Identifying Economic Moats I

The Way Capitalism Works

“The dynamics of capitalism guarantee that competitors will repeatedly assault any business “castle” that is earning high returns.” – Warren Buffett

Money flows where it sees the highest possible return. High return on capital in an industry leads to entry of new players. As competition intensifies, return on capital shrinks. However, some companies do manage to earn high returns for long periods of time. What is it that protects them from the onslaught of competition? The answer is economic moat!

What is an Economic Moat?

The term ‘economic moat’ coined by Warren Buffett refers to the competitive advantage a firm has over its peers. It is a structural feature that helps to ring-fence a firm’s profitability and enables it to earn return on capital much higher than the cost of capital. We can also think of moats as entry barriers that prevent competitors from reducing the firm’s profitability. If there is no moat, competition will eventually drive return on capital down to the cost of capital or even lower.

Why do Economic Moats Matter?

Assume two companies that are growing sales and profits at the same rate employing the same amount of capital. The only difference is that one company (A) has a moat while the other (B) does not have one. While B will see its returns decline with rising competition, A will manage to earn superior returns for long periods of time. Economic moats show the durability of a company’s future earnings. Companies with wide moats are the most resilient businesses and the best shareholder wealth creators.

Types of Economic Moats

The two main factors that define a firm’s profitability are Price and Cost. Firm’s can boost their profitability in two ways:

- Increase product prices
- Cut down costs
But not many firms can do this. The one’s that can do so on a sustainable basis can be said to be enjoying an economic moat. All moats can be divided on the basis of price and cost advantages.

Let us discuss them in detail...

**Types of Moats: Price Advantages**

Economic moats that allow a firm to charge a premium over its competitors could be referred to as moats arising from price advantages. The most important moats under this type:

I. Real Product Differentiation  
II. Intangible assets  
   a) Brands  
   b) Regulatory licenses  
   c) Patents & Intellectual Property  
III. Switching Costs  
IV. Network Effects  

**I. Real Product Differentiation**

Real product differentiation refers to distinctive attributes in a company’s product that set it apart from competition. Differentiating factors could include appearance, features, durability, performance quality, technology, etc. Product differentiation enables a firm to command a premium price over its competitors. Firms can earn very high returns by staying ahead of competition in terms of quality and innovation.

However, this kind of moat may not ensure long term durability due to the following reasons:

- **Competitors will replicate** the product and grab market share.
- Customers may be **unwilling to pay a high premium** if competitors’ products are only slightly inferior and may be selling at a significantly lower price.
- **It is pertinent to constantly innovate, improve the product and add new features** in order to stay ahead of competition.
- Innovation requires **substantial R&D expenditure**.
A market leader today may be replaced by a competitor who manages to offer better products at a lower price. Hence, a moat arising out of product differentiation is not only difficult to sustain over the long term but also requires huge capital investments. Example: Consumer electronics, technology sector, etc. Companies such as Nokia and RIM were once ahead of the curve but later on failed to adapt themselves to changing customer preferences and needs.

II. a) Intangible Assets: Brands

A brand is a name (or other feature) that creates a **perceived product differentiation in the minds of the consumers**. The company’s products may or may not be very distinct from those offered by competitors. But the perceived superiority and trustworthiness of the product allows the firm to charge a premium price. Because customers have loyalty towards a particular brand, they may be reluctant to switch to other similar products. Brands tend to create a moat by not only making it difficult for new competitors to enter the market, but also limiting the scope of existing players to expand. **But do all brands imply an economic moat?** A well-known brand does not imply an economic moat unless it gives the company pricing power and brand loyalty (repeat business).

Examples of brands that have an economic moat: Coke, Colgate, Nestle, Titan, Cadbury etc. Examples of well-known brands that do not have an economic moat: MakeMyTrip, Flipkart, Videocon, etc.

II. b) Intangible Assets: Regulatory Licenses

Regulatory licenses can create a strong moat as new players cannot enter the market without the requisite approvals. As a result, a few number of firms have control over the entire market. This must, however, not give the impression that all sectors that require regulatory licenses may enjoy a strong moat. The key condition that makes **regulation a strong moat is when only entry to the market is regulated, whereas there is no regulatory control on pricing of products or services**.

Take the case of state-run electricity boards and private banks. Entry to both sectors is highly regulated. But most utility companies are under heavy losses because they have no pricing power. On the other hand, profitability in the private banking sector is determined largely by market forces and as such, banks tend to enjoy higher returns. However, the moat in case of regulatory licenses is dependent on an external factor and as such any **adverse change in regulation could be a major risk.**
II. c) Intangible Assets: Patents & Intellectual Property

When a company innovates a new product, it can patent the product so that no other firm is legally allowed to sell this product. Think of a patent as the financial reward for creating a new product, or as intellectual property the company can use. The pharmaceutical industry makes heavy use of patents whenever they create a new drug. The patent allows them to recoup the high capital expenditure that goes into research and development of new drugs. Companies that have a patent on a particular good are immune from competition.

Patents provide a very strong moat and allow the firm to earn very high returns. However, moats arising out of patents do not assure long term durability because patents have a finite duration. Once a patent expires, it brings in heavy competition in that market and drives down the profitability. As such, a company has to keep innovating new patented products to enjoy high returns. Patents are often vulnerable to legal battles and could be revoked. As such, the moat of firms that have just a few patented products may lack long term durability.

