
CHAPTER 1

Business models: investing
in companies with strong
competitive advantage

What is a business model?

'Competitive advantage is based not on doing what others already do well but on doing what others cannot do as well.'

John Kay, economist.

A business model describes a company's operations, including all of its components, functions and processes, which result in costs for itself and value for the customer. Therefore, it is how the engine of the business actually works. The objective is to have low cost and high value and thus maximise profit. All attractive business models will have some magical secret or 'pixie dust' and the investor's task is to find it. More importantly, it is to discover the pixie dust that others cannot see. A company's strategy of combining the four factors of production, namely land, labour, capital and enterprise, will determine its unique business model, the superiority of which over the competition is a crucial determinant of sustainable, competitive advantage. The ability of a company to achieve this is largely determined by the competitive advantage of the sector, which is discussed in chapters 2 and 4.

Business models are not a new phenomenon. They have existed since time immemorial, whether it was the success of the Roman Empire, Christopher Columbus' discovery of the New World or the advent of the industrial revolution. For example, an excellent and simple business model was the monasteries in Britain. They usually received a free grant of land from a pious king and set up shop. The land was expanded by gifts from local landowners, such as knights, who had an eye on the afterlife. It was grazed by sheep that added great value just by eating what nature provided free. All that was needed was to cut white gold off their backs. This enabled fabulous monasteries to be built and furthered their expansion and power. This virtuous circle continued for centuries until eventually these tycoons owned two million acres or a fifth of all cultivated land. There were 600 establishments with 40,000 people, enjoying a mouth-watering income, given their strong competitive advantage. Then Henry VIII and rapacious politicians decided to confiscate them and sell the assets to private individuals in an early form of privatisation.

Why are business models so important?

An attractive business model (also called a franchise by some people, like Warren Buffett) is of crucial importance in choosing winners. It can only be achieved in two ways, both of which management must comprehend and sustain:

a. Low cost

If a company has the same costs as competitors, then it will have the same profits. Superior profits will, however, be earned if costs are lower and bite less into revenues. Therefore, the strategy is to have the lowest-cost business model compared to the competition. This can be done in a variety of different ways, such as by being number one in the sector, having excellent management, a modest head office, power over suppliers, and superior raw materials, buying skills, technology and quality control. There are trade-offs, so, for example, cost savings on quality of inputs may lead to more product rejects, thus increasing overall cost. Value is added to the customer if his costs are lowered and this can be achieved through a variety of means, such as increased reliability, being easier to use and therefore needing less training, an extended free warranty or insurance, cheap financing and just-in-time delivery.

b. Different

A company should strive to do something different from the competitors in its 'value chain', which is all the activities and costs in the entire production process from the initial receipt of inputs, then processing and resulting in the final output. If it does the same as competitors, then customers have no reason to prefer it and it will earn the same, rather than superior, profits. The value the company captures from differentiation depends on the price charged and profit margin earned, rather than the cost borne by the customer. Thus, if a company succeeds in erecting high barriers to entry then it could charge a premium price and earn a high profit margin. However, the cost borne by the customer would be higher than if the barriers did not exist.

Companies often focus on creating differentiation in their product, but it can be done anywhere in the value chain, which encompasses competitors, customers, economics, management and suppliers. However, product differentiation is singled out because of its prime importance to the customer. It must be valuable to him, either by lowering his cost and/or increasing the utility of the product. Either way, if it offers better value it will be bought instead of the competition's product. The differentiation must be both real and understood by the customer. For example, there could be a wonderful product but the customer may be oblivious of its benefits. There are trade-offs, so, for example, a firm may focus on improving reliability but also cut back on the length of the guarantee. Consequently, the product is better but the customer may be unaware of this and choose a substitute with a longer guarantee.

Sources of product differentiation include advertising, customer care, management, delivery time, guarantee, quality, reliability, reputation and service. One example of a differentiated product is the BBC. It does not have irritating advertisements and has two terrestrial channels so it can readily cater for minority audiences.

