http://www.oldschoolvalue.com/blog/investing-perspective/5-ways-to-identify-wide-economic-moats/

5 Ways to Identify Wide Economic Moats

August 20th, 2012

by Daniel Sparks ValueFolio, Facebook, Twitter

Table of Contents:

- A Competitive Advantage is Different from an Economic Moat
- Why are Economic Moats so Important?
- How to Identify Economic Moats?
- Using free cash flow (FCF) yield to to find reasonably priced, wide-moat companies
- About Daniel Sparks
- Recent posts by Daniel Sparks

I don't know about you, but I never get tired of hearing about Warren Buffett. He's central to the value investor community, and there's good reason for that. He merged Fisher's growth investing with Graham's margin of safety. Also from Graham, he adopted the "Mr. Market" approach to thinking about the stock market. Finally, Munger brought the final touches to Buffett's investing: a resolute determination to invest in only wonderful companies even if they have to be bought at fair prices.

But there was a Buffett original that emerged from all this: **the economic moat**. This criterion is what allows Buffett to rephrase Fisher: *"Our favorite holding period is forever."* An economic moat represents some sort of protection of business cash flows. In other words, businesses with economic moats have *sustainability*.

A Competitive Advantage is Different from an Economic Moat

There is a great distinction between the typical competitive advantage and a wide economic moat.

A competitive advantage is any advantage that *currently* allows a company to earn premium margins over its competitors. But an economic moat is a *sustainable* competitive advantage–a competitive advantage that will last.

You can also refer to a previous article on how **Buffett Interprets financial statements** to identify sustainable competitive advantages.

Why are Economic Moats so Important?

Economic moats are incredibly important simply because it is impossible to estimate future cash flows without an economic moat. Sure, you can give it a shot. But there is generally too much risk associated with estimating cash flows that are not protected by a moat.

So, I follow a simple rule of thumb: If there is no economic moat, I require a significant discount to liquid-able assets. And based on this rule of thumb I can quickly throw out many of the stocks I analyze after only a few minutes. Even Buffett threw out companies without doing a full analysis:

When I started, I went through the manuals page by page. I went through 20,000 pages in the Moody's industrial, transportation, banks and finance manuals — twice. I actually looked at every business — although I didn't look very hard at some. – Warren Buffett (2001 Annual Letter to Shareholders).

All of this is why wide moats have become central to my entire approach to investing, from searching to researching to investing.

How to Identify Economic Moats?

Here is a list of the 5 economic moats discussed by Morningstar's Paul Larson and some related "symptoms" to help us identify them:

1. Intangible assets: Fanatically loyal customers. Profit margins or cash returns on invested capital (CROIC) that consistently exceed the industry average or those of their competitors ($KO). Successful companies with high priced, quality products or services for decades, supported by their brand strength ($AAPL, $COH).

2. Customer Switching Costs: Products and services that are not easily abandoned for a substitute or for a competitor's product ($ZMH).

3. Cost advantage: Meaningful economies of scale and over a decade of healthy operating and profitability ratios ($WMT, $JNJ, $MCD).

4. Networks Effect: Networks that become more useful as more people join ($EBAY).

5. Efficient Scale: Monopolies that exist for the purpose of efficiency; consistent positive free cash flow and dividend payouts ($XEL).

Also, refer to the book review on **The Little Book That Builds Wealth** that discusses these **economic moats.**

Quick, easy, and straight forward. Any of these could mean there is a moat at hand. A combination of these is even better and might mean you've found yourself a wide moat.

Using free cash flow (FCF) yield to find reasonably priced, wide-moat companies

There is one crucial criteria to finding great, wide-moat investments that we have left out: Price.

Keeping an eye on free cash flow (FCF) yield or owner earnings yield is one great way to initially identify wide-moat companies that are trading relatively inexpensively. Companies that have a wide moat and trade at a FCF yield that is approaching 10% are generally in a great price range for a potential purchase.

