Three economic moats to look for before investing

Why is it that some companies such as Hindustan Unilever (HUL) or Nestle enjoy very high valuation compared to their peers? The answer lies in the term "economic moat", which has been coined by the renowned international investor Warren Buffet. He defines economic moat as a company's durable competitive advantage, which enables it to maintain an edge over its competitors and protect its profitability and market share.

In literal sense, economic moat is nothing but a water body surrounding a castle, which delays the invaders from attacking the castle and buys time for the occupants inside the castle to prepare for the attack. In corporate context, the castle is the company, and the economic moat is the company's core competitive advantage and the invaders are the competitors.

Companies that have strong economic moats can survive competition over time, as its competitive edge makes it difficult for the rivals to capture market share.

Three such economic moats to look for in a company include:

- Low-cost advantage
- Differentiated strategy
- Distribution channel

1. **Low-cost advantage:** A company, which can bring contain costs, either through operational efficiency or by following a differentiated strategy that helps to cut costs can usher in a durable cost advantage for the company. For example, direct marketing as against traditional distribution channel.
   Cairn India has one of the lowest operating expenses of $6 per barrel in the world. It has been able to achieve this through adoption of pioneering technology such as polymer flood EOR, skin effect heating system, modular well pad concept and drilling efficiencies. Operational efficiency-driven lower operating costs are hard to achieve and would be difficult for any competitor to match.

2. **Differentiated strategy:** Innovative business strategies adopted by a company to develop products or deliver services with unique features (which are not easy for competition to copy) also act as economic moats. Such novel products/services are developed through technological breakthroughs, R&D capability and patents, leading to customer loyalty/stickiness and high pricing power. For example: Sun Pharmaceuticals focuses on super specialty therapeutic segments such as Psychiatry, Neurology and other complex categories, which other Pharma players would find it tough to venture into.

3. **Distribution channel:** A company, which has a large distribution channel to distribute its products, has an edge over its competitors, as it would require substantial distributor margins and strong dealer relationships for a new entrant or a competitor to attain. For example: going by the distribution network wise, Castrol India has 380 distributors, servicing over 110,000 retail sites. This network enables the company to garner a huge market share in the Indian lubricant market.

   Among the other key economic moats include: economies of scale, high switching cost, heavy capital expenditure etc (leading to high entry barriers for competition). If you like to learn more about economic moats, then register for one of our free “Power Money Workshops” and join our investing education program “Stock Investor” to polish your investing skills.