Talks at Google

Pat Dorsey

Competitive Advantage and Shareholder Value

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Competitive Advantage and Shareholder Value: Making Money by Digging Moats

Introductions

- Pat Dorsey, CFA
  - Founder, Dorsey Asset Management
  - Former Director of Equity Research at Morningstar: Created investment philosophy, built team from 20 to 100 analysts, developed institutional research platform.
  - Author of *The Five Rules for Successful Stock Investing* and *The Little Book that Builds Wealth*.

- Dorsey Asset Management
  - Global mandate, concentrated portfolio, focused on owning competitively-advantaged compounders

Capitalism Works

Capital seeks the highest returns possible: High profits attract competition.

So….most businesses with high returns on capital will see returns decrease over time.

Beating the Odds

- But, a small minority of companies enjoy many years of high returns on capital.

- How? By creating structural competitive advantages, or economic moats.

- *Absent a moat, competition destroys excess returns.*

Moat Basics

- Economic moats are structural & sustainable qualities that are inherent to the business.
  - Not hot products. (Heelys? Krispy Kreme?)
  - Not just a cool piece of tech (Iomega?)
  - Not the biggest market share (GM? Compaq?)

- Moats generally manifest themselves in pricing power: A company that can't raise prices is unlikely to have a strong moat.

Intangible Assets

- Brands
  - Increase willingness to pay / lower search costs
    - Sony vs. Tiffany
    - Amazon, Groupe Richemont, Coca Cola İçecek
- Patents
  - Legal monopoly vs. expiry/challenge/piracy
    - Novo Nordisk, Qualcomm, Chr. Hansen
- Licenses / Approvals
  - Legal oligopoly vs. regulatory fiat
    - Casinos, landfills, aircraft parts

Widening the Moat: Brands

- Brands are valuable if they deliver a <u>consistent</u> or <u>aspirational</u> experience.
  - <u>Consistency</u> lowers search costs & drives loyalty. Don't change & give people a reason to switch!
    - New Coke, The Schlitz Mistake
  - <u>Aspiration</u> increases willingness to pay. So, create scarcity & exclusivity.
    - Tiffany's store layout
    - "You don't own a Patek Philippe, you merely take care of it for the next generation."

Aspirations Differ

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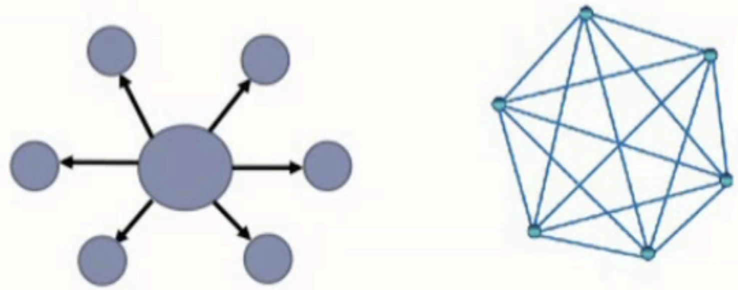
Switching Costs

- Does the cost of switching to a competing product or service outweigh the benefits?
  - Integrate with customer's business: Upfront costs of implementation → payback from renewals
    - Silverlake Axis, Oracle, SimCorp
  - Sell ongoing service relationships
    - Rolls Royce, Kone, Schindler
  - Provide a product with a high benefit/cost ratio
    - Fastenal, Ecolab, Novozymes, Fuchs Petrolub

The Network Effect

- Provide a service that increases in value as the number of users expands.
  - Aggregate demand b/t fragmented parties.
    - Edenred, Henry Schein, XPO Logistics
  - Non-linearity of nodes vs. connections.
    - Visa, Mastercard, Facebook
  - Radial vs. Interactive Networks



Cost Advantages

- Process: Invent a cheaper way to deliver a product that can't be replicated quickly.
  - Inditex, RyanAir, GEICO, Dell
- Scale: Spread fixed costs over a large base. Relative size matters more than absolute size.
  - UPS, Aggreko, Stericycle
- Niche: Establish minimum efficient scale

What About Management?

- “Good jockeys will do well on good horses, but not on broken-down nags.” (Buffett)
- Pat wins this race

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Get a Good Horse

- Managers matter -- <u>in context of the moat.</u>
  - The required level of managerial skill is inversely related to the quality of the business.

- Bad business?
Better have a great manager.

- Great business?
- Genius not needed.

