



How Moats can protect your portfolio in a downturn

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Why should moats matter to investors?

- Tangible and lasting competitive advantages underpinning returns.
- Material entry barriers.
- Quality factor – we view moat rated businesses as superior.

What does it mean to have a moat?

- Able to generate sustained returns on invested capital.
- In the best cases, firms can reinvest at high rates to compound those earnings and returns.
- Earnings and valuation may be more defensive and better able to recover from cyclical downturns.

How to measure a moat

A company has a moat if can generate

Return on Invested Capital

that is greater than weighed average cost of capital for at least 10 years

Calculating ROIC

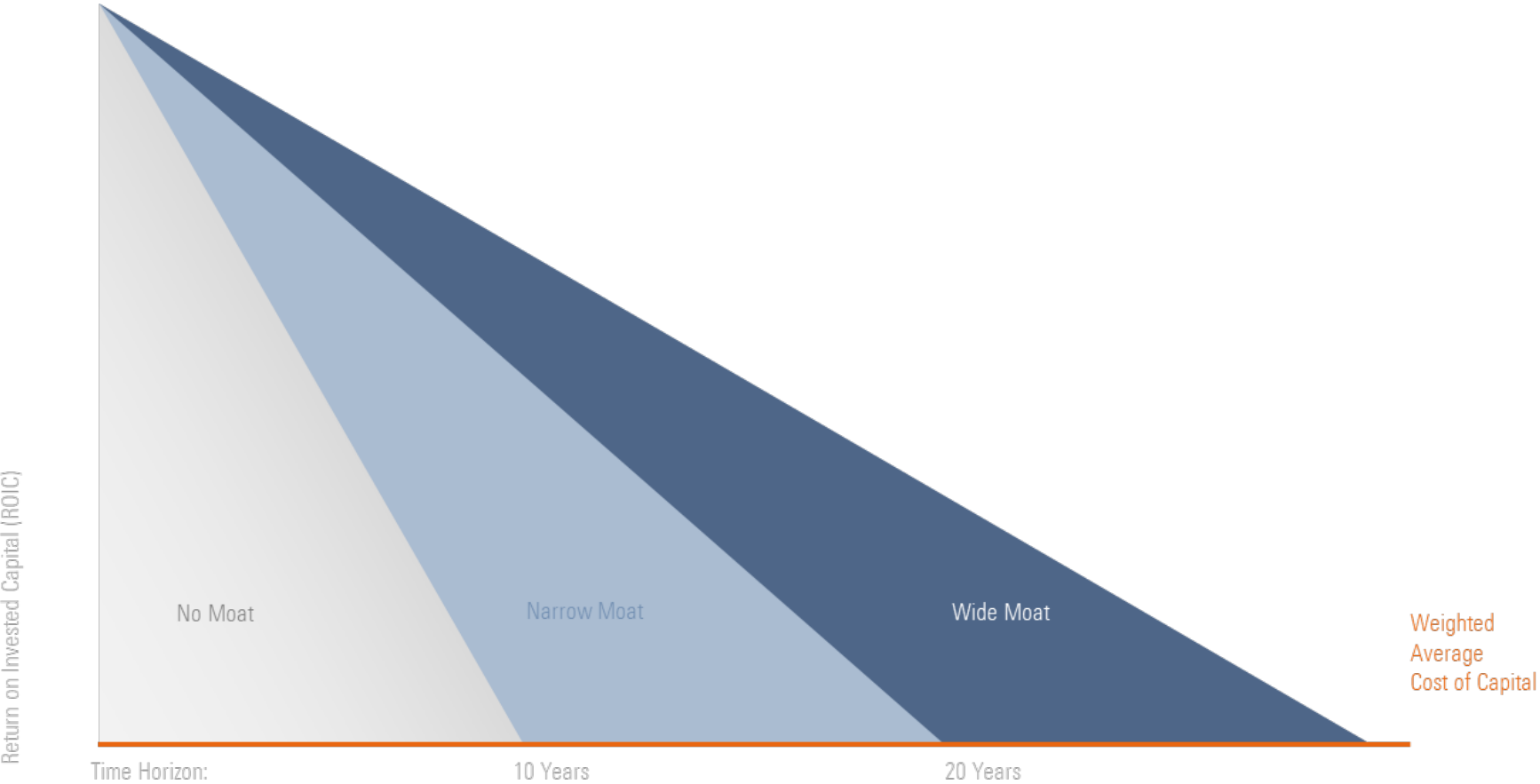
A quick and easy ROIC calculation:

