What Makes a Moat?

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What Makes a Moat?

Economic moats represent sustainable competitive advantages that allow companies to protect their value and lead to excess returns over a long-term investing horizon.

To make money in today's dynamic market environment, one needs to invest in companies that will perform in the face of sustained competitive pressure. But how can you accurately identify companies that are great today and likely to remain great for many years to come? The answer to this question lies in competitive advantages, or economic moats. Just as moats were dug around medieval castles to keep the opposition at bay, economic moats protect the high returns on capital enjoyed by the world's best companies.

Moats 101

In a famous 1999 Fortune article, legendary investor Warren Buffett wrote, "The key to investing is…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." This idea, coined "economic moat," refers to the sustainable advantages that protect a company against competitors—the way a moat protects a castle. While Warren Buffett may have developed the moat concept, Morningstar has taken the idea a step further.

Whenever a company develops a profitable product or service, it isn't long before other firms try to capitalise on that opportunity by producing a similar—if not better—version. Basic economic theory says that in a perfectly competitive market, rivals will eventually eat up any excess profits earned by a successful business. In other words, profits attract competition, and competition makes it difficult for firms to generate strong growth and margins for long periods.

But looking at the history of firms, many companies earn high returns on capital for an extended period of time, in conflict with economic theory. Such companies are able to withstand the relentless onslaught of competition for long periods, and these are the wealth compounding machines. The explanation lies in structural characteristics known as economic moats.

Moats Determine the Size of Value Creation

The amount of value a company will create for itself and its shareholders is largely determined by two things: the amount of value currently being created and the sustainability of the excess returns on capital. The first factor is readily apparent to the market because it is in the financial statements. However, the second factor—which is not in the historical financial statements and cannot readily be screened for—is just as important and is a function of the duration of the competitive advantage.

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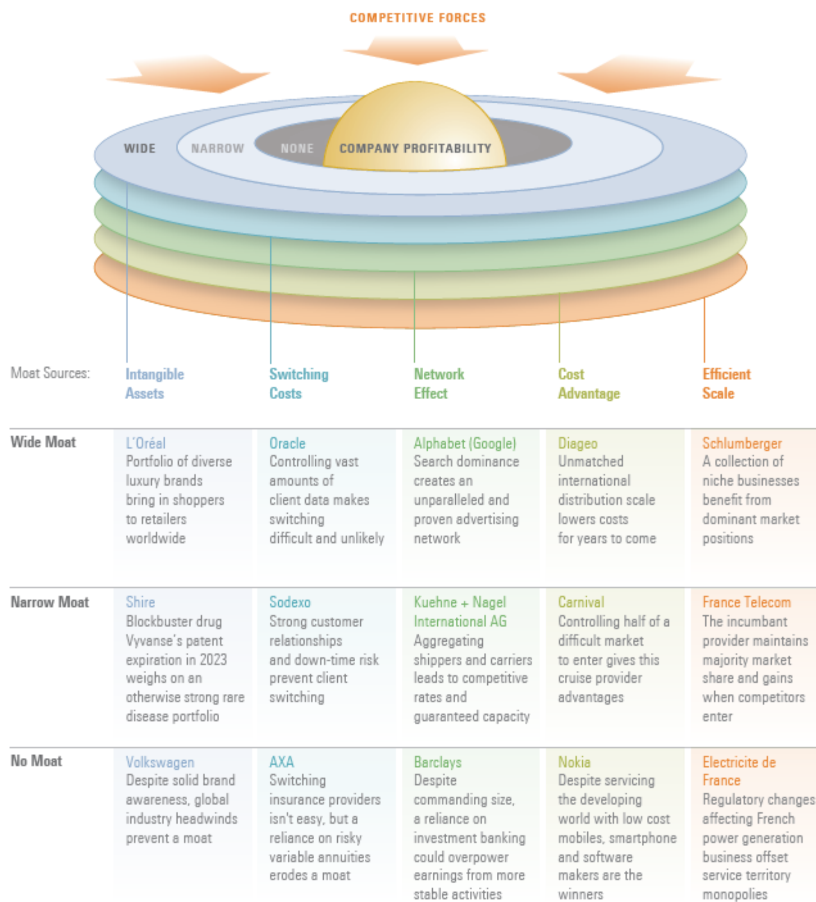
Here is another way to illustrate this idea: Take three companies, each with a similar value-creating return on invested capital (ROIC) today. The company that is able to sustain its high ROIC the longest is going to be able to add the most value for itself over the coming years. The company with the widest moat and the longest advantage period has the greatest value creation. In a nutshell, companies that have moats can create value for longer periods of time and are worth more, all else being equal.

