MOI GLOBAL

The Most Important Moat

This article by John Huber is excerpted from a letter of Saber Capital Management. John spoke about common sense and the most important moat and presented his investment thesis on a wide-moat business at Wide-Moat Investing Summit 2017.

[Earlier this year] I headed to Omaha to attend Berkshire Hathaway's annual meeting. Nowadays, there is less of a reason to attend the meeting in person because it is available to watch online, but I love attending the event for all of the peripheral meetings that occur. It was a great weekend, and I got to connect with a few Saber Capital clients, as well as some good friends that I don't see very often.

No matter how long you've been following Buffett and Munger, there are almost always some valuable learnings to be had at this event, and they usually touch on a topic or two that provokes me to think more deeply about a particular subject.

Here are a few main highlights from the meeting that I thought were worth mentioning:

On Learning and Getting Better

I've talked before about the process of continually getting better as an investor. I think investing is in some ways similar to other performance-based disciplines such as athletics or music. Top performers work on getting better each day, and while there isn't usually a noticeable difference on any given day, stringing together a bunch of days where you are getting incrementally better by even a very small margin leads to a collectively significant improvement over time. As Buffett has pointed out many times, knowledge builds on previous foundations and grows over time, just like compound interest.

Munger has often said that **your goal as an investor should be to go to bed a little bit smarter than when you woke up**. Along with the idea of focusing on "the work that's on your desk" (i.e. not looking too far ahead and just keeping focused on the task at hand), I think this goal of daily improvement is one of the most useful and practical lessons that Munger has ever taught us. I've tried to build Saber Capital's business around this idea, keeping a clear schedule each morning to ensure that this objective stays at the top of my priority list.

Over the weekend, this topic of self-improvement came up, as it often does. Munger talked about his most important learning lesson, which he thought was See's Candies.

I want to go into a brief tangent on some thoughts I have relating to this discussion. I occasionally think about what Buffett and Munger might be investing in if they were starting today. I think it would look a lot different than it did then.

First off, Munger said See's was his most important learning lesson because it taught Munger and Buffett about the value of owning a great business, specifically one that can produce ever growing levels of cash flow with very little incremental capital requirements. See's was a cash cow that didn't need to be fed. And it produced more and more milk each year, still without requiring any "food" (i.e. little to no cash needed to be invested back into the business to grow).

See's produced $4 million of pretax earnings the year they bought it. They paid $25 million, or somewhere around 12 times earnings after tax. Since that time, the company has sent around $2 billion of pretax cash flow to Berkshire, using just $40 million or so of incremental capital investments. As Buffett said in the 2014 shareholder letter:

"See's has thus been able to distribute huge sums that have helped Berkshire buy other businesses that, in turn, have themselves produced large distributable profits. (Envision rabbits breeding.) Additionally, through watching See's in action, I gained a business education about the value of powerful brands that opened my eyes to many other profitable investments."

What If Buffett Knew What He Knows Now?

Everyone knows by now that See's was a great business to buy. But the tangent I wanted to briefly take is to consider how the See's experience likely would have impacted the decisions Buffett previously made. In other words, would it have changed some of his investments, or would it have changed his investing approach had he been able to go back in time, knowing in the 50's and 60's what he learned in the 70's from the See's investment?

I think the answer to that is **undoubtedly yes**. And while I've always thought that there is somewhat of a misunderstanding* about Buffett's early investment strategy, it is true that he bought some cigar butts (seemingly cheap stocks of poor businesses). I think the learning experience they had with See's would have significantly changed some of their major early investments. Buffett almost certainly wouldn't have started buying Dempster Mill in the 1950's—a capital intensive windmill and farm equipment company with sub-par returns on equity. Nor would he likely have purchased Hochschild Kohn (the Baltimore department store) in the 1960's.