$$\frac{\mathbf{EBI}}{\mathbf{Invested\ Capital}}$$

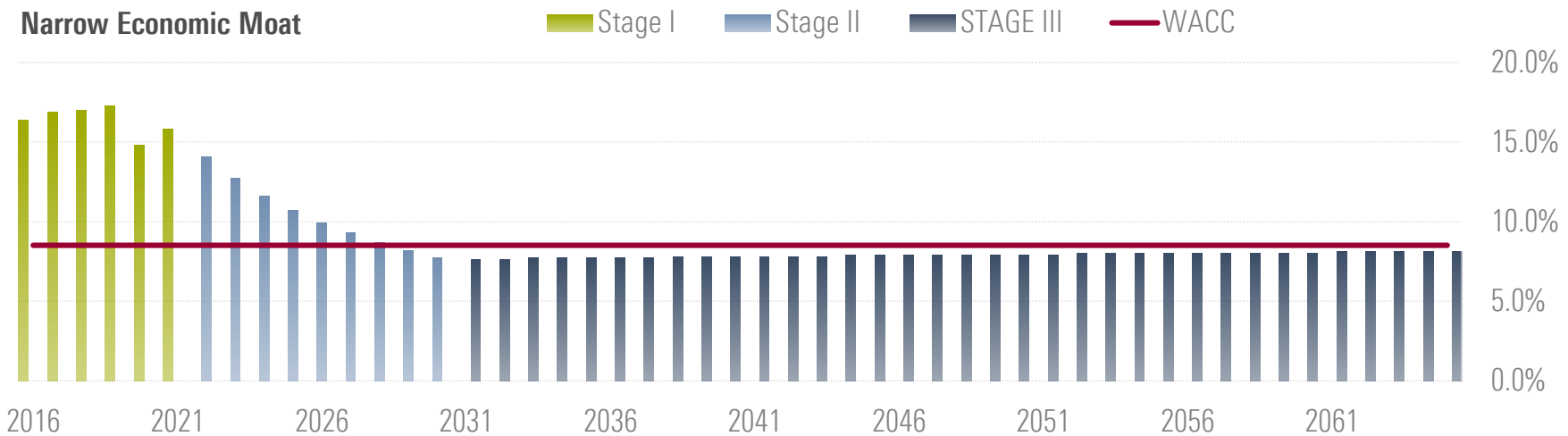
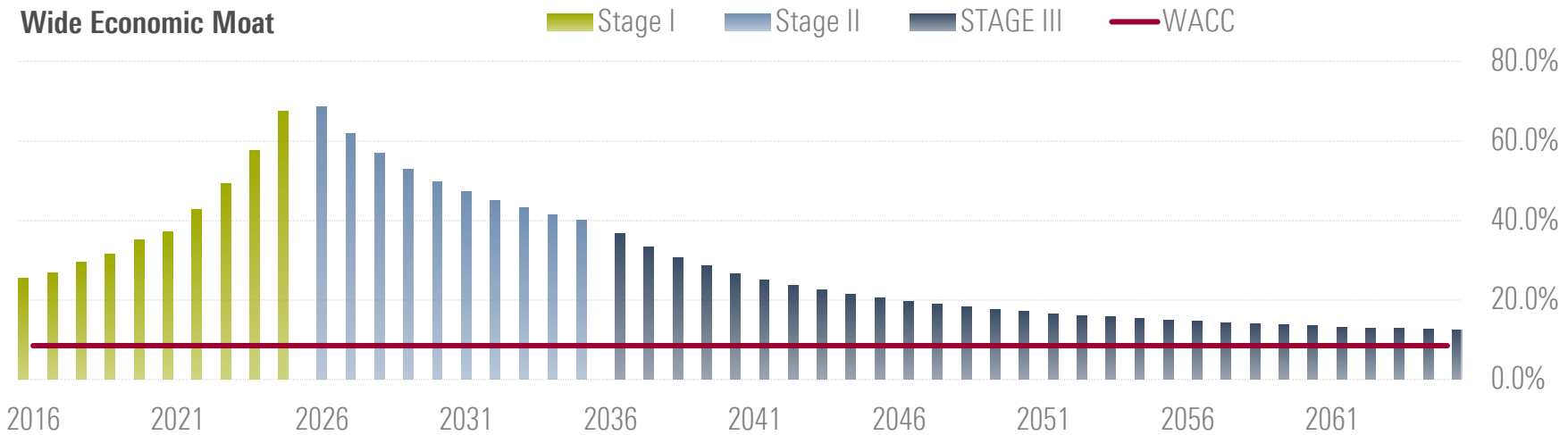
EBI = EBIT - Tax

Invested Capital = Debt + Equity (from the balance sheet)

Our confidence in the duration of excess returns drives the moat rating



Moat and moat width directly add to our fair value estimates



Where do moats come from?

