

Shareholder Value & Economic Moats

Introductions

- Pat Dorsey, CFA

- Founder, Dorsey Asset Management
- Former Director of Equity Research at Morningstar: Created investment philosophy, built team from 20 to 100 analysts, developed institutional research platform.
- Author of *The Five Rules for Successful Stock Investing*, and *The Little Book that Builds Wealth*.

- Dorsey Asset Management

- Single strategy, separately managed accounts
- Global, all-cap, concentrated in 10-15 stocks

Global Moat Strategy



We focus on moats, management, and compounding potential because all three are sources of perpetual inefficiency.

Agenda

- Moat foundations
- Sources of economic moats
- Mistaken moats
- Management and moats
- Why moats matter
- Valuing moats

Moat Foundations

- High profits attract competition, as capital seeks the highest returns possible.
- Most businesses with high returns on capital see returns decrease over time.
- But, a small minority of companies enjoy high returns on capital for long periods.

Beating the Odds

- So...how do some firms beat the odds and fend off competition for years at a stretch?
- By creating economic moats.
- Structural and sustainable characteristics that insulate companies from competition.
 - “Structural” = “inherent to the business.”

Moat #1: Intangible Assets

- Brands

- Increase willingness to pay / lower search costs.
 - Sony vs. Tiffany
 - Amazon, LVMH, Groupe Richemont

- Patents

- Legal monopoly vs. expiry/challenge/piracy
 - Novo Nordisk, Qualcomm, Novartis

- Licenses/Approvals

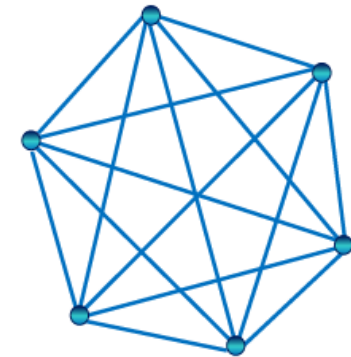
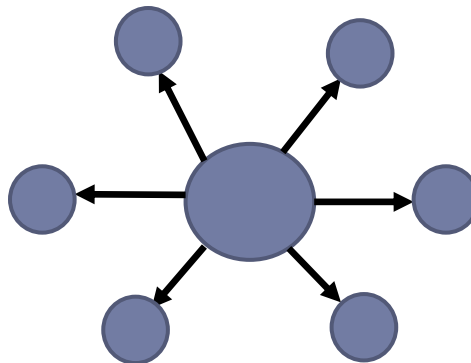
- Legal oligopoly vs. regulatory fiat
 - Casinos, some financial exchanges, aircraft parts

Moat #2: Switching Costs

- Does the cost of switching to a competing product or service outweigh the benefits?
 - Integrate with customer's business: Upfront costs of implementation = payback from renewals
 - Microsoft, MTU Aero, Oracle
 - Sell ongoing service relationships
 - Rolls Royce, Kone, Schindler
 - Provide a product with a high benefit/cost ratio
 - Fastenal, Ecolab, Fenner

Moat #3: Network Effect

- Provide a service that increases in value as the number of users expands.
- Aggregate demand b/t fragmented parties.
 - Edenred, Henry Schein, many distributors
- Benefit from non-linear relationship between network nodes and network connections.
 - Visa, Mastercard, Facebook
- Radial vs. Interactive Networks



Moat #4: Cost Advantages

- Process: Invent a better way of delivering a good/service that rivals can't replicate.
 - Inditex, EasyJet, RyanAir, Dell
- Scale: Spread fixed costs over a large revenue base. Relative size generally matters more than absolute size.
 - UPS, Aggreko, Stericycle

What's Not a Moat

- Dominant Market Share
 - High market share \neq moat. (Ask GM – or Dell)
- Technology
 - Commoditization and disruption
- Hot Products
 - Can generate high returns for a short period of time, but sustainable returns make a moat.