Here is an example of 5 companies that I feel have wide moats and trade at reasonable prices:

Company	Free Cash Flow Yield
Apple ($AAPL)	7.54%
Microsoft ($MSFT)	11.3%
Oracle ($ORCL)	8.17%
Abbott Laboratories ($ABT)	6.89%
Johnson & Johnson ($JNJ)	7.81%

What about you? Do you know of any great, wide-moat companies trading at decent prices?

Part 1: http://www.oldschoolvalue.com/blog/valuation-methods/competitive-advantage-income-statement/

Identify Durable Competitive Advantages through the Income Statement

August 16th, 2010

Isn't it awesome how the internet has evolved so that your web of connections can expand although you've never met the person?

It's fantastic how people email me with a common interest in investing and we can immediately pick up a conversation like we've been friends for ages.

Frank recently emailed me with some comments and we got to discussing about investing, BOLT, his take on valuation methods and also has graciously allowed me to edit his notes on Durable Competitive Advantages (DCA) and the set of criteria he uses to identify companies with durable competitive advantages.

Finding Durable Competitive Advantages

The concepts that you find in this article is from the book **Warren Buffett and the Interpretation of Financial Statements** and addresses Warren Buffett type investing ideas and methodology.

This is not a book review, but notes from the book to discussing and identify durable competitive advantages.

The Exceptional Company

The exceptional company has a durable competitive advantage differentiated by the following:

- Unique product/service
- Low cost buyer AND seller of a product which public needs consistently

The exceptional company has durability.

- Consistency in product = consistent profits
- Consistent: high gross margins / low debt / low R&D exp. /strong earnings / earning growth

---

Analyzing the Income Statement

When it comes to **analyzing the income statement**, it is important to investigate further and drill down to detect what the **quality of earnings** are made up of and what the numbers interpret.

Revenue: Analyze expenses

Cost of Goods Sold: investigate what the company includes

Gross Profit Margin: firms with excellent long term economics tend to have consistently higher margins

- Durable competitive advantage creates a high margin because of the freedom to price in excess of cost
- Greater than 40% = Durable competitive advantage
- Less than 40% = competition eroding margins
- Less than 20% = no sustainable competitive advantage
- CONSISTENCY is KEY

SG&A: Consistency is key.

Companies with no durable competitive advantage show wild variation in SG&A as % of gross profit

- Less than 30% is fantastic
- Nearing 100% is in highly competitive industry

R&D: if competitive advantage is created by a patent or tech advantage, at some point it will disappear.

- High R&D usually dictates high SG&A which threatens the competitive advantage

Depreciation: Using EBITDA as a measure of cash flow is very misleading

- Companies with durable competitive advantages tend to have lower depreciation costs as a % of gross profit

Interest Expenses: Companies with high interest expenses relative to operating income tend to be either:

1) in fiercely competitive industry where large capital expenditure required to stay competitive

2) company with excellent business economics that acquired debt in leveraged buyout

- Companies with durable competitive advantages often carry little or no interest expense.
- Warren's favorites in the consumer products category all have less than 15% of operating income.
- Interest expenses varies widely between industries.
- Interest ratios can be very informative of level of economic danger.

Rule: *In any industry, the company with the lowest ratio of interest to Operating Income is usually the one with the competitive advantage.*

Gain (Loss) Sale Assets and "Other": For non-recurring income or losses, remove from calculations of net earnings

Income Before Tax: Buffett uses this number when calculating his return. It allows for comparison with other investments types. E.g. Equity and bonds.

Income Taxes Paid: Helps figure out who's window dressing

- Check SEC docs and see what they are paying in income tax.
- Take pre-tax operating income and deduct tax rate (USA 35%)
- Compare with reported income tax paid

Net Earnings

- Look for consistency and upward long term trend.
- Because of share repurchase its possible for net earnings trend to differ from EPS trend.
- Preferred over EPS
- Durable competitive advantage companies report higher % net earnings to total revenues.

Rule: *If a company is showing net earnings history greater than 20% on total revenues, it is probably benefiting from a long term competitive advantage.*

- If less than 10%, likely to be in a highly competitive business
- Exception – Banks and financial companies where abnormally high ratio of net earnings to total revenues usually means poor risk management.