Moats, Management & Mistakes

- Moats can buffer management mistakes
  - Microsoft minted money despite Steve Ballmer
  - New Coke didn't kill Coca-Cola
  - Moodys put profits before integrity, and still cranked out a 40% operating margin
  - But even a genius like David Neeleman couldn't change that fact that JetBlue is an airline -- the worst industry known to mankind.

The Good & the Bad

- Good managers are constantly looking for ways to widen a company's moat
  - Amazon's focus on the customer experience
  - Costco's focus on using scale to lower costs

- Bad managers invest capital outside a company's moat, lowering overall ROIC
- This process is called "deworsification," or "setting fire to large piles of cash."

I'm Investing Outside My Moat!

An Exception to Every Rule

- A tiny minority of managers can create enormous value via astute capital allocation – even if they don't start with great horses.
  - Warren Buffett (Berkshire), Brian Joffe (Bidvest), Dick Kovacevich (Wells Fargo), Steve & Mitch Rales (Danaher)

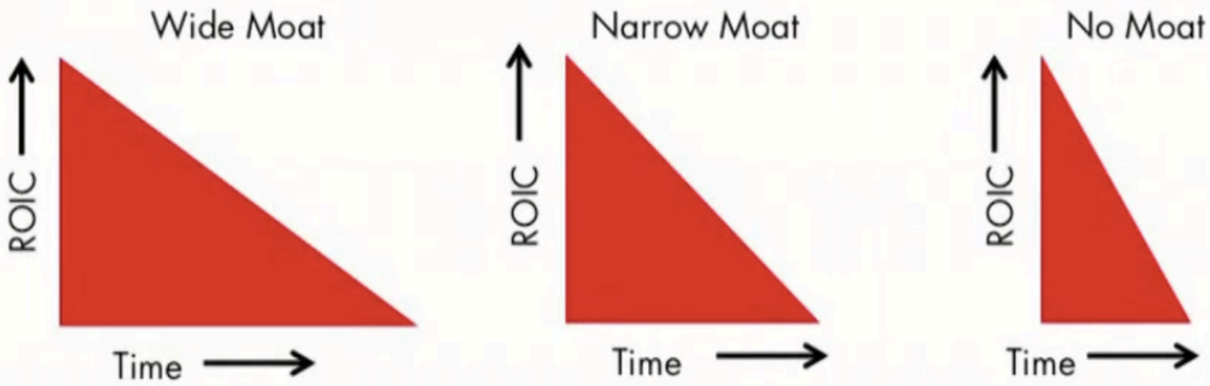
- They are hard to find, and false positives abound…but they can create enormous wealth over time. Keep an eye out!

Moats in a Global Context

- Local differences create moats
  - Canadian banks, Edenred, German car washes
- Minimum efficient scale is more common
  - South African retailers, Globo, BEC World
- Cultural preferences create barriers to entry
  - Beer travels. Candy & snacks generally don't.

Why Moats Matter

- Moats add intrinsic value!
  - A firm that can compound cash flow for many years is worth more than a firm which can't.



Valuing Moats

- The value of an economic moat is largely dependent on reinvestment opportunities.

- The ability to reinvest tons of cash at a high incremental ROIC = a <u>very</u> valuable moat.
  - Fastenal, XPO, Curro

- If a firm has limited ability to reinvest, the moat adds little to intrinsic value.
  - McCormick, Microsoft, Oracle

Moat ≠ Inevitable

- Moats are not limited to super-stable companies your grandkids will own.
  - A small subset of the investable universe
  - Limited reinvestment opportunities

- Moaty businesses that pay cash are good… but moaty businesses that can <u>reinvest</u> cash are totally awesome.

Investing in Moats

- <u>Overestimating</u> the moat means paying for value creation that will never materialize.

- <u>Underestimating</u> the moat means paying a large opportunity cost.