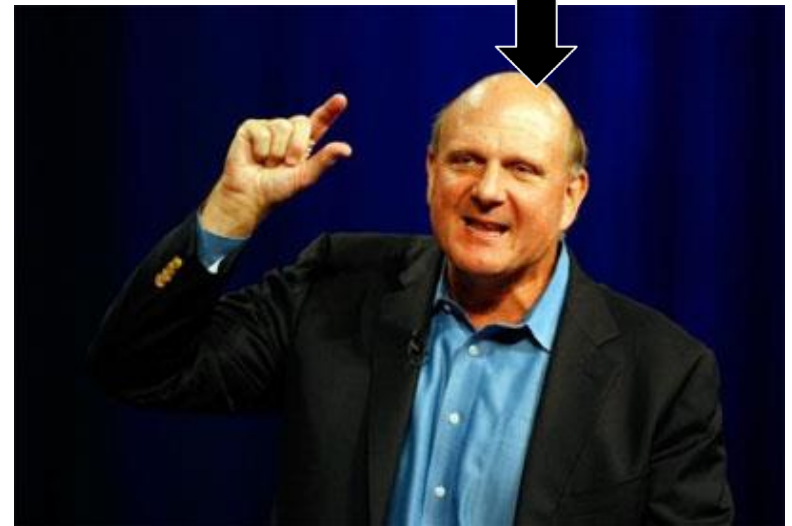
Management & Moats

- “Good jockeys will do well on good horses, but not on broken-down nags.” (Buffett)
- Lo wins this race



Jockeys & Horses

- Managers matter -- in context of the moat.
 - The required minimum level of managerial skill is inversely related to the quality of the business.
- Bad business? Better have a great manager.
- Great business? Genius not needed.

