

Competitive Advantage  
and Shareholder Value:  
Making Money by  
Digging Moats

# Introductions

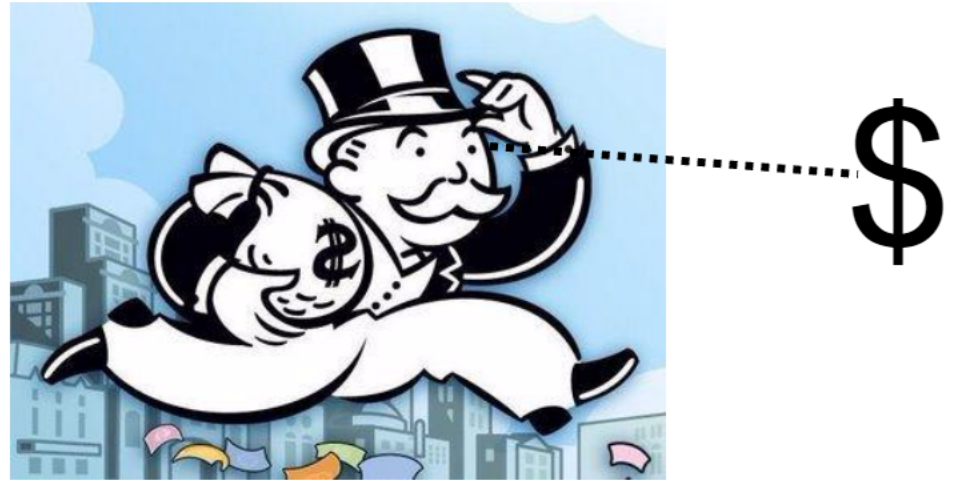
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- Pat Dorsey, CFA
  - Founder, Dorsey Asset Management
  - Former Director of Equity Research at Morningstar: Created investment philosophy, built team from 20 to 100 analysts, developed institutional research platform.
  - Author of *The Five Rules 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

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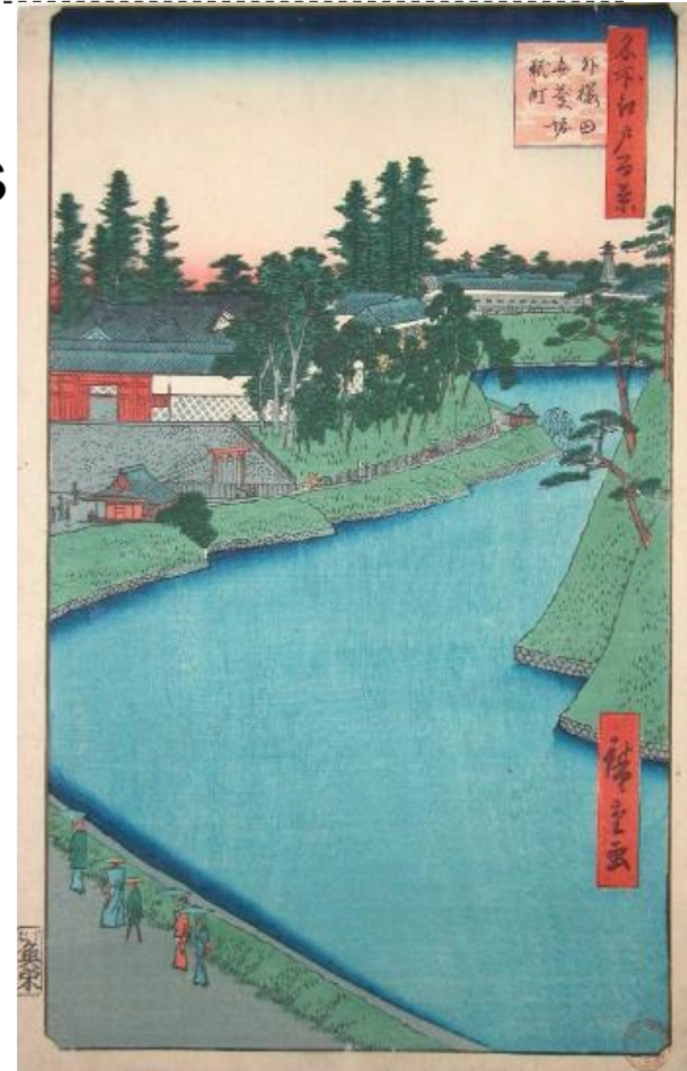
Capital seeks the highest returns possible: High profits attract competition.