Companies that do something different in their value chain are attractive investments and are contrasted with commodity products and commodity-type businesses. Commodity products, such as sugar and steel, are indistinguishable from one another and so lack differentiation. Price is the single most important factor determining a purchase and competition is intense. The low-cost producer triumphs and the quality of management is crucial. Companies can have commodity-type businesses where little value is added and price competition is paramount, such as box-shifting distributors. Such activities are unattractive and should be avoided as they have poor competitive advantage. The future belongs to those companies that have products containing less material and more thought. This combination is often difficult but it frustrates the competition and is more highly prized by customers.

The holy grail

'When I was young I used to think that wealth and power would bring me happiness. I was right.'

Gahan Wilson, cartoonist.

Competitive advantage stems from low cost and/or differentiation. The holy grail is for the extra cost of being different to be less than the premium price charged to customers. If the extra cost is higher than the premium price, then profits will be less than those of competitors. For example, a restaurant chef may want to use top quality ingredients to produce superb food but the extra cost may exceed the higher price charged, thus leading to lower profits.

There can be trade-offs between lower costs and being different. A bar may serve cheap, unbranded drinks to lower costs but customers might reject the taste or image, thus reducing the ability of the firm to differentiate itself. Firms should concentrate on finding out what really matters to customers and satisfy those wants that cost little or nothing to provide. Thus, a software company may discover that customers really want technical support and this could be satisfied by a trouble-shooting page on the internet at minimal cost, rather than a telephone support centre.

All-weather shares not share price killers

The combination of low cost and motivated customers choosing to buy from a company, rather than a competitor, and at a premium price means it will have strong competitive advantage. This results in superior, sustainable and growing profits. The operating risk of the company will also tend to be low and the predictability of profits should be greatly enhanced. The strong control over revenues means that the share should be resilient throughout the economic cycle and, as such, will be more suitable for 'all-weather' not just 'fair-weather' stock markets. This minimises the chance of profit warnings, which are share price killers. Companies with no competitive advantage are hammered in a bear market, whereas those with strong competitive advantage tend to be de-rated much less and are quick to recover. Note that competitive advantage stems from what companies do, rather than from such 'advantages' as being a 'gorilla' (blue chip company) or having a leading market share. This is a common misconception, although these advantages could be important if the companies had a low-cost or differentiated business model.

A strong business model also means that if the share price weakens then an investor should be confident that the setback is likely to be temporary because the company is sound. He will be less worried about selling at the first whiff of a falling share price. This is because buyers will be tempted back and thus push up the low share price. It is also a buying opportunity for contrarians, who are investors that do the opposite of what most investors are doing at any particular time. Some companies have better business models than others within a sector, just as some sectors have greater competitive advantage than others. Both are subject to constant change and this can happen swiftly. The mission is to find companies with excellent business models in the best sectors, which are likely to be comprised of many profitable companies that have low costs and/or different activities that add value to the customer. However, there can be profitable companies in unattractive sectors and vice versa.

64 company business models

Sixty-four company business models are now examined in detail and, although this list is not exhaustive, it is designed to cover the main points. Six factors determine the strength of a business model that gives a company its competitive advantage, which is achieved through low cost or differentiation. These factors are: having good economics, management and products, plus power over customers, competitors and suppliers. This format is also used to analyse the

competitive advantage of sectors in the next chapter. A summary is provided in the table below, for ease of reference, that can be a useful checklist for investors to evaluate any company. Some companies feature several times and the aim is for candidates to score well in numerous business models, not just one or two. A worked example, Radstone Technology, illustrates this point in appendix 1.

Business models, prices and valuations are in a constant state of change, given the fluctuations in the economy and unfolding events. Therefore, examples of companies and sectors given are illustrations of the points being made and are not recommendations. Indeed, it is the test of a company that its business model does change over the medium term, which is about five years. This ensures it moves to where the profit zone has shifted. Otherwise, it will become marooned in a profitless zone as competitors encroach. For example, it may be necessary to enter a new sector, as South Staffordshire did when it moved from the water to the support services sector.