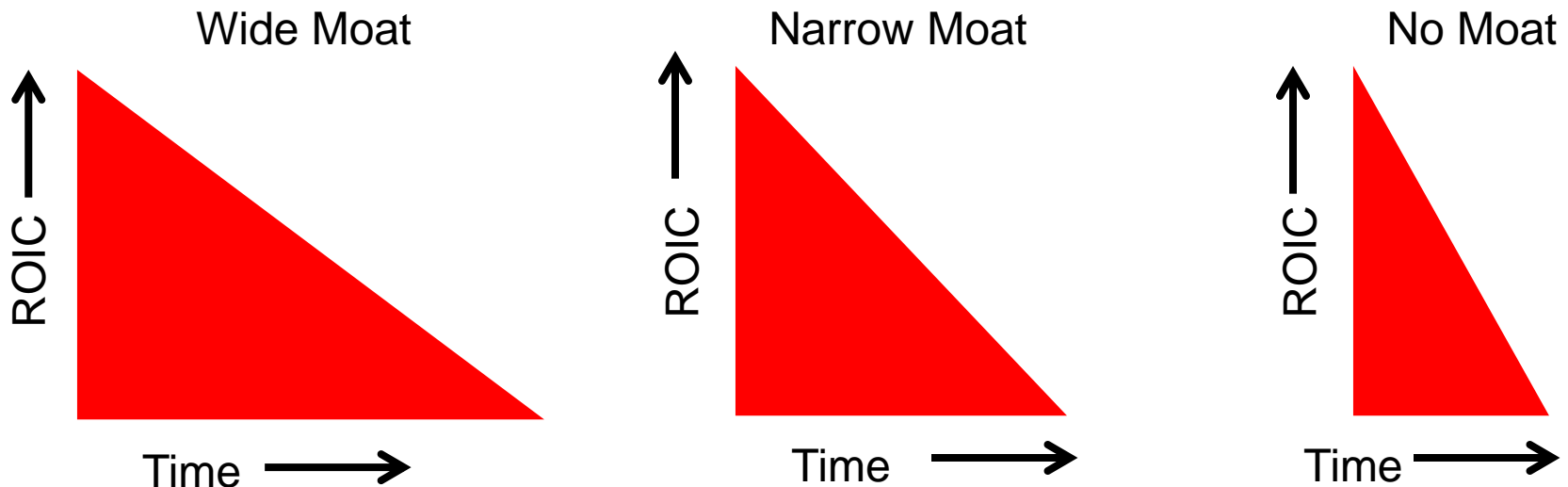


Moats & Management

- Managers can affect competitive advantage
 - Wells Fargo, ExxonMobil prove that managers can beat poor economics.
 - Brian Joffe at Bidvest
- But moats can buffer management mistakes
 - Microsoft minted money despite Steve Ballmer
 - New Coke didn't kill Coca-Cola
 - Moodys put profits before integrity...

Why Moats Matter

- Moats add intrinsic value!
 - A firm that can compound cash flow for many years is worth more than a firm which can't.



Why Moats Matter

- Companies with moats have more resilience
 - A firm that relies on a competitive advantage is more likely to recover from temporary troubles.
 - A great psychological backstop for investors who buy when the market is screaming “sell!”
 - When negative news hits, ask: “*Does the information affect the company’s moat?*”



Why Moats Matter

- Moats help frame the valuation decision: “Should I pay up for this business?”
 - Overestimating the moat means paying for value creation that will never materialize.
 - Underestimating the moat means paying a large opportunity cost.

Motorola: Real Cost

RAZR
released

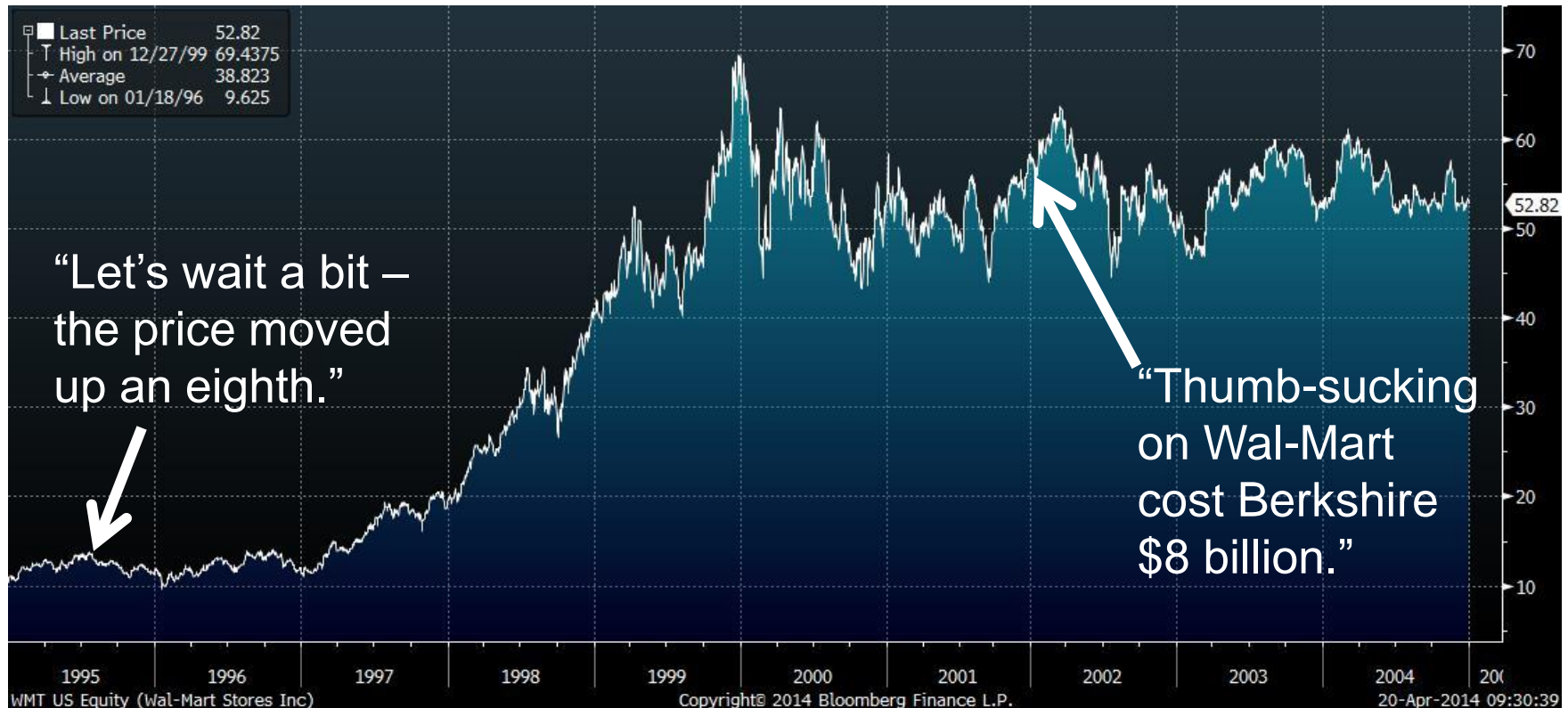
MOT has 22% market
share, market prices in a
non-existent moat

