



Reversal of fortune

A competitive advantage is great while it lasts, says Roger Montgomery

MY PREFERENCE IS FOR companies with high rates of returns on equity. As I describe in my book *Value*.

able, there are many reasons that high rates of return on equity should be sought and, when available at bargain prices, acquired.

Principally, a company with a high rate of return on equity (ROE) is able to turn a dollar of retained earnings into more than a dollar's worth of long-term market value. And when that dollar of profit is not being paid to you as a dividend, you really want to make sure it's being turned into more than a dollar of capital gain. Only a company with a high rate of ROE can achieve this. It's the basic reason the Montgomery [Private] Fund has a portfolio of companies whose average returns are much higher than the market average.

Importantly, we don't invest by looking in the rear-view mirror. These high rates of return need to be sustained into the future. And only companies with sustainable competitive advantages can be sure to produce those high rates of return - all things being equal.

Sustainable competitive advantages come in many forms. The best internet companies simply offer lists of cars, houses, boats, jobs, websites or flights and hotel rooms. The best have a competitive advantage that comes from having the most products or services listed by suppliers, because they enjoy the largest number of visitors. This is known as the "network effect". The jury is out as to precisely how long such advantages can be sustained but for the moment REA Group, Carsales.com and Google all enjoy the benefits of the network effect.

Another competitive advantage comes from high switching costs. Banks, for example, enjoy the ability to charge whatever they like in fees because they know that the benefit of switching banks is less than the cost of doing so. Other companies that enjoy this advantage are IRESS Market Technology, Computershare and, until recently, the provider of the Quicken and QuickBooks ranges of accounting software, Reckon. You see, if you have installed a particular brand of accounting software in your business and started using it, switching becomes inconvenient, if not difficult. The switching costs are relatively high, so whether you use MYOB, Quicken or, more recently, Xero, you aren't likely to change your systems and processes in a hurry.

But Reckon has recently experienced

an exogenous threat to this competitive advantage and it highlights the impermanence of what we think is otherwise sustainable. After February 2014, the licensing agreement Reckon has with its major shareholder, the US company Intuit, for the Quickbooks and Quicken brands, will be formally terminated.

Under the agreement, Reckon pays Intuit about \$6 million a year in royalties and, as it will no longer have to make these payments, there's an apparent saving. But it will instead have to fund its own R&D to keep its suite of products up to date. Competitor MYOB is reported to invest about \$25 million a year in R&D. Without an investment in R&D, the switching costs for users will be lower than the cost of staying with an out-of-date product and they will start to switch. And there goes Reckon's competitive advantage.

More worrying is the fact that Intuit may enter the Australian market as another competitor, spreading a fixed number of clients over a greater number of suppliers. Confusion for clients may also occur if Reckon is forced to rebrand its offering because Intuit markets the brand it previously supplied Reckon.

Finally, there's the small matter of what Intuit will do with its 11% shareholding in Reckon. It may simply offer it as a "line" to institutional investors at some discount to the market price, but until it does something it will now act as an overhang that must be digested by the market.

My Scaffold.com valuation is \$1.69 this year and \$2.06 for 2013. But whatever the valuation, investors can say goodbye to the recent share price highs of \$2.70 for some time.

Roger Montgomery is founder of Montgomery Investment Management and author of *Value.able* available at www.rogermontgomery.com