All business models are not equal

'Look for companies that have high returns on capital, strong balance sheets, sustainable competitive advantages and shareholder-oriented management.'

Joe Mansueto, founder of investment information provider Morningstar.

All business models are not equal, as some are more powerful than others. Consequently, the company business models table overleaf scores them on a rating of 1, being the highest, to 5, being the lowest. These ratings are inevitably subjective and some could arguably be moved up or down to an extent but a top rated business model would unlikely to be relegated to the bottom or vice versa.

Company business models table

| Company business models | Competitive advantage (1 highest, 5 lowest) | Illustrations |
|---|--|--|
| 1. Competitors 1a. Barriers to entry and exit 1b. Being number one or two in the sector 1c. First and late mover advantage 1d. Lack of competition 1e. Moats 1f. Threat of substitute products | 2 2 2 2 1 2 | Radstone Technology, Michael Page Royal Bank of Scotland, Coca-Cola Ford, McDonald's BAA, British Airways Berkshire Hathaway, Ratner Microsoft, ARM |
| 2. Customers 2a. Choosing customers 2b. Cross-selling 2c. Global reach 2d. Long-term contracts 2e. Niche player 2f. Not dependent on a few customers 2g. Owning the customer 2h. Payments in advance 2i. Recurring contacts 2j. Recurring revenues 2k. Selling directly 2l. Stature of customers | 2 2 3 1 2 2 2 4 3 1 3 3 | Chorion, Barclays Bank Alliance & Leicester, Ford Accounting firms, HSBC Umeco, McAlpine Plasmon, Merchant Retail Interlink Foods, CRC Tesco, Telecom plus Berkshire Hathaway, RAC Hit Entertainment, Belhaven Eurocopy, South Staffordshire Direct Line, Dell KPMG, Watermark |
| 3. Economics of the company 3a. Appropriate gearing 3b. Asset-backed shares | 4 4 | Gallaher, British Sky Broadcasting Hardys & Hansons, Lloyds TSB |

| | | |
|--|---|---|
| 3c. Bolt-on acquisitions | 3 | BAE Systems, Eurocopy |
| 3d. Bull market acquisitions | 4 | Marconi, Vodafone |
| 3e. Changing sector and FTSE index | 5 | South Staffordshire, AOL Time Warner |
| 3f. Economies of scale | 2 | Stagecoach, Belhaven |
| 3g. Feed off another's growth | 2 | Aero Inventory, Biotrace |
| 3h. Good institutional and directors' shareholdings | 4 | Umeco, Merchant Retail |
| 3i. Headroom to grow | 2 | JD Wetherspoon, Plasmon |
| 3j. High dividends | 2 | Friends Provident, Broadcastle |
| 3k. KISS principle | 3 | Mears, ICAP |
| 3l. Low break-even point | 2 | Microsoft, General Motors |
| 3m. One-off action provides revenue for years | 2 | RJR Nabisco, Albemarle & Bond |
| 3n. Public perception | 4 | Shell, Virgin |
| 3o. Recreate the company | 2 | General Electric, Hornby |
| 3p. Strong cash flow | 3 | Barratt Developments, Telecom plus |
| 4. Management | | |
| 4a. Auditors, opinions and policies | 3 | Lloyds TSB, Berkshire Hathaway |
| 4b. Changes in professional advisors | 4 | BCCI, Arthur Andersen |
| 4c. Conflicts of interest | 2 | Polly Peck, Versailles |
| 4d. Corporate governance | 2 | Robert Maxwell, WorldCom |
| 4e. Excellent, honest, well-motivated management | 2 | BP, Umeco |
| 4f. Follow the man when a talented director moves on | 4 | Carpetright, Aero Inventory |
| 4g. Modest head office | 4 | Boo.com, British Airways |
| 4h. Past success | 3 | Morrisons Supermarkets, NSB Retail Systems |
| 4i. Shareholder values | 2 | Racal, Hardys & Hansons |
| 4j. Something new | 2 | Celsis, Stagecoach |
| 5. Products | | |
| 5a. Brand loyalty rather than a well-known name | 2 | Nokia, Lastminute.com |
| 5b. Dumbing down of products creates niche market | 4 | ITV, Tesco |

