How Do I Find a Company with a Moat?

Hi, Geoff. I have just recently read your old article titled “How To Find Competitive Advantages In The Real World”. My question is, is that article still relevant at this point in time (because it is quite old)? If any, what would you update or change in that article? And about your comments on books about competition, do you believe that it is still true till today (Or you would like add to other book recommendation on competition besides “Hidden Champions”) ? Is it possible to identify economic moat without scuttlebutt? In your opinion, which is better: screen stocks for cheapness first and determine whether the stock in the cheap screen has quality OR screen for quality first and determine whether the price is right?

Answer: Here are 10 Checklist Items You Can Start With

There’s a checklist you can work through to see. It’s made up of 5 items from Michael Porter and 5 items from Morningstar. You may be able to identify if some of these items might apply to the company you’re looking at. And then, you can judge how durable they are or not. So, here’s the 10-point checklist.

Porter’s 5 Forces

1. Threat of new entrants

2. Threat of substitutes

3. Bargaining power of customers

4. Bargaining power of suppliers

5. Competitive rivalry

Morningstar’s Economic Moat

6. Network Effect

7. Intangible Assets

8. Cost Advantage

9. Switching Costs

10. Efficient Scale

You could start your analysis by just finding a cheap enough stock, finding any stock at all, finding a stock that has strong enough past results, or finding an industry that has strong enough past results.

I suggest finding an industry. The performance of any stock over time might be like 50% or so the stock's position within its industry. But, the other 50% will be the industry. If you buy a basket of regulated utilities or a basket of bank stocks at the same price-to-book ratio – the basket of bank stocks will outperform the regulated utilities over time. This is because – in the U.S. – banking is a much better business than regulated utilities.

Certain industries are better choices to look for moats. I'd suggest:

Household Products

Personal Products

Food

Beverage

Alcohol

Tobacco

Hotels

Restaurants

Food retailing

Consumer staples retailing

Really – "consumer staples" in general is the best place to look for a moat. Products that are: branded, frequently purchased, and used by people (not businesses) both in the home and away from the home are your best bet to look for a durable competitive advantage.

So, I would focus on those industries. There are other industries that are often not big enough to get included as "industries" by investors but sort of just a subset that are pretty good too. So, for example, I think theme parks tend to be good sources of moats though that doesn't mean the group they belong to "entertainment" is necessarily as good overall. I think lime and cement companies – especially located in the interior of a country, far from any ports accepting imports – are likely to have moats. But, this just means that some "aggregates" companies may have moats. I think there's less likely to be a moat around an asphalt company than a lime company. I think there's likely to be more of a moat around a cement plant than around "ready mix concrete" and so on. If you just stuck with "consumer staples" manufacturing and retail – you'd be safest.

Okay. You identify industries that might have a moat. By that I mean you've picked some specific consumer staple in a country:

– Tobacco

– Alcohol

– Coffee

– Tea

– Drugs

– Meat

– Eggs

– Milk

– Bread

– Cheese

– Soft drinks

– Cereal

– Soup

– Condiments

– Underwear

– Razors

– Soap

– Detergent

– Etc.

You know the kinds of things I'm talking about. Now, start trying to think up: who makes these things? And who sells these things? You can just look through your own household stock of these things, remember what your parents kept in their house, etc. You can look at each item and consider where you bought it. You can consider where your parents used to buy the things they bought. You can observe your own habits and those of your friends, family, co-workers etc. who you might be out with while consuming a "staple". Just keep mental track of all this. You can then go to stores where you buy these things and look around some more to get more exhaustive lists.

Then ask yourself how good a business might each of these be? How predictable? Does everyone have milk in their house? Does everyone have coffee? Does everyone have tea? If the milk is an unbranded commodity that is widely trusted to be safe in that country – it's probably not a great business. But, in some countries the brand of milk matters. Is the bread generic store brand or some specific brand. Go down the bread aisle. Can you find other things like that bread – crackers, cookies, pastries, rice, tortillas, etc. – that are branded. Where can you find a few competitors in the same aisle. Maybe soft drinks. Maybe soup. Maybe razors. Whatever it is – make a note of that. You can then try to find out if companies in that business have tended to have good returns. If they have, it's an area you might want to study.

Once you have a few examples, you can think about how each company is positioned in that industry. Is there a very expensive alcohol everyone perceives to be good? Is there a cheaper alcohol it seems almost everyone has in their house? Is there some particular hot sauce, mustard, ketchup, mayonnaise, soy sauce, butter, etc. that it seems like you'd see at every restaurant or in every kitchen cupboard? Then that company might have a stronger position in that industry.

Really, to make good investments the way Warren Buffett does you only need to establish 3 facts.

1) This is an above average industry

2) This company has an above average position in this above average industry

3) The stock of this company with an above average position in an above average industry is selling for less than the stock of average companies in average industries do in "normal times".

