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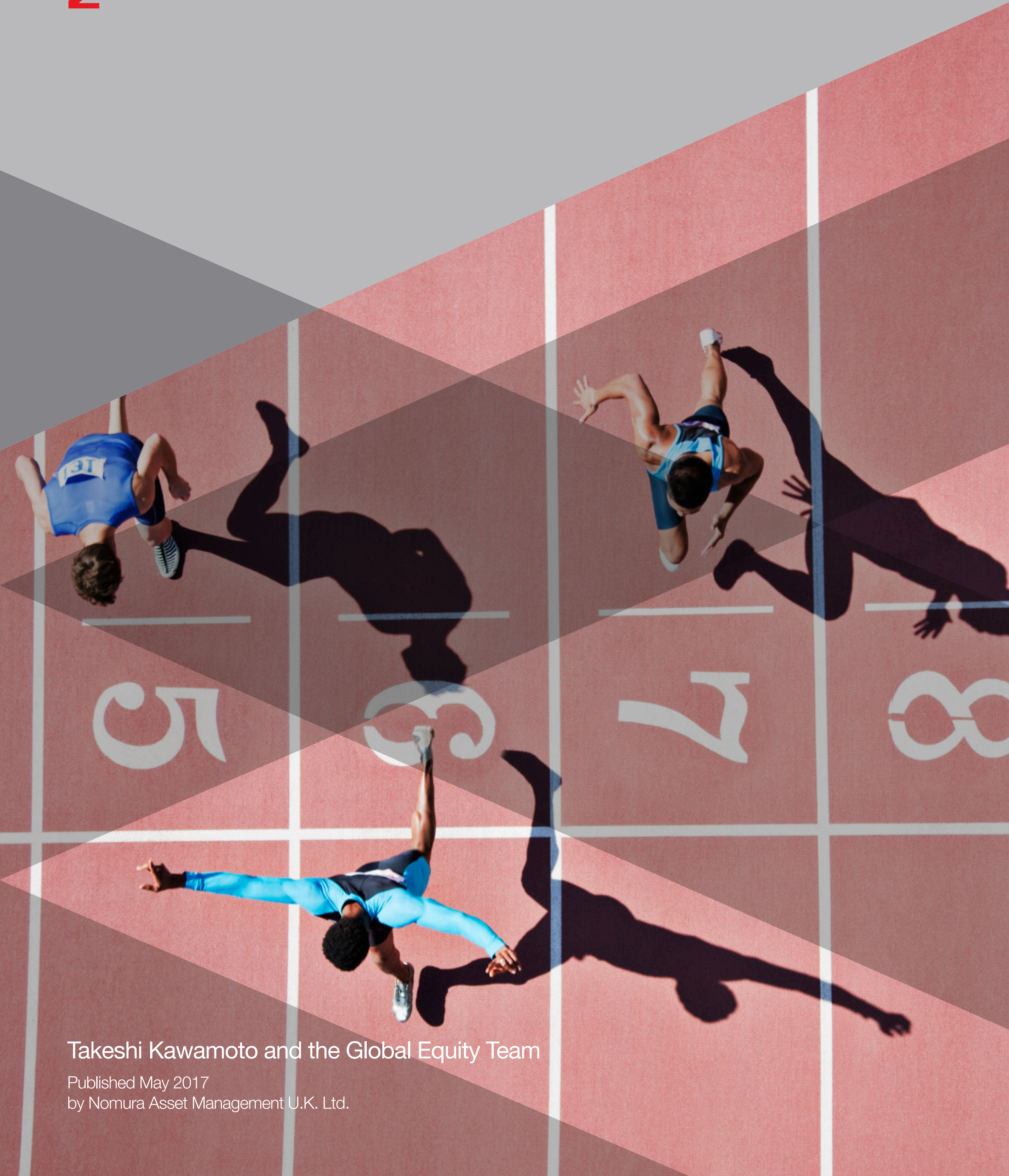
Nomura's Global Equity Team on Competitive Advantage



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Competitive Advantage

There is a mathematical series, well known to man, but often misunderstood. It is at the heart of the concept of “long term investing”, but investors often act counter to its mathematical laws. The mathematical series is geometric, but commonly goes by the name ‘compound interest’. Its passage of time magnifies its impact on investment results, amplifying profits and making losses hard to recover from. It makes repeatability and the avoidance of substantial declines in investment values key components of a long term investment strategy. Our investment process is designed with this in mind. We look for “Quality at Discount Valuation” and with this philosophy we aim to repeatedly find investments that are priced too cheaply and are unlikely to irreversibly decline in value.

