A Conversation With

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Spotlight On: Moats

(Economic, Not Medieval)

You often talk about companies having a “moat.” What do you mean by that term?

When you think about a moat, the first thing you think of is a medieval castle, with a trench filled with water surrounding the castle. And possibly some alligators in that trench. The point of the moat was to make it hard for people to attack the castle. It’s the same idea when we talk about a company having a moat. When a company earns high returns on capital, that normally attracts competition, because other companies look at those high returns and want to get in on the action. So, when we talk about a moat, we mean something the company has – whether it’s a unique product, or a powerful brand, or legal protections like patents – that makes it hard for competitors to capture that company’s customers. Moats are what enable companies with high returns on invested capital to sustain those returns, sometimes for many years.

So, are moats related to the persistence of ROIC that you often talk about?

Yes, definitely. We’ve looked at the ROIC of every company in the MSCI World Index every year back to 1990 and sorted them into quintiles, so we can trace how each company has migrated among the quintiles from year to year. What we have found is that there is a remarkable degree of persistence in ROIC from year to year, both among companies with high ROIC and companies with low ROIC. On average since 1990, companies that were in the top quintile of ROIC in one year had a 75% chance that they stayed in that top quintile the next year, versus only a 2% chance that they fell to the bottom quintile. And companies in the bottom quintile, on average, had a 62% chance that they stayed in the bottom quintile the next year versus only a 1% chance that they rose to the top quintile. You can think of companies who move from the bottom quintile to the top quintile as examples of “turnarounds” which investment managers like to talk about. The data indicate that they happen, but they are quite rare.

Is this persistence phenomenon found in every industry, and if not, why not?

It's helpful to bring Michael Porter's famous "five forces analysis" into the picture here. Porter was a young professor at the Harvard Business School when he published an article in 1979 titled "How Competitive Forces Shape Strategy." (He's still on the faculty there today.) Porter identified five forces that he argued determined the profitability of a given industry, which were: 1) the bargaining power of suppliers, 2) the bargaining power of buyers, 3) the threat of new entrants, 4) the threat of substitute products, and 5) the rivalry among existing competitors.

Now, think about what ROIC actually is. It is your net operating profit after tax (NOPAT) divided by your invested capital. And NOPAT is essentially your revenues minus your costs (it also factors in depreciation, which is a non-cash expense, but we can ignore that for the moment). So, the way to generate higher ROIC than your peers is to either have a way to charge higher prices than they do (i.e., pricing power), produce things more cheaply than they do (i.e., cost advantage), or to run the business with less capital. Porter's five forces help us see why some companies are able to do one or more of those things better than others within a given industry, and also why high ROIC is more prevalent in some industries than in others.

Think about pricing power. Who has it and who doesn't, and why? In the pharmaceuticals industry, a company's product might be the only option for treating a particular condition, and can also benefit from patent protection for a number of years, which reduces the threat of new entrants. Contrast that with, say, a lumber company. One company's lumber is pretty much indistinguishable from another's. Not to mention the fact that if lumber becomes too expensive people will have an incentive to find other, cheaper materials (i.e., the threat of substitute products, not really an issue for a one-of-a-kind drug). So pharmaceutical companies generally have more pricing power than lumber companies, which is one reason they tend to earn higher ROIC. Broadly speaking, industries with more product differentiation, more intellectual capital, and more intangible capital – think of consumer products, technology, and health care – have wider moats and higher returns on capital than industries where product differentiation is low or where regulation plays a greater role, such as materials, energy, utilities, or certain types of financial companies.

Do moats vary much within an industry, and can Porter's five forces help us understand why?

Yes, even within an industry, some companies can have wider moats than others. I can give you a few examples. The first two involve ways that companies can reduce the threat of new entrants or substitute products. Think about consumer products like soft drinks or sneakers. Some companies in those industries have very powerful brands, such that people will pay more to own products from that brand. Sometimes the power of the brand may reflect true underlying quality (and hence cost) differences, but in some cases the power of the brand may simply result from years of successful advertising, or an association with celebrity athletes who lend their names to a product. So, one soft drink company or one sneaker company may be able to charge more for its product than a competitor, and that difference in price may be totally – or at least partially – unrelated to any difference in costs. The company with the stronger brand will earn higher margins and a higher return on capital. The second example is software, where a company might benefit from the so-called "first mover advantage." If you were the first to market with a particular type of software, and companies have devoted a significant amount of time and other resources to training their employees on your software, then there will be large "switching costs" associated with switching to some newer company's software. The new software might actually be a little better at the margin, but it would have to be better by a wide enough margin to justify the costs of retraining everyone in order to get customers to switch, and that constitutes a barrier to entry. Finally, here's an example having to do with the bargaining power of buyers and the power of suppliers. I'm talking about retail, where certain mega-retailers may have more bargaining power than a "mom and pop" store, and can obtain lower pricing from their suppliers than those smaller retailers. The advantage of scale may enable the large retailer to charge lower prices than the small store, and yet earn higher margins.

Presumably, no moat lasts forever. What signs do you look for to see if a moat is in danger of being breached?

It's true, it's very hard to make a competitive advantage last forever. Think of all the household names that were once dominant that eventually disappeared: Pan Am, Circuit City, Polaroid, Woolworth's, Compaq. Sometimes the culprit is technological disruption; an existing company may have all its capital – both physical and intellectual — tied up in assets that become technologically obsolete. Today, the clearest threat of technological disruption probably comes from artificial intelligence (AI). We recently sold a stock in the online travel business because we were concerned about the threat that AI engines pose to its business. In the case of some of the retailers who have disappeared, one could argue that it was changes in consumer preferences — away from shopping at large general retailers and toward shopping at specialty stores and online – that contributed to the demise of these company's moats. So, with retail businesses we always look to see where the growth is coming from at the margin. Is it coming from organic growth in same-store sales? Or have same-store sales stagnated, with top-line growth only coming from the addition of new stores? If it's the latter, then that tells us that consumer tastes are probably shifting away from this company's concept; there is a limit to how many new stores you can open before you have saturated the market. There are of course other types of threats to company moats as well, such as regulatory changes that reduce barriers to entry, or mergers that create a larger competitor and change the nature of the rivalry among the industry's players. It is very important to be mindful of the fact that no "sustainable competitive advantage" can be sustained forever, and to avoid complacency.

Disclosure