DSR PREMIUM NEWSLETTER

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Dear DSR member,

It is with great pleasure that we present our weekly premium newsletter which is an important component of your subscription to Dividend Stocks Rock.

You may benefit from viewing our video explaining the differences between the Buy List, our ratings, and our portfolio models. You can retrieve this information in the Videos section of the website.

Referral

Feel free to share our ideas with your friends or associates who may benefit from this information. **We would personally consider any referrals you make on our behalf to be the ultimate compliment for our efforts.**

DIVIDEND STOCKS ROCK

INVEST WITH CONVICTION, ENJOY YOUR RETIREMENT

WHAT'S A MOAT?

By definition, a moat is a deep, broad ditch, either dry or filled with water, that is dug and surrounds a castle, fortification, building, or town, historically to provide it with a preliminary line of defense.

Moat has been used throughout history to protect one of our most important assets: where we live.

The term "economic moat" has been popularized by Warren Buffett.

Buffett explained his moat principal at the 1995 Berkshire Hathaway (BRK.A /BRK.B) annual meeting of shareholders.

"What we're trying to do," he said, answering a question from the audience, *"is we're trying to find a business with a wide and long-lasting moat around it, surround -- protecting a terrific economic castle with an honest lord in charge of the castle."*

More specifically…

"But we are trying to figure out what is keeping -- why is that castle still standing? And what's going to keep it standing or cause it not to be standing five, 10, 20 years from now. What are the key factors? And how permanent are they? How much do they depend on the genius of the lord in the castle?"

When I first looked at the Costco (COST) dividend triangle, I was asking myself the same question:

"What makes this business so special that it can find ways to sell more goods and make more profit year after year? Even more important is knowing why COST is able to do it better than most of its competitors?

I found my answer by studying the company and understanding Costco's economic moats.

I thought it would make an interesting topic to dig deeper (pun intended) into this concept and see how it could help you while you write your investment thesis.

This newsletter is about adding another string to your bow.

ECONOMIC MOAT CLASSIFICATION

An economic moat is more or less a competitive advantage that makes a business better than others. To get a better comprehension of what is a good and durable competitive advantage, I've used Morning Star's classification (you can watch this short video on the topic).

While we don't solely focus on economic moats at DSR, you will find similar wording when you read our investment theses. Let's dig into each of these moats and find useful examples.

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Switching cost

You will often hear me talk about a "sticky business model". By "sticky" I mean "it's hard to change the product/service you are using". For example, since "half of my home" is connected to an Apple product (air pod, iPhone, Mac book, Apple TV, and no doubt other products in time), it makes it very difficult for me to change my smartphone to an Android. I love the convenience and connectivity of Apple's product ecosystem. But that also creates a "product prison" I can't escape without going through a steep learning curve and significant costs.

Microsoft's suite of products, including Windows OS and Office software, are deeply embedded in both individual and corporate workflows, creating high switching costs. Imagine a corporation that would like to move away from Microsoft products…

Many software/service-related companies benefit from the high cost of switching providers. Automatic Data Processing is well imbedded in companies' payroll systems, Thompson Reuters offers subscription services to legal and accounting departments (and I'm using Refinitiv, which was sold to LSE Group, to power DSR).

Other industries are benefitting from high switching costs. If you dig deeper, you will find 3 types of switching costs:

- **Financial switching costs:** Pipelines like Enbridge and TC Energy benefit from long-term contracts (take or pay) that ensure the company is paid regardless of the economic environment. Financial switching costs are usually enforced by contracts or fees.
- **Procedural switching costs**: This represents all the time, the set-up costs and the learning curve I was referring to with my examples of Apple and Microsoft.
- **Relational switching costs:** The losses from ending long-term business relationships could be quite costly. Think of how much companies using Fastenal's on-site vending machines or hydrogen on site connection to Air Products & Chemicals would be forced to pay to change suppliers. Relational switching costs also include loyalty perks (such as you, dear member, that will never see your subscription cost increase), specialization (custom relationships such as the one Magna International built with automakers), product compatibility (Apple again) and data migration (think of the co-location services Equinix offers their customers that do business with one another).

Industries with many competitors or where the product is seen as a "commodity" (little differentiation) do not benefit from high switching costs. They do not benefit from a high level of loyalty from their customers. For example, I may have a loyalty card to shop at IGA (a grocery store owned by Empire), but it doesn't restrain me from going to a local butcher's shop or even to go to Metro or Loblaws. The concept of building a higher switching cost through a loyalty program is a good way to increase switching costs, but it's a small ditch, and not really a moat protecting the castle. As much as I love Alimentation Couche-Tard, this company has little to no switching costs compared to other convenience stores and gas stations.