Earnings Per Share (EPS)

- Look for at least ten-year period showing consistency and an upward trend.
- Consistent earnings is usually a sign that the company sells products that doesn't need to go through costly process of change.
- Upward trend reflects the company is strong enough to allow it to make expenditures to increase market share through advertising and expansion.
- Or a company could use financial engineering like stock buybacks to increase EPS
- Avoid erratic earnings pictures

http://www.oldschoolvalue.com/blog/valuation-methods/identify-durable-competitive-advantages-balance-sheet/

Identify Durable Competitive Advantages through the Balance Sheet

August 17th, 2010

This is part two of **Identifying Durable Competitive Advantages by Analyzing Financial Statements.**

Part one: Finding Durable Competitive Advantages by Analyzing the Income Statement

Part two: *Finding Durable Competitive Advantages through the Balance Sheet*

Part three: Finding Durable Competitive Advantages through the Cash Flow Statement

The information provided in this article can be found in the book Warren Buffett and the Interpretation of Financial Statements.

Before you proceed, you may be interested in a primer on analyzing the balance sheet.

How to Identify Competitive Advantage through the Balance Sheet

Assets

Current Asset Cycle: Cash – Inventory – Accounts Receivable – Cash

Cash and Equivalents: Cash is king.

A high number means either:

1) The company has competitive advantage generating lots of cash

2) Just sold a business or bonds (not necessarily good)

A low stockpile of cash usually means poor to mediocre economics. There are 3 ways to create large cash reserve.

1) Sell new bonds or equity to public

2) Sell business or asset

3) It has an ongoing business generating more cash than it burns (usually means durable competitive advantage)

When a company is suffering a short term problem, Buffett looks at cash or marketable securities to see whether it has the financial strength to ride it out.

Rule: *Lots of cash and marketable securities + little debt = good chance that the business will sail on through tough times.*

- Test to see what is creating cash by looking at past 7 yrs of balance sheets. This will reveal which way it was created.

Inventory

- Some companies have the risk of inventory becoming obsolete
- Manufacturers with durable competitive advantage have the advantage that the products they sell do not change, and therefore will never become obsolete. Buffett likes this advantage.
- When identifying manufacturers with durable competitive advantage, look for inventory and net earnings that rise correspondingly. This indicates that the company is finding profitable ways to increase sales which called for an increase in inventory.
- Manufacturers with inventories that spike up and down are indicative of competitive industries subject to boom and bust.

Net Receivables

Net receivables tells us a great deal about the different competitors in the same industry. In competitive industries, some attempt to gain advantage by offering better credit terms, causing increase in sales and receivables.

If company consistently shows lower % Net receivables to gross sales than competitors, then it usually has some kind of competitive advantage which requires further digging.

Total Current Assets & Current Ratio

- Current ratio greater than 1 = good
- Current ratio less than 1 = bad
- However, a lot of companies with durable competitive competitive advantages have a current ratio less than 1 (e.g. PG = 0.77). For companies with moats, their earnings power is so strong they can easily cover current liabilities. These companies also have no problem securing cheap short term commercial paper if needed.
- Another reason for the low current ratio is that these companies also pay big dividends and repurchase stock thus diminishing cash reserves
- **Current ratio is useless in identifying durable competitive advantage.**

Property, Plant & Equipment

A company with durable competitive advantage doesn't need to constantly upgrade its equipment to stay competitive. The company replaces when it wears out. On the other hand, a company without any advantages must replace to keep pace.

Difference between a company with a moat and one without is that the company with the competitive advantage finances new equipment through internal cash flows, whereas the no advantage company requires debt to finance.

Producing a consistent product that doesn't change equates to consistent profits. There is no need to upgrade plants which frees up cash for other ventures. Think Coca Cola, Johnson & Johnson etc.

Goodwill

Whenever you see an increase in goodwill over a number of years, you can assume it's because the company is out buying other businesses above book value. GOOD if buying businesses with durable competitive advantage.

If goodwill stays the same, the company when acquiring other companies is either paying less than book value or not acquiring. Businesses with moats never sell for less than book value.

Intangible Assets

- Intangibles acquired are on balance sheet at fair value.
- Internally developed brand names (Coke, Wrigleys, Band-Aid) however are not reflected on the balance sheet.
- One of the reasons competitive advantage power can remain hidden for so long.