III. Switching Costs

Switching costs refer to factors that make it difficult or undesirable for consumers to switch to the products/services of a competitor. The factors include time, capital, convenience, etc. If the switching costs are high, a firm is able to lock in its customers. It can charge its existing customers higher prices because it knows the customers are reluctant to switch to competitors.

Think about the difference between a bank and a retailer. Do you change your bank account every time some bank offers higher interest and lower fees? Would you continue to buy things from the same retailer even if he charges more than his next-door competitor? Another example is Microsoft Office. Users are reluctant to switch from Microsoft as learning a new product would be inconvenient and time-consuming.

IV. Network Effects

Network effects refer to the fact that the value of a product or service increases with the increase in the number of users. This effect is largely observed in fields where businesses rely on information sharing or linking users together. Consumers are unlikely to move to a new competitor because there would be very few people using the new product/service.

Take the example of the National Stock Exchange. The higher the trading volumes on the exchange, the more efficient is the pricing process. This creates a self-reinforcing pattern, bringing in more volumes on the exchange.
Another example is Facebook. Facebook is valuable to a user because many other people they know also use it, making it difficult for new social networking sites to succeed in the market.

**Types of Moats: Cost Advantages**

While price advantages refer to how a firm can charge a premium to its customers, cost advantages refer to supply-side factors that enable a firm to be a low cost player. The most important moats under this type:

I. Economies of scale
II. Cheaper access to resources
III. Process-based cost advantages

I. **Economies of Scale**

In an industry where the fixed costs are relatively much higher than the variable costs, the greater the size of the firm, the greater are the cost benefits that it can enjoy over its peers. **Due to high fixed costs, new competitors are discouraged from entering the market.** The absolute size of a firm is not as important as its size relative to its competitors. For instance, a small cap firm could be a dominant player in a niche industry and enjoy scale advantage within that industry.

Cost advantages based on economies of scale can be divided into two main types:

a) **Large distribution network**

A firm that possesses an extensive distribution network can enjoy a remarkable edge over competitors and new entrants. The higher volumes and lower lead times thus enable companies to cut costs. It can not only achieve higher volumes but can also introduce various new products through the same channel. Example: ITC Ltd

b) **Large scale operations**

For a manufacturing firm with high fixed costs, the average cost per unit decreases as the output increases. Example: Maruti Suzuki

For a retailer, the cost advantages lie in its ability to procure merchandise on a large scale at a price that is significantly lower than what its competitors can get. Example: Wal-Mart
II. Cheaper Access to Resources

In many commodity businesses, the **access to key raw materials or assets is an important component** of their success. Usually, firms will buy/lease access to a land/onshore/offshore asset and use that asset to access raw materials. Cheap access to a resource or raw material can lead to significant cost savings and, in turn, high profitability. Examples: oil, gas, mining companies. Energy and mining companies can be very profitable due to their ability to cheaply access raw materials.

III. Process-based Cost Advantages

Process-based cost advantages refer to **cost savings occurring due to efficient and cheaper production or supply processes**. By innovating and building better processes, a firm can produce or supply its products more cheaply than other competitors. Competitors may not have access to these processes, and cannot necessarily implement it themselves. However, competitors could catch up and erode the moat over time. Example: Amazon.com (online retailer), Toyota (Total Quality Management), Dell (sold direct to buyers) Tata Steel (low cost steel producer), etc.

**Determining a Moat**

- Has the company consistently earned high returns on capital?
- Does the company enjoy better profitability relative to its competitors?
- Identify the key factors that enable the company to earn such high returns.
- Can the company continue to enjoy these high returns for a long time?

If the answer to these questions is in the affirmative, the company under consideration does have an economic moat.

**Note:** Certain industries, by their very inherent structural characteristics, offer economic moats to a relatively large number of firms. Example: Consumer goods, pharma, etc.
Durability of a Moat

Once we identify a company with a moat, the next step is to determine its long term durability. How long can the company earn higher returns while keeping competitors at bay? Certain moats tend to erode over time, while few get more durable over time. The Buffett test: Can a well-financed competitor erode the company’s profitability?

“Give me $10 billion dollars and how much can I hurt Coca-Cola around the world? I can’t do it.” – Warren Buffett

Avoiding False Moats

✓ Temporary favourable economics should not be confused for moats. Example: High profitability due to supply shortages will end once new capacities come on stream.
✓ Advantages that cannot be scaled up do not imply a moat.
✓ Popular products, strong market share or technological superiority do not guarantee a durable long term moat.
✓ Never confuse a great management for a moat.

“Go for a business that any idiot can run -- because sooner or later, any idiot probably is going to run it.” – Peter Lynch

Conclusion

✓ Moats are entry barriers that prevent competitors from eroding a firm’s profitability.
✓ Economic moats are indicative of the durability of a company’s future earnings.
✓ Price advantage moats are competitive advantages that allow a firm to charge a premium price from its customers.
✓ Cost advantage moats are supply-side factors that ensure a firm’s high profitability.
✓ It is important to determine durability of a moat & avoid getting trapped by false moats.

Special Update: Now that we have discussed the conceptual framework of economic moats, the next two lectures would be entirely dedicated to discussing practical examples of economic moats in listed Indian companies.
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