**(While it's true that Buffett bought some cigar butts, even very early on he grasped the power and value of owning a good business—he bought GEICO in 1951, putting 65% of his then-small net worth into the stock as a 21-year old. Also, two of his biggest and most meaningful contributors to his results in the 1960's, American Express and Disney, were stocks purchased while still running his partnership. Even the incredibly cheap stocks that he bought in the early years of his fund, like Commonwealth Bank or Western Insurance, were still decent businesses with stable earning power and good balance sheets. He certainly bought some laggards like Dempster Mill and even Berkshire Hathaway itself, but those were usually when he felt like he could gain control of the business eventually and reallocate the cash. Even early on, he made most of his money in the stocks of better businesses).*

So the point is: I don't think Buffett and Munger would be buying cigar butts in today's world if they were starting from scratch, given the knowledge they gained in the 70's and 80's from investing in both good and bad businesses.

If they could start over with their current knowledge base, I think Buffett and Munger would be buying small and large cap stocks (and everything in between). I think they'd be turning over rocks just as they did in the early days, but I think they'd place a much greater emphasis on the earning power and longer-term viability of the business.

This Time is Different

This also gets me into a broader point on today's markets: Things would look a lot different if Buffett and Munger were starting today. Buffett said recently that if he had started a

partnership in 2004, he would have been 100% invested in South Korean stocks. Munger said at the Daily Journal Meeting that he'd be focused on looking for opportunities in China if he were starting out today.

Neither of these ideas are recommendations, it just means that they'd be approaching things differently based on the skillsets they've developed over the years and the knowledge they've accumulated. They would use that experience to capitalize on the most obvious and best available opportunities that are offered in today's business world.

Capital-Light Businesses

Along these lines, Buffett talked about how different businesses are now. He mentioned that business moguls like Carnegie, Mellon, and Rockefeller would be absolutely shocked if they knew how quickly companies could grow today and how little capital would be required to support that growth.

He pointed out that the five largest companies in the market are:

- Apple
- Google
- Microsoft
- Amazon
- Facebook

With the exception of maybe Amazon, those companies require virtually no capital to grow, and even Amazon, despite spending billions of dollars building out its foundation for growth, has a number of major business lines like its third party seller marketplace and its cloud business that produce extremely high returns on incremental capital investments. Facebook, which was founded just over a decade ago, did $27 billion of revenue that had 45% operating margins last year. In just the last twelve months, the company grew its pretax earnings by $6.2 billion on just $3.7 billion of additional capital investments, including acquisitions (good for a healthy 170% incremental ROIC).

In fact, the business probably would be growing even without that additional capital, and the nature of Facebook, Microsoft, and Google's main businesses are that they produce huge returns on capital, significant cash flow, and require little to no capex.

All of these businesses got to scale much more quickly than Carnegie's steel plants, Rockefeller's oil refineries, or Mellon's banks. It took decades of toil and significant sums of capital to go around the country and cobble together a network of refineries in the late 19th and early 20th century. It took Zuckerberg just eight years to build a business from scratch that reached a $100 billion valuation, and four more to reach $300 billion. In 2010, Facebook had $1.9 billion in revenue. Last year it did over $12.5 billion in pretax profits. These are businesses that Carnegie and Rockefeller could only have dreamed about.

I'd also add that the great companies of a century ago were confined primarily to their industries. Rockefeller was an oil man. He wouldn't have even thought about getting into retail, or banking. But companies like Alibaba or Amazon start in retail, and then use their foundations and user bases to expand into businesses such as banking, payments, storage, and even investment management.

Given the value these companies provide and the size of the markets they might enter, these

businesses can likely become much larger than the relative size of even the greatest monopolistic giants of last century.

I'm simply using the large-cap tech stocks as an example to illustrate my point (I'm not suggesting that buying mega-caps is solely what Buffett would be doing). I don't pretend to know what stocks Buffett and Munger would be buying today if they were starting over, but what I do think is relevant to take home is that Buffett and Munger were both very independent-minded in the 1960's. They did things their own way. They capitalized on the opportunities they had at that time, and I think they'd be doing the same today.

I think the foundation of value—getting more future cash flow for the price paid—will always be the philosophy that works. I also think that investors should use Buffett's blueprint to form their own independent thoughts about opportunities—both big and small—in today's business world. There are lots of incredible opportunities, and the one thing that will always stay the same is human nature—Mr. Market will always be moody.

Consumer Shift

Buffett also mentioned Apple, and how his main thesis was observing consumers' perception of the brand and the stickiness of the software ecosystem. This leads to predictable demand for the iPhone, and other related Apple hardware products.

