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## Moat companies: Warren Buffet VS â€œHalf-Buffettologistsâ€

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Warren Buffett has made the term “moat company” famous. What exactly does it mean? He uses the term to metaphorically compare a strong company to a castle. Castles used to be surrounded by wide moats with crocodile-infested deep water in the moats. This prevented the attacking enemies from crossing it and entering the castle. Thus the supremacy and ownership of the castle was maintained.

On similar lines, Buffett imagines a company which has deep economic moats which cannot be crossed by the economic enemies, i.e. competitors. This company has entrenched itself in the landscape in a manner akin to a castle. Its suppliers, distributors, customers, consumers, employees, vendors, service providers, the upstream and downstream value chains of the company, i.e. the whole economic enterprise is a castle and the linkages with the company are so strong that it is difficult to cross over into this and replace the company.

With such a moat in place, a company can have much stronger bargaining power in the extended enterprise and hence can keep a larger share of the “value-pie” created in the value chain. Such companies will typically have fat margins. For example, fmcg companies (fast moving consumer goods) or cpg companies (consumer packaged goods), such as HUL, Dabur, Colgate have fat margins and a high return on assets or return on equity. On the other hand there can be moat companies like WalMart which have very low margins but very high return on equity and they too are moat companies. Companies like WalMart have high profitability despite having low margins because of extraordinary asset turns.

In all cases, a moat company should definitely have a high ROE. But one should also analyse where the high ROE is coming from and how sustainable is it. ROE can be broken down into its component parts using a DuPont analysis. We will not do that here but it comes down to profit margins, asset turns and leverage. If the high ROE is because of high leverage then it is probably not a moat company. Rather, it is a very risky company which one should avoid. Of course, infrastructure and real estate operating companies and utilities are an exception where high leverage is the norm due to the capital intensive nature of the business and hence they can be moat companies despite having high leverage as long as the companies are highly profitable for a long period of time. Imagine the famous “toll bridge” example of Buffett. Toll bridges are literally moat companies.

For other sectors, typically, low to zero leverage and high ROE can be the result of either fat margins or high asset turnover or both. The safest moat companies will have both.

***What is the advantage of a moat company?*** The moat companies are able to generate huge cash flows every year which can be reinvested for growth without resorting to raising more debt or equity. Hence, the growth can be captured if opportunities are available. But many high ROE companies do not have growth opportunities and hence these companies are not worth as much. They have no use for the huge cash flows they are generating and hence they can either send it back to investors as dividends or via buybacks or reinvest. Incompetent management can get bad ideas to grow organically into areas where they cannot maintain their ROEs and waste investor money; or waste it via bad acquisitions. Investment bankers are notorious for chasing such management to palm-off their junk goods. One will wonder, is it possible that an incompetent management is running a high ROE company. As Peter Lynch says, "Go for a business that any idiot can run - because sooner or later, any idiot probably is going to run it." When an energetic idiot runs it he is going to destroy the ROE of the firm by venturing into unrelated areas where it has not competitive advantages.

A lazy idiot running it is good since then the ROE is maintained and ideally the company is paying out fat dividends. Such companies will have a good yield since there is slow or no growth.

The real moat companies that Buffett covets are companies which have high ROE with low leverage and have investment opportunities in the same business with the moats and those opportunities are likely to last for decades. These are the ideal “moat” companies. So they can utilize the cash flow generated and invest them to grow their business further while maintaining the high ROE. If on top of it a company happens to have a very competent and passionate management team which has, potentially, many more years to contribute then you have what Charlie Munger calls the “Lollapalooza effect”. However, such companies are very rare.

Do not go ahead and grab one as soon as you identify it!

Why not? Most likely, it is extremely expensive. Yes, since these are rare and have an extraordinary growth and profitability record, they have already been identified by the markets. Beware! Don’t violate the first principle of value investing: ***Thy Shalt Not Overpay!***

The “**Half-Buffettologists**” have figured out and understood the “moat” part very well. Most Buffettologists start out as “Cigar-butt” investors in the tradition of early Graham and then learn about Phil Fisher and Charlie Munger and Buffettology as practiced 1980s onwards. The crazy power of compounding your capital at high returns on equity completely overshadows the mind and you want to be the doing a “Buffett”, i.e. identify and acquire a “moat” company.

That is the dream of every Buffettologist and by Jove they shall have it! The Half-Buffettologists tilt at any company with high ROE, whatever the price, and see a moat company and buy it. Yes, some are better and correctly identify the very rare companies which have the Lollapalooza effect going for them. But then they forget to “What am I paying for what I am getting?” The ironclad rule for Buffett is never to pay more than the intrinsic value determined conservatively given the fundamentals of the business. In practice, this has never resulted in Buffett paying a PE of more than 20.

Identify moat companies, but the lollapalooza companies one can buy at times of extreme panic when they are available below their intrinsic value. Rest of the time buy other moat companies when they become available below their intrinsic value. In most years, there will be at least 2 to 3 times when some moat company is available below its intrinsic value. But they might not be as popular or may be facing some temporary problem even though they have a strong moat. That is how one practices the art of buying moats: with patience and careful calculation of value.