STOCK STRATEGIES

# Economic Moats Matter Less Than a Stock's Valuation

The economic moat concept alone is less important than an evaluation of how the market has priced a company's future economic value stream, or whether the marketplace is valuing the equity correctly within the enterprise valuation construct.

**BRIAN NELSON, CFA**

**"Moat" wasn't part of my vernacular until 2006.**

That's when I first walked through the doors at research firm Morningstar. The company's equity department truly "lived" competitive-advantage analysis, and I met some of the smartest people there that I will ever come to know. Having worked a couple years on the buy side, I was just getting my bearings in independent research at Morningstar during the years prior to the financial crisis of 2007–2009. However, I would soon have 30+ companies under full coverage—from airlines to environmental services companies to engineering & construction firms and beyond. By the time I left the company in 2011, I believe I had written more articles than perhaps any other person employed at the firm through that date. I'm proud of the time I spent there.

One of the most valuable experiences was having the opportunity to cover one of the worst industries out there—airlines—while covering one of the best industries out there—garbage haulers. It was truly a dichotomy that perhaps few other analysts get to experience, but I think every analyst should. It seemed that one week I'd be writing about a failed airline, and the next I'd be writing about the strong fundamental backdrop and increasing value of airspace emanating from a garbage hauler's disposal capacity. It was great. These industries represented two textbook case studies on both sides of the spectrum of Michael Porter's Five Forces business analysis model, and I couldn't think of a better experience to soak up as much as there was to know about competitive-advantage analysis.

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Though Warren Buffett coined the term "moat" in 1999, Morningstar deserves a tremendous amount of credit for making the term "economic moat" go mainstream. The firm has written several books about economic moats, and I'd be remiss if I didn't give them a shout out. Pat Dorsey's "The Five Rules for Successful Stock Investing" (John Wiley & Sons, 2003) and "The Little Book That Builds Wealth" (John Wiley & Sons, 2008) are two fine pieces of literature on the topic, and more recently the Morningstar team wrote "Why Moats Matter" (John Wiley & Sons, 2014), which dives deep into what the firm believes are the five sources of an economic moat: intangibles, cost advantage, switching costs, network effect and efficient scale.

Because competitive-advantage analysis, or economic-moat analysis, has become so engrained in my thoughts after years of training new analysts at Morningstar as director of global equity and credit research (training and methodology), I can't possibly begin to tell you how much it influences the way I think about individual equities. Thinking about the competitive advantages of a company is about as natural as breathing for me. It just happens, and I think for any investor, a solid fundamental framework in economic moat analysis is simply par for the course. Investors can go wrong in a great many ways, but there's only an upside to learning the ins and outs of what separates the best companies from the worst ones.

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## What Is an Economic Moat?

The concept of an economic moat, or sustainable competitive advantages, generally focuses purely on the sustainability and the duration of the competitive advantages that a company possesses. The concept generally does not emphasize the cumulative sum of a company's potential future economic profit creation as a consideration of the quality of the business, but only that at some point in time in the future a moaty company will continue to have an economic profit spread. Let's define a bit more about what I am talking about.

Economic profit is different than accounting profit. Economic profit measures the ability of a company to generate a return on its invested capital greater than the estimated cost of that capital. Accounting profit, on the other hand, is information found on the income statement. A positive economic profit spread means a company is generating a return greater than its capital costs, and this can happen regardless of the level of accounting profits. In most cases, the moaty company may have the largest cumulative economic profit stream, but a potential problem might arise if an investor focuses only on companies that have economic moats—or sustainable and durable competitive advantages—and overlooks those with shorter-duration, high-magnitude economic profit spreads, which can also be mispriced.

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## The Role of Moats in Economic Value Creation

A moaty company's operations may certainly be more stable, generating economic profits that are more sustainable and durable (the slowly fading blue curve in Figure 1). However, the moaty firm's total economic value creation (net area of slowly fading curve), in absolute- and present-value terms, can still be significantly less than that of the no-moat firm (net area of volatile curve in Figure 1), as calculated. In present-value terms, in the hypothetical example in Figure 1, the moaty company generates less than half the economic profit of the no-moat company. A no-moat company, as in this example, can generate more value for shareholders than a company with sustainable and durable competitive advantages. The takeaway is that, while moaty firms are durable and sustainable businesses, they may not always be the best value-generators for shareholders, as cumulative economic value generation matters most when assessing the value-add to shareholders.