There are five sources of economic moats.

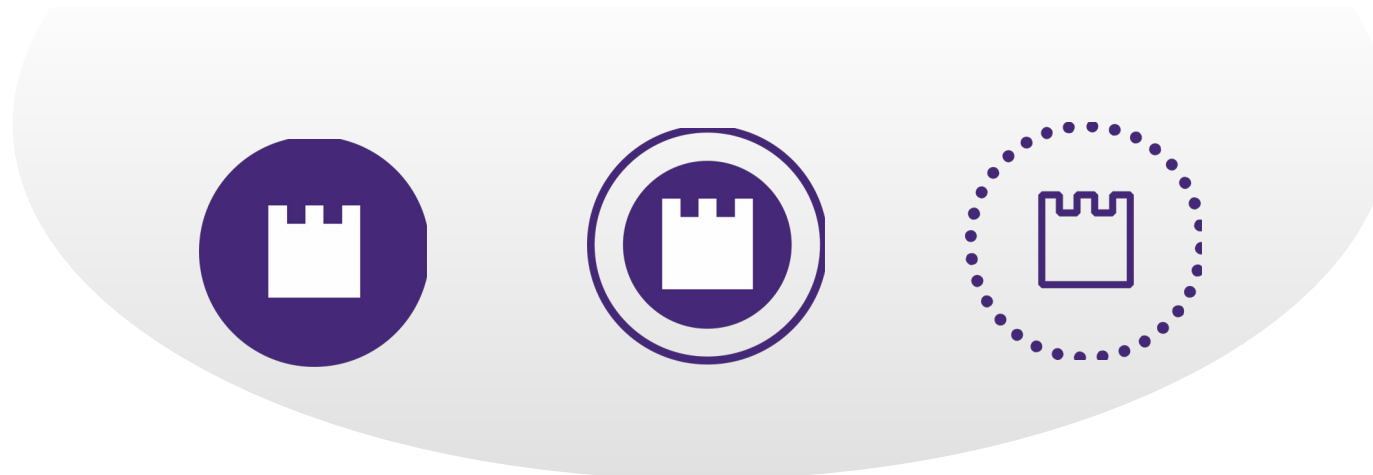
Intangible
Assets

Switching
Costs

Network
Effect

Cost
Advantage

Efficient
Scale



Wide

Narrow

None

Australian and New Zealand Examples of Wide Moat Companies



Intangible Assets

Invocare

Strong reputation and relatively price insensitive customers. Funeral service customers generally don't shop around.

Switching Costs

Cochlear

Key clinics are exclusive with almost no brand switching. Once installed, customer switching costs are very high.

Network Effect

ASX

More buyers attracts more sellers which attracts more buyers. A virtuous circle that's hard to break.

Cost Advantage

Brambles

Global scale as the largest provider of pallet services drives a sustainable cost advantage.

Efficient Scale

Auckland Airport

A regional monopoly. Likelihood of additional airport is remote, as it's more cost-effective to expand the current facility.

Intangible Assets Wide Moat Example: Invocare

- Moat underpinned by brand intangible, with White Lady the flagship.
- Premium service – costs about 35% more on average than the industry. The strong brand allows Invocare to charge a premium price.
- Prepaid funerals – account for about 10% of total sales, contract life is around 11 years.

Switching Cost Wide Moat Example: Cochlear

- Overvalued, probably due to low prevailing interest rates and perceived safety, but it's a very strong business.
- Switching costs exist both with the clinics which install the implants, and with the installed base.
- 26% of revenue comes from services: processor upgrades and accessories, and this will grow over time with the installed base.

Network Effect Wide Moat Example: ASX

- Network effects common in financial markets.
- Financial market participants value volume and liquidity.
- The ability to transact quickly at low cost, in part due to low bid-ask spreads, is important.
- Increasing transactions benefits both new and existing participants.

Cost Advantage Wide Moat Example: Brambles

- Global leader in pallet pooling.
- Scale and density of service centre network delivers a cost advantage.
- Higher density network improves pallet utilisation among customers.
- Superior scale allows Brambles to be a price leader while still generating attractive returns.

Efficient Scale Wide Moat Example: Auckland International Airport

- Auckland's only international airport and key domestic hub.
- Serves a discreet market that is unlikely to support a competitor.
- The large land bank provides a long runway for development.
- Regulation is relatively favourable and allows the firm suitable returns.