That's it. So, say it's normal in some country for the entire index to trade at like 15 times earnings. Okay. Then, all you need to do is find a company with an above average position in an above average industry trading at 14 times earnings or less. It's really not more difficult than that. Or, I should say – it's really that simple. It's not necessarily easy. It depends on how efficient the market is in the country you're looking at.

Many stocks trade at low P/Es – but, most are not in above average industries like consumer staples. And even if they are in above average industries – they usually have below average positions.

For example, Hostess Brands (TWNK) has an above average position (it's one of just a couple well positioned brands of "bakery" type items in the snack food aisle of supermarkets plus in gas stations and dollar stores and so on). The problem is that Hostess Brands has an EV/EBITDA of like 12x. That's probably higher than an average business in an average industry in normal times. So, we can't really judge – without getting into math and projections and stuff – that the higher quality of the industry and the greater competitive position of its brands will outweigh the higher price you have to pay for this stock. Therefore, my advice is just skip it. Only buy a "wide moat" stock that meets 3 criteria (and it has to meet ALL three at the same time):

1) Above average industry

2) Above average position in industry

3) Below average stock price

In a podcast I mentioned Hanesbrands (HBI). I mentioned it at a much lower price than today. But, I'll use today's price as an example.

1) Industry = underwear, T-shirts, and "athletic wear" — the industry doesn't grow, but ROIC and stability is above average

2) Position in Industry = Hanes has the #1 brand, it is the #1 supplier to the largest retailers, etc.

3) Below average price = EV/EBITDA is 6x.

So, Hanesbrands would definitely be a stock you should investigate on a Buffett basis. Another reason we know that is because Berkshire owns 100% of Hanes's biggest competitor (Fruit of the Loom).

Another example could be Kroger. This is more iffy. But, I think it qualifies enough to investigate it further.

1) Industry = supermarkets. Mixed bag here. Unleveraged returns on capital are about equal with other industries. Leveraged returns are higher. Predictability and consistency of leaders, their returns, etc. are very high compared to other industries. It's consumer staples retailing. Yes, I'd say supermarkets are an above average industry.

2) Industry position = another mixed bag. Kroger is one of the biggest supermarket focused companies in the U.S. It is also #1 or #2 in many markets. However, its returns are not as good and its position probably not as good as certain regional supermarkets serving places like Texas, Florida, and the Northeast U.S. specifically. Nationally its position is above average. In many markets, its position is above average. In markets where it does not yet compete or is not #2 or better – it may have an inferior business model.

3) Below average price = 6x EBITDA

A supermarket doesn't convert as much of EBITDA into free cash flow as an underwear maker. And Kroger owns some of its stores – in which case depreciation is a pretty real expense. But, yes, the stock is probably trading a bit cheaper than an average stock. It does however have a P/E of 15 for example. I'd say Kroger is not necessarily trading below the price at which an average business in an average industry has traded in the past in the U.S. But, stock prices are a bit high now. So, it may appear slightly cheap compared to other choices.

I'd be careful. You might want to see it like 20% cheaper or so before you could really start thinking about Kroger being at a "below average price" as a stock.

Starbucks trades at 18 times EBITDA and 24 times P/E. It would meet criteria #1 and #2. It would clearly fail #3. So, you don't need to analyze it right now.

Cheesecake Factory (CAKE) falls in the "restaurant" group I mentioned before. It's a higher priced, table service restaurant – so, not as predictable as fast food. We don't know if it's a good stock – this applies to all restaurants right now – in terms of surviving the coronavirus shutdowns. But, we can see:

1) Restaurant industry is an above average industry

2) Cheesecake Factory has an above average position in the industry

3) EV/EBTIDA of 5, P/E of 7, etc. is a "below average price".

So, yes, it's a stock you'd want to start applying that 10 item checklist to.

It is true that Buffett tries to identify a company's competitive advantage. But, he doesn't buy companies that are unproven in terms of their past financial results. If you look – Buffett buys into proven companies in proven industries. So, the easiest way to search for good stocks to buy would be to focus your search on industries proven to be above average and companies in those industries proven to have an above average position. Then you can worry about price.

Price changes faster than competitive positions do, than industry economics do, etc. So, it's not a big deal if you end up wasting time analyzing a company that's too expensive now. You could get a chance to buy it later.

But, I wouldn’t start by trying to just find a stock with a moat.

I’d list certain industries that are better than others.

Then, I’d look for which companies in that industry have been the most predictable in terms of consistent earnings per share growth from year to year, low coefficient of variation in their historical operating margins, etc.

For example, if you didn’t know Costco had an above average position in retailing – a check of the company’s coefficient of variation in its operating margin would show it has basically the lowest CV in EBIT margin among all retailers. It can’t be a marginal player in the industry and have margins like that. You have to have some sort of leadership position to have much more stable margins than your competitors. That’s true in all industries if you look over a long enough time period.