This note is part of a series of four that looks at our definition of “quality”, which may differ from other investors. We aim to invest in ‘decent’ quality companies according to four key quality characteristics. This note looks specifically at the importance of strong competitive advantage.

***Quality: Strong competitive advantages*, consistent cash returns to shareholders, skilled management, a history of attractive returns on capital and the opportunity to make attractive reinvestments are characteristics of “quality” companies. These companies can often sustain their returns for longer than the market recognises or are less likely to experience irreversible declines in profitability**

Most companies claim to have a competitive advantage or an 'economic moat' as coined and popularized by Warren Buffet. In fact, we are constantly bombarded by the term in company presentations and in the media. But what does it actually mean?

We see competitive advantage as an attribute or characteristic of a company that gives it the opportunity to earn **sustainably** attractive returns on capital. If two companies spend $100 each to build a gadget factory and Company A is left with $30 profit every year vs. $20 for Company B, which one do you think is more likely to have a 'stronger competitive advantage' and what are the qualities that give the company its superiority over the competition? We've highlighted below some common sources of economic moat, but you'll notice there is some overlap and some companies have more than one of these attributes.

1) High barriers to entry: The open loop card payment networks such as Visa or MasterCard are good examples of companies that have a "wide economic moat" or high barrier to entry. These open loop card networks act as a hub connecting the global banking system that issues credit/debit cards to consumers with the global retail system that accepts credit/debit cards as a form of payment. It would be impossible for every bank in the world to enter into a contract with every merchant in the world to enable electronic payments. Allowing banks and retailers to connect to the Visa or MasterCard network is the only practical way of enabling electronic payments. Closed loop networks such as American Express do the card issuing and merchant servicing as well as extend credit. The open loop card payment networks leverage the global banking system to sign up consumers and extend credit. Therefore, closed loop networks will stay a niche business compared to open loop networks.

Visa and MasterCard have a time to market advantage – in that they were the first to set up global operations. There are examples of successful domestic card schemes such as China UnionPay in China and JCB in Japan but, since these cards are not widely accepted outside of their home markets, consumers who travel abroad will tend to have a Visa or MasterCard as well. This makes it hard for domestic card brands to compete because Visa and MasterCard already have huge scale and are widely accepted so there is little incentive for merchants to accept other card brands and therefore for consumers to carry other card brands.

2) Cost advantage: Ambev is a Brazilian beverages company with operations across Latin America and Canada. In Brazil, they have a very strong cost advantage that allows them to price products at ~20% cheaper than competitors using their returnable glass bottle format. Ambev is able to achieve this by having a dominant market share (~68%) which provides sufficient scale to make investments in their returnable glass bottles worthwhile. The cost of setting up these operations can be diluted by using the existing distribution infrastructure and supplier relationships, as well as high sales volume. These are advantages the competition does not possess.

The frequently cited "first mover" advantage is often realised as superior scale. Scale can bring about cost advantages in terms of materials purchasing, marketing spend or, in technology driven markets, R&D scale; designing more, or simply creating faster-to-market products. R&D scale advantage can be critical in a market like computer software, where the are no production scale advantages. Additionally, in manufactured goods, first mover advantage can deliver "experience curve"[(1)] benefits; that is better production yields achieved through higher cumulative volumes. For example, experience curve benefits are important competitive drivers in leading edge semiconductor production. Companies like Intel or TSMC in Taiwan, focus on moving quickly along the experience curve to maximise production yield thereby minimising costs and maximising gross margin.

Notes:

(1) Experience Curve : the more experience a producer of a product has, the lower the unit cost. Source: Boston Consulting Group.

