Lifecycle of an Economic Moat

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In our March 2017 note, we introduced the concept of 'Economic Moats', as popularized by the legendary Warren Buffett. To recollect, the following is what we said then:

> *Traditionally, a moat is a wide body of water or even a large dry ditch that surrounds a castle. The purpose of such a moat would be to prevent unauthorised entry into the castle. Metaphorically, Warren Buffett compares a high return generating business with a castle and the factors that help the business sustain or improve its returns as moats.*
>
> *Just as a wonderful castle would have attracted enemies, a business with high returns would attract competition. Thus, to protect your valuable castle (wonderful business), you need to build a moat (durable competitive advantage) around it. The moat can be in the form of a strong/popular brand, superior product, quality of service, infrastructure, size and scale of operation, distribution network, management reputation etc. All these factors individually make the moat deeper, while a combination of factors together make the moat wider. Deeper moats are sources of high profitability while wider moats protect the consistency of supernormal profitability over a longer period.*

Thus, an economic moat helps businesses in generating & maintaining high returns on the capital invested. In other words, companies with an economic moat would exhibit either high profitability or low capital intensity, or a combination of the two. The following derivation explains this:

$$ROCE = \frac{EBIT}{Capital\ Employed}$$

The above can be re-written as:

$$ROCE = \frac{EBIT}{Sales} \times \frac{Sales}{Capital\ Employed}$$

Thus,

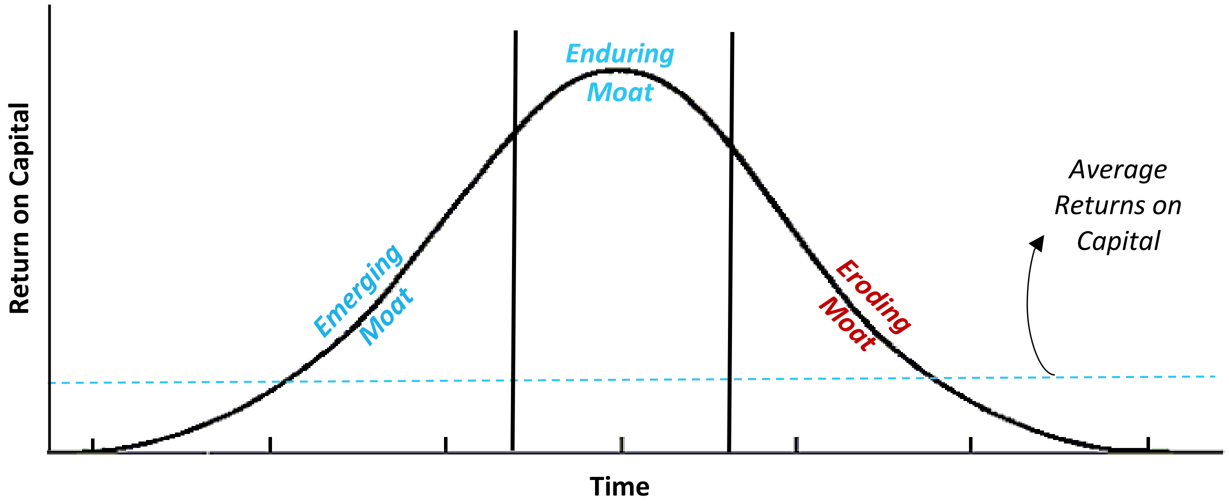
$$ROCE\ = Profitability \times \frac{1}{Capital\ Intensity}$$

where,
EBIT = earnings before interest and taxes;
Capital Employed = shareholder's fund + borrowings

Based on the above, would it suffice for investors to buy businesses with high profitability and/or low capital intensity at reasonable valuations, and expect superior investment results? The answer, unfortunately, is no. This is because moats are not static, but transient i.e. they have a life-cycle of their own. Broadly, moats can be classified in to three categories based on the life-cycle stage in which they currently exist: ***Emerging, Enduring, Eroding***.

The following chart depicts these three classifications.

