

#6 Always look to invest in companies with a strong competitive advantage

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One of the key attributes that IML looks for when we invest in stocks is to focus on companies that have a sustainable competitive advantage. In our view a strong competitive advantage is a key reason

why some businesses can outperform others over the longer term. At its core, a strong competitive advantage allows a company to earn higher returns than a company that operates in a commodity type business or in an industry with lots of competitors making similar goods.

So how can one identify companies with strong competitive advantage?

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Exclusive licences or concessions

Some companies are in the position where they own exclusive licences or concessions which provides them with near monopoly positions in certain industries. A good example of this is **Transurban**, which over the years has won or acquired many toll road concessions from State Governments to operate major roads mainly in Sydney and Melbourne, Australia's largest cities.

Crown and **Sky City** are other good examples of owning licences which gives the operator a strong competitive position. Crown holds the licence to operate a casino in Melbourne until 2050 and holds the only licence to operate gaming machines and tables in Western Australia. Sky City holds an exclusive licence to operate a casino in Auckland, New Zealand's largest city, until 2048.

Companies that own these exclusive licences are clearly in a very strong competitive position and IML is always interested in buying these types of companies when they are out of favour and representing good value.

Scale

Another important aspect that often gives many companies significant competitive advantage is scale. While scale alone does not guarantee success, being the number 1 or 2 player in an industry can certainly help a company gain a competitive advantage through aspects, including:

- **Better buying power than competitors** – quite often larger companies are able to buy its inputs for better prices or better buying terms than many of the smaller competitors in that industry because of the company's large buying power. These volume discounts occur across many industries but appear most evident in sectors such as the supermarket sector where there is no doubt that **Woolworths** and **Coles** scale in Australia allows them to command better terms from many of their suppliers.
- **Bigger budgets to spend on research and development (R&D)** – because of their scale, many large companies often have significant R&D budgets. These large R&D budgets can be used to improve a company's existing products and develop new products, in order to stay ahead of smaller competitors in the same industry. **CSL** is a standout example of this where over the last 20 years the company has continued to spend large amounts on R&D, outspending many of the company's competitors in the global blood plasma market. Given the long lead times in new drugs being approved, this spending by CSL has seen the company develop many new products which have helped to grow CSL's profitability. This has been particularly evident in the last few years with the commercialisation of new drugs such as Kcentra which is used for Warfarin reversal and Haegarda which is used in the treatment of Hereditary Angioedema (random swelling attacks in sufferers).
- **Bigger IT spend to improve processes** – larger companies often have much bigger IT budgets than smaller competitors which they use to spend on technology that can help make their processes more efficient and allow them to earn better margins than smaller competitors. **Sonic Healthcare** is a good example of a company that



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has used its scale to build world leading technology. Sonic is one of the largest pathology operators in the world. Through heavy investment in technology, in the last few years Sonic has developed proprietary technology which has enabled many testing processes in Sonic's laboratories to now be fully automated and much more efficient than those used by smaller competitors.

It is also important to point out that in Australia you don't have to necessarily be a top 100 company to be the number 1 or 2 in an industry to enjoy many of the benefits of scale we discussed earlier in this paper. For example, **Steadfast** (an ex 100 company) is the largest SME insurance broker firm in Australia the country and has used its scale to build a unique customised IT platform. This platform has given Steadfast a significant advantage over its competitors in attracting insurance brokers to use the company when writing business. **Events**, one of the largest hotel and cinema operators in Australia, is another ex 100 company which has used its scale to build two of the best-known leisure brands in Australia, namely Rydges Hotels and Events Cinemas.

Can competitive advantage be taken for granted?

A company's competitive advantage is never in a stable state - it can grow or shrink depending not only on whether new competitors are entering the sector, but also on the actions of management to ensure that their competitive advantage is maintained.

It's important that a company continues to invest in sustaining its competitive advantage. If management gets enticed by the prospect of making stronger short-term profits and cuts back on many of the facets that allow it to stay ahead of competitors, then its competitive advantage can be eroded very quickly. We saw this occur at **Woolworths** during 2009-2014, where instead of using its scale to continue to offer the best value to its customers, management decided to raise prices to maximise short term profits which led to the loss of customers, market share and to lower profits. Woolworths price competitiveness was restored under the new leadership of Brad Banducci in 2016 but only after a significant investment in price, service and better execution across the company's supermarket footprint.

Conclusion

A sustainable competitive advantage is one of the key attributes a company needs if it is to be successful in the long term. This can lead to above average returns compounded over time, which can lead to outstanding results for investors over the long term.

So the lesson for investors is to always look to invest in companies which have a strong competitive advantage, while keeping a close eye on management's actions to ensure that the company continues to invest in their business to sustain its competitive advantage over the long term.

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