

## The smartest thinkers on competitive advantage

**‘Competitive advantage’ is the most commonly used concept in business. However, proper application of the concept - to figure out whether an investment is worth making - is not easy. Three smart thinkers – Joan Magretta, Yefei Lu, and Bruce Greenwald - have discovered insightful ways to apply competitive advantage in the context of investing.**

*“We are like dwarfs sitting on the shoulders of giants. We see more, and things that are more distant, than they did, not because our sight is superior or because we are taller than they, but because they raise us up, and by their great stature add to ours.”*  
– John of Salisbury in “Metalogicon” (1159 AD)

### Oft used but misunderstood concept

During my years in Ambit I had the privilege of meeting most of the well run companies in the BSE500. With ROCE well above the cost of capital for extended periods of time, most of these companies had some sort of competitive advantage. But then, after meeting them, I would wonder whether the said company’s competitive advantage would endure. And, more importantly, would the return on the incremental capital that the company would invest over the next ten years be higher than the ROCE clocked by the company over the previous decade?

Given the multiple hats that I wore for my erstwhile employer, I regret not delving deeper into these questions whilst at Ambit. Now that I have my whole day free to think about these issues, I have tried to learn from the smartest thinkers on this subject and have discovered three exceptional books on this subject. My key learnings are summarised in this piece.

#### 1. “Understanding Michael Porter: the Essential Guide to Competition and strategy” (2011) by Joan Magretta

Joan Magretta was Michael Porter’s editor at the HBR and in this book she has produced a clearer framework than given by Porter’s own writings! There are three useful mental models given in the book – uniqueness, quantification of competitive advantage and looking beyond the received wisdom on growth & scale:

- Don’t look for companies who are trying to be the best or the largest. Look out for companies who are unique and are focused on staying unique. Being the best or trying to become the best does not lead to  $ROCE > WACC$ . Sustained uniqueness, on the other hand, does.
- Stay away from companies which are trying to be all things to all men. Such companies can rarely sustain  $ROCE > WACC$ .
- The prices charged by a firm tell you a lot about the firm’s offering. Specifically, if a firm is being able to charge premium prices for long periods of time and retain market share then this has to be underpinned by a distinctive/unique product.
- Don’t look at costs in isolation – it is relative costs that matter i.e. if it costs firm X Rs100 to make a widget, then how much more does it cost firm Y.
- Quantify the extent of competitive advantage a company has by quantifying the previous two bullets i.e. if firm X’s ROCE is 5% higher than firm Y, then how much of that is because of higher prices and how much is because of lower costs?
- Don’t assume that high growth industries will be attractive industries to invest in. Growth is not only NOT a guarantee of profitability, it often puts suppliers in the driving

seat and – when combined with low entry barriers – might attract new rivals. (Growth in a prominent B2C industry also attracts the attention of Indian politicians.)

- Don't overplay the importance of scale. *"In industry after industry... economies of scale are exhausted at a relatively small share of industry sales. There is no systematic evidence that indicates that industry leaders are the most profitable or successful...General Motors was the world's largest car company...that didn't prevent its descent into bankruptcy...BMW, small by industry standards, has a ROIC 50% higher than the industry average."*

Thanks to Samit Vartak of SageOne Investment Advisors for pointing me towards this book.

## **2. "Competition Demystified: A Radically Simplified Approach to Business Strategy" (2005) by Bruce Greenwald & Judd Kahn**

In this provocative book, the authors argue that there is only one essential factor in determining competitive advantage: how easy it is for competitors to enter or expand in a specific market. If a company can erect strong barriers to entry - through customer captivity, lower production costs, or economies of scale - it can manage these advantages, anticipate competitors' strategies, or achieve stability through bargaining/cooperation. Even more interestingly, the authors:

- Discuss ways to gain protected positions from which businesses can be run badly but still earn ROCE significantly above WACC. Hence investors are advised to look for small/local/niche markets without existing competitors.
- Place heavy emphasis on supply-related advantages (based on patents, experience, know-how) or advantages related to customer captivity (underpinned by switching costs, search costs, habit) rather than obsessing about demand.
- Argue that branding or product differentiation or operational efficiency is NOT a barrier to entry since this can be copied by competitors. "Although the nature of the competition may change, the damage to profit persists because the problem is not lack of differentiation, but the absence of barriers to entry."
- Efficiency matters in industries where no player has a competitive advantage eg. steel, textiles, airlines, bulk chemicals, telecom. In such industries, ROCE will often be below WACC for most players barring the most efficient player. The best, perhaps the only, time to invest in such sectors is when capacity is shut down thus allowing the most efficient player to enjoy higher ROCEs for a while. (Therefore, it makes sense to follow the Jet Airways saga.)
- Show that economies of scale by itself are NOT a competitive advantage. The book contains many examples of large companies that enjoyed scale economies but then fell away as competition intensified eg. Compaq, Phillips. For scale economies to matter, incumbents must have privileged access to customers, and this involves customer captivity in some shape or form. Ironically, scale economies can be effective in local markets, but firms should be careful not to expand to more geographically dispersed markets where they will be subject to increased competition.

Thanks to the folks at MIT Investment Company for pointing me towards this book.

## **3. "Inside the Investments of Warren Buffett: Twenty Cases" by (2016) Yefei Lu**

This book gives you access to the financial statements that Warren Buffett would have analysed real time (30-40-50 years ago) before he pulled the trigger on his most successful investments. Piecing together Buffett's letters to his Limited Partners, the author helps you

understand how the legendary investor linked competitive advantage to the sustenance of ROCE and thence to valuation. Two case studies in the book stand out – American Express and GEICO.

