I could only repeat what the great investors have put in writing. There is, however, one specific concept I found appealing and wanted to analyze/backtest further but have not gotten around to doing so yet. It is the concept Sanjay Bakshi describes in a presentation about floats and moats. To quote Bakshi: “My argument in the presentation is that float comes in many forms, and if there is a solid moat, it’s quite likely there will be a low or zero cost float as well. If I am right, then there is a quantitative way to spot a moat — just measure the size of float and its trend over time…”

GREG SPEICHER, PRIVATE INVESTOR

Finding wide-moat businesses begins with developing a clear idea of what you are looking for. To do this, you need, à la Munger, a latticework of mental models drawn from the master teachers on competition and competitive strategy: Buffett’s complete corpus, Porter’s five forces, Greenwald, Pat Dorsey, and classic microeconomics works such as Shapiro and Varian’s *Information Rules*. This needs to be complemented by a growing mental library of wide-moat companies to use as reference points when evaluating possible investments. Obvious examples include Coke (brand, scale, cost advantages), GEICO (low-cost provider), See’s (brand), BNSF (lack of substitutes, insurmountable barriers to entry). An added plus is experience running a business, because there is no substitute for seeing these competitive forces from an operating perspective. This can be further complemented by reading the best books on industries, companies, and business leaders.

Once you know what you are looking for — an ongoing, cumulative process — there is no subsitute for broad, sustained reading and thinking to find wide-moat business. There is no way to automate this process. Good places to look are industries with superior economics: high barriers to entry, high returns on capital, stable market share. Another place to look is the 13Fs of focused value investors who specialize in wide-moat businesses. Once you find a wide-moat candidate, you must research it like a journalist, looking for insights into the nature and durability of the moat. Many such businesses are hard to find, but some great ones are hiding in plain sight and simply require the patience to wait for the right opportunity and the courage to invest when the time arrives.

JEFFREY STACEY, FOUNDING PARTNER, STACEY MUIRHEAD CAPITAL MGMT

Most investors intuitively understand the concept of investing in companies with enduring competitive advantages or what is referred to as a wide moat. But while the concept is simple, it is not easy to do. Judging whether a moat exists and the sustainability of that moat is difficult. Even Warren Buffett, who is clearly the greatest wide-moat investor of all time, misjudged the sustainability of the moat around newspapers when the Internet emerged as a disrupting force.

As I search and sift and study companies in an attempt to assess the size and durability of the moat a business may possess, I try to keep things as simple as possible. Does the business show a high return on shareholders’ equity over a long period of time? Does it have a pristine balance sheet? If a business generates high returns through leverage and financial engineering, it probably doesn't possess an enduring moat. Does the business have pricing power or brand presence or a low-cost production? Does it have high margins and a track record of consistent free cash flow generation? These are all pretty basic things and are easy to assess. While it won't necessarily result in an investable moat, insisting on the basics will lead you to high-quality companies, which should result in an ample margin of safety if you don't pay too much.

The search is never easy and there are many potholes on the investment road. Several years ago we invested in Indigo Books and Music [Toronto: IDG]. Indigo is the largest book retailer in Canada with the largest market share by far. At the time we invested, it had best-in-class margins, net cash on the balance sheet, and high returns on equity. It was a destination stop with a great brand image with Canadian book lovers. However, the moat wasn't enduring, and the emergence of e-reading was a game changer. While management is very talented and continues to do all the right things, the simple fact remains that book retailing must reinvent itself to be successful. It seems so easy to conduct this public post mortem and reach the conclusion that Indigo didn't have an enduring moat. But while the concept of investing in wide-moat companies is a simple one, our experience with Indigo all too convincingly demonstrates that it isn't easy to do. The search continues…

GLENN SUROWIEC, PORTFOLIO MANAGER, GDS INVESTMENTS

I probably have a non-traditional perspective on "wide-moat" investing. I largely accept that, if executed correctly, wide-moat investing is a relatively low-risk way to achieve market-beating returns. That said, in this pursuit one will likely find more "moat imposters" than not. Why?

There are certain "laws" of capitalism and economics. One that routinely holds is that capital chases high returns and withdraws from low returns. The majority of high-return companies can't withstand a flood of new supply. Industry pricing and returns come down; companies get re-priced from extraordinary to ordinary. It's easier for me to invest in this high-probability scenario than the low probability that a high-moat company retains its position over the long term.

The other issue with wide-moat investing is that most obvious moats are priced as such, e.g., Coca-Cola [KO] or Disney [DIS]. It's rare to find a truly wide-moat company, and even more so to find one that's materially undervalued. I do track a list of wide-moat companies and do buy them when they occasionally fall out of favor. Specifically, I look for consistently high returns on capital and exceptional brand strength. You need both because many high-ROIC companies have the illusion of strength simply because there's an absence of competitors. Microsoft [MSFT] stands out in this regard—high returns, with ambivalent customers just waiting for a new entrant. Cable/phone companies are other examples—we deal with them because we have to; this is a temporary condition.

My advice is to be really honest about how durable the moat is. If you find a company that truly has a wide moat that's materially discounted, then back up the truck because there are few easier ways to make money. A current example would be Apple [AAPL].

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