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Network effect

Have you ever looked at a business and thought, “Wow, it’s so easy for this company to make money because everybody uses their product or service”. The network effect grows as the company offers more value to its customers as that customer base grows. Ironically, DSR benefits from that network effect as the more members we have, the more financial means we have to improve the platform. As the platform improves, more investors want to become members, and so on.

The best example in the dividend world is probably Visa and Mastercard who have built a duopoly. At the beginning, not all merchants accepted credit cards or not all of them. The more people used Visa and Mastercard, the more merchants started to accept them. Fast forward to today, V and MA are processing billions of transactions per year. The best part is they earn a fee for each of those transactions. Try to create your own credit card company today and attempt to get merchants to accept your card, and you will fully understand the benefit of having developed that network.

Outside of the dividend world two great examples exist. The more people use Google for their research, the more Google gets data from those search efforts and then works to improve future search results (that’s debatable sometimes!) and can also sell ads. As search results become better, even more people use it. Facebook (Meta that is now paying a dividend!) also benefits from the network effect. Who would go on Facebook to share their stories or to reach out to others if most of their friends and family aren’t on the platform?

There are three types of network effects:

- **One-sided network effects**: This relates to a single group of users of the platform. The more users on a platform, the stronger the growth of the company, the more value it provides, and the more new users come. Meta and Google would fall in this category.
- **Two-sided network effects**: This relates to two groups of users of the platform. The more sellers you have on a platform, the more choice you have, and the more buyers will come and then this will attract more sellers. There is a close relationship between the number of people looking for a place to rent and the number of people renting their place on Airbnb. Visa and Mastercard would fall into this category.
- **Complementary network effects**: This relates to separate companies mutually benefitting from the growth of related companies. For example, the more Apple grows its iPhone sales, the more Broadcom will sell RF filters and the more Qualcomm will sell 4G and 5G wireless chips.

Companies primarily in commodity sectors or those offering undifferentiated products, such as basic materials, some traditional manufacturing, and certain energy companies, might not benefit significantly from network effects. For example, if everybody wants to buy gold, gold miners will just sell more of it but they will not benefit from a moat protecting their business.

These businesses compete on price and operational efficiency rather than the increasing value that additional users or participants would bring to a platform or service.

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Intangible assets / Brand identity

This one is probably the easiest one to explain, but sometimes the hardest one to put a number on. I often use the word "iconic brand" which relates to the brands that are known by everyone. Coca-Cola, Nike, Starbucks, Disney, Apple, Kirkland (Costco), McDonald's, etc.

When someone wants to open a burger joint, he knows that opening a McDonald's will bring customers instantly due to the strong brand identity. However, a strong brand doesn't necessarily mean that you will be highly profitable. Disney has run into its fair share of problems as of late even though everybody knows about Mickey Mouse and the Avengers.

On top of a strong brand, a company can benefit from other types of intangible assets. Those are non-physical assets that bring value to a company but lack a physical presence. There are several types of intangible assets:

- **Intellectual Property (IP)**: This relates to the creation of the mind that has commercial value and that is protected by law. Patents, trademarks, copyrights, and trade secrets are all part of a company's IP. Coca-Cola, on top of its iconic brand, also enjoys the trade secret of making its famous beverage. Eli Lilly and Novo Nordisk can sell diabetes drugs protected by patents which assures that no one can make the same drug formulation as long as the patent is valid.

- **Brand Equity**: I just provided a long list of iconic brands that enjoy strong pricing power and generate healthy margins because of the iconic nature of their brand.

- **Customer Relationships**: This one translates into high customer satisfaction which should drive repeat business and word-of-mouth growth. It's not always easy to scale customer relationships across a wide network, but I feel that most Starbucks offer a better service than when I get a coffee at McDonald's or Tim Hortons (Restaurant Brands).

- **Proprietary Technology**: this can include software systems, algorithms, innovative manufacturing processes, or specialized tools. Texas Instruments' analog chip manufacturing process or ASML photolithography systems are good examples of this.

As intangible assets are hard to identify and then quantify, they can also disappear as fast as they come around. Before Michael Jordan signed with Nike, he wanted to sign with Converse, the shoe leader in basketball back then. Nike had to load the truck with advantages, benefits, and royalties to get Jordan on board. Fast forward to today, and Converse's value is $2.4B which represents only 5% of its parent company… Nike!