| | | |
|--|---|--|
| 5c. Focus on competitive advantage | 1 | Hanson, Scottish & Newcastle |
| 5d. Growth in profits for a decade or more | 3 | Associated British Ports, Provident Financial |
| 5e. Launching new products | 2 | Boeing, Diageo |
| 5f. Lean manufacturing | 3 | Toyota, Hewlett Packard |
| 5g. Like-for-like sales growth | 3 | Pizza Express, Tesco |
| 5h. Low depreciation and amortisation | 3 | Tomkins, Telecom plus |
| 5i. Maximising profit from different revenue streams | 2 | Dana Petroleum, Faroe Petroleum |
| 5j. Moving up the value chain | 2 | Shell, General Electric |
| 5k. Owning the standard | 1 | Microsoft, JVC |
| 5l. Product differentiation | 1 | Halifax, Tesco |
| 5m. Rolling out a consumer chain | 3 | JD Wetherspoon, Harry Ramsden's |
| 5n. Secondary profit zones | 3 | Avesco, Chorion |
| 5o. Superior product or service | 2 | GlaxoSmithKline, Sellotape |
| 5p. Supported by a famous personality | 5 | Planet Hollywood, Pepsi |
| 5q. Unique selling point | 2 | Gateway, Ford |
| 6. Suppliers | | |
| 6a. Bargaining power over suppliers | 1 | Luminar, Premier Direct |
| 6b. Buying opportunistically | 4 | Merchant Retail, Lastminute.com |
| 6c. Not dependent on a few suppliers | 2 | De Beers, BOC |

The competitive advantage points from 1 to 5 above are awarded according to the business model's power to achieve low cost and/or differentiate itself from the competition. Above all, it is crucial for a company to be able to control its revenue streams. Consequently, those that score the maximum 1 are: moats, long-term contracts, recurring revenues, focus on competitive advantage, owning the standard, product differentiation and bargaining power over suppliers. Medium scorers include selling directly and lean manufacturing. At the bottom of the pile are those that do not have a major impact on revenue streams or have limited applicability, such as supported by a famous personality and changing sector and index. This same scoring is used for the sector table in the next chapter and includes business models to avoid.

As noted above, a company should have multiple business models and be scoring well throughout to be highly-rated, as this strengthens their overall competitive advantage. For example, Radstone Technology has erected barriers to entry, put a moat around its business and does not have intense competition. JVC owns the VHS industry standard and is also a brand. Diageo is five times bigger than the number two gorilla in beverages, SABMiller, and thus dominates the sector, owns the customer and has some of the best brands in the world. Microsoft owns the standard, it piggybacks on the work and growth of others and is a brand.

1. Competitors

'I read the annual report of the company I'm looking at and I read the annual reports of competitors – that is the main source of material.'

Warren Buffett, CEO of Berkshire Hathaway.

Companies with sound business models will be able to compete. This section examines some ways that this can be achieved and is also a guide to analysing the threat from competitors.

1a. Barriers to entry and exit: competitive advantage rated 2

A company's business model is attractive if it has erected high barriers to entry. An example is Microsoft which has largely locked out the competition by owning the industry standard in computer operating systems with its Windows product. The barrier stops new companies entering the market, which would otherwise increase capacity and put pressure on prices. Avoid companies that seek to diversify into sectors where such barriers exist, as it is likely to be an uphill

struggle. There are many forms of barriers to entry. A classic barrier is the pyramid, where companies have cheap and cheerful products at the base and high margin products at the top. The base is protected by a firewall of low prices and brands to stop competition from attacking it and working their way up the pyramid to the top where the pot of gold lies. Japanese car makers penetrated such a barrier in Western markets by starting with building British motorbikes and cars under licence and steadily moving up the value chain to compete in the luxury market with brands like Lexus. Sheer size can be an important barrier, such as in steel and mining which need large economies of scale to operate efficiently. Life insurance companies and banks need national coverage with the attendant branches and marketing organisation. The cost of complying with the formidable regulations is significant with HSBC, for example, having to contend with over 350 bodies worldwide. Establishing a brand name may be very difficult in a crowded market where consumers are reassured by an existing brand they trust.

