CHAPTER 2

Business models: investing in sectors with strong competitive advantage

Business model of a sector

'Competitive advantage comes from being different. Increasingly, difference comes from the way people think rather than what organisations make.'
Dr. Kjell Nordstrom, author of *Funky Business*.

A business model describes a sector's competitive advantage and depends on factors or capabilities that drive consistent outperformance. This depends on having good economics, management and products plus power over customers, competitors and suppliers, which result in strong competitive advantage. These same headings were used to analyse the company business models in chapter 1.

The profitability of a company is largely determined by being in a sector with a sound business model. An attractive sector has the ability to mould the world for its benefit, rather than weakly reacting to pushes and shoves over which it has no control. It will contain many companies that are profitable, due to low costs and/or doing something different, examples being banks, oil, tobacco and pharmaceuticals. If a sector has a weak business model then most companies are unprofitable, examples being engineering, automobiles and household goods. The product itself is but one important ingredient and straightforward products can be attractive investments, e.g. beverages, whereas those that seem exciting can be unattractive, e.g. technology. This chapter looks at these power points in alphabetical order and one of the business models may be applicable to *numerous* sectors, for example beverages, tobacco and mining. This is followed by some examples of sectors that should be avoided. The merits of *individual* sectors, such as telecommunications, are analysed in chapter 4.

65 sector business models

The table below lists each of the power points for ease of reference and provides a checklist for investors to score sectors easily. There are 65 business models to assess the competitive advantage of sectors and this list is not exhaustive. These are analysed in detail after the table below. Please note that, in order to provide a comprehensive picture, some aspects in this sector-wide analysis inevitably overlap with those of their underlying companies (chapter 1) and the individual sector analysis (chapter 4), although this has been minimised as much as possible.

All business models are not equal

As explained in chapter 1, all business models are not equal, as some are more powerful than others. Consequently, the table scores them on a rating of 1 to 5, with 1 being the highest and 5 the lowest. These ratings are subjective and could arguably be higher or lower, to an extent, but a top-rated business model would unlikely to be relegated to the bottom or vice versa.

The points are awarded depending on the power of the sector to achieve low cost and/or differentiate itself so that it adds value. Above all, it is crucial to be able to control its revenue streams. Consequently, those that score the maximum 1 are: rivalry; substitutes; value added; recession resistant; addictive or highly compulsive; long-term and opaque pricing; make once and sell many times; and moving up and down the value chain. Medium scorers include consolidation and demographics. At the bottom of the pile are those with poor competitive advantage because they are commodity-type businesses that have serious flaws or do not add value, such as dying sectors.

Sector business models table

Sector business models	Competitive advantage (1 highest, 5 lowest)	Illustrations
1. Competitors		
1a. Collaboration	2	Information technology, oil
1b. Consolidation	3	Stockbroking, banking
1c. Entry and exit barriers	2	Oil and gas, aerospace
1d. Rivalry	1	Telecommunications, food retailing
2. Customers		
2a. Elasticity of demand	2	Beverages, leisure
2b. Elasticity of supply	2	Telecommunications, construction
2c. Materiality	3	Automobiles, aerospace
2d. Motivation	3	Retailing, financial services
2e. Predictability of demand	2	Tobacco, retailing
2f. Size and number	3	Mortgage banks, aerospace
2g. Substitutes	1	Tobacco, internet
2h. Sticky customers	2	Utilities, banks
2i. Value added	1	Beverages, chemicals

3. Economics		
3a. Deflation and inflation	3	Tobacco, pharmaceuticals
3b. Demographics	3	Healthcare, leisure
3c. Global potential of a sector	2	Mobile phones, supermarkets
3d. Government spending	3	Health, transport
3e. Hubs and spokes	3	Media, oil
3f. Legislation and regulation	4	Financial services, utilities
3g. Low-cost overseas production	3	Automobiles, electronics
3h. Market size	3	Banks, diversified industrials
3i. Megatrends	2	Energy, leisure
3j. Outsourcing to third parties	3	Airlines, television
3k. Recession resistant	1	Tobacco, life insurance
3l. Self-reinforcing	4	Financial services, engineering
3m. Spending other people's money	4	Entertainment, government
3n. Technology	2	Electronics, food
4. Management		
4a. Ability to attract top talent	3	Dot coms, financial services
4b. Intellectual capital	3	Advertising, information technology
5. Products		
5a. Addictive or highly compulsive	1	Tobacco, gambling
5b. Commodities	5	Sugar, distributors
5c. Crazes	5	Emerging markets, property
5d. Crossing the chasm	3	Mobile phones, automobiles
5e. High growth markets	2	Mining, pharmaceuticals
5f. High value product	2	Software, stockbroking
5g. Intellectual property rights and proprietary products	2	Pharmaceuticals, consumer goods
5h. Internet threat	3	Music, retailers
5i. Obsolescence	3	Tobacco, technology
5j. Long-term and opaque pricing	1	Life insurance, support services
5k. Make life easy	3	Supermarkets, leisure
5l. Make once, sell many times	1	Information technology, financial services
5m. Monopoly, oligopoly and cartels	2	Oil, utilities
5n. Must-have products	2	Information technology, music
5o. New products	2	Electronics, transport
5p. Positional goods	4	Automobiles, clothing
5q. Research and development to maintain lead	3	Aerospace, pharmaceuticals

