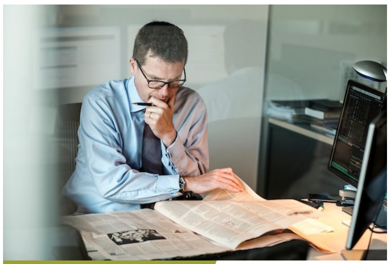


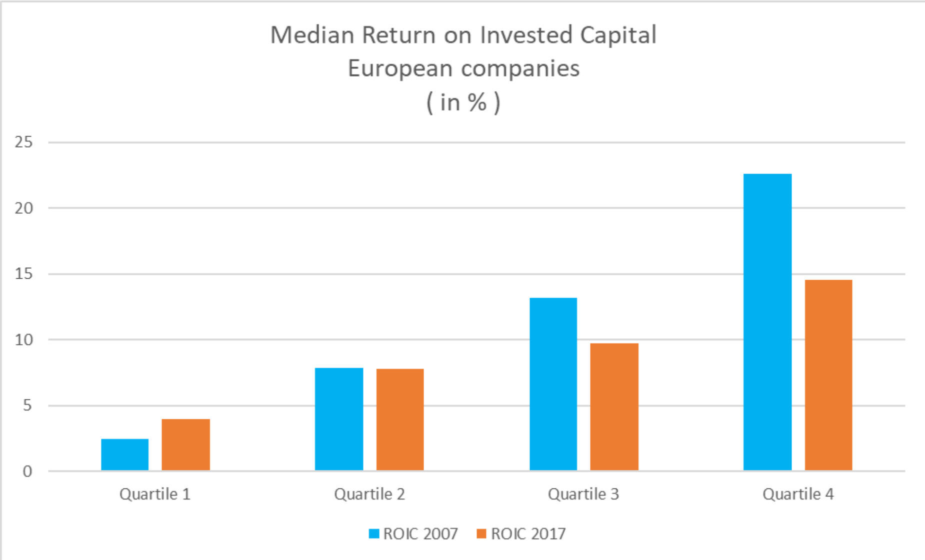
Friday Morning Coffee

Nr. 40 – Moats are alive and well

In May last year there was a highly mediatized clash between Warren Buffet and Elon Musk on moats and candy. In an earnings call, Musk criticized the importance given by value investors to the so-called moats of a company. Moats are all the buffers or competitive edges companies try to surround themselves with like strong brands, low production costs, market shares or intellectual property that protect their franchises against competitors in the same way a castle is protected against its enemies by the water surrounding it. These moats enable them to achieve a higher profitability than the competition over time. Musk argued that moats have lost their importance in today's world and that "the pace of innovation" is the only relevant factor. The CEO of Berkshire Hathaway was quick at shooting back arguing that companies with strong, sustainable moats do exist and that technology has not destroyed them in every industry: "Elon may turn things upside down in some areas. I don't think he'd want to take us on in candy." For the record, Berkshire bought the candy producer See's Candies in 1972 for 25 million USD. In 2011, Buffett said See's had brought in $1.65 billion in total profits since he bought it 40 years ago.

This debate between Buffet and Musk has not only a high entertainment value. It raises a much more fundamental question for us as value investors. **With the accelerating speed of innovation, highly profitable industries are being disrupted**. The moats have become certainly less and can only be defended over a shorter period of time before an innovative competitor with a better product gets on the market place and "gets across" the moat to attack the profitability of the historic top dog. That creates an issue for the value investor who by nature has a strong preference for the companies that have solid balance sheets and have shown a solid track record of high profitability.

Fortunately enough Musk is only partly right. **Moats have become smaller** indeed and some industries like the car industry or newspapers are being completely disrupted. **However, to us, it is incorrect to generalize and conclude that moats do no longer exist.** One simple way to measure moats is to measure underlying profitability of the business over time. In the case Musk is right and moats cannot be defended due to more incoming disruptors, companies who have shown exceptional profitability in the past will rapidly loose it. We looked at return on invested capital (ROIC) of the constituents of the 600 largest European companies (DJ Stoxx 600) and compared their profitability ten years ago to the current one (2007 vs 2017). The result of this simple non-exhaustive analysis is in our opinion quite clear.



Source: Bloomberg, ECP

The companies in the quartile with the lowest profitability in 2007 managed to improve their profitability slightly over the last 10 years but are still not earning their cost of capital. On the other side of the spectrum, the companies with the highest profitability (Quartile 4) remained highly profitable, albeit at a somewhat lower level. To us, this clearly means that their **moats have not disappeared** within 10 years but have been under attack.

To conclude, **it continues to make absolute sense for us as value investors to look at moat companies**, businesses that have been highly profitable in the past as evidence suggests they will be able at least partly defend themselves against new entrants. For the record, we are invested in the candy producer Cloetta in Sweden but have at this stage not heard Musk is getting active in candies …

I wish you a great weekend,

Léon Kirch, CFA
Partner & Chief Investment Officer
January 18th , 2019