Beyond water and crocodiles

A Modern taxonomy of moats

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Using Hamilton Helmer's Seven Powers framework, we identify the different types of moats that companies utilize to maintain a sustainable competitive advantage.

We further elaborate on this framework by examining Indian companies that leverage these powers to maintain a sustainable advantage.

Additionally, we explore how "Culture" can serve as a moat for these companies.

Ask any long-term investor, and they'll tell you they look for businesses with moats. This term is so overused that if investors received a dollar each time they used it, they would have enough money to challenge even the strongest of moats. And yet, few can clearly articulate how to recognize a moat and how they are established.

Quite simply, a moat is some characteristic of the business that allows it to generate a high return on capital for a sustained period of time. Cyclical businesses often have periods of high returns on capital. But, durability of these high returns is also an important element of businesses with real moats.

Returns on capital can also be distorted by quirks of accounting rules. For example, the lives of fixed assets can be much longer than is accounted for in depreciation. The asset continues to remain productive but is effectively removed from the balance sheet. Historical cost accounting distorts the reported value of assets like land. As companies age, the real economic value of such assets is not correctly reported in the balance sheet. In both these cases, return ratios can seem to be higher than they really are.

It is, therefore, important to establish that the return ratios are genuinely high (and not an outcome of accounting quirks) and sustainable. That establishes the existence of a moat. But the moat itself can be built using different mechanisms. Each type of moat has its own defining characteristics - its strengths and weaknesses.

Understanding the nature of a business moat then becomes important. Hamilton Helmer's *seven powers* framework is a useful one to analyze moats. It classifies moats into seven categories. The seven powers the Helmer identifies are:

1. Brand
2. Network Effects
3. Cornered Resource
4. Scale
5. Process Power
6. Switching Costs
7. Counter Positioning

In this article, we dig deeper into this framework to identify the moats in some interesting Indian companies.

1. Brand

David Aaker talks about a brand as a promise, a covenant with customers about what they can expect from products and services bearing that brand name. A strong brand is one that delivers consistently over time. It's a promise made and kept, day after day, month after month, year after year.

However, brands themselves can derive their power by different mechanisms. A brand can be built on the basis of trust, search costs, exclusivity, quality, etc. Ferrari, for instance, benefits from its brand because of its exclusive nature. Ferrari's brand power allows it to command premium prices for its cars, resulting in out-of-the-world gross margins and return ratios for a car manufacturer. The company limits its production to maintain scarcity and exclusivity, carefully controls its distribution channels, and engages in brand-building activities such as sponsorships and merchandise sales.

Tata is a brand that has built a reputation on trust and integrity. Through its ethical business practices and commitment to corporate social responsibility, Tata has created a positive image in the minds of customers. The brand's ability to adapt to changing market conditions and consumer preferences while staying true to its core values and principles has contributed to its strong brand power.

Unlike some brands that rely on exclusivity, Tata's brand power is rooted in the belief that the company will always do right by the customer. Whether it's a Tata car, Tata salt, or a Tata Consultancy Services project, customers know they can trust the Tata brand to deliver on its promise.

Nestlé is yet another company that benefits from its brand. Unlike Ferrari, Nestlé does not rely on exclusivity nor is it solely built on trust and integrity like Tata. Its moat comes from the quality, convenience (wide availability) and trust that is embedded in its brands. Any new competitor would have to spend a considerable amount of money and time to build a brand that could compete with Nestlé's established brands.

There may be some debate over how to account for the value of intangible assets on the balance sheet. In the case of a Nestlé, one could argue that their branding expenses ought to be capitalized. This would reduce the return on capital. Even with this adjustment, though, Nestlé India's returns would still be around 50%, well above its cost of capital.

Building a strong brand takes consistent effort and time. Rome wasn't built in a day, and neither is a strong brand.

2. Network Effect

The National Stock Exchange of India (NSE) is one of the largest stock exchanges in Asia. A key source of its competitive advantage is the network effect. This is a powerful moat that creates barriers to entry and protects the exchange's market position.

A network effect refers to the phenomenon where the value of a product or service increases as more people use it. For example, social media platforms like Facebook or Instagram become more valuable to their users as more people join and share content on the platform.

In the case of NSE, as more traders and investors use the exchange to buy and sell stocks, the liquidity of the market increases. This increased liquidity leads to lower transaction costs for everyone. This in turn attracts even more users, further increasing liquidity.

Higher liquidity also allows NSE to offer a wider range of services and products to its users. For example, the exchange can introduce new financial instruments, such as options and futures, which require a deep pool of liquidity to operate effectively. The availability of interesting products on the platform also attracts new users.

NSE's dominant position as an exchange is not easily challenged. The technology and platform behind NSE could be replicated. But the liquidity it commands makes it challenging for new entrants to attract traders and maintain the same level of activity.

3. Cornered resource

Cornered resources are assets that are under the control of a business, and are not easily replicable or substitutable by competitors. A classic example of a cornered resource is the mining rights on a significant portion of a rare mineral deposit. Other companies would have a hard time replicating this advantage, giving the mining company a competitive edge.

In India, the Indian Railway Catering and Tourism Corporation (IRCTC) holds exclusive rights to provide online train ticket booking and catering services for the Indian Railways. This is a cornered resource that is impossible for competitors to replicate.

Another example of a business with a cornered resource is the Indian Premier League (IPL). The IPL is a lucrative tournament, with a loyal fan base and high levels of viewership. The BCCI, which owns the IPL, has a cornered resource in the form of Indian players who play in the IPL. Indian players need to obtain a "no-objection certificate" (NOC) from the BCCI to participate in other T20 leagues. This control means that the BCCI can effectively scuttle any attempts at setting up a competing league.