Licences are effective in stopping new entrants. For instance, the number of black cabs in London or commercial television stations is controlled by the authorities. Know-how and proprietary products provide effective barriers, as in the case of Radstone Technology with its made-to-order, rugged computer boards. Large international professional firms, such as accountants and lawyers, win multinational accounts because they provide worldwide service, which is not feasible with smaller competitors who are locked out of the bidding. A professional recruitment company like Michael Page can often be the first port of call, as it has a leading database of candidates thus offering more choice. The barrier could be location, as is the case with the few available sites for supermarkets and airports.

The barriers to entry may be low, on the other hand, but the reaction of existing players may still be effective in preventing new entrants from establishing a foothold, for example, by threatening a price war. The existing players may dominate the available distribution channels, such as in newspapers, with the likes of John Menzies and WHSmith. Another illustration is the restriction on the location of dispensing pharmacies near doctors' surgeries, where the demand for fulfilling subscriptions is high. A new entrant is locked out by being unable to obtain a site. There are low barriers to entry in telecommunications, thanks to the regulator, and a myriad of both large and small resellers provide ferocious competition. Providing office plants has low barriers to entry but Rentokil Initial has been adept at winning new customers before some of the competition was even aware of the opportunity.

Conversely, an attractive company should have low exit barriers so it can easily leave the sector should the need arise. For example, a struggling holiday operator can easily leave that sector and cut its losses. By contrast, heavy industry, such as aluminium, coal or nuclear power, may face crippling exit costs and it may be cheaper to carry on. This creates a profitless zone for all players.

1b. Being number one or two in the sector: competitive advantage rated 2

'We are watching the dinosaurs die but we don't know what will take their place.'

Lester Thurow, MIT economist.

Being number one or two in the sector implies that the company has achieved competitive advantage to reach this position, examples being BP and Royal Bank of Scotland. It can be particularly attractive if the number one company is much bigger than the number two, say by a factor of five times, as it can then reign supreme in the sector. Coca-Cola, for example, has half of the world soft drink market whereas Pepsi has a fifth. The advantages of being the top dog include: economies of scale; tying up suppliers; dominating distribution channels; superior know-how; advertising; and brands. These can be important sources of low cost and differentiation, the two essential ingredients of competitive advantage. However, size is not everything, and gorillas are a list of yesterday's winners rather than of tomorrow's. Many with dominant market share face problems, such as intense competition and adding little value. Consequently, profits have been eroding, at the likes of Invensys, BT and ICI. Market share does not translate into a successful business model unless the company has competitive advantage, like Diageo and Tesco who add value and possess strong brands. The single-minded pursuit of market share is a dazzling but flawed strategy for many companies, such as Vodafone, which has been a key ingredient in curbing net profit. It is crucial to think of customers and profit first and then determine an appropriate business model, rather than have preset ideas and strategy and hope that customers and profits emerge at the end.

The problem with a gorilla is what to do next. Its big disadvantage is its very size, because it may not be able to grow by much more than that of the overall market. The recourse is often to grow via acquisitions, but studies have shown they generally destroy shareholder value. Blue chip companies' shares tend to be overpriced and bought because they are well known. Although they seem to offer the allure of stability, they can fall dramatically from grace, like British Energy, ICI, Invensys, Marks & Spencer, Railtrack and Royal & Sun Alliance, and are no

panacea for protecting your wealth. Further, once they are troubled, they are like an oil tanker and take considerable time and money to turn around, with no guarantee of success. High exceptional costs can be expected during such restructurings and these destroy shareholders' wealth.