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Cost advantage

Companies with a cost advantage are companies able to produce goods or services at a cheaper price than its competitors. Think of Costco which positions itself as the largest customer of its many suppliers to gain negotiating power and in turn offer the lowest prices to its customers.

The cost advantage can be used through two different strategies:

- **Crush competition with low price:** For many, the easiest way to gain market share is to sell at a cheaper price than their competitors. Companies that can produce the same goods or services at a lower cost can undercut competition and lower their respective prices.
- **Sell at the same price, but make a lot more profit:** When the business model permits, some companies (see CNQ examples below) will sell at the same price as their competitors. The advantage is then found in the higher margin generated with their lower operations cost. They then become money making machines.

Walmart is the perfect example of a cost-advantaged business. As a dominant retailer and among the largest grocers in the U.S., WMT built its entire business model around offering “low prices every day”. Walmart is known to “squeeze” every penny from its suppliers in order to offer the cheapest price possible to customers and crush most competitors. When you go to Walmart, you don’t go there for their exceptional customer service, but rather to pay as low a price as possible for everyday goods.

In Canada, you can think of railroad operators such as Canadian National Railway and Canadia Pacific. Railroads are known to be one of the least costly (and in many cases the cheapest) means of transportation across land. Since Canada and the U.S. are amongst the largest countries in the world, CNR and CPKC are quite popular. Railroads are less flexible than trucks, but they are surely the lowest cost source of transport.

You can also find many companies in the commodity space (materials and energy) that benefit from a strong cost advantage. One of the most common examples is Canadian Natural Resources. CNQ benefits from long life low declines in their reserves and asset base. The company can produce oil and natural gas at an extremely low cost. This enables CNQ to ramp up production when prices are up (and boost their margins) and slow down production during down cycles (while remaining highly profitable). In other words, its cost advantage makes CNQ a cash flow-making machine.

The cost advantage could be deadly. Amazon founder, Jeff Bezos, once said “Your margin is my opportunity”. While many companies (such as Barnes & Noble) thought they were doing well, and no competition could kill them. Amazon came around with a different business model focused on building a strong cost advantage. Barnes & Noble barely survived, but it’s not a flourishing business anymore.

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Efficient scale

Wouldn't it be nice if you could find a business with little competition? Efficient scale benefits companies operating in a market that only supports one or a few competitors. Think utility companies, airports, telecommunications, railroads, and pipelines. In Canada, we could almost include Banks too since the Big 6 operate in an oligopoly.

Once the demand is filled by the existing companies and the market's growth is limited, there is little incentive for new competitors to enter that market. We can all remember that Verizon once thought of entering the Canadian market but quickly decided otherwise. Rogers, Telus, and BCE handle 90% of the wireless industry in this country.

Railroads and pipelines have the same advantage: there is no point in building a new railroad or pipeline right beside an existing one in order to compete. The cost of construction of another transport route would be prohibitive and could drive both the old and new routes to lose money.

As you can imagine, it's a rare type of moat that is not always durable. Governments tend to dislike such business models as the lack of competition would likely drive prices higher. Therefore, another aspect of economic moats is how long they will last. Some advantages could quickly disappear while others may remain for a long period. Morningstar has classified moats into three categories:

Wide moat (20+ years)

These are companies with long-lasting competitive advantages. From examples mentioned in this newsletter, you can find companies like Apple, Canadian National Railroad, and Canadian Natural Resources.

Narrow moat (10 years)

Companies with a clear competitive advantage today that may not continue in the future. This is where your interpretation could come into play. For example, Morningstar gives a "narrow moat" rating to Enbridge's business. While ENB's contracts are usually over 20 years, Morningstar mentions *"we are far more uncertain around long-term demand in the latter stages of our forecast due to the high carbon emissions intensity associated with the full cycle of oil sands production, which is a primary source for Enbridge's assets".*

No moat

A company with no clear competitive advantage or one that they think will quickly dissipate has no moat.