Long Term Investments

Long term investments are carried on books at the lower of cost/market price. This means a company can have valuable assets on its books at a valuation below its market price.

It can tell us about the investment mindset of management. i.e. do they invest in durable competitive advantages or those in highly competitive markets.

Other Long Term Assets

Doesn't tell us anything e.g. Pre paid expenses, tax recoveries

---

Total Assets & Return on Total Assets

- Measure efficiency using ROA
- Capital is barrier to entry. One of things that make a competitive advantage durable is the cost of assets needed to get in. This is why we calculate the Asset Reproduction Value along with the EPV.
- Many analysts argue the higher return the better. Buffett states that really high ROA may indicate vulnerability in the durability of the competitive advantage.
- E.g. Raising $43b to take on KO is impossible, but $1.7b to take on Moody's is. Although Moody's ROA and underlying economics is far superior to Coca Cola, the durability is far weaker because of lower entry cost.

Current Liabilities

Includes accounts payable, accrued expenses, other current liabilities and short term debt.

- Stay away from companies that 'roll over the debt' e.g. Bear Stearns

When investing in financial institutions, Buffett shies from those who are bigger borrowers of short term than long term debt.

- His favorite 'Wells Fargo' has 57 cents short term debt for every dollar of long term
- Aggressive banks (like Bank of America) has $2.09 short term for every dollar long term

Durability equates to the stability of being conservative.

Long Term Debt coming Due

Some companies lump their yearly long term debt due with short term debt on the balance sheet. This makes it seem like there is more short term debt than the real amount.

Rule: *Companies with durable comparable advantages need little or no LT debt to maintain operations.*

Too much debt coming due in a single year spooks investors and can offer attractive entry points.

However, a mediocre company in problems with too much debt due leads to cash flow problems and certain bankruptcy.

Total Current Liabilities & Current Ratio

- The higher the ratio, the more liquid. The greater its ability to pay current liabilities when due.
- Useful in determining liquidity in average business
- Durable competitive advantages do not require 'liquidity cushion' so the ratio may be less than 1.

Long Term Debt

Buffett says that durable competitive advantages carry little to no LT debt because the company is so profitable that even expansions or acquisitions are self financed.

We are interested in long term debt load for the last ten years. If the ten yrs of operation show little to no long term debt, then the company has some kind of strong competitive advantage.

Buffett's historic purchases indicate that on any given year, the company should have sufficient yearly net earnings to pay all long term within 3 or 4 year earnings period. (e.g. Coke + Moody's = 1yr)

Companies with enough earning power to pay long term debt in less than 3 or 4 years is a good candidate in our search for long term competitive advantage.

- BUT, these companies are targets for leveraged buy outs, which saddles the business with long term debt
- If all else indicates the company has a moat, but it has ton of debt, a leveraged buyout may have created the debt. In these cases the company's bonds offer the better bet, in that the company's earnings power is focused on paying off the debt and not growth.

Rule: *little or no long term debt often means a **Good Long Term Bet***

Deferred Income Tax, Minority Interest, Other Liabilities

- No help in search for durable competitive advantage

Total Liabilities & Debt to Shareholders Equity Ratio

- Debt to shareholders equity ratio helps identify whether the company uses debt or equity (includes retained earnings) to finance operations.
- Company with a moat uses earning power and should show higher levels of equity and lower level of liabilities.
- *Debt to Shareholders Equity Ratio : Total Liabilities / Shareholders Equity*
- Problem with using as identifier is that economics of companies with durable competitive advantages are so great they don't need large amount of equity or retained earnings on the balance sheet to get the job done.

Treasury Share Adjusted Debt to Shareholder Equity Ratio

- Wrigley 0.68, Goodyear 4.35, Ford 38.0

Financial institutions like banks, have a much higher ratio. This is why Buffett says they are highly leveraged operations. Exception is M&T (his favorite) is 7.7

***Rule**: if the Treasury Share Adjusted Debt to Shareholder Equity Ratio is less than 0.8, the company has a durable competitive advantage.*

Shareholder Equity & Book Value

- Net worth = Book Value = Shareholders Equity
- Shareholder equity is under the heading capital stock, which includes preferred and common stock, paid in capital, and retained earnings.