While a cornered resource can provide benefits hard for competitors to attain, government intervention can limit returns and even lead to industry nationalization. Thus, when a resource is cornered due to the government, the government giveth and may also taketh away.

4. Scale

Sheer scale of a business can often be a moat. Scale allows a business to achieve cost advantages that smaller competitors cannot match. As a company grows larger, it can spread its fixed costs over a larger revenue base, lowering its per-unit costs. Additionally, larger companies have more bargaining power with suppliers, which can further reduce costs. These cost advantages allow larger companies to compete more effectively on price. A smaller competitor would then have to compete with lower profit margins, often even operating at a loss. This effect is particularly visible when the cost structure of a business is dominated by fixed costs – as is the case in telecom and even in banking.

Take the case of HDFC Limited, India's largest mortgage lender. HDFC didn't start out as a behemoth in the Indian financial sector. In fact, it was a scrappy startup when it was first launched in the late 1970s. But over the years, HDFC grew and grew, amassing a customer base that now stretches into the millions.

Scale is a powerful weapon in the world of mortgage lending, where margins are razor-thin and competition is fierce. With a large customer base, HDFC is able to spread its operating costs over a larger revenue base, reducing its per-unit costs. This allows the company to offer interest rates and fees that smaller competitors simply can't match.

But scale is about more than just cost advantages. It also gives HDFC access to a wider range of funding sources. The company can tap into capital markets and attract foreign investors, lowering its funding costs and allowing it to offer more attractive interest rates to its customers.

In a battle between David and Goliath, David does not always win.

5. Process Power

The best-known example of process power in manufacturing is Toyota. Over decades, dozens of books have been written about, training programs have been organized on, and companies have tried to adopt what is known as the Toyota Way.

Optimized processes, the hallmark of the best manufacturing companies, cannot be built overnight. They are built over time, bit by bit. And many optimizations only pay dividends when they are applied to a large number of units produced. Better processes can help improve return ratios in multiple ways. The most obvious ones are cost savings – reduced wastage, fewer errors, more efficient designs, reduced manpower requirements. Another less obvious way is the reduction in production times, leading to lower inventory and hence lower working capital requirements.

The surprising feature of process power is that it can only be built slowly over time. As many American car companies discovered, simply knowing the “tricks” that Toyota used did not translate into process improvements.

Arguably, Motherson Sumi Wiring in India has also cracked the code. Their process power is reflected in the returns on capital employed and tremendous market share. In what would seem like a commodity product business.

6. Switching Costs

Switching costs are the expenses and hassles that customers face when switching products or service providers. CAMS is a transfer agency for mutual fund companies. In their case, if a fund house wants to switch, it would involve costs such as employee training and data transfer. Although these costs may not be significant, the inconvenience discourages customers from leaving. This helps CAMS charge higher fees, and yet retain its customers and market leadership.

Moreover, the fee that mutual funds pay to CAMS is relatively low compared to their other expenses. So even if a competitor were to offer slightly lower prices, the cost savings would be relatively small. This has allowed CAMS to establish a competitive advantage.

7. Counter Positioning

Counter positioning is less a moat, and more a strategy to breach them. This strategy is based on the premise that an established player would not do anything to disrupt its existing business. This permits a challenger to establish a competing business while the incumbent remains locked into an outdated strategy.

Kodak's failure to embrace digital photography was largely due to its reluctance to compete against its own cash cow - traditional film-based products. The company was so focused on protecting its existing business that it failed to recognize the potential of emerging technologies. If Kodak had moved to selling digital cameras (which they were the first to develop), their entire photographic film business would have been in jeopardy. This short-sighted approach ultimately led to Kodak's downfall. By building a business around digital cameras, its competitors were able to build scale and destroy the analog camera business, while Kodak remained locked out of that market.

In India, Zerodha is one company that successfully counter positioned against the incumbents, and built a moat. Traditional brokers were focused on providing high-touch, personalized services. Zerodha took a different approach by offering a no-frills, low-cost trading experience. By reimagining the source of revenue, they could play on volumes, and were able to disrupt the industry and establish a leadership position. This let them build scale while the incumbents were left immobilized. Their scale is now their moat.

The eighth power

In addition to the seven powers discussed by Hamilton Helmer, there is an eighth power that we believe is a definite moat for a company: culture. A strong culture can help a company attract and retain top talent, foster innovation, and create a unique identity that sets it apart from competitors.

A company's culture is a reflection of its values, beliefs, and behaviors. Values are principles or standards that a company deems critical, such as honesty or accountability. Beliefs are the assumptions or convictions that shape the way a company operates. Behaviors are the actions that reflect a company's values and beliefs, and they are often observable and measurable. These elements work together to create a unique identity that sets the company apart from its competitors.

However, creating a strong culture requires a top-down approach. When leaders demonstrate their commitment to the company's values and beliefs, it sends a powerful message to employees that these are not just words on a piece of paper, but principles that the organization truly stands for.

Leaders play a critical role in ensuring that the company's culture remains strong over time. They must consistently model the desired behaviors and reinforce the company's values and beliefs through their words and actions. By doing so, they create a culture that is not only enduring but also capable of evolving as the company grows and changes.

A company's culture is a crucial component of its success and can serve as a significant moat against competitors. Understanding a company’s culture and the role that leadership plays in shaping it, can help identify winners in the making.

Conclusion

No moat is completely impenetrable. Competitors will always try to challenge the status quo. They might even succeed with enough time and capital. The idea of a moat is to make this difficult for challengers. It's intended to provide a sustained period of high returns on capital for the company.

As investors, our goal is to identify companies with sustainable competitive advantages that can weather the storms of disruption and maintain their edge over the long term.

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