MARKET LEADERSHIP

Albin Kistler AG opinion piece
September 2023

The ability of outstanding companies to create value is often based on strong market leadership. But what exactly does that mean, and how do the competitive advantages required manifest themselves in the corporate world?

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Outstanding companies stand out due to a whole range of quality attributes. These include, for example, the management quality described in one of our recent studies,[1] conservative financing, attractive long-term growth prospects and a high level of profit stability – all decisive factors in our assessment of whether a company is worth investing in. Another key feature of excellent companies is strong market leadership. This makes a decisive contribution to a company's value added, as described below.

Value-creating companies

One of the fundamental concepts of economics states that a company creates economic value if it generates a return on capital employed (ROCE) that is higher than its cost of capital. A consistently high ROCE coupled with growth opportunities that allow the company to productively invest additional capital are particularly valuable. This combination of high ROCE and attractive growth opportunities is one of the things that sets outstanding companies apart. Warren Buffett put it very succinctly in one of his highly readable shareholder letters almost precisely 30 years ago:

> *"Leaving the question of price aside, the best business to own is one that over an extended period can employ large amounts of incremental capital at very high rates of return." – Warren Buffett*

There is now empirical evidence that long-term sales growth – particularly organic sales growth – is the most important driver of returns for companies with a high ROCE.[2] By contrast, caution should be used in the case of inorganic growth. A high premium often has to be paid for acquisitions, which reduces the ROCE. Not least for this reason, large acquisitions in particular regularly give rise to intensive discussions in our decision-making bodies.

In order to generate a consistently high ROCE, however, a company must possess a sustainable competitive advantage. Otherwise, other companies – enticed by the attractive ROCE – would enter the market and over time squeeze return levels down to the cost of capital. Sustainable competitive advantages are therefore the fundamental prerequisite for generating a sustainably high ROCE.

Ascertaining whether a company possesses a competitive advantage, identifying the reasons behind it, and finally assessing the durability of the advantage are key to the assessment of a company's quality. If a company generates a ROCE significantly above its cost of capital for a prolonged period, then as mentioned this points to the existence of a competitive advantage. Another clue is a relatively stable market share, which suggests that there are relatively high barriers to market entry and that the existing market participants are not excessively aggressive in competing for market share.

Different types of competitive advantage

There are two fundamental ways of achieving a competitive advantage. A company can either have consistently lower costs than its competitors (cost leadership), or set its products apart from the competition in any way that allows it to charge a higher price in the market (differentiation).[3]

A successful differentiation strategy means a company is able to differentiate its products or services from those of its competitors with regard to certain performance dimensions. If customers value these unique performance parameters enough, the company is able to charge a higher price. And if this frequently cited pricing power is achieved at reasonable costs, the company can achieve above-average profitability.

By contrast, a successful cost leadership strategy enables a company to provide a product or service at lower costs or with a smaller capital outlay than its competitors. If at least a comparable price can be achieved on the market, cost leadership also results in an above-average ROCE.

[1] Excellent Management, Albin Kistler opinion piece, 2023, available at https://www.albinkistler.ch/en/dokumente.

[2] How to Choose between Growth and ROIC, McKinsey on Finance no.25 (2007).

[3] Competitive Advantage: Creating and Sustaining Superior Performance, Michael E. Porter (1985).

Based on the two fundamental categories of competitive advantage described, there is a whole range of sources that can provide a competitive advantage. The key features of a selection of these, which is by no means exhaustive, are outlined below with the aid of specific examples.

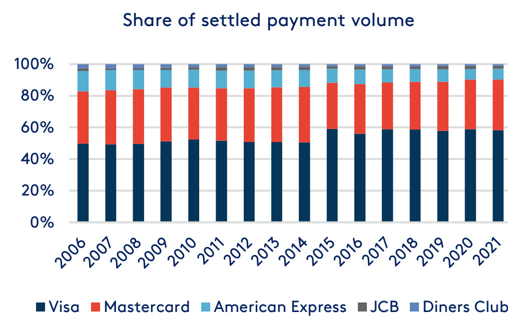
Network effects – Mastercard

Mastercard operates the world's second-largest payment network, which enables transactions to be settled in more than 210 countries using a complex four-party system. This primarily comprises payment authorisation, the exchange of financial and transaction data (clearing) and settlement.

