SageOne

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Dear Investors,

We hope our endeavor to write 'Knowledge Series' notes are serving the purpose of imparting knowledge and information and concepts, important in Capital Markets and Equity Research. Our last note was released by my colleague Pratik, where he discussed 'analysis of company management' in its 2nd edition. It was extremely detailed and well explained.

In this note, we shall discuss about one of the very important concepts in Company research i.e., 'Economic Moat'.

Economic Moat

An Economic Moat is a concept in business and investing that refers to a sustainable competitive advantage that allows a company to protect its market share and maintain healthy profitability for an extended period of time.

Economic Moat and Competitive Advantage and High Entry Barriers are essentially identical.

Professor Michael Porter calls barriers to market entry that a business may have as 'sustainable competitive advantage'. He says, "We have to have a business with come inherent characteristics that give it a durable competitive advantage".

Warren Buffett and Charlie Munger call them 'economic moat'. Buffett puts is as, "The key to investing is not assessing how much an industry is going to affect society, or how much it will grow, but rather determining the competitive advantage of any given company and, above all, the durability of that advantage. The products or services that have wide, sustainable moats around them are the ones that deliver rewards to investors".

Economic Moats can be of various forms which contribute to a company's ability to maintain a strong and defensible position in the market. Some of the common types of economic moats include –

- **Brand Moat** – a strong and well recognized brand can create a great moat. Consumer recall of well-established brands is high and creates high entry to barrier for newer entrants. Some brands are synonym to certain product categories. Few examples are as follows –
    - Cadbury for chocolates
    - Bisleri for mineral water
    - Colgate for toothpaste
    - Maggi for noodles

  So on and so forth…. these brand moats are extremely strong giving companies a big competitive advantage.

- **Cost Moat** – companies with lower manufacturing and/or operational cost have a competitive advantage over its peers. Firms with structural cost advantage can either undercut competitors on price while earning similar margins or charge market level prices and make higher profit margins.

Cost advantages are often gained through economies of scale, lower distribution and manufacturing costs and/or access to low-cost resource base.

- Walmart Inc., which is the largest retailer in the US and has carved out an enviable position in a fragmented and competitive landscape. As per Morningstar, "The firm leverages its unmatched scale by spreading its omnichannel and distribution investments over a wider sales and profit base, allowing the firm to adapt to the dynamic retail environment while maintaining robust profitability". As Morningstar explains, the company has built its moat around, its strong brand and leverage over suppliers and a vast supply chain network to drive down costs.
- Similarly, in India, DMart has created a similar moat around its brand, leverage over suppliers and a vast supply chain network, leading to significant cost advantage.

- **Switching Cost Moat** – a company can build a moat, if it is expensive or inconvenient for customers to switch from one product or service to another. This may include the costs associated with changing suppliers or adopting new technology.

  Apart from monetary aspect, switching costs can also be measured by the effort, time and psychological toll it may take to switch to a competitor. Switching cost provide a company with the leverage to increase prices and deliver substantial profits over time.
    - This is evident in a range of industries, from banks, to software, to telecoms, among others.

- **Network Effect Moat** – network effect grows with reach. Business become more valuable as user base increases. Internet companies, social media platforms, online market places and communication tools often exhibit network effect.
    - Visa dominates the global electronic payments industry and has reached essentially universal acceptance in most developed markets. According to reports, Visa has over 50% market share (by purchase volumes) in US, Europe, LatAm and Middle East/Africa. This is a great example of how network effect can create a powerful competitive advantage.
    - Google, with a global market share of over 80%, leads the online search market. The network effect primarily comes from Google products including Android, Maps, Gmail, YouTube and more. Google's large and growing user base has created a network difficult to replicate.

