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What Makes a Moat?

Morningstar's Five Sources of Moat

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Moat investing is based on a simple concept: Invest in companies with sustainable competitive advantages trading at attractive valuations. One of the first steps in implementing this approach is finding companies with a moat.

A company's moat refers to its ability to maintain the competitive advantages that are expected to help it fend off competition and maintain profitability into the future. Morningstar has identified five sources of moat:

Switching Costs

Switching costs give a company pricing power by locking customers into its unique ecosystem. Beyond the expense of moving, they can also be measured by the effort, time and psychological toll of switching to a competitor.

Intangible Assets

Though not always easy to quantify, intangible assets may include brand recognition, patents and regulatory licenses. They may prevent competitors from duplicating products or allow a company to charge premium pricing.

Network Effect

A network effect is present when the value of a product or service grows as its user base expands. Each additional customer increases the product's or service's value exponentially.

Cost Advantage

Companies that are able to produce products or services at lower costs than competitors are often able to sell at the same price as competition and gather excess profit, or have the option to undercut competition.

Efficient Scale

In a market limited in size, potential new competitors have little incentive to enter because doing so would lower the industry's returns below the cost of capital.

In this paper, we provide an overview of how these attributes may contribute to a company's moat and highlight companies that showcase these sources of moat.

Switching Costs Lock-In Customers

Switching costs are present when a customer's cost of switching to a new supplier exceeds the value they would enjoy from making the switch. Switching costs endow the incumbent supplier or provider with pricing power that can, in turn, lead to economic profits.

> Switching Costs: When it would be too expensive or troublesome to switch away from a company's products, that company often enjoys pricing power.

Not just monetary in nature, switching costs can also be measured by the effort, time and psychological toll it takes to switch to a competitor.

Switching costs provide a company with the leverage to increase prices and deliver substantial profits over time. They are a key competitive advantage and are evident in a range of industries, from banks, to computer software/hardware, to telecoms, among others.

Switching Costs Build Moats and Retain Customers

Stryker Corp. (SYK) is a top-tier competitor in a number of medical markets. These include orthopedic implants, surgical equipment, endoscopy, and neurovascular devices. Since switching costs can be significant for surgeons when it comes to orthopedic implants, this is, according to Morningstar, one of Stryker's "moatiest divisions" in support of the company's wide economic moat. Morningstar adds, "Relative to other specialists, an orthopedic surgeon's skill and experience can play an outsize role in the clinical outcome for the patient. These factors leave surgeons reluctant to train and master multiple instrumentation systems."

Salesforce.com Inc. (CRM) is a leader in software solutions for both client relationship management and customer service industries. According to Morningstar, its salesforce automation application is "mission critical to business users in that they drive the selling and servicing processes, contain all known information on the customer base, and are tied to a variety of other back-end systems." Morningstar notes the high organizational risk of moving away from the platform, as well as the time, expense, and lost productivity associated with the implementation of a new application.

Company-specific information based on Morningstar analyst notes last updated as follows:
Stryker Corp.: 8/2/2024; Salesforce.com, Inc.: 5/30/2024.

An Early Example: Gillette Razor Blades – Designed to Create Brand Attachment

King Camp Gillette, the inventor of the first mass produced safety razor, was one of the first entrepreneurs to optimize the switching cost approach to lock in customers. In 1902, Gillette developed and began selling inexpensive razors with disposable blades that he had patented. This ensured Gillette a constant high demand for blades, as customers who considered other blades quickly realized that they would incur the cost of a new razor as well.

Intangible Assets Raise Hurdles for Competitors

Patents are a legal barrier to entry that protect companies from unauthorized commercial usage of their products by competitors. Similarly, government licenses may raise the entry hurdles for new competitors. Additionally, brand equity can increase a customer's willingness to pay for a product or service. These are examples of what Morningstar refers to as "intangible assets."

> Intangible Assets: Patents, brands, regulatory licenses and other intangible assets can prevent competitors from duplicating a company's products, or can allow the company to charge a significant price premium.