Figure 1: Lifecycle of an Economic Moat



Source: Tamohara

As the name suggests, an ***emerging moat*** is a moat that is currently under formation. This type of moat is typically characterized by a business or product that is still in the formative stages. Investments in building a distribution network or creating manufacturing capacities can lead to depressed profitability or high capital intensity initially. However, over time, as the business scales, the fixed costs slow down and an improvement in profitability and/or capital intensity is observed. Thus, an emerging moat cannot be identified by focusing on the headline numbers. Such moats are typically hidden in details like gross margin, market share, return on revenue generating investments, capacity utilization, current size vs size of the opportunity etc.

It is important here to differentiate between an emerging moat i.e. potential to generate high returns on capital and businesses that are inherently low return business. Such differentiation calls for a detailed understanding of the sector/industry that the company belongs to, the size of the opportunity, the strategy of the management, the competitive landscape, emerging consumer trends etc – details that we will talk about in a follow-up note.

Tellingly, a successful emerging moat usually translates in to an enduring moat. When this happens, the reported numbers reflect the quality of the moat and the business is widely recognized or accepted as a strong moat business. Such recognition is usually reflected in the valuation multiple of the business, as strong moat businesses seldom trade cheap. While the above average returns on capital ensure that continuing long term investors are rewarded with above average returns over a multi-year period, the returns are seldom as splendid as they are in the case of an emerging moat business. This happens on account of a multitude of factors, including, but not limited to:

- **Size** – More often than not, an improvement in profitability and capital intensity comes with scale. The business, at this stage, has gained in size and the fast growth phase, requiring heavy investments, is behind. Thus, even as they remain above average, growth rates tend to normalize.
- **Competition** – Tellingly, the faster growth and improving profitability would have attracted competition that would be fighting for a share of the market. This would also result in some amount of growth slowdown as well as normalization of profitability.
- **Valuation** – Certainly, the past performance of the business wouldn't have gone unnoticed. Enterprising investors would have bid up the price, and in turn, the valuations of the business, at least in line with other businesses of similar characteristics.

It is important to note here that while the above factors can lead to lower than historical returns, they do not imply below average returns. As mentioned earlier, the above average returns on capital ensure that the multiyear returns continue to remain above average, only, by a smaller margin compared to earlier.

It is only when companies experience a steady erosion of the moat that the returns tend to fall below average. An ***eroding moat*** is typically the result of hyper-competition, technological obsolescence, inefficient capital allocation, or simply lack of management focus. Just like an emerging moat, an eroding moat is difficult to identify early based on the reported headline financials. This is because the business usually transitions from the emerging or enduring moat stage to the eroding moat stage. The erosion of capital returns is gradual initially, followed by an accelerated deterioration. Competition does not spring overnight, nor does new technology; similarly, it takes time for to the results of new investments to take-up a material share of the overall numbers, and therefore, for investors to notice them (unless reported separately). Needless to say, as the moat starts to erode, the valuations also start to correct. Typically, the correction in the valuation precedes a visible deterioration of the capital returns of the firm.

In order to preserve the returns made hitherto, it is therefore important for investors to timely identify any sustainable deterioration in the moat of a company. Ideally such identification should happen before the deterioration appears in the overall financials of the business. For this timely identification, it is imperative the discerning investor develop an understanding of the individual product or business lines that the company is in. The investor should seek out the sources of durable competitive advantages for the firm, and then test each product or business line for these sources. We will cover a detailed case study of one such analysis in a future note.

To Sum It Up…

While high returns on capital are usually considered to signify a moat in the business, they may not always reveal the complete picture. For instance, younger enterprises building their franchise quality and investing in rapid growth may not necessarily report very high capital returns. On the other hand, high capital returns from a legacy business line or product may be hiding the inefficiencies of the new business line or product. Thus, high returns on capital should be only one of the many inputs in identifying high quality businesses. Investors would be better off building alternative tools to identify the emergence or deterioration of the moats in a business. We will follow up a future note highlighting such tools and their practical usage.

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