- **Regulatory Moat** – certain industries are heavily regulated, creating high barriers to entry. Incumbents are at an advantage versus new players due to high regulatory restrictions.
    - Banks and NBFCs are highly regulated. They need to obtain license, meet capital requirements and adhere to strict reporting and disclosure standards. Companies that navigate and comply with regulations effectively can establish a competitive advantage.
    - Tobacco and Cigarette companies are other such example of operating in highly regulatory regime.
    - Even Nestle India has been a big beneficiary of regulatory moat. They had the first mover advantage of launching infant food products and thereafter, govt ruled that companies cannot advertise infant foods products and thus other companies could not market their products via TVCs or newspaper ads. This gave a big competitive advantage to Nestle, who now enjoys over 90% market share in infant food market in India.

- **Intellectual Property Moat** – patents, copyrights, trademarks and other intangible assets are legal barriers to entry that protect companies from unauthorized commercial usage by competitors. They protect company's innovation and creation, making it challenging for competitors to replicate them. Not always easy to quantify, intangible assets are one of the primary sources of strong competitive advantage.
    - Innovator pharma companies like Pfizer, Eli Lilly, etc. own patents preventing competitors from duplicating its drugs.
    - Several chemical companies own process patents, which provide them advantage of producing products with highest efficiency, making it difficult for competition to provide products at similar pricing or quantity.

- **Process Moat** – a process moat is not derived from any single or few factors. Rather, it derives from a company's chase for excellence and innovation in every single component of its business so that the sum of the parts becomes much greater than whole. When every part is scrutinized and optimized, it creates something incredibly hard to replicate.
    - Amazon is a classic example. Amazon always seeks to build its own optimal infrastructure that's uniquely suited to its needs and scale, from software infra (AWS) to loyalty program (Prime) to logistics and delivery. Developing its own delivery fleet was incredibly expensive for Amazon but after few years, once the investment bore fruits, it allowed Amazon to deliver faster, wider and more reliably as well as track delivery better than anyone.
    - Apple too develops the most critical software and hardware components for iPhone in-house. In early to mis 2010s, Apple's vertical integration was seen as weakness by many. Skeptics said, Apple should instead be investing for the next big thing. However, people have not moved away from iPhone and one key reason is Apple's process moat – the way they made its software, hardware, camera, etc. and how it got better and better with each new iteration. And the way they do it, their competitors cannot coz of its vertical integration.
    - Rolex owns its own foundries where it creates from scratch its proprietary steel and gold.

Any discussion around economic moats should address the following questions –

1. What is the source of the company's advantage?
2. How can we measure the advantage?
3. Is the advantage widening or narrowing?

We discussed some of the common sources of company's competitive advantage above. Apart from them, there can be several other sources such as customer service, geographic location, exclusive access to resources, economies of scale, access to capital and so on.
One of the biggest advantages a Moat offers to companies is – TIME. A competitive advantage gives a company heads up against its peers, which allows the company with moat to focus on maximising long-term value of the business.

Measuring a moat may vary by company. For example, in case of DMart, who has cost moat, one can track the expense ratio of the company to measure its cost advantage. For a luxury goods company, one can pay attention to trends in gross margins.

Whichever company one may be looking at, you can identify or create key metrics that can be used to track company's moat trend. One good metric can be Return on Capital Employed (RoCE – we have discussed the concept of RoCE in detail in the past note).

Companies with widening economic moat produce higher RoCE or at least make their current RoCE more durable than before.

Any conversation about moats requires a definition, a way to measure it and a way to judge its trend. If one is not able to answer these questions, the moat may be non-existent or further investigation is warranted.

At SageOne, 'high barrier to entry' or 'competitive advantage' is one of the most important parameters while evaluating an investment idea. Several of our investee companies currently and in the past, having strong competitive advantage, have produced great returns for our fund/investors.

- **Some of our portfolio investment companies in the past, having a strong moat** –
  - **Bajaj Finance** – company had a first mover advantage in the area of consumer lending. Its interest-free EMI product worked wonders. For many quarters, Bajaj Finance reported around 50% growth. Over time, BFL become a prominent NBFC, boasting of a wide customer base and graduated to a diverse portfolio of financial products and services. Its well-established brand and consumer trust gave it a strong competitive advantage.
    However, over time, several of its peers, including banks, entered consumer lending space, thus increasing competition, leading to narrowing of its moat and there by moderating its growth.