5r. Recovery plays	4	Banks, TMT
5s. Product pipeline	3	Automobiles, tobacco
5t. Toll bridge – intangible	2	Software, support services
5u. Toll bridge – tangible	2	Transportation, leisure
6. Suppliers		
6a. Cost of inputs compared to selling price	2	Pharmaceuticals, food retailing
6b. Excess capacity weakens supplier	3	Telecommunications, financial services
6c. Moving up and down the value chain	1	Beverages, oil
6d. Weak and numerous suppliers	2	Food retailing, leisure
7. Sectors to avoid		
7a. Attracts capacity in the good times	5	General insurance, telecommunications
7b. Based on a quirk that politicians can remove	5	Retailing, banking
7c. Being the bacon in the sandwich	5	Distributors, food producers
7d. Dying sectors	5	Engineering, textiles
7e. Endless restructuring	5	Heavy industry, airlines
7f. High depreciation and amortisation of goodwill	5	Steel, telecommunications
7g. Long tail liability insurance	5	General insurance, reinsurance
7h. Prone to the economic cycle	5	Builders, cyclicals
7i. Prone to litigation	5	Tobacco, health
7j. Regulated	5	Transport, utilities
7k. Unethical	5	Beverages, tobacco

We now look at each of the sectors in detail. A sector should enjoy multiple business models and be scoring well on these to be highly-rated, as this strengthens its overall competitive advantage. For example, pharmaceuticals' competitive advantage is rated 1, as it has a top score in such business models as entry and exit barriers, value added and recession resistant.

1. Competitors

'A horse never runs so fast as when he has other horses to catch up and outpace.'
Ovid, Roman poet.

Sectors are attractive where the profitability is captured by the participants and not frittered away by strong competition, which results in low prices. If the latter does happen then the customers capture the profitability instead. Unfortunately, the days of making easy money have gone and now global competition is generally as fierce as it is widespread. This has been due to, inter alia, lowering of trade barriers, free currency movement, competition regulations, technology and rapid industrialisation of some developing economies. This has empowered customers, who are increasingly more demanding, at the expense of companies. The implications are far-reaching and have not yet run their course. It has hollowed out the profitability in those sectors that have poor competitive advantage, examples being textiles, distributors and manufacturing. Others are squeezed by ever more powerful gorillas, such as food producers by supermarkets. Some customers are not wanted because they can no longer be profitably served. Various business models have been abandoned, for instance relying on products rather than services. Clearly, no longer is it relevant to have a mission statement just to 'increase sales' or 'create a bigger empire', as these are no panaceas for profitability.

Therefore, sectors vary and some have greater intensity of competition than others. A reasonable assumption is that those sectors with the highest profit margins have less intense competition. These are, in order, tobacco, pharmaceuticals and health, and utilities. This concept is more fully explored in chapter 4.

1a. Collaboration: competitive advantage rated 2

Sector profitability can be enhanced by the collaborative behaviour of the participants, such as choosing not to compete in certain areas and thus avoiding a backlash. Microsoft collaborates by code-sharing with preferred partners who are not competitors, examples being printers and cameras, and are thus outside its sphere of activities. The dominant players may act paternally, like Coca-Cola, and desire a stable and profitable environment for all in the sector and act accordingly, for example, with pricing, expansion policies and setting technical standards. There may be a cartel operating that enables all the participants to earn super profit, e.g. OPEC, or a more informal cosy relationship, e.g. petrol retailing. Companies can collaborate in joint ventures and thus share the risk. Such partnerships can enhance trust and reasonable behaviour, with 'milestone' payments made when progress is made. Joint ventures are not generally very attractive, however, as a company loses some control over its destiny and partners can be unreliable. Joint ventures are evident in oil, aerospace and biotechnology. Generally, fierce competition has weakened collaboration between companies within a sector, an example being clothes retailing, and is the exception rather than the rule.

1b. Consolidation: competitive advantage rated 3

'Why anybody thinks they will produce a gazelle by mating two dinosaurs is beyond me.'

Tom Peters, author of *In Search of Excellence*.