## Economic Value Creation Versus Stock Price

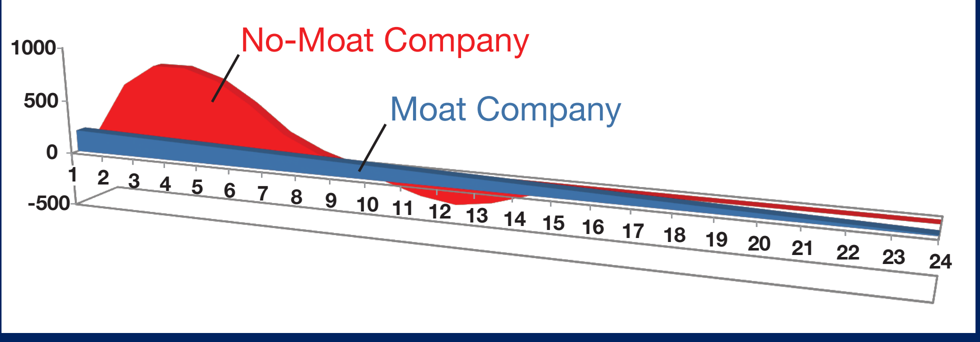
The trajectory of a company's economic value creation (or the areas of the curves in Figure 1) is not equivalent to the trajectory of a company's stock price. An estimate of a company's valuation, which is used to identify stock mispricings, already implicitly embeds a forecast of the firm's future economic value creation. Figure 1 just shows pure economic value creation. It's possible, though unlikely, that the stock price volatility of the no-moat stock in the example could even be less than that of the moaty stock, despite expectations for the much more volatile economic

**FIGURE 1**

### Cumulative Economic Profit Generation Is What Matters Most

**Moat versus no-moat:** In this hypothetical example, a moaty firm's operations are more stable; they generate more sustainable and durable economic profits into the future, as shown by the slowly fading blue curve. The no-moat firm's operations are much more volatile, generating economic profit and destroying capital at times as shown by the more volatile red curve.

In this particular example, the moaty firm's total economic value creation, in absolute- and present-value terms, is significantly less than that of the no-moat firm, as calculated. In present-value terms, the moaty firm generates less than half the economic profit of the no-moat company. The no-moat firm, in this example, is generating more value for shareholders than the firm with sustainable and durable competitive advantages.




The graph above represents a hypothetical future economic value added (EVA) curve for a moaty company (blue) and a no-moat company (red), where any area above the x-axis represents economic value added and any area below the x-axis represents economic value destroyed. The moaty firm never destroys shareholder capital, but the no-moat firm generates the most cumulative economic profit for shareholders, both in absolute and discounted terms. The no-moat firm ceases to generate economic profit or destroy capital at the end of year 15 due to competitive forces, while the moaty firm continues to generate economic profit for significantly longer, through year 25.

value-added stream. Stock price volatility, which can be viewed through the lens of expectations revisions within the enterprise valuation context, and economic profit volatility, which is based on fundamental business dynamics, are two separate concepts, albeit related ones.

That said, regarding a moaty or a no-moat company's stock price, if the company is fairly valued, the stock price may already largely reflect its respective forecasted economic profit trajectory. As BlueMountain Capital's Michael Mauboussin puts it in "Measuring the Moat: Assessing the Magnitude and Sustainability of Value Creation" (Credit Suisse First Boston, December 16, 2002), under a scenario where the equity is fairly priced, "investors should expect to earn a risk-adjusted market return." Put another way, the value of fairly priced moaty stocks, which tend to be less risky, may advance at a lower annual pace than the value of fairly priced no-moat stocks due in part to the lower risk-adjusted discount rate (the rate of return required by investors as compensation for parting with their money for a period of time) applied to the moaty company's respective future free cash flow stream. A company's intrinsic value generally advances at the annual pace of its corresponding discount rate less its dividend yield. Since moaty firms generally have lower discount rates and pay dividends, the pace at which their fair values should be expected to increase will trail that of a no-moat firm (assuming the future forecasts are accurate).

### Look at Pricing of Future Economic Value Stream

What we are after as investors, as Mauboussin states, is anticipating revisions in expectations of financial performance. Is a no-moat's economic value trajectory correctly priced in? Is a wide moat's economic value trajectory overvalued? Is a no-moat company's economic value trajectory undervalued? The economic moat concept alone is less important than an evaluation of how the market has priced a company's future economic value stream, or whether the marketplace is valuing the equity correctly within the enterprise valuation construct. This means that investors should be looking for companies in the global investment universe that have mispriced future economic value streams (i.e., stocks that are underpriced relative to their discounted future free cash flows—meaning the future expectations of how the business will perform—and net balance sheet), not whether a company has a wide economic moat or a narrow one, per se.

To quote Warren Buffett in his 1992 Chairman's Letter to Berkshire Hathaway shareholders, "the investment shown by the discounted-flows-of-cash calculation to be the cheapest is the one that the investor should purchase—irrespective of whether the business grows or doesn't, displays volatility or smoothness in its earnings, or carries a high price or low in relation to its current earnings and book value." But don't revenue and earnings have to go up for a stock to advance? In short, no. If a stock is undervalued based on its future enterprise free-cash-flow stream (its future economic profit stream), price-to-estimated-fair-value convergence can occur even if future fundamentals are less than desirable and regardless of the trajectory of revenue and earnings in future periods. Within the enterprise valuation framework, undervalued stocks with expectations of declining revenue and earnings can still advance in the context of price-to-estimated-fair-value convergence, meaning that the market has priced the stock too low to begin with, even relative to its declining expected revenue and earnings stream.