In the early 1960s, the credit card was only just beginning to take off courtesy of American Express (Amex). However, Amex's mainstay at that point was traveller's cheques – the equivalent of which is called a Demand Draft in India. Amex was a well run firm when disaster hit in 1963 – a subsidiary which earned fees by inspecting warehouses and then issuing warehouse receipts was hit by fraud (similar to what happened to NSEL in India). This Amex sub had issued receipts for what it thought was tankers full of salad oil. Instead, these tankers were full of sea water. The banks which had lent money against the warehouse receipts threatened to sue and the word on the Street was that the banks' claims would be around \$150 mn (in comparison, Amex's networth was only \$78m). Amex's share price fell from \$60 to \$35 by early 1964 when Buffett stepped into buy a stake in the firm at around \$40 per share (implying a forward P/E of 20x).

Buffett was willing to pay a fair market multiple because his discussions with Amex users (restaurant owners & diners, SMEs in Omaha) told him that the Amex brand had NOT been dented by the salad oil debacle. In fact, the network effects underpinning Amex (more people wanted to use it if more vendors accepted Amex cards and vice versa) were getting stronger by the year. Furthermore, in Amex's balance sheet he saw something which would later define his career – there was a time lag between the date on which customers gave money (in lieu of traveller's cheques) and when this money was withdrawn (say, when the customer went on holiday to Europe). In between these two dates, Amex could earn interest of \$4-5 million per annum on this "float". Hence if the Amex brand was not damaged then both the fees from issuing traveller's cheques and the revenue from the float would sustain. That in turn would put Amex on a forward P/E of 11.5x (rather than the 20x everyone else in the market was working with). This insight/conviction underpinned Buffett's investment in Amex.

GEICO was an auto insurer which specialized in insuring Government employees who were inherently a low risk group. However, unbridled expansion across the US meant that GEICO had ended up writing insurance in several states where the state had capped the premiums at a low level. This had triggered underwriting losses and in 1976, GEICO found itself on the verge of bankruptcy and running out of cash. Its share price had dropped from a high of \$61 to \$2 by 1976.

By that time, Buffett had been following GEICO for 25 years and he understood three things about GEICO which nobody else did: (a) the customer base was inherently low risk and was not the source of the problem, in fact it was a major competitive advantage; (b) since GEICO sold directly to the customer, rather than through agents, it had a structural cost advantage; and (c) the "float" was massive – because for every 100 people who paid insurance premiums each year, only a third made a claim in that year (implying that if the firm could be stabilized, it would have surplus cash on which it could make an investment return. In fact, GEICO's three advantages were inherently linked to each other and that insight convince Buffett to recapitalise GEICO (by buying from the firm 1.3 mn shares at \$3.18 per share) when the rest of the market had given up on it.

### **Investment implications**

Integrating the thinking of these authors has given me a framework to disaggregate AND quantify a company's source of superior ROCE. Is the higher ROCE relative to peers driven by premium pricing or lower costs or both? If it is premium pricing then what is the underpinning

of this premium pricing? Are these advantages enjoyed by the firm strengthening or weakening over time?

Had I understood this framework properly ten years ago, I would have avoided investing in Bharti Airtel in 2009 when it was apparent that it was heading into markets where it had little or no competitive advantage. I would have avoided buying Tata Motors five years ago just because it screened well on ROCE as I would have understood that sooner rather than later the challenge of having to compete with BMW & Mercedes would drag down the ROCE of this firm (as it would have spend more on R&D to compete with the German firms in the global luxury car market). And I would have ejected Axis Bank from my Coffee Can Portfolio five years ago when I could see that the firm was pushing aggressively into a retail lending market where it did not have any obvious sustainable competitive advantage.

Looking forward, a clearer assessment of competitive advantage will help me stay away from most Housing Finance Companies as it appears that almost none of them have any pricing power or a unique access to raw material/funds even as regulation makes it easier for customers to switch their mortgage provider. I will also stay away from large asset management companies whose funds struggle to beat the benchmark index. Brand is not a competitive advantage if your product is expensive and does not deliver performance!

In contrast, Indian life insurers seem to have significantly higher competitive advantages – distribution through captive bank branches (captive by regulatory dictat), opacity around pricing/performance of the product, high costs for the consumer of switching from one insurer to another (especially for traditional life and unit linked products) and significant regulatory barriers to entry. Similarly, Indian pharma companies with FDA approved drugs and with strong domestic distribution appear to have competitive advantages which could endure. I am also enthused by an emerging group of small cap industrial companies who make unique products in the B2B context (products where they have a technological edge) and have long standing relationships with large customers like Dr Reddy's, Cipla, UPL, etc who are locked into these smaller suppliers.

Seven years ago I shared a long car journey with a senior Private Equity fund manager. Trying to show off my knowledge, I told him about several well run southern Indian firms with consistently high ROCEs and niche franchises (confined to south India). The PE fund manager told me that *"The problem with these Tamil firms is that they are too conservative. They get out of bed every morning and do the same thing that there fathers had done. They are not dynamic you see...no aggression to create a pan-India franchise. That's why I don't go to Chennai or Bangalore too much."* In the years that followed the PE fund manager's portfolio (of investments in the West and the North of India) did not do so well – rapid expansion beyond any semblance of competitive advantage meant that many of these firms never made money. Reading Magretta, Greenwald and Lu might help me avoid such a fate.

*Saurabh Mukherjea is the author of "The Unusual Billionaires and "Coffee Can Investing: the Low Risk Route to Stupendous Wealth". He's also the Founder of Marcellus Investment Managers.*