Preferred + Common Stock: Additional Paid in Capital

In search for durable competitive advantage, we look for absence of preferred stock in the capital structure.

Retain Earnings: Buffett's Secret

Net earnings can be paid out as dividends, used to buy back shares or retained for growth. To find net earnings to be added back we take after-tax net earnings and deduct dividends and stock buy back.

If the company loses more than it has accumulated, retained earnings is negative.

One of the most important indicators of durable competitive advantage

- If a company isn't adding to its retained earnings, it isn't growing its net worth.
- Rate of growth of retained earnings is good indicator whether it's benefiting from a competitive advantage.
- Mergers pool earnings together
- Microsoft is negative because it chose to buyback stock and pay dividends
- The more earnings retained, the faster it grows and increases growth rate for future earnings.

Treasury Stock

- Carried on the balance sheet as a negative value because it represents a reduction in shareholders equity.
- Companies with moats have free cash, so treasury shares are hallmark of durable competitive advantages.
- When shares are bought back and held as treasury stock, it is effectively decreasing the company equity. This increases return on shareholders equity.
- High return is a sign of competitive advantage. It's good to know if it's generated by financial engineering or exceptional business economics or combination.
- To see which is which, convert negative value of treasury shares into a positive and add it to shareholders equity. Then divide net earnings by new shareholders equity. This will give the return on equity minus effects of window dressing.

***Rule**: presence of treasury shares and a history of buyback are good indicators that company has competitive advantage*

Return on Shareholders Equity

Net earnings / Shareholders Equity = Return on Shareholders Equity

- Companies moats show higher than average returns on shareholders equity (Coke 30%) (AA 4%)
- High returns on equity means company is making good use of retained earnings.
- This will add up and increase the underlying value, which will eventually be reflected in the stock price.
- Note: some companies are so profitable they don't need to retain any earnings, so they pay them all out to shareholders. This sometimes shows up as negative equity. Danger is that insolvent companies also show negative equity.
- If the company shows a history of strong net earnings, but shows negative shareholders equity, there is a durable competitive advantage.

Leverage

Leverage can make the company appear to have some kind of competitive advantage when just using debt. Avoid businesses that use a lot of leverage to generate earnings.

Durable Competitive Advantages through the Cash Flow Statement

August 23rd, 2010

This is part three of **Identifying Durable Competitive Advantages by Analyzing Financial Statements.**

Part one: **Finding Durable Competitive Advantages by Analyzing the Income Statement**

Part two: Finding Durable Competitive Advantages through the Balance Sheet

Part three: *Finding* ***Durable Competitive Advantages through the Cash Flow Statement***

The information provided in this article can be found in the book **Warren Buffett and the Interpretation of Financial Statements.**

Before you proceed, you may be interested in a primer on analyzing the **cash flow statement**.

Table of Contents:

- How to Identify Competitive Advantage through the Cash Flow Statement
- Capital Expenditures
- Stock Buybacks
- Valuing the Company With Durable Competitive Advantage
- Durable Competitive Advantage Summary
- About Jae Jun
- Recent posts by Jae Jun

How to Identify Competitive Advantage through the Cash Flow Statement

Capital Expenditures

- Never invest in telephone companies because of big capital outlays

Rule: *company with durable competitive advantage uses a smaller portion of earnings for capital expenditure for continuing operations than those without.*

- To compare capex to net earnings, add up total cap exp for ten-yr period and compare with total net earnings over the same period

Rule: *if historically using less than 50%, then good place to look for durable competitive advantage. If less than 25%, probably has a competitive advantage.*

Stock Buybacks

- Buyback increases EPS even though actual net earnings do not. More shares outstanding = lower EPS. Buybacks increase shareholder wealth without taxes.
- To assess: look at cash from investment activities. "Issuance (Retirement) of Stock, Net"
- If buying back consistently, the company has a competitive advantage because it is generating lots of cash

Rule: *history of repurchasing/retiring shares is an indicator of competitive advantage*

