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How to find the stocks most likely to sustain competitive advantage

Just find companies that know how to grow, and buy a share in them.

by **Mark Story**

Investing can't be that hard. Just find companies that know how to grow, and buy a share in them. But while identifying stocks with a competitive advantage is one of the most critical aspects of stock selection, it isn't easy. Only a fraction of the 2400 stocks listed on the ASX qualify.

There's no better measure of any company's competitive advantage than its ability to reinvest capital back into the business to achieve above-average returns, and based on historical measures this would be around 10 per cent.

In other words, for every $1 invested back into the business, can the company turn it into $1.10? It's that simple.

To ensure that above-average returns are not just flukes or attributable to abnormal trading conditions, investors should look for sustainable above-average return on equity (ROE) over a number of years.

Fewer than 10 per cent (216) of stocks listed on the ASX have a historical ROE greater than 15 per cent-plus, typically the measure for a growth stock. However, once you overlay a forecast ROE greater than 10 per cent, that reduces the list to just 122

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stocks. By going one extra step and filtering on stocks with a historical change in value greater than 10 per cent – which any growth stock with a sustainable competitive advantage should have – the list is culled to a mere 58 stocks.

Montgomery Investment Management portfolio manager Andrew Macken says it's critical that investors understand where exactly a company's sustainable competitive advantage comes from and how defendable it really is.

Companies enjoying strong competitive advantage typically either have a structural cost advantage, a capital advantage or attributes that foster pricing power, while the best companies exhibit a combination of all three. Macken says the more difficult or costly it is for competitors to re-create a stock's business, the stronger its competitive advantage is likely to be.

Two key sources of competitive advantage include scale or size, and government protection. As a case in point, Macken cites Rio Tinto's and BHP Billiton's ability to derive a competitive advantage from access to the world's lowest-cost iron ore mining production, plus government protection in the form of mining tenements, as key factors that can't be re-created by competitors.

Due to the big four banks' size and scale, plus myriad forms of government protection – enshrined in the "four pillars policy" that prevents them from merging – he says Commonwealth Bank, Westpac, ANZ and NAB collectively enjoy competitive advantage. Macken says Ramsay Health Care seems to have an unassailable competitive advantage due to its scale and customer captivity, having locked up geographical locations, as does Cochlear for its global reach and patent technology.

Challenger Ltd enjoys an 80 per cent share of Australia's annuity market from regulatory barriers discouraging other players from entering the market, he says. Given that regulatory hurdles will only perpetuate limited competition, Macken expects Challenger to go on achieving above-average returns on invested capital for at least the next 10 years.

Those who doubt the impact of government protection only need to look to Telstra, he says. More recently Tatts and Tabcorp have lost varying shades of monopoly to regulatory reform. Echo Entertainment's Star City is also poised to lose its monopoly in Sydney when Crown Resorts opens at Barangaroo from 2019.

Other classic examples of one-time growth stocks losing their competitive edge to disruptive technologies are the listed network TV channels. Nine Entertainment's recent earnings downgrade dragged down the market value of several major media companies, including Seven West Media, amid fears the ad market will continue migrating from free-to-air TV into other forms of media.

A third source of competitive advantage is customer captivity, which relates to the difficulty with which customers can move to another supplier. For example, when its core youth market abandoned Billabong International in the early 2000s, sales plummeted along with the company's intrinsic value; its share price tumbled from $12.47 in May 2007 to around 56¢ this week.

There are no better examples of customer captivity, Macken says, than internet stocks like Seek, REA Group and CarSales.com that dominate their respective sectors. "These stocks benefit from the 'network effect', where the greater the number of people joining, the more valuable and bigger it becomes in scale – which only adds to pricing power," he says.

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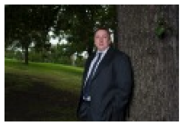

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Those who question the value of the network effect in sustaining a competitive advantage should look at the impressive growth trajectory of recently listed midcap iSentia Group. Formerly known as Media Monitors, this media and social media monitoring company has captured 90 per cent market share using in-house software. Rather than losing customers, average revenue-per-client has gone up along with price rises that cater for more extensive data searches, and to Macken, this demonstrates true sustainability within its competitive advantage.

According to Australian Ethical Investment portfolio manager Mason Willoughby-Thomas, the network effect is the source of competitive advantage for listed construction collaboration software firm Aconex Ltd. "The company's highly scalable SaaS-based platform – reflected in high operating margins and revenues three to five times larger than the near competitor – within Australia's mature market, also creates an increasing barrier for new entrants."

But it's no good finding high-quality growth stocks like iSentia or Aconex, warns Macken, if you have to pay too high a price for them. While paying a (slight) premium for the best of these growth stocks might be justifiable, he says if you're paying $1.60 for $1 worth of value, your potential downside is too high.

the price falls below a stock's intrinsic value. The three stocks deemed to have the hallmarks of a sustainable competitive advantage trading at June 10 at varying discounts to their intrinsic value – and with no debt – are CBA (3.65 per cent below intrinsic value), Flight Centre (8.91 per cent below) and Monadelphous (47.87 per cent below).

It's a mistake, warns Willoughby-Thomas, to assume stocks trading at a discount to intrinsic value are always cheap. For example, he suspects that energy procurement company Energy Action is trading at a significant discount (following numerous earnings downgrades) due to management's inability to derive competitive advantage from its reverse auction energy procurement platform as originally expected.

It's also a mistake, adds Macken, to assume that every blue-chip stock trading at a discount should be snapped up. For example, if the Woolworths board, accused of lacking retail experience, can't compete within a post-duopoly market, the 21 per cent discount to its intrinsic value may widen and take the company into value-trap territory. "That's why it's critical to evaluate any business independent of the share price," he says. "It's your job to make a call on the sensibility of implied growth rates, and what could stop the business from becoming a lot bigger over 10 to 20 years."

Filtering for competitive advantage

Smart Investor used Skaffold stock filtering software to highlight stocks consistently able to generate higher returns by searching on: historical change in intrinsic value greater than 10 per cent (they must have a proven ability to consistently grow the value of the business), historical return on equity greater than 15 per cent and forecast return on equity greater than 10 per cent (companies with a sustainable competitive advantage should be achieving above average returns from capital reinvested back into the business).

Based on these criteria, we identified 58 stocks most likely – through superior returns – to have varying degrees of sustainable competitive advantage. However, with much of that upside already factored into the price, most of these stocks look too expensive at current levels.

We then filtered on stocks trading at premiums to intrinsic value no greater than 30 per cent, and narrowed the pool down to 29 stocks.

With funding providing meaningful clues into how sustainable growth and superior returns might be into the future, we then removed all remaining stocks trading with a funding gap.

The nine stocks with a funding surplus in our final universe are more likely to avoid excessive borrowing, expand their businesses, pay dividends and withstand economic downturns.

All things considered, the nine remaining stocks worthy of further homework to discover the full extent of their competitive advantage are shown in the table: