Upper crust supremo

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Few company traits are more valuable than a sustainable competitive advantage that competitors find hard to replicate or surpass.

Morningstar calls competitive advantage an "economic moat" to illustrate how the best companies can vigorously defend their market position – and earn higher profit margins and returns – against invading competitors.

Some of the market's top value investors, such as Montgomery Investment Management's Roger Montgomery, swear by sustainable competitive advantage, which is best reflected in a high, consistent historical and future return on equity (ROE).

I also favour companies with sustainably high ROE (see below table) because it usually leads to rising share prices over time and is a good clue to spot exceptional companies. Owning hard-to-replicate assets also makes companies much dearer to take over.

Of course, ROE is only one of several considerations. Finding companies with low debt, high and free cash flow and management that treats all shareholders equally, is just as critical. Like any investment metric, treat ROE with care.

Consistent, high historical ROE over several years is a good sign but future ROE matters more.

Also, the prospect of high future ROE might have already been priced into the company's share price, which is now higher than its true value.

The embattled department store, David Jones, is a good example. It has averaged 22 per cent ROE over the past five reporting periods – a strong performance.

Yet its share price has halved from its 52-week high to $2.46, as investors worry about its future earnings and ROE in a weak retail climate. David Jones still looks more of a value trap than good value, despite recent share price falls.

The accompanying table shows small and mid-size listed companies with the highest ROE, based on their last reported full-year profit. It is calculated by dividing net profit before abnormals by shareholders' equity.

Ideally, investors should examine at least five years of historical ROE data, preferably more; the table includes only the last ROE because of space constraints.

The data filter I used to find high ROE companies had two simple parameters: a market capitalisation below $2 billion, to exclude large-cap stocks, and a ROE greater than 20 per cent. The full table of my findings is available on the website, BRW.com.au.

Regular readers will see column favourites, such as ARB Corporation, OrotonGroup and carsales.com on the list. The mining services companies MACA, Forge Group and Decmil Group have also been covered recently.

Domino's Pizza Enterprises seems an unlikely exemplar of sustainable competitive advantage.

It sells a commoditised, low-margin product in an industry with seemingly low barriers to entry. Yet its product, a fast-growing franchise network of pizza stores in Australia and Europe, is becoming harder for competitors to overtake or surpass.

Other pizza chains have emerged but I doubt they have anywhere near Domino's management skill or organisational culture in the low-priced pizza segment.

Astute use of technology in pizza ordering and delivery also improves sustainable competitive advantage and gives Domino's a big headstart over smaller competitors that lack the financial firepower to invest as heavily in technology and scale their business as rapidly.

I doubt investors fully appreciate how technology is helping transform a commoditised food offering such as pizza.

Domino's has what experts call a "profit loop" – as it gets bigger, it earns and reinvests more and widens the gap from its competitors and earns more again.

The big question is valuation. I rarely write about stocks that have rallied 80 per cent from their 52-week low but will make an exception with Domino's, with a few caveats.

Most broking research I see on Domino's has "hold" or "reduce" recommendations and some share valuation services have its share price trading well ahead of the company's intrinsic value.

Morningstar, for example, values the shares at $7.15, compared with the $9.49 share price, which puts them firmly in "sell" territory on valuation grounds.

I would not chase Domino's shares higher at current prices but see them among the first small-cap stocks to buy on price weakness, or during periods of broader sharemarket volatility.

It is far from a mature business: strong prospects in Europe, another 60 or 70 new stores in 2011-12, according to company guidance, and the use to technology, give Domino's plenty of growth options.

Perhaps the best sign is the product itself. Years ago, I wrote that Domino's pizzas tasted like the box they came in and that I could not get excited about the company given its product flaws.

Its pizzas are not to everyone's taste but quality has improved in recent years: better toppings, an expanded product range, and undeniably good value, which attracts

people to the stores and lifts the average spend as customers upgrade pizzas with extra toppings or side-serves.

That should further entrench Domino’s sustainable competitive advantage, boost return on equity and drive the share price higher.

It may take time for the next rally after stellar share price gains this year but it is hard to see competitors eroding the company’s competitive advantage any time soon.

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