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

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- 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.
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# Intangible Assets

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- 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

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- Brands are valuable if they deliver a consistent or aspirational experience.
  - Consistency lowers search costs & drives loyalty. Don't change & give people a reason to switch!
    - New Coke, The Schlitz Mistake
  - Aspiration 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

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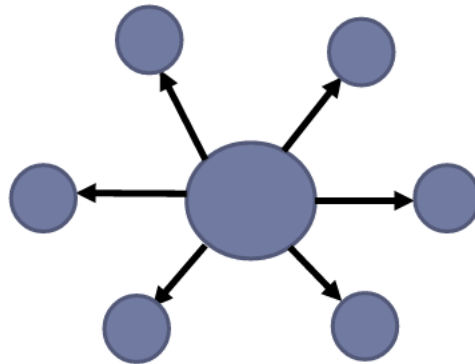
- Does the cost of switching to a competing product or service outweigh the benefits?
  - Integrate with customer's business: Upfront costs of implementation → payback from renewals
    - Silverlake Axis, Oracle, SimCorp
  - Sell ongoing service relationships
    - Rolls Royce, Kone, Schindler
  - Provide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

# The Network Effect

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- 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

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- 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?

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



# Get a Good Horse

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- Managers matter -- in context of the moat.
  - 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

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- 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

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- 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!

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# An Exception to Every Rule

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- 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

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▶ 17 eye out!

# Moats in a Global Context

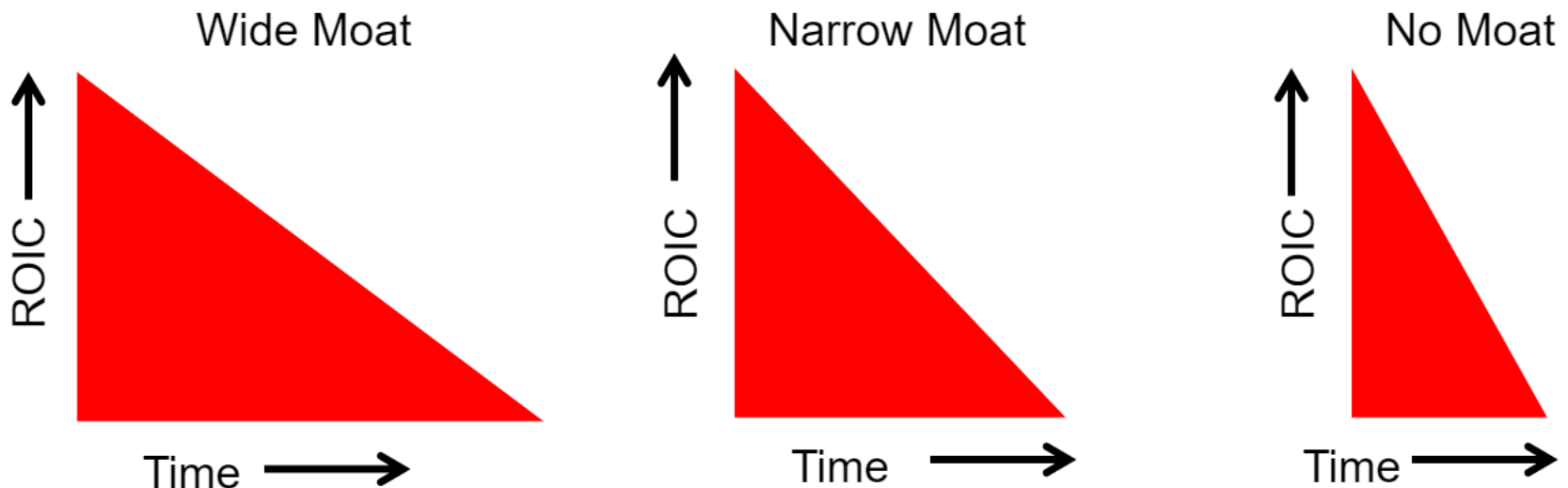
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- Local differences create moats
  - Canadian banks, Edenred, German car washes
- Minimum efficient scale is more common
  - South African retailers, Globo, BEC World
- Cultural preferences create barriers to entry
  - Beer travels. Candy & snacks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

# Why Moats Matter

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- 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

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- 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 very valuable moat.
  - Fastenal, XPO, Curro
- If a firm has limited ability to reinvest, the moat adds little to intrinsic value.