As an intermediary, Mastercard sets the rules for participating in this network and thus provides the framework for efficient transaction settlement between buyers and sellers. At the end of 2022, there were more than 2.7 billion Mastercard-branded cards in circulation, accepted by more than 80 million retailers globally.

For individual cardholders, the more retailers that join the network, the greater the benefits of participating in the network, because it increases the number of places where the card is accepted. It is a similar story for individual business owners, who can increase their business volume if more of their customers have a card their business accepts. The system's benefits increase with the number of participants.

This network effect is a significant competitive advantage for Mastercard, creates a barrier to market entry that is almost impossible to overcome, and leads to steady gains in market share at the expense of smaller networks with lower acceptance. The market shares of the duopoly of Visa and Mastercard are now correspondingly high, and the two companies have been successfully defending and even expanding their high combined market share for years.



Source: own chart based on data from Nilson Reports.

Reputation – Moody's

Moody's has been providing credit ratings for more than 100 years. These ratings make it easier for issuers to access capital and reduce the risk premium, which is reflected in lower financing costs. For creditors, the ratings increase transparency because they reduce the information asymmetry between the creditor and the issuer, thus strengthening confidence in the issuers.

Moody's benefits from the fact that both issuers and creditors want the credit rating to be provided by a well-known agency. The reputation the company has built up over the decades signals high quality and creates the confidence needed. Since a credit rating from one, or in fact usually several, well-known rating agencies is virtually a prerequisite for borrowing at attractive conditions in the market, the barriers to market entry are very high.
The major rating agencies are therefore now firmly established in the market. Investment funds or pension funds, for example, are often bound by rules regarding a minimum rating from a recognised agency. Credit ratings are also used to determine banks' capital requirements. Finally, and rather ironically, regulatory authorities such as the US SEC have also cemented the existing market structure by maintaining a list of government-approved rating agencies, making it even harder for alternative providers to enter the market.

Unsurprisingly, therefore, the three biggest agencies – S&P Global, Moody's and Fitch – have dominated the credit ratings market for decades, with a combined market share of almost 95% since before the global financial crisis. The high operating margin (>50%) in the rating business is also a clear indication that the agencies have a high level of pricing power.

Switching costs – Microsoft

With revenues of over USD 200 billion and more than 220,000 employees, Microsoft was the world's largest software company by far in 2022. The group covers a wide range of product categories, including MS Office, the Windows operating system, Azure (cloud computing), gaming and the social network LinkedIn.

In many of these categories, Microsoft has built up an enviable market position over the years, benefiting in large part from its customers' high switching costs. The MS Office suite and Windows operating system in particular are strongly anchored in the operating environment and work flows, especially in a professional context. Compatibility requirements and any migration costs prevent many corporate customers from seriously considering a switch.

Switching to another operating system or different productivity software would also entail training costs and effort, which should not be underestimated. Anyone who has worked in the Microsoft environment for many years will have picked up a lot of application-specific knowledge that cannot easily be transferred to a new software environment. These additional, non-monetary switching costs often also prevent private individuals from changing their software. Unsurprisingly, Microsoft's pricing power is correspondingly high.

Brand loyalty – LVMH

LVMH, the world's largest luxury goods group, was created in 1987 by the merger of Moët Hennessy and Louis Vuitton. The group, which remains majority-owned by family shareholders, now consists of 75 largely decentralised Maisons in the categories of fashion and leather goods, watches and jewellery, wines and spirits, perfumes and cosmetics and selective retailing.

The brand portfolio, which alongside Louis Vuitton also includes Christian Dior, Tiffany's, TAG Heuer, Hublot, Moët & Chandon, Veuve Clicquot, Dom Pérignon and many other world-famous brands with long histories, has an enviable appeal.