3) Switching costs: High switching costs lock customers into a company. This allows companies to charge more for their products and have better visibility of their revenue streams. A good example of a company with high switching costs is SAP. SAP is the leading Enterprise Resource Planning (ERP) applications vendor in the world. ERP applications act as a hub, tying together a company's financial, human resource and operations data with data from suppliers, customers and partners. It makes running your company more efficient. SAP focuses on high end clients and most of the largest manufacturers and retailers run their business on SAP. In addition to the high functionality of their software, high switching costs also come in the form of customization and data storage. Implementing SAP software takes a lot of time and resource because every company is different and SAP software is customized to fit into the workflow of a corporation. Once up and running, critical data such as transactions are stored in databases that support SAP applications. Since SAP applications are proprietary, applications would have to be re-written if the company moved to a different software vendor. Since SAP software is used for mission critical activities in day-to-day operations, moving an application risks operational disruption and reputational damage. Switching costs are reflected in SAP's high customer retention rate.

4) Network effect: "The more people use a product, the more people use a product". This is the virtuous cycle of a network effect and why network externality is an interesting characteristic of strong competitive advantage. Often these companies, such as social media providers, have limited physical infrastructure so limited capital spending needs.

Alphabet (Google) has the network effect working in its favour. It was the early leader in internet search so was able to attract the most consumers and attain top market share. Google uses the vast amount of data generated by its users to adjust search algorithms to improve search results. This keeps users loyal to Google. Since Google retains the largest number of users, advertisers favour Google to reach these users. Subsequently as advertisers then need to compete with each other to reach these users, Google can charge higher prices to advertisers than the competition. This leads to a virtuous cycle of high growth.

As investors, how do we benefit from investing in companies with "strong competitive advantages"? We did some empirical analysis, looking back over 35 years, and found that in general returns on invested capital tended to reduce over time as competitive advantage erodes and management make bad decisions. However what we did find was that the best companies tended to stay the best and the worst the worst, so although competitive advantages tend to erode from their peak level, they do tend to persist at reduced strength for long periods. Great companies, though, are able to sustain their returns for much longer than the average, suggesting that some competitive advantages are much 'stickier' than others. Ambev, the Brazilian beverages company that we discussed earlier, has been particularly surprising. The company has been improving its returns on capital for the best part of 15 years, stabilising at above 30% in the last 5 years. According to our analysis, companies at the top of their game still tend to see some degradation in their return on capital but we are yet to see this with Ambev. Their dominant market share, strong brands, low cost structure and impressive management tells us that they are likely to continue to achieve above average return on capital.

But what about a company with a once strong competitive advantage that now looks much weaker? Companies like Link Net, Indonesia's largest cable TV provider, are in danger of seeing returns on capital reduce significantly and as the stock market reacts to that, shareholders can expect a poor outcome. Link Net does not have pay TV content; rather its competitive advantage is its use of Hybrid Fibre Coaxial cable for the provision of broadband as well as cable TV. For years such cable allowed Link Net to offer market leading broadband speeds which were not available from the Telecommunications companies using Asynchronous Digital Subscriber Lines (ADSL). But now Telkom Indonesia is deploying a fibre optic cable throughout Indonesia, so suddenly what looked like an unassailable competitive advantage does not appear so unassailable anymore. Telkom Indonesia has now exceeded Link Net's market share and what's worse is that the Indonesian government, a 53% owner of Telkom Indonesia, treats the delivery of broadband as a public good so pricing has become aggressive. The impact on Link Net is huge; its competitive advantage is evaporating and its returns on capital are starting to reduce and will likely to continue to in the future. The customer's share of the value Link Net produces is rapidly rising at the expense of its shareholders.

So what does this mean for our approach to investment? We are hunting for part ownerships of businesses (stocks) that are worth more than they currently sell for on the equity market, so it is critical to understand how the returns on capital are likely to develop over time, since this is critical to estimating the stock's value. Of course long term returns on capital are dependent on several factors, but we believe competitive advantage both now and in the future is paramount. If strong competitive advantages continue to remain strong in the future then the rate of value creation by a company will stay high, so there will be more value available for the company's stakeholders to share, including us, the shareholders.

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