A gorilla can dominate the market by setting prices and standards, launching new products and controlling the entrance and exit of competitors. A second division player may be weak and takes what crumbs it can from the table if it lacks strong competitive advantage. It may have to accept the ruling price set by the gorilla if it is unable to lower its price to gain new customers, either for fear of retaliation by the gorilla or because production constraints inhibit increasing output. Examples of well-known companies that are gorillas include Microsoft, Vodafone, HSBC, Sony and Toyota. Second division companies include mmO2, Bradford & Bingley and Fiat. Buying shares in a company like Microsoft or Vodafone when they are small but have the tenacity and competitive advantage to become the gorilla can be one of the most rewarding plays in the stock market. A sensible strategy is to sell when growth tails off and look for the next upstart. One way to spot companies making this transition is to look at those quickly moving up through the ranks from one FTSE index to the next. These movers are published quarterly and this information is widely available. The main FTSE indices are AIM, Fledgling, Small Cap, mid 250 and 100.

Gorillas are able to attract the top talent, so the management is usually the best around but often excessively paid, judging by the wrath expressed by shareholders. Moreover, they are usually run by 'employee' directors on a salary rather than being run with an 'owner's eye' by founders with a substantial stake in the business. Employee directors can also damage the company by empire building using shareholders' money. They can have conflicts of interest due to share options, which encourage 'accounting for growth' and maximising profit in the short-term rather than the long-term.

1c. First and late mover advantage: competitive advantage rated 2

'If you gave me \$100 billion and said take away the soft drink leadership from Coca-Cola, I'd give it back to you and say it can't be done.'

Warren Buffett

To be the first mover in a new sector can be a great advantage for a company because it can enjoy high, initial profits for the first few years due to its power over the choice of sites, personnel, partners, sector standards, quality of product,

pricing, distribution channels, brands, etc. There have been many examples of this, such as railways, mining, shipping, canals and textiles in the past, and technology and telecommunications in the present. It is more difficult for new entrants to gain market share after first movers are established, whose steep learning curves can be a source of competitive advantage as experience often leads to lower costs.

If the market is growing rapidly then the first mover may not be able to keep up with demand and, for the sake of the health of the sector, may not be too perturbed by new entrants. Usually, however, it will fight to maintain its dominance. Coca-Cola, Ford and McDonald's are instances of companies with first mover advantage that are still dominant in their sectors. Microsoft was an early mover in operating systems and triumphed over IBM, which was largely the latter's own fault as it did not insist on owning the rights to the software. In the UK, first mover examples include Shell and Lloyds TSB.

First mover advantage may be from a new process in an established sector. An example is Telecom plus, with its one database controlling all the services sold to customers and presenting just one bill. This is very hard for the gorillas to replicate because they have separate and cumbersome computer systems. The Japanese have been keen to grab first mover advantage and rush out a rudimentary prototype of a new product, such as automatic cameras and video, and refine them with later versions, as has Microsoft.

However, there can be advantages in being a late mover. This tends to happen when the new sector is very risky and costly. Many mistakes can be made along the way and a late entrant can avoid them, benefiting from the efforts of the pioneers in establishing the work force, technology and infrastructure, and buying their assets in a fire sale. A classic example is the debris of TMT, which was the technology, media and telecommunications mania, after its collapse in 2000, with companies bombed out and billions wasted. For example, BT was forced to sell off some good businesses cheaply, such as its Yellow Pages, to prop up its battered balance sheet.