# Moat ≠ Inevitable

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- 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 reinvest cash are totally awesome.

# Investing in Moats

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- Overestimating the moat means paying for value creation that will never materialize.
- Underestimating the moat means paying a large opportunity cost.

# Real Cost: Motorola

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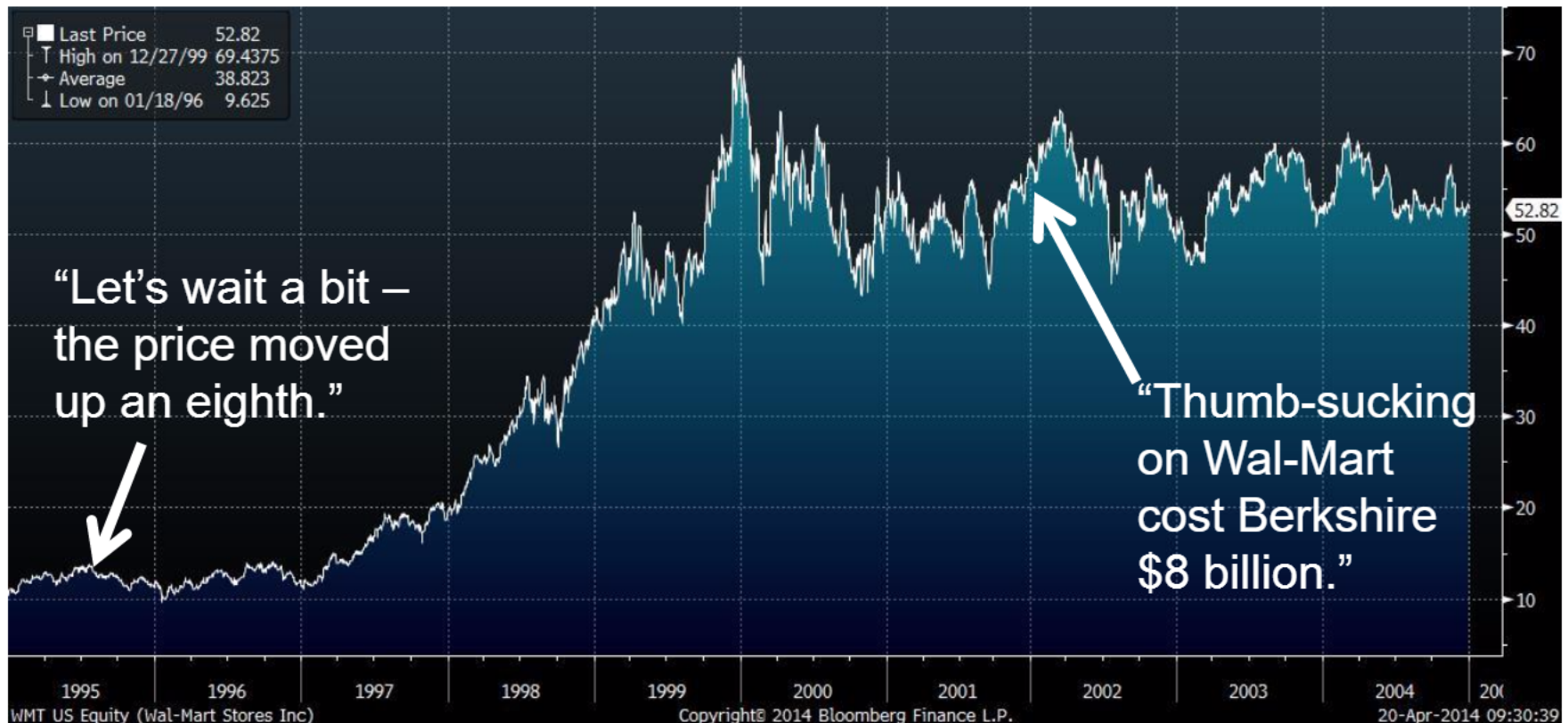
MOT has 22% market  
share, market prices in a  
non-existent moat

MOT has 10%  
market share



# 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?

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- 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

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

Quantitative data  
is efficiently priced

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

Qualitative insight is  
less efficiently  
priced



# Questions?

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