Valuing the Company With Durable Competitive Advantage

Equtiy Bond Idea

- A company with competitive advantage shows great strength and predictability in earnings growth, that growth turns the shares into a kind of equity bond, with an ever-increasing coupon/interest payment. (Bond=shares/equity. Coupon/interest payment = pretax earnings)
- e.g. In 1980 Buffett bought Coke for $6.50 a share against pre-tax earnings of $.70 a share = after-tax $.46. Historical earnings growth = 15%
- Buffett argues that he got a Coke bond paying initial pretax interest rate 10.7% on a $6.50 investment, with yield increasing at 15% annually.

Durable Competitive Advantage Summary

Income Statement	(DCA = Durable Competitive Advantage)	Comments
Gross Profit Margin	>40% = D.C.A. < 40% = competition eroding margins < 20% = no sustainable competitive advantage	Consistency is Key
SG&A (SGA as % of gross profit)	< 30% is fantastic Nearing 100% is in highly competitive industry	Consistency is Key
Depreciation (depreciation costs as a % of	Company with moat tend to have lower %	

gross profit)		
Interest Expenses (interest expenses relative to operating income)	Durable competitive advantages carry little or no interest expense. Buffett's favorite consumer products have <15%	Company with lowest ratio of interest to Operating Income = competitive advantage. Varies widely between industries.
Net Earnings (% net earnings to total revenues)	Net earnings history >20% = Long Term moat < 10% = in highly competitive business	consistency and upward LT trend
EPS	10-year period showing consistency and upward trend. Avoid erratic earnings pictures.	Consistency = sign products don't need to change. Upward trend = strong
Balance Sheet		
Cash and Equivalents	lots of cash and marketable securities + little debt	Test to see what is creating cash by looking at past 7 yrs of balance sheets
Inventory	Look for an inventory and net earnings that are on a corresponding rise	inventories that spike up/down are indicative of competitive industries prone to (boom/bust)
Net Receivables	consistently shows lower % net receivables to gross sales than competitors	d.c.a. no need to offer generous credit
Goodwill	increase in goodwill over number of years assume because company out buying companies >BV	d.c.a.'s never sell for less than BV
LT Investments	can have valuable assets on books at valuation < market price (booked at lowest price)	tells us about investment mindset of management (Looking for d.c.a.?)
Intangible Assets	Internally developed brands not reflected on BS	
Total Assets + ROA (Measure efficiency using ROA)	Higher return the better (but: really high ROA may indicate vulnerability in durability of c.a.)	Capital = barrier to entry

ST Debt	financial institutions. Buffett shies from those who are bigger borrowers of ST than LT debt	
LT Debt Due	d.c.a. need little or no LT debt to maintain operations	
Total CL + Current Ratio	higher the ratio, the more liquid, the greater its ability to pay CL	d.c.a.'s don't need 'liquidity cushion' so may have <1
LT Debt	LT debt load for last ten yrs. ten yrs w/ little LT debt = d.c.a.	earning power to pay their LT debt in <3/4 yrs = good candidates
Total Liabilities + Treasury Share-Adjusted debt to Shareholder Eq Ratio	If <.80, Good chance company has d.c.a.	
Preferred + Common Stock	in search for d.c.a. we look for absence of preferred stock	
Retained Earnings	Rate of growth of RE is good indicator	
Treasury Stock	presence of treasury shares and a history of buyback are good indicators that company has d.c.a.	convert –ve value of treasury shares into +ve and add shareholder eq. Divide net earnings by new shareholders eq. give us return on equity minus dressing.
Return on Shareholder equity	d.c.a. show higher than average returns on shareholders equity	If company shows history of strong net earnings, but shows –ve sholder equity, probably d.c.a. because strong companies don't need to retain
Cash Flow Statement		
Capital Expenditures	historically using < 50% then good place to look for d.c.a. < 25% probably has d.c.a.	Add up total cap exp for ten-yr period and compare w/ total net earnings over period.
Stock Buybacks	indicator of d.c.a. is a history of repurchasing/retiring its shares	Look at cash from investment activities. "Issuance (Retirement) of Stock, Net"