  - **Page Industrie**s – Page industries holds license to manufacture and retail products under the 'Jockey' brand. Page succeeded in creating and maintaining aspirational value of the brand over a long period of time. The pace of new launches, quality and innovation in products kept Page ahead of its competitors. Page also benefited from being one of the lowest cost of manufacturers.
    However, as the retail sector opened up, several international brands entered India and domestic manufacturers and retailers expanded their product portfolio and launched similar products under their private brands. Over a period of time, their competitive advantage started reducing leading to lower growth.

- **Few more examples of companies having a strong economic moat (from our current portfolio holdings without taking names) is as follows –**
  - This company is India's largest structural steel tubes and value-added product manufacturer. This company has actually developed several competitive advantages over time. Today, they have over 50% market share in the industry they operate. This has been possible coz of first mover advantage in adopting leading technology much ahead of competition, built the largest network of distributors to sell their products, achieved critical economies of scale where the second largest player would be less than half their size which in effect gives the company the advantage to negotiate better with their raw material supplier. Company has followed extremely prudent working capital management which has led to generation of handsome cash flows. **Thus, this company has not one but several moats – cost moat, technology advantage (though peers have started adopting now) and economies of scale.**

What this has led to is that the company has delivered sales growth CAGR of 28% in the last 3 years and 25% CAGR in the last 5 years. In the same time, the profit after tax has grown at CAGR of 39% in last 3 years and CAGR of 32% in the last 5 years. However, the stock has returned a CAGR of 48% for the last 3 years and 68% for the last 5 years.

- Another of our investee companies, is one of the largest manufacturers of gensets, selling their products in India and the export market. While this company is a market leader in smaller capacity gensets, they earlier lacked products in larger capacity category which was gaining lot of traction in new age business like data centers, etc. However, the company through its in-house R&D has now developed these new range of high capacity gensets where competition is low. What has now worked in favor of the company is certain regulatory changes with regards emission norms. This has led consolidation in the market in favor of big companies who have products ready adhering to these new emission norms where the unorganized sector cannot compete. Another moat for the company is its customer service network which is one of the largest in the country. This makes them the preferred supplier for their customers. **Thus, the company has regulatory and customer service advantages viz-a-viz many of its peers.** The result has been that the company has reported sales growth CAGR of 14% and 10% for the last 3 and 5 years respectively. However, the profit after tax has grown at CAGR of 27% and 25% respectively for the same period. Launching of newer high-capacity products and low competition intensity has led to improvement in profit margins and increase in exports. Thus, during the same periods, the stock has returned a CAGR of 77% and 32% for 3 and 5 years respectively.

- This investee company of ours operates in the retail space. The company is one of India's largest fast fashion and value fashion retailers offering products at every price point. One of the biggest successes of the company is its supply chain management. **This involves large distribution network via its stores and ability to churn inventory much quicker and with much higher efficiency which is very difficult for competition to replicate.** This coupled with its brand positioning gives the company unique competitive advantage. Its peers have tried to replicate their model in the past but have failed. Inventory days for this company is the lowest viz-a-viz any of its peer in the space in India.
  This company has compounded its sales at 33% and 31% in 3 years and 5 years respectively. During the same period the PAT has grown at 47% and 26% respectively. This superior and resilient fundamental performance of the company has also been reflected in the stock price performance when compared with peers for the same period.

In conclusion, understanding the concept of an economic moat is essential for investors and businesses alike. Economic moats represent the competitive advantage that companies possess, enabling them to maintain profitability and market dominance over time. **Identifying and nurturing economic moats can significantly contribute to company's long-term success and shareholder value.**

This note is an attempt to help explain to our investors and readers an important concept in an easy language and the examples of companies cited above should help them relate to concept of Economic Moat / Competitive Advantage of a company. It is also an attempt to make our investor relate to the investment approach followed at SageOne while screening companies for making investment.

We hope you will enjoy reading this compilation as much as we enjoyed penning it for you.

Happy Reading!!

Best Regards,
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