Real Cost: Motorola

RAZR released

MOT has 22% market share, market prices in a non-existent moat

MOT has 10% market share

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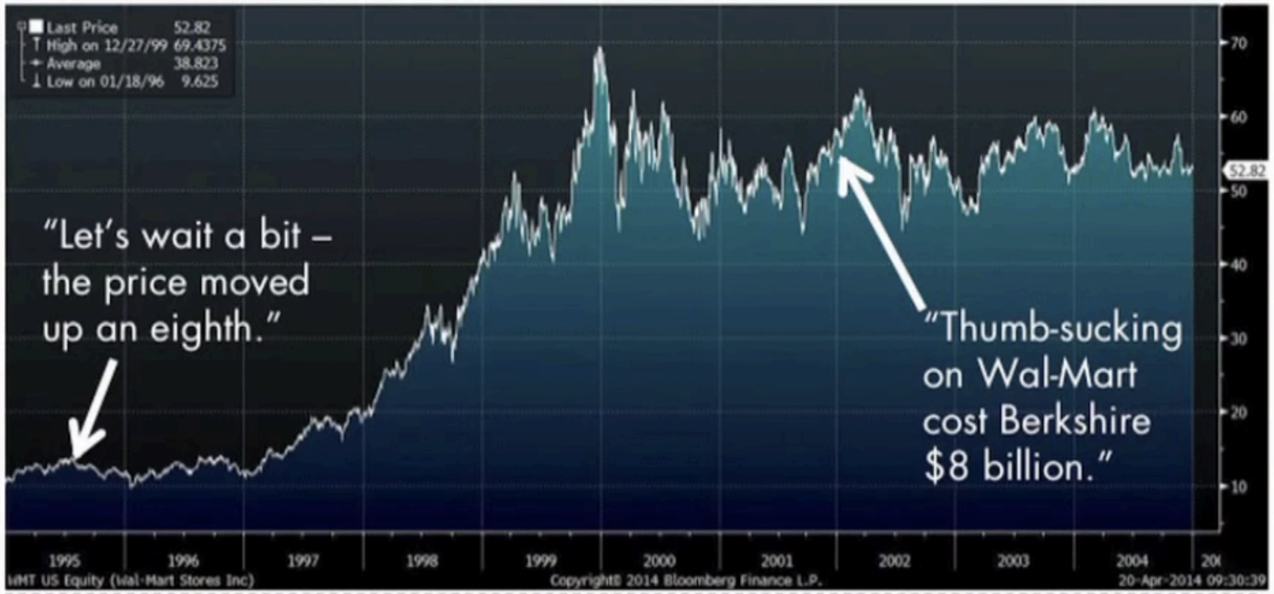
Opportunity Cost: Wal-Mart

- Most investors spend lots of time on margin of safety, and too little on opportunity cost.



Isn't the Moat Already Priced In?

- Short answer: Less often than you think.

- Long answer:
  - Most investors own securities for short time periods, and moats matter in the long run.
  - Most investors assume the current state of the world persists longer than it usually does.
  - Most investors focus on short-term changes in price, not long-term changes in moats.

Finding Moats = Finding Inefficiency

"All of the information is in the past,
but all of the value is in the future."

<u>Quantitative data</u> is efficiently priced

$$
\begin{aligned}
\overline{\int_a^b f(x)\,dx} &= \lim_{n\to\infty} \bar{A}(f,n) = \lim_{n\to\infty} \frac{b-a}{n}\sum_{k=1}^{n}(\bar{f}_k) = \lim_{n\to\infty} \frac{1}{n}\sum_{k=1}^{n} x_{k+1} \\
&= \lim_{n\to\infty} \frac{1}{n}\sum_{k=1}^{n}\left(1+\frac{k+1}{n}\right) = \lim_{n\to\infty} \frac{1}{n}\left[\sum_{k=1}^{n}1+\frac{1}{n}\sum_{k=1}^{n}(k+1)\right] \\
&= \lim_{n\to\infty} \frac{1}{n}\left[\sum_{k=1}^{n}1+\frac{1}{n}\left(\sum_{k=1}^{n}k+\sum_{k=1}^{n}1\right)\right] = \lim_{n\to\infty} \frac{1}{n}\left[n+\frac{1}{n}\left(\frac{1}{2}n(n+1)+n\right)\right] \\
&= \lim_{n\to\infty} \frac{1}{n}\left[n+\left(\frac{1}{2}(n+1)+1\right)\right] = \lim_{n\to\infty} \frac{1}{n}\left[n+\left(\frac{n+1+2}{2}\right)\right] \\
&= \lim_{n\to\infty} \frac{1}{n}\left[\frac{2n}{2}+\left(\frac{n+1+2}{2}\right)\right] = \lim_{n\to\infty} \frac{1}{n}\left[\frac{3}{2}n\right] = \frac{3}{2}
\end{aligned}
$$

<u>Qualitative insight</u> is less efficiently priced

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