1d. Lack of competition: competitive advantage rated 2

Companies are more attractive if they lack competition, a position gained through low cost and/or differentiation. Radstone Technology makes rugged computer products for use in military hardware, such as planes, and does not have intense competition. When it comes to protecting high value assets and operators' lives, saving a few pounds on components is not high on the priority list. Quality and

delivery are more important so customers are not price sensitive. Its competitive advantage is based on a strongly differentiated, ‘must-have’ product that is very cost effective. The sales contracts are long-term, which secures revenue for years, and helps to shut out the competition. Albemarle & Bond has a chain of 53 pawnshops with a strongly differentiated product. Almost all its customers live within two miles of each outlet, allowing it to dominate the area and achieve a high level of repeat business. Since physical goods are handed over the counter, competitors’ other normal channels to market, such as post or phone, are not a threat. This controlled customer base is cross-sold ancillary products like unsecured loans and pay day advances.

Supermarkets and retailers have intense price competition. Their ‘known value items’, such as milk and bread, are largely commodity products and are easy for price-sensitive consumers to judge. The competition in media is intense, as people are usually short of time, inundated with supply and have many compelling, alternative claims on their disposable income, such as mobile phones and cars. This makes life hard for newspapers, books, television, music and cinemas. The fiercest competition may increasingly be from the internet, where price comparison is but a click away. Some products are free, such as music and films which are swapped by consumers on the internet, and it is difficult for companies to combat this threat to their revenues. Holiday companies regularly have to discount prices to tempt customers, as over-capacity is often prevalent and consumers wait for last minute bargains.

Swap an investment in a company facing strong competition for one that is shielded from it. Incumbent gorilla utility companies, like BT and British Gas, used to have an easy life. Then their sectors were opened to a multitude of competitors. They relied on customer inertia rather than keen pricing to stem the lost sales but it is a strategy of death by a thousand cuts. A nimble, fast growing company like Telecom plus is a more attractive prospect than BT. British Airways is a full cost carrier and is under tremendous pressure from fast growing, no frills airlines like Ryanair and easyJet. Their business models are similar to the very profitable Southwest Airlines that pioneered low-cost airlines in the US. Neither was British Airways successful in trying to emulate the competition by starting its own low-cost carrier. BAA, the national airport operator, may have competition from regional airports but they are small and in remote locations. It earns low risk landing fees and makes money from its monopoly retail outlets. BAA faces far less competition than British Airways and is more attractive on this score.

1e. Moats: competitive advantage rated 1

'Wonderful castles, surrounded by deep, dangerous moats where the leader inside is an honest and decent person. Preferably, the castle gets its strength from the genius inside; the moat is permanent and acts as a powerful deterrent to those considering an attack; and inside, the leader makes gold but doesn't keep it all for himself. We like great companies with dominant positions, whose franchise is hard to duplicate and has tremendous staying power.'

Warren Buffett

A company with a moat around the business can powerfully ward off competitors and has the highest competitive advantage rating of 1. Sometimes the moats are benign and filled with water, whereas others are infested with sharks. One example is Microsoft, which will leave players alone in some areas or collaborate with them, if it so chooses, but will fight fiercely if anyone tries to cross or even approach its moat. Evidence for this was its demolition of Netscape, which has been the subject of court action, as outlined in appendix 2. Warren Buffett's objective is to widen and deepen the moat round Berkshire Hathaway every year and he reports his progress, or otherwise, in achieving this goal. By any measure, he has been successful.

One classic way to build a moat is to take out the competition by various means, examples being: acquisition (banks and insurance companies); price wars (newspapers); and patents (pharmaceutical companies). Customers themselves can strengthen the company's moat by increasing their loyalty, turning them from being one-off, or 'transactional', into long-term customers. Also, they can shun the competitors, examples being the protests against Shell in Germany and fast food in France. Radstone Technology's moat is strengthened by sending its technicians to the customer's site to develop the rugged computer products. The technicians can then inform them of new products and are in pole position to make sales, compared to little known competitors who have to resort to banging on doors. Microsoft shares its computer codes with favoured partners, including Hewlett Packard, Intel and Logitech. This minimises compatibility problems, for example, and gives them an advantage over competitors.