Moat Sources

Over the years of looking at companies, Morningstar has identified five major sources of competitive advantage:



Moat Sources:	Intangible Assets	Switching Costs	Network Effect	Cost Advantage	Efficient Scale
Wide Moat	L'Oréal Portfolio of diverse luxury brands bring in shoppers to retailers worldwide	Oracle Controlling vast amounts of client data makes switching difficult and unlikely	Alphabet (Google) Search dominance creates an unparalleled and proven advertising network	Diageo Unmatched international distribution scale lowers costs for years to come	Schlumberger A collection of niche businesses benefit from dominant market positions
Narrow Moat	Shire Blockbuster drug Vyvanse's patent expiration in 2023 weighs on an otherwise strong rare disease portfolio	Sodexo Strong customer relationships and down-time risk prevent client switching	Kuehne + Nagel International AG Aggregating shippers and carriers leads to competitive rates and guaranteed capacity	Carnival Controlling half of a difficult market to enter gives this cruise provider advantages	France Telecom The incumbant provider maintains majority market share and gains when competitors enter
No Moat	Volkswagen Despite solid brand awareness, global industry headwinds prevent a moat	AXA Switching insurance providers isn't easy, but a reliance on risky variable annuities erodes a moat	Barclays Despite commanding size, a reliance on investment banking could overpower earnings from more stable activities	Nokia Despite servicing the developing world with low cost mobiles, smartphone and software makers are the winners	Electricite de France Regulatory changes affecting French power generation business offset service territory monopolies

1. Switching Costs—Switching costs are those one-time inconveniences or expenses a customer incurs to change from one product to another. Customers facing high switching costs often won't switch unless they are offered a large improvement in either price or performance. Companies whose customers have switching costs can charge higher prices (and reap more profits) without the threat of losing business. Consider a firm like Oracle—the massive software giant that sells database programs to companies that store and retrieve vast amounts of data. Oracle's databases are generally connected to other software programs, so if a company wants to change from an Oracle database, it would not only need to move all its data, but also reattach all the different programs that pull from Oracle. Therefore, companies tend not to switch, which is why businesses like Oracle have extraordinarily high renewal rates.

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2. Network Effect—The network effect occurs when the value of a particular good or service increases for both new and existing users as more people use that good or service, often creating a virtuous circle that allows the strong to get stronger. Take eBay as an example—it has the most buyers on its platform, so it attracts the most sellers. Meanwhile, because it has the most sellers, it is the most compelling source for buyers looking for non-standard goods.

3. Intangible Assets—Intangible assets are things such as patents or government licenses that explicitly keep competitors at bay. A pharmaceutical firm such as AstraZeneca certainly benefits from this, thanks to its portfolio of patent-protected drugs. Another sort of intangible asset that can provide an advantage is a strong brand, or collection of brands. L'Oréal is a prime example. Intangible assets can have a powerful connection with performance and market characteristics.

4. Cost Advantage—Firms that can figure out ways to provide goods or services at lower cost have an advantage because they can undercut their rivals on price. Alternatively, they may sell their products or services at the same prices as rivals, but achieve a fatter profit margin. Diageo is an example of a firm with unmatched distribution scale in several international markets.

5. Efficient Scale—This is a dynamic where there is a limited market size that is being effectively served by one or a small handful of companies. The companies that benefit from this phenomenon are efficiently scaled to fit a market that only supports one or a few competitors, limiting rivalry because any new entrant would result in insufficient returns for all players. ExxonMobil has built refineries integrated with chemicals that are located in markets where new refinery assets would not earn sufficient returns, giving Exxon an advantage in the chemicals industry. Further, its pipelines exist in markets that would not be large enough to support additional pipelines, making Exxon the only game in town in those regions.

Assigning Moat Ratings

Given the importance that the Economic Moat Rating has in Morningstar's process and with a number of products, a committee of more than 15 senior Morningstar researchers oversees all of the individual ratings. When assigning Moat Ratings, Morningstar's analysts and the committee first look for the attributes explained previously. But the proof should be in the pudding, namely, a company's returns on invested capital; Morningstar looks for a company to achieve an ROIC in excess of its cost of capital. The size of the ROIC-cost of capital spread is far less important than the expected duration of the excess profits. A company needs to have an expected competitive advantage period of at least 10 years to attain a narrow moat rating, and at least 20 years to attain a wide moat rating.

Important to the Process

Beyond its importance in valuation, analysing moats can improve returns in two other ways. First, the market often does not perceive the additional value companies with high and sustainable returns will generate. Simple math dictates that firms with economic moats should trade at significant premiums (e.g., higher multiples of earnings, cash flow, and book value) over those with no moats. But it takes time for a company's moat to be confirmed, and the market—with all of its short-term incentives—is all too myopic in this day and age. In other words, the market is often much more homogenous than it should be. This is an inefficiency that can be exploited.

The second way that moats add value is when the market underestimates the durability of advantaged companies (and also underestimates the fragility of firms with no moats), something that happens with surprising frequency. Investing in firms that hold the high

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ground is a sound strategy when periodic floods (recessions, crisis of confidence, and so on) are bound to hit.

Using Morningstar's differentiated economic moat framework in combination with the stock valuations that are based on long-term projected cash flow, our process has produced excess returns that have persisted through different market environments. In fact, Morningstar manages indexes and strategies, which are focused on economic moats. These have performed well over the last decade, which has seen two back-to-back commodity booms, a major financial crisis, a Great Recession, a boom-bust cycle in the housing markets, and a surprisingly strong rebound in corporate earnings. If a prerequisite to properly evaluating an investment strategy is looking at it across a variety of market environments, the past decade certainly fits the bill.

Conclusion

The concept of identifying economic moats and their sources is a cornerstone of Morningstar's differentiated equity research methodology. Morningstar's equity research team has demonstrated a strong ability to identify the implications of economic moats when forecasting the long-run cash flows of businesses, increasing the probability of finding mispriced stocks and leading to a better investor experience.

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