

THE LONG VIEW

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An Enduring Competitive Advantage

The key to investing is not assessing how much an industry is going to affect society, or how much it will grow, but rather determining the competitive advantage of any given company and, above all, the durability of that advantage. The products or services that have wide, sustainable moats around them are the ones that deliver rewards to investors. Warren Buffett, 1999

A few of us were talking last week about whether we had the best software for portfolio reports. Someone mentioned in passing that changing our software supplier would involve retraining costs and be time-consuming for our back office people.

While we were not discussing investments, this touched on an important investment issue. Established businesses with high customer switching costs often have a sustainable advantage over their competitors.

These businesses have what Warren Buffett has called an economic moat.

Economic Moats

In a free enterprise market, a business that produces high returns on capital is likely to attract competitors. In theory this should, over time, largely eliminate any difference in rates of return on capital between companies. And, in any commodity business, such as mining, forestry, oil and gas production etc., this is generally what happens.

However, a number of companies have been able, for extended periods of time, to withstand the onslaught of competition and continue to earn well above average returns on investment. These stalwarts include: all the major Canadian banks, Investors Group, Moody's and American Express.

To understand how these companies have been so successful, one must ask why an effective, well financed competitor has not been able to steal market share from them. What form did the economic moat around these companies take?

False Moats and Real Moats

Generally speaking, moats are not created by advantages such as product quality, technology, strong execution or even exceptional management. An effective CEO can improve performance. However, as Peter Lynch has put it, it is better to buy the type of company that any idiot can run because, sooner or later, one will. That's particularly true today, given the high turnover of CEOs.

In some cases a large market share (Walmart), a strong brand (Coke) or an ongoing series of valuable patents (Pfizer) can result in increased profitability over the long run. However, size is no guarantee of success. The value of many brands is subject to fashion. And patents have a limited life.

In our view, there are three attributes of a business that have the greatest likelihood of constituting real economic moats – regulatory restrictions, high customer switching costs and network effects.

Regulatory Restrictions

A regulatory regime that makes it difficult (or, better still, impossible) for competitors to enter a market in a meaningful way is a form of moat. In Canada, due to ownership restrictions, the Canadian banks have long operated within what is in effect an oligopoly. It is not surprising that they have enjoyed unusually high profit margins and growth over the past thirty years.

Canadian cable and cell phone companies such as Rogers also fall into this category.

Another example is the bond-rating industry in the United States. Currently, in order to provide ratings for bonds, a company has to be designated a “nationally recognized statistical ratings organization”. This designation is not easily obtained. Both Moody's and Standard & Poors have, for many years, enjoyed operating margins above 40% and extremely high returns on capital.

Of course, as these examples make clear, it is important to consider the likelihood of future regulatory change.

High Customer Switching Costs

A business with high customer switching costs (like our software provider) is often a business with a strong moat.

Toronto-based Constellation Software provides business software for a number of niche sectors, including window manufacturers, private clubs and government departments. Constellation is able to charge an annual fee as well as sell periodic upgrades to its customers. In part because of the steep cost of switching, Constellation's customer retention rate is exceptionally high.

Another company providing specialized software is Pason Systems. Pason provides software and equipment to record and display (by satellite uplink) drilling data from land-based oil and gas drilling rigs. Over time, Pason's revenue growth and return on equity have been unusually high. The same could be said for many other niche business software providers.

Other businesses that benefit, to some extent, from high perceived switching costs include banks and credit card companies (particularly if the customer has preauthorized certain payments). And retail mutual fund companies build in high switching costs in the form of "back end" fees payable by investors who leave the fund within the first six years.

Network Effects

Perhaps the deepest and widest moat is found when the value of the product or service sold increases with the number of users. This "network effect" is typically associated with businesses based on information or knowledge transfer.

An example of this would be companies in the credit card business, such as American Express, Visa and Mastercard. The huge network of merchants who accept these cards protects the card companies against a competitor that may want to start a new credit card business. A growing number of cardholders makes merchants more likely to accept the card, and more merchants accepting the card increases consumer demand for the card. And, if a credit card company can attract higher spending cardholders, it can charge retailers a higher fee, which allows it to provide better benefits to its cardholders, etc.

Another good example of network economics is a futures exchange such as the CME Group (which owns the Chicago Mercantile Exchange). Futures exchanges are in effect closed. If you buy a commodity or interest rate future on the Chicago Mercantile Exchange, you also have to sell it on the CME. As with all businesses having strong network economics, increasing volume not only increases profits; it also increases the size of the economic moat.

Identifying Moats is Key to Value Investing

The existence of a moat is not, in itself, a sufficient reason to invest. Intelligent investing also requires that you wait until the company is selling at a price well below its intrinsic value. However, an enduring competitive advantage increases the odds that the business will grow earnings far into the future. And, because the stock market price usually assumes growth in earnings for only about five years into the future, a company with a deep economic moat is more likely to trade at a price well below its true value.

As Buffett has said, the ability to identify a business with a durable competitive advantage is a key element of successful investing.