Moats can be made by the ineptitude of competitors, such as that of British car manufacturers in their largely self-inflicted death throes in the 1970s, due to shoddy products and strikes. This handed success to the Japanese and Germans, whose differentiated cars were well made by a motivated workforce and offered value for money. Another example was British Airways' 'dirty tricks' campaign

against Virgin. It was the height of foolishness to alienate its customers, given that British Airways did not compete on price but heavily relied on their loyalty. It compounded this error with its infamous decision to replace the union flag on its tail wings with what looked like graffiti, incurring the public ire of Margaret Thatcher. Gerald Ratner made a famous speech belittling the jewellery sold in his jewellery chain and said 'what we sell is crap'. It was a spectacular own goal that should have had its competitors rubbing their hands with glee.

1f. Threat of substitute products: competitive advantage rated 2

Companies have strong business models that suffer little from the threat of substitute products, one example being superior plastic corks supplanting wood corks in wine bottles. A substitute is a potential impediment to the quantity and quality of output and can cap the price a company can charge, given the fear that the customer can shop elsewhere. Remove that fear and the company can do pretty much what it likes. An extreme case was the East German Trabant car that remained unaltered in its appalling state for decades, as every one was sold for a high price and had a long waiting list. Microsoft's Windows operating system is routinely pre-installed in personal computers and has a 90% market share. There are operating system substitutes from the likes of IBM, Macintosh and Linux, but the consumer lacks knowledge and choice. He does know Microsoft, however, and is very wary about straying from the well-trodden path with such a complicated product. Consequently, Microsoft has an immensely powerful, monopolistic competitive advantage.

The threat of substitution can be low because of a company's superior product or control over the customer. For example, banks and stockbrokers control customers who are described as being 'sticky' because they wish to avoid the hassle or cost of changing the account to another provider, so accept the product on offer. Another reason may be due to customer ignorance. A tourist chooses a busy restaurant in a town square and is unaware of better alternatives in a back street or is unable to make a rational choice through lack of information. A company may have no wish to substitute since it may want return favours from the existing relationship. Examples include beverage companies that need the distribution channels provided by retail chains, such as pubs; investment funds that receive refund commissions from selected stockbrokers; and information technology companies that share information or technical specifications with each other. Substitution may be thwarted because there is ineffective competition at the point of sale. For instance, stores sell warranties when electrical products

are sold and, similarly, travel agents sell insurance with holidays. These warranties can account for 30-50% of profits at retailers like Dixons. The Competition Commission has examined this area and aims to increase choice and reduce prices, thus generally increasing the threat to a company from substitute products.

Long-term contracts can be effective in stopping substitution because, when they are renewed, the incumbent has the relationship, inside knowledge and track record, so is in a prime position to win again. Examples of such contracts are in the support services activities of companies like McAlpine, Mears Group and MITIE Group. Generally, the threat of substitution diminishes if the price of the item is low because the potential cost savings from doing a bit of homework by the customer are much less. Thus, the threat is great when buying a car but very low for buying an ice cream. At the other end of the scale, commodity products are not differentiated and are easy to substitute, like food. When a company that was fairly immune from competition finds its products, like computer chips, are becoming easier to substitute it is undermined, as in the case of ARM, the once high-flying, information technology company. Surfcontrol is a world-leading, internet filtering company with a commanding position in controlling what content can be viewed but now faces substitute products from the US. Commercial terrestrial television enjoyed a loyal audience up to the 1980s but digital television has been a powerful substitute with hundreds of channels and unique content in some cases, like premier league football.

2. Customers

'The customer is the appreciating asset.'

Federal Express

Customers are the cornerstone of success and, whereas a company can automate the production of goods, it cannot automate the production of customers. Companies with the best business models will have customers glued to them who pay a premium price because their products add great value in a way that is not met by competitors. This section examines what the company can do to configure its value chain to try to achieve that objective. In a world awash with excess capacity, companies need to concentrate on customers rather than products. This turns the normal company on its head because, traditionally, the focus has been on making a product and then figure out how to sell it to customers. Instead,