But he also said that consumer behavior is more difficult to judge than it used to be. I think that this is in part because people aren't as beholden to consumer brands as much as they used to be. Or, put differently, I think many companies that we think had a brand really just had a distribution advantage that came from being a big incumbent with the largest market share for many years. The high gross margins led to bigger advertising budgets, which further entrenched these market leaders. Kraft used to own its place in the center of the grocery isle. This advantage is eroding, as distribution costs have plummeted. The internet and social media have lowered the cost of getting products to market and reduced the time required to get to scale. They've cut out the middleman in many cases, allowing small upstart companies to sell directly to consumers and avoid the typical retail markup.

Is the Product Undervalued?

As I mentioned in my 2016 year-end investor letter, one of the things I try to consider when analyzing a potential investment is whether the company's product or service is a good deal for customers. If a business has attractive economics but is extracting value from (rather than adding value to) its customers, then I think there are some inherent risks in that model that will eventually come home to roost. This parasitic relationship might lead to above average profitability in the near term, but it also leads to customers who feel exploited, and when a competitor comes in that offers more value to customers (in the form of better products and/or lower prices), these alienated customers will be much more quick to leave.

For example, Costar owns a commercial real estate website called Loopnet, which had enormous embedded pricing power when Costar bought the site. The company understood that the site was essential to commercial real estate brokers, and began raising prices very rapidly. Some brokers I've talked to have seen their Loopnet subscription costs rise multiples from where they were just a couple years ago. Just about everyone in that business that I've talked to feels that they aren't getting good value, but they continue to pay because of the monopoly-like position of the website (it's basically the commercial real estate MLS, and brokers must have access to it to do business in most cases).

This type of position is often viewed as an attractive asset, a moat. But as a business owner, I'd be worried that my customers would quickly jump ship if a competitor came up with an alternative. Contrast that with the experience customers feel at Amazon Prime, which continues to provide more and more value to customers through wider selection, greater convenience, and prices that more often than not can't be beat. This extreme customer value makes it more and more difficult for a competitor take customers away from Amazon's platform.

The Most Important Moat

I gave a talk in Omaha called "*The Most Important Moat*", which basically outlined this idea that the best way to build an enduring competitive advantage is to focus on ensuring that the customer feels like the product or service that you're selling is a good deal.

If not, you will no longer be able to rest on the laurels of barriers to entry, high distribution costs, incumbent advantages like shelf space, bigger advertising budgets, switching costs, or just about any other advantage that you used to enjoy in years past. It's much easier to start a business, sell directly to consumers and build a product brand using social media. This allows you (and other small like-minded upstart companies) to collectively compete against much larger brands, despite having much lower advertising or distribution resources.

I think the advantages that used to be relied on by big incumbents like Gillette, Kraft, or Kellogg are eroding. Consumers have more options to choose from, better information on products, and receive more value for the price paid.

High margins and consumer brands are still very valuable, but I think the key is determining whether a company's perceived brand comes from its market share, distribution, or advertising budget, or whether it comes from providing customers with great value. I think the former category will see their brands lose value. The latter category will still face plenty of competition, but I think it's much harder to dislodge a company with the best value proposition to the end customer.

Bezos said the following:

> "The balance of power is shifting toward consumers and away from companies. The right way to respond to this if you are a company is to put the vast majority of your energy, attention and dollars into building a great product or service and put a smaller amount into shouting about it, marketing it."

So I think some things to keep in mind regarding Buffett's comments about the greater difficulty in predicting consumer behavior are the following:

- Brands are generally less powerful than they used to be
- Distribution and advertising costs are no longer insurmountable barriers to entry (companies can sell directly to consumers on a shoestring ad budget)
- Products can scale much faster
- Large market share and well-known products don't necessarily equal a moat

Key questions:

- Does the company have a true brand that offers a valuable product?

- Or is it a highly profitable incumbent whose high margins are due to an overpriced product and an eroding “shelf space” distribution advantage?

Is the customer getting a good deal when they buy the company’s products or services? I think spending time trying to think about and answer this question will go a long way in helping understand consumer behavior and also help value the business in question.