Why is it important in your analysis you may ask? Because it will determine how much time you have to generate profit from your investment:

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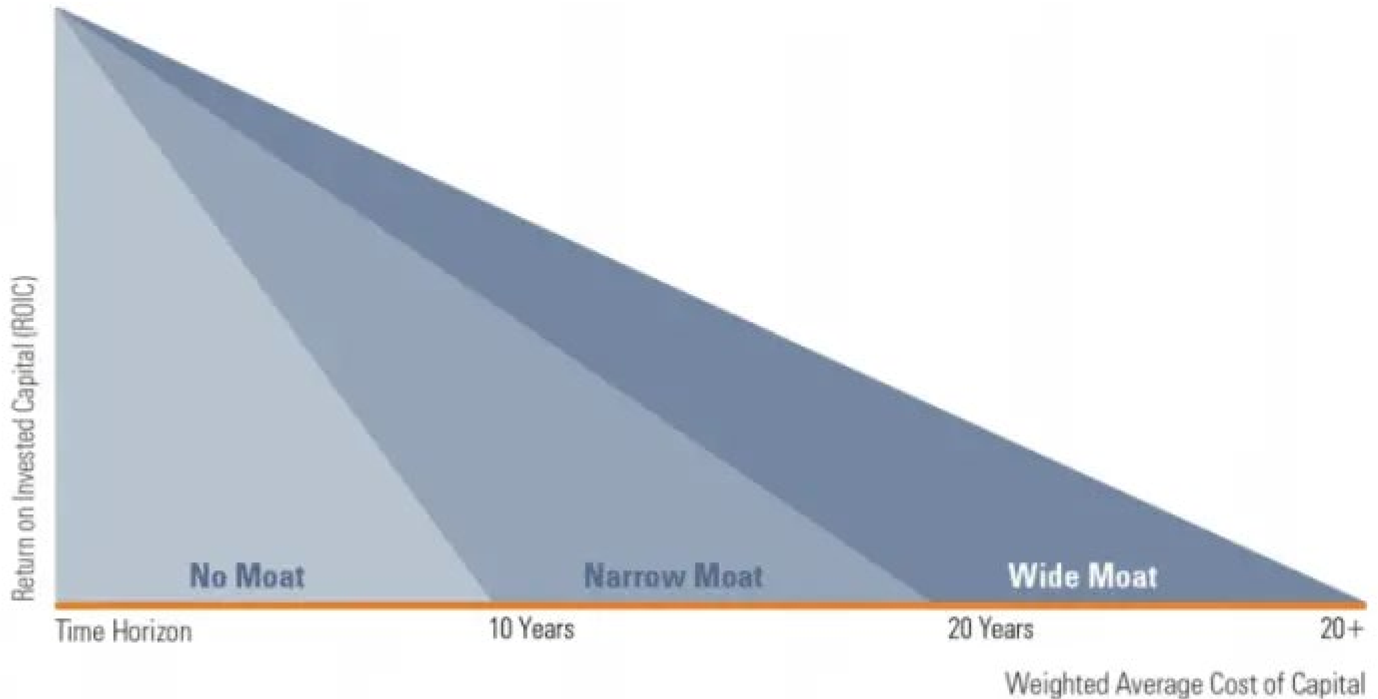

Morningstar explains its methodology in this document. When you invest in a company with a wide moat, you have a longer time horizon to make money since the business you invest in will benefit from competitive advantages for a very long period.

On the other hand, a company that has no moat (think of Peloton) has little time to generate a maximum profit before competitors see the opportunity and enter the market. Since there is no protection, the castle can easily be taken by force.

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IS THE ECONOMIC MOAT EVERYTHING YOU NEED?

Unfortunately, no. Some companies don't have a great moat and are still amazing. Some other companies show a strong moat and end up showing terrible results. Here are a few examples:

- **AT&T (T)** has a narrow moat according to Morningstar but has shown terrible returns over the past 10 years (32% total return).
- **Equinix (EQIX)** also has a narrow moat rating but generated 485% in total return during the same period.
- **Great-West Lifeco (GWO.TO)** has no moat and generated a 121% total return.

Beauty is in the eye of the beholder

After reading several economic moat ratings by Morningstar, I can say that I don't always agree with their analysis. I guess we could make an interesting comparison with my "core holding, educated guess and falling knife/speculative play" classifications.

Since we assess what could happen in the future, your result could be different than Morningstar's or mine. For that reason, I will not include a "moat rating" at DSR but rather keep this nomenclature in mind when I write my investment thesis.

FINAL THOUGHT

I like the concept of economic moats. I think it helps define a strong investment thesis and it helps investors figure out if the dividend triangle will continue to grow based on the company's competitive advantages. If you can't find those advantages, those moats, it's probably because the company is riding on short-term hype.

Thriving businesses will have many things in common. You can include a strong dividend triangle along with a set of moats protecting the business.

Next time you review a company's dividend triangle, ask yourself if the business has a strong economic moat that will enable it to maintain its dividend triangle.

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