Although not always easy to quantify, intangible assets are one of the primary sources of strong competitive advantages for businesses and a key economic moat source. Intangible assets can include corporate intellectual property, such as patents, trademarks, copyrights, government licenses and business methodologies that help companies generate economic profits.

Intangible Assets: The Leading Source of Moats

Starbucks Corp. (SBUX) is one of the few operators in Morningstar's coverage of the restaurant industry to boast a wide economic moat. According to Morningstar, Starbucks has "brand strength evidenced by pricing power, attractive unit-level economics, successful international replication, and strong results in the retail channel underpinning a durable brand intangible asset." Morningstar adds, "The firm's ability to generate excitement and traffic, evidenced by impressive comparable sales growth in the core U.S. market, while spending less on marketing than category peers, reinforces the importance of the brand and its impact on results."

Eli Lilly and Co. (LLY) is a pharmaceutical company that focuses on neuroscience, endocrinology, oncology and immunology. Patents are critical in preventing competitors from duplicating its drugs. Morningstar notes that "patents, economies of scale, and a powerful distribution network support Eli Lilly's wide moat. Lilly's patent-protected drugs carry strong pricing power, which enables the firm to generate returns on invested capital in excess of its cost of capital."

Company-specific information based on Morningstar analyst notes last updated as follows:
Starbucks Corp.: 11/1/2024; Eli Lilly and Co.: 9/27/2024.

Network Effect Grows with Reach

The "network effect" moat source has become increasingly relevant as our world has grown increasingly digital. It describes the phenomenon where the value of a product or service increases as the number of its users grows.

> Network Effect: As more people use a company's product or service, the value of that product or service increases for both new and existing users.

The internet is a good example. It originally had few users outside the military and research science spheres, but its expanding user base exploded its reach and impact. More recently, companies like Facebook and Google have been labeled network effect paragons. Morningstar posits that a network effect can help a company to increase its advantages over competitors, and is often an important source of a company's moat.

Network Effect: A Proven Way to Create a Moat

Visa (V) dominates the global electronic payments industry and has reached essentially universal acceptance in most developed markets. According to the Nilson Report, Visa holds over 50% market share (by purchase volume) in the U.S., Europe, Latin America, and the Middle East/Africa. It is a great example of how the network effect can create a powerful competitive advantage. According to Morningstar, "Visa has about 14,500 financial institution partners and over 50 million merchants accepting Visa."

Meta Platforms Inc (META) has scale in the social media business that is staggering. Almost 4 billion people use at least one of its applications each month. According to Morningstar, "Meta's ad-targeting and content recommendation algorithms improve as more users give it their data by using its applications. This dynamic creates a potent network effect with the value of its application ecosystem increasing as more people use it."

Company-specific information based on Morningstar analyst notes last updated as follows:
Visa.: 12/13/2024; Meta Platforms: 9/19/2024

From Critical Mass to Network Effect

The term "critical mass" is often used in connection with the network effect. In game theory, this means that not all game participants need to be convinced for a strategy to succeed, just a very specific portion of them. If this participation threshold is exceeded, the strategy is likely to succeed of its own accord. The network effect works in similar fashion. If the user base for a product or service reaches a critical mass, the network is likely to expand under its own power. Ultimately, however, a company's ability to monetize a network is also important to consider before network effect can be assigned as a moat source.

Cost Leadership Provides Market Control

Companies that are able to produce and offer products or services at lower costs than competitors are often able to achieve higher profit margins. Within many industries, cost leaders often exert significant control over market prices, which may give them an advantage over competitors. The cost advantage moat source is the second most frequent source of economic moat ratings, according to Morningstar.

> Cost Advantage: Firms with a structural cost advantage can either undercut competitors on price while earning similar margins, or can charge market-level prices while earning relatively high margins.

Cost advantages are often gained through economies of scale, lower distribution and manufacturing costs and/or access to a low-cost resource base. The increasing level of competition in today's global economy makes this competitive advantage one of the most difficult for companies to maintain. For example, over the past 30 years, the U.S. manufacturing and consumer goods industries have been flattened by punishing price competition from overseas.

