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The Concept Of Economic Moat While Analysing a Company

Economic Moat 101

A Thread ■

Inspiration -- @FI_InvestIndia

What is a Moat ?

The dictionary defines the word 'moat' as a "deep, wide ditch surrounding a castle, fort, or town, typically filled with water and intended as a defense against attack ".

In stock market investing, an economic moat is an important concept with none other than Warren Buffet as one of its strongest proponents.

In fact, he has stated this multiple times that he loves companies with huge and long term competitive advantage over others, which he refers to as buying an economic castle with a 'moat'.

A company with a moat has an edge over others as :

- It will have little or no competition

- it will be in an industry which would be difficult to penetrate into

-It will have a distinct cost advantage

- It will be tough to achieve the kind of scale and pricing power that it enjoys

- it has a proven track record of generating huge profits

Stock identification on the basis of economic moat means identifying a business that holds a competitive edge over others, has the potential to grow rapidly, earns high profits, keeps on enhancing its economic footprint and is rewarding for its owners and shareholders.

What Makes Companies Achieve Economic Moat?

It might take years for some companies to reach a certain scale like the traditional brick and mortar companies to the likes of Walmart, P & G, Asian Paints, Dabur.

On the other hand, new-age companies in technology or digital space may take just a few years to achieve unthinkable heft, scale, and valuations – Apple, Amazon, Infosys, TCS to name a few.

No matter how long they took, they were able to establish a sustained advantage over peers by a combination of strategies mentioned below – let’s see what they are :-

1. High Customer Switching Costs

There are certain businesses where customers find it difficult to switch over either due to cost or due to the hassle in doing so.

However once companies reach a certain size or scale, with the value proposition that they offer to the customers, their services become almost indispensable.

It becomes difficult for customers to switch over to a competitor.

There is not much which the competition has to offer – either by way of features, benefits or cost savings, and this is what gives established businesses an economic moat.

2. Wide Network Effect

It works on the premise that existing satisfied customers bring more customers and so on, which in turn creates a wide network of customers.

More customers mean higher revenues, greater market share, more companies vying for advertising and marketing on the network and thus working as a multiplier.

From the competition perspective, such a huge network benefit becomes tough to crack.

3. Low Operational Costs

A company can either offer a lower price at the same level of service or at the same price as the competition but can still earn higher profits.

This is possible through economies of scale which a large company achieves by improving its production efficiency.

These companies are able to offer lower prices per unit as their costs et spread over a larger amount of goods.

Low cost helps because companies with economic moats have inherent advantages and/or capabilities like in house production plants, oil fields, mines, research houses etc.

Businesses that would want to get into a similar line of product would take years for achieving such kind of cost-efficiency

4. Intangible Assets

Technology and legal licenses, patents, intellectual property rights, brand formulations in the pharmaceutical industry, government approvals, brand name, goodwill, etc – all these give a unique competitive advantage to the businesses.

These are intangibles that are tough to get access to and thus can act as entry barriers or can prevent a competitor from growing beyond a certain level.

These intangibles bring pricing power and provide the distinct advantage of ‘premium’ over others.

How To Identify A Company With Strong Economic Moat?

Now that we are clear with what moat is and how companies establish it,
The important question needs to be answered- how to identify these companies for investments ?

1. Cash in Hand

Such companies have huge pile of cash either to be invested back in the business or is maintained to carry out normal business if there is any sort of short term business disruption or an expectation of revenue loss etc.

2. Steady Performance In Slow Economic Conditions

Most businesses would not perform when the economy is slow.

However during such times a business with economic moat sustains well and even if it is impacted, its performance is far better than the overall market or competition.

3. Brand Value

Such companies come with formidable brand value and name recognition.

In fact, most of the times the industry is identified with the brand itself.

This is a material advantage for any business.

4. Line Of Product

The product can define the advantage the company has over others and also against its own ‘not so great products’.

5. Size Of the Business

Companies with moat will always be way ahead of the competition.

Thus a look at their year on year profit and revenue numbers will prove beyond doubt that their size and market capitalization is way ahead of any fathomable competition.

To Sum Up-

A company with so many benefits or a wide moat is definitely a company that is worth investing in and will create a lot of value for the shareholder.

It will generally remain profitable even during volatile times.

It would also act as a cushion and will be way ahead of the competition if any.

As an investor, analyze a company from the characteristics mentioned above to identify economic moat and do exhaustive research.

Remember, invest only in companies and sectors you know and understand.

Thanks For Reading This Thread.

Happy Investing!

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