What is a Moat?
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Dear Fellow Investors:

moat/mōt/

Noun: *A deep, wide ditch surrounding a castle, fort, or town, typically filled with water and intended as a defense against attack*

At Smead Capital Management our investment committee talks and thinks about the moat of a business a great deal. Based on the definition above, we believe that a wide moat is provided by the aspects of the company and their business which prevent competition from damaging highly sustainable profitability. Wide moat is one of our eight proprietary criteria for selecting common stocks. We have seen a number of organizations begin to include logic associated with moats into their equity research formats. Unfortunately, we believe many market participants confuse the by-products of a moat with the actual moat itself. We think this spells opportunity. Looking for stocks with a wide moat that are priced as if they don't have one adds to the advantage of the long-duration common stock investor.

I read recently that after years of trying and millions of dollars invested, Google (GOOG) is considering folding Google Wallet and Google Checkout together. When it was announced five years ago, Google Checkout was thought by some to be a potential "PayPal killer". PayPal appears to have successfully defeated one of the largest cash-rich, wide-moat companies in the world from getting into its secure, online payment castle. PayPal's moat includes over 100 million existing customers, consumer brand recognition and nearly a decade of statistical information on transactions. Google has the same kind of moat in search that PayPal has in payments. The economic need that PayPal meets is identification privacy and ease of transaction facilitation. It's a huge market and will grow tremendously in the next ten years. We believe as Google admits defeat, it will mean that the moat at PayPal is so strong that it can't be overcome by massive financial resources and tech savvy. Google had both of those merits.

PayPal is a wholly-owned subsidiary of Ebay (EBAY). Ebay has a wide moat in its core marketplace business. Ebay is one of the most recognized brands in the world and most of its advertising is free thanks to the lock it has on market share for pre-owned items. When an athletic milestone is reached, the ball or puck or jersey is expected to immediately be offered on Ebay. Sportswriter's frequently mention this fact in their writing. When

Michael Jackson dies, his memorabilia becomes an instant hit on Ebay. This moat makes the low-risk, high free-cash flow nature of Ebay's original business nearly impregnable. After backing out the cash net of long term debt, Ebay trades for 11 to 12 times the 2012 consensus earnings estimate. It is very unusual to see a fast-growing, wide-moat business trade for anything short of a premium to the S&P 500 Index multiple.

The symptoms of a wide moat are things like high, sustainable profit margins, huge market share, pricing flexibility and long histories of these identifying characteristics. However, the symptoms are not the moat. The moat causes the symptoms. Walgreens (WAG) is one of the two largest drugstore companies in America. Their properties dominate the best locations in the US, their brand recognition is the highest in the industry, their real estate ties up very little of the company capital and they have decades of experience in customer needs and satisfaction. Their financial muscle puts them in position to buy Duane Reade and walk away from Express Scripts. A college buddy who did extensive research on the subject told me that one out of every two Americans will never get a prescription filled outside of the walls of a drugstore. Walgreens castle is being attacked by a disagreement over pricing with Express Scripts and their moat is very busy defending the company. We think it will succeed.

HR Block (HRB) has spent the last ten years fighting off the attacks of Jackson Hewitt and Liberty, two tax prep companies started by former HR Block employees. My favorite test for a moat is putting 100 people through a survey. You ask them, "What is the first thing that comes into your mind when the surveyor says tax preparation"? Almost everyone will say, "HR Block". If the question was online payments, it's PayPal. If it is, “where do I find pre-owned items, or sporting event tickets?” the answer is Ebay. If the question is, “who do I trust to entertain my children and spouse?” it is Disney/ESPN (DIS). If the topic is coffee the answer is Starbucks (SBUX), burgers it’s McDonalds (MCD), retail service and selection it’s Nordstrom (JWN). The moat in business is about deeply, rooted competitive advantages which business cycles can't uproot. It is about a love affair between a company and an addicted customer base which grows as population grows.

Warren Buffett was asked by the Financial Crisis Commission what one single characteristic he looks for in a business. He referred to the stickiness of the customer and the company's ability to raise prices without affecting unit sales. We feel the moat of the business is what protects the ongoing success of a business even when legitimate competition comes along. It is what is behind wonderful long-term profitability and high levels of free cash flow. Moat analysis is not about number crunching, it is about mind-space control and forces which block or kill competition.

Lastly, we at SCM are value investors. Something very difficult has usually had to happen to open the door for us to get a good entry price on common shares of a wide-moat company. Ironically, in many cases, the temporary reason for the disfavor actually increases the size of the wide moat. Big pharmaceutical companies have had the most hostile political, regulatory and legal environment in the industry's history the last four years. Major drug stocks have seen blockbuster products lose their patent and the combination of the aforementioned forces have brought many drug stocks down to the lowest PE quintile (bottom 20%) in the S&P 500 index. Instead of doing permanent damage to companies like Merck (MRK), Pfizer (PFE) and Bristol Myers (BMY), these circumstances have increased the depth and width of their moat. It is estimated that a new drug costs over one billion dollars to create and bring to market. Nobody besides these large pharma giants can afford to fight the battle. This high original investment threshold has turned the biotech industry into mostly farm teams feeding the major leagues. Smaller drug and biotech firms do research for creating wonderful new health science and are forced to hand it off to someone with deep pockets and an international manufacturing and sales force. Now that companies like Merck and Amgen (AMGN) are having great success with new products, the naysayers can begin to recognize how incredibly well defended these companies are from competition going forward. We believe they have wide moats.

Best Wishes,

William Smead

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