Consumers' desire for these world-famous luxury brands is so strong that their pricing power is almost unrivalled. One peculiarity of the luxury goods market is that demand is not merely inelastic in the face of price rises, but in certain cases even increases. This effect, which was named after the US economist Thorstein Veblen, arises because the luxury goods market is largely based on exclusivity. This exclusivity only persists if the pool of people who can afford a luxury product remains small. This is also why you will never find Louis Vuitton products, for example, in a sale – the negative effect on the brand would be far too great. The importance of brand desirability for pricing power – a clear sign of a competitive advantage – was aptly explained by the group's CFO in 2022:

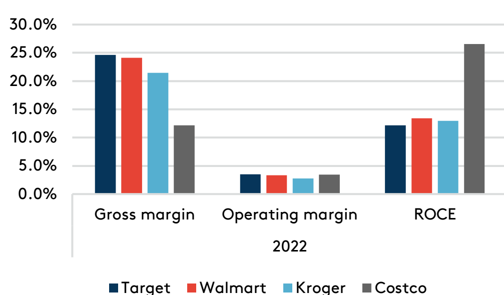
> *"The reality is that pricing power is a function of the desirability of the brand. Desirable brands can increase prices and non-desirable brands cannot. It's as simple as that." – Jean-Jacques Guiony, CFO, LVMH*

Economies of scale – Costco Wholesale

With close to 600 locations in the USA, Costco Wholesale (Costco) is one of the country's largest cash-and-carry chains. Its warehouses sell food, household goods, electrical appliances, clothing and more at much lower prices than traditional wholesalers and retailers.

The company is able to offer lower prices thanks to a razor-sharp focus on cost control, and attempts to eliminate the majority of the costs traditionally incurred in wholesale and retail business. This cost focus runs through the entire organisation and includes no-frills sales locations, fewer sales staff, bulk sales only, and lean support functions. Costco also has considerable purchasing power with its suppliers, thanks in particular to its extremely streamline product range.

In addition to low costs of goods, this also enables Costco to keep its overheads as low as possible and thus reduce its average costs. The savings can then be passed on to customers in the form of lower prices, securing the company's cost leadership. The success of this strategy can be seen in a direct comparison with some of its competitors.



Source: own calculations based on Bloomberg data.

Despite its considerably lower gross margin, Costco achieves a comparable operating margin thanks to its low overheads. In terms of ROCE, however, Costco clearly stands out due to its significantly higher capital efficiency (asset turnover).

Its membership model helps Costco protect the permanence of this competitive advantage. To shop at a Costco warehouse, you first need to become a member, which costs between USD 60 and USD 120 per year. This promotes customer retention, which in turn makes a decisive contribution to securing the company's economies of scale and thus its cost leadership. Costco's high degree of customer loyalty – membership renewal rates are over 90% – bears out the success of this model.

Conclusion

One of the key prerequisites for sustainably generating shareholder value is the existence of a consistent competitive advantage. This is the only way to ensure that ROCE is higher than the cost of capital over the long term, leading to the creation of economic value.

When selecting companies of outstanding quality, it is therefore important to focus on a company's competitive advantage. First and foremost, it is essential to understand whether a competitive advantage actually exists, and if so to identify exactly what has created it. Finally, the durability of the competitive advantage must also be assessed. In particular, caution should be exercised in the case of companies that operate in markets undergoing rapid technological change, and companies that are exposed to changing consumer preferences.

Ideally, a company should have a combination of competitive advantages from several sources, which together create an insurmountable barrier. If additional capital can be used within this barrier (i.e. at a high ROCE) over a long period, the effect of compound interest leads to remarkable growth in profits:

		CAGR FY06-22	
	ROCE (Ø FY17-22)	Revenue	EPS
Mastercard	60.6%	12.6%	23.6%
Moody's	34.6%	6.4%	7.8%
Microsoft	26.4%	9.8%	13.1%
LVMH	18.4%	10.8%	12.9%
Costco	23.8%	8.7%	11.7%

ROCE: return on capital employed
Source: own calculations based on Bloomberg data.

It is common knowledge that quality comes at a price. For companies of outstanding quality, you therefore often have to pay a corresponding price. Nevertheless, we believe that outstanding companies offer the most attractive investment opportunity over the long term. Our experiences over the years have shown us that many market participants underestimate such companies' potential for long-term value creation, and with it their share price potential.

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