Cost Advantage in Action

Walmart Inc. (WMT) is the largest retailer in the U.S. and has carved out an enviable position in a fragmented and competitive landscape, according to Morningstar. "The firm leverages its unmatched scale by spreading its omnichannel and distribution investments over a wider sales and profit base, allowing the firm to adapt to the dynamic retail environment while maintaining robust profitability." As Morningstar explains, the company has built its moat around both its strong brand and leverage over suppliers and a vast supply chain network to drive down costs.

United Parcel Service Inc. (UPS) is exceptionally capable of keeping would-be competitors at bay for a prolonged period. "An upstart would incur immense financial losses while trying to amass the volume and density necessary to absorb the remarkably high capital outlays and fixed costs associated with a global parcel delivery network," according to Morningstar. "In replicating a network of planes, trucks, sorting facilities, and skilled employees, a new entrant would face massive investment before it could win a critical volume of customers from the entrenched incumbents."

Company-specific information based on Morningstar analyst notes last updated as follows:
Walmart Inc.: 11/20/2024; United Parcel Service: 1/3/2025.

Efficient Scale Leads to Natural Monopoly

Virtually every company dreams of a market with few competitors. An environment with only a handful of business rivals can become one where "efficient scale" is possible, according to Morningstar.

> Efficient Scale: When a company serves a market limited in size, new competitors may not have an incentive to enter. Incumbents generate economic profits, but new entrants would cause returns for all players to fall to a level in line with or below the cost of capital.

Companies that benefit from this dynamic typically operate in a market that may only support one or a few competitors, which limits competitive pressures. Additionally, for efficient scale markets, market entry often requires very high capital costs, which are not justified by the limited profit potential a new competitor might achieve.

Efficient scale commonly applies to companies involved in telecommunications, utilities, railroads, pipelines and airports. For example, while the U.S. does not have publicly traded airports, they are common in other areas of the world. Few cities can support more than one major airport. The financial incentive may not exist to compete with an existing airport because, due to limited demand, reduced market returns may not justify the initial capital necessary to build another airport.

Efficient Scale: Moats with Natural Monopoly

Union Pacific Corp. (UNP) is a leading public railroad in North America. In addition to cost advantages, perhaps not surprisingly, Union Pacific's wide economic moat is also based on efficient scale. According to Morningstar, "Would-be entrants are fended off by the steep barrier to entry formed by the need to obtain contiguous rights of way on which to lay continuously welded steel rail spanning a significant portion of North America." The company's system stretches across the Western U.S., from the Pacific to the Mississippi, and captures about half of the rail volume in the region.

Company-specific information based on Morningstar analyst notes last updated as follows:
Union Pacific Corp.: 10/28/2024

Often a "Narrow" Moat

Though it can be powerful, efficient scale is one of the least common sources of moat among companies with a "wide moat" rating, or companies with sustainable competitive advantages expected to last 20 years or more, according to Morningstar.

Across the five sources of moat, efficient scale is the most likely to drive a "narrow moat" rating from Morningstar, meaning that economic profits are more likely than not to persist ten years into the future but are highly uncertain thereafter. Returns on invested capital for efficient scale companies tend to be only modestly above capital costs, which makes it difficult to have a high degree of conviction that a company will continually generate economic profit 20 years from now.

Is the Moat Built to Last?

Companies may demonstrate one or a combination of the five sources of moat. Evaluating a company against these attributes are a key part of how Morningstar's equity research team measures the strength of a company's competitive advantage. Based on this assessment, Morningstar assigns a company one of three economic moat ratings: none, narrow or wide. In turn, these ratings help inform Morningstar analysts' long-term forecasting decisions, which impact bottom-up fair value estimates.

A wide moat rating is given to a company that is more likely than not to sustain its competitive advantage for at least the next 20 years, while a narrow moat rating means a company is more likely than not to do so for at least 10 years into the future. A company with no moat has either no advantage or one expected to dissipate relatively quickly.

When companies are successful and earning excess profits, they often become targets for competitors, which may pose a threat to its profits. Companies with a wide moat tend to be best equipped to hold off competitors, which may help defend profitability over the long term.

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