Consolidation is an ongoing trend in some sectors, driven by their economics. They may have no choice if they need to reduce capacity and competition or reap economies of scale, such as achieving critical mass. This could be a spur to increased profitability and a re-rating. Consolidation may be due to empire building by CEOs in some cases. Some sectors have not consolidated and have a large number of participants with no one being dominant.

Consolidation is prevalent in sectors at different times and recent activity has been in stockbroking, oil, banking, food retailing, media and pharmaceuticals. Some undergo consolidation where emergent gorillas grow by bolting-on acquisitions. This may increase competition or not, depending on how the participants behave. For example, the cigarette sector in the US has been threatened by price-cutting by struggling competitors. Increased size is a driving force in banking and life insurance to cope with international competition, or the

need for global reach. The regulatory burden is a large overhead that cannot be easily afforded by small players. In such an environment, takeovers are inevitable. Supermarket chains are consolidating to achieve economies of scale in order to compete. Utility companies need the critical mass of millions of customers and consolidation quickly helps to achieve this. Commercial terrestrial television is consolidating into a single ITV company, given the merger between Granada and Carlton, so that it can compete with the BBC and British Sky Broadcasting.

Investing in a takeover target is usually a more attractive investment than the gorilla in a consolidating sector because of the takeover premium. It is particularly attractive if the number of targets is small. A bidding war may ensue over who will acquire the limited number of players still left in the market and this drives up the take out price. Thus, a minor company in the life insurance sector like Friends Provident would be more attractive than a gorilla like Prudential, all things being equal. Similarly, in mortgage banking, smaller players like Alliance & Leicester and Bradford & Bingley are targets, as is Gallaher in tobacco. It may be worth thinking of buying a struggling company in the hope of a takeover but be aware that a white knight may take years to come to the rescue, if at all, and a takeover price could be lower than the current price if the target's fortunes decline further. Therefore, it is sensible to invest in a company because it is attractive on its own merits, with the possibility of a takeover thrown in as a bonus.

1c. Entry and exit barriers: competitive advantage rated 2

Sectors benefit from high barriers to entry because they keep out competitors that may otherwise undermine profitability by increasing capacity and lowering prices. The barriers may be because the existing companies in a sector have locked in the customers, suppliers or distributors, for instance in oil and gas. Switching costs may be high and incur risk or inconvenience, a feature of information technology. A newcomer may fear retaliation if the companies then overlap sectors, such as media and entertainment. Government can impede newcomers to protect home markets, as the French did by limiting Japanese cars. Brands may be very important and the cost, time and risk are too great for newcomers to build their own, e.g. newspapers and cars. The sector may be dominated by a few gorillas, with propriety products, that put a moat around the business. A newcomer may find it impossible to gain comparable proprietary expertise, let alone exceed it. Some sectors need global reach, huge economies of scale or capital to operate, examples being international advertising agencies and

pharmaceuticals, and this makes it very difficult for a small company to gain a foothold and grow.

Sectors also benefit by having low barriers to exit so that firms who want to leave can easily do so. This reduces capacity and enhances profitability. Exiting is easier when the costs of doing so are low, for instance in support services or software, where it might mean closing a rented office and firing mainly temporary staff. At the other extreme are sectors where the fixed cost is very high and it might be cheaper to carry on than close down, examples being power generation, car plants, mines, aerospace and defence. Exiting will be easier if the player has other sectors on which to focus, rather than having to face annihilation.

In conclusion, it should be hard to enter the sector but easy to leave it. Information technology is a case in point, where know-how and proprietary products can make entry hard but it is straightforward to close down.

1d. Rivalry: competitive advantage rated 1

'I would rather see a battalion enter the field than him.'

Duke of Wellington's estimation of Napoleon.

Great rivalry tends to undermine profitability and such sectors should generally be avoided. This could stem from low growth or fighting over declining demand. There could be overcapacity, e.g. telecommunications, or a dominant gorilla that is determined to crush opposition, e.g. British Sky Broadcasting. Some players may see the sector as a loss leader to make profits elsewhere, e.g. holiday companies cut prices but make money in travel insurance. The balance of power may be uneven, so a struggling player with poor competitive advantage may resort to desperate action and thus increase the rivalry. Price wars can develop where competition is intense, with adverse effects on share prices. This occurs frequently in food retailing and has featured in newspapers, tobacco and pubs.

Rivalry can feature when there are large fixed costs and low marginal costs. This structure means that prices can be cut significantly to produce some contribution to the fixed costs. An example is air travel where the cost of filling the seat is minimal but the overheads are enormous. This price-cutting can become an expectation by the consumer, who increasingly becomes resistant to paying the full fare, e.g. last minute holidays. This undermines the long-term health of the sector. Rivalry is very likely in profitless sectors where little value is added. The participants are cornered and panic, with disorder resulting in ruinous competition. This tends to be particularly evident in a recession and sectors include construction, household goods and textiles.