### Comparing Companies' Moats: An Example

The concept of cumulative economic value versus the sustainability and duration of economic value is worth examination with an example. Without question, railroads are fantastic businesses. North American railroads operate as an oligopoly, benefit from substantial barriers to entry and boast significant pricing power. The group's return on invested capital (ROIC), however, won't be but a few percentage points greater than their cost of capital at any point in time, given the capital intensity of their operations (it's costly to maintain tracks), but absent any abnormal shocks to the business, the railroad group will likely add a modest amount of economic value year after year. However, will a moaty railroad such as Union Pacific Corp. (UNP) generate as much value as, perhaps, a less-moaty company like Apple Inc. (AAPL)? The answer is probably not.

Apple boasts a significantly larger economic value spread, and it can be reasonably argued that Apple may even generate more economic value in just a few years of peak-level earnings than Union Pacific may generate for the remainder of its corporate life. The duration of Apple's economic value creation or competitive advantage period—which may be much shorter than that of Union Pacific—is less important than the absolute and discounted economic value that a company delivers to shareholders. One could even argue that since the near term is more predictable than the long term, a front-end loaded economic value stream like Apple's (where most of the business' economic value is realized earlier) may be preferable to a long-duration and slim economic value stream like Union Pacific's (where the economic value is realized over a lengthy period of time). That said, either Apple's or Union Pacific's future economic profit spread can become mispriced, resulting in either stock becoming undervalued or overvalued.

### Economic Castles

The sustainability and duration of a company's economic value creation, or its competitive advantage period, tells us little about a company's economic castle, or the magnitude of the value creation that it is expected to deliver to shareholders. Though a focus on economic moats remains an integral part of any competitive-advantage analysis, identifying economic castles—those businesses that will deliver the most value to shareholders, regardless of the economic-value composition—may be equally important to an investor's process.

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Whereas an economic moat assessment evaluates a company based on the sustainability and durability of its economic value creation stream, Valuentum's Economic Castle rating evaluates a company based on the magnitude of the economic profit that it will deliver to shareholders. Companies with the best ratings are expected to generate the most economic value for shareholders in the future five-year period, regardless of their competitive positions.

### Enterprise Valuation

Over a look-back period of 10 years ending 2012, Morningstar concluded that companies with wide economic moats underperform stocks with narrow economic moats, and that stocks with no economic moats had the best returns ("How Our Stock Star Ratings Have Performed," by Warren Miller, Morningstar, January 2014).

The relative outperformance of no-moat stocks may be explained in part by the context of enterprise valuation. The values of higher-risk stocks, by definition, should theoretically grow at a higher annual pace than lower-risk stocks over time, all else equal. (The higher-risk stocks are assigned higher discount rates in the valuation process to reflect their heightened risk profile. Investors require a higher implied rate of return as compensation for a greater perceived risk of incurring a loss.)

## Investor Preferences for Moats Can Change

There may be another dynamic at play. As markets are generally benign during economic upswings, riskier stocks are generally repriced higher using lower discount rates (credit is more readily available, and investors are less averse to risk). The longer-duration cash-flow profile of higher-risk, no-moat companies is then magnified when the cost of borrowing is reduced. This makes no-moat firms very volatile through the credit cycle, but it may also help explain their significant outperformance during good times. (The combination of lower discount rates and less risk aversion increases the value of these companies and the price investors are willing to pay to own them.) Moaty stocks, on the other hand, are less impacted by credit availability, and therefore their discount rate and intrinsic value should not experience as much volatility.

One might hypothesize that investors may sometimes prefer stocks with moats because they tend to be less volatile, not necessarily because they may be better long-term performers. Most investors, for example, may not be able to sleep at night if their portfolio experiences wild swings. Investors then accept the lower returns for reduced levels of volatility.

It's important not to misread this takeaway. Investors seeking better long-run returns shouldn't just consider stocks with the worst fundamental qualities either. There is individual bankruptcy risk and potential for considerable price declines in higher-risk small- and micro-cap stocks under tightening credit cycles. Plus, a concentrated portfolio of fundamentally poor companies is still a bad idea, even if the portfolio might have a good run during the best of times. If not a good business or a bad business, what then makes a company among the best types of investments to consider?

I'd argue that a great company (one with a royal castle!) that is significantly undervalued on an enterprise valuation basis, whose valuation is supported by relative "behavioral" multiples, and one that is experiencing strong share price momentum may be worth a look. In other words, what we call a Valuentum stock. If this company pays a strong and growing dividend, too, all the better.

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