MOT has 10%
market share



Wal-Mart: Opportunity Cost

- Most investors spend lots of time on margin of safety, and too little on opportunity cost.



Valuing Moats

- The value of an economic moat is largely dependent on reinvestment opportunities.
- The ability to reinvest tons of cash at a high incremental ROIC = a very valuable moat.
 - Fastenal, Amazon, XPO, Curro
- If a firm has limited ability to reinvest, the moat adds little to intrinsic value.
 - McCormick, Microsoft, Oracle

Isn't the Moat Already Priced In?

- Short answer: Less often than you think.
- Long answer:
 - Most investors own securities for short time periods, and moats matter in the long run.
 - Most investors assume the current state of the world persists longer than it usually does.
 - Most investors focus on short-term changes in price, not long-term changes in moats.

Finding Moats = Finding Inefficiency

“All of the information is in the past,
but all of the value is in the future.”

Quantitative data
is efficiently priced

Qualitative insight is
less efficiently priced

$$\begin{aligned}\overline{\int_a^b f(x)dx} &= \lim_{n \rightarrow \infty} \bar{A}(f, n) = \lim_{n \rightarrow \infty} \frac{b-a}{n} \sum_{k=1}^n (\bar{f}_k) = \lim_{n \rightarrow \infty} \frac{1}{n} \sum_{k=1}^n x_{k+1} \\ &= \lim_{n \rightarrow \infty} \frac{1}{n} \sum_{k=1}^n \left(1 + \frac{k+1}{n}\right) = \lim_{n \rightarrow \infty} \frac{1}{n} \left[\sum_{k=1}^n 1 + \frac{1}{n} \sum_{k=1}^n (k+1) \right] \\ &= \lim_{n \rightarrow \infty} \frac{1}{n} \left[\sum_{k=1}^n 1 + \frac{1}{n} \left(\sum_{k=1}^n k + \sum_{k=1}^n 1 \right) \right] = \lim_{n \rightarrow \infty} \frac{1}{n} \left[n + \frac{1}{n} \left(\frac{1}{2} n(n+1) + n \right) \right] \\ &= \lim_{n \rightarrow \infty} \frac{1}{n} \left[n + \left(\frac{1}{2} (n+1) + 1 \right) \right] = \lim_{n \rightarrow \infty} \frac{1}{n} \left[n + \left(\frac{n+1+2}{2} \right) \right] \\ &= \lim_{n \rightarrow \infty} \frac{1}{n} \left[\frac{2n}{2} + \left(\frac{n+1+2}{2} \right) \right] = \lim_{n \rightarrow \infty} \frac{1}{n} \left[\frac{3}{2} n \right] = \frac{3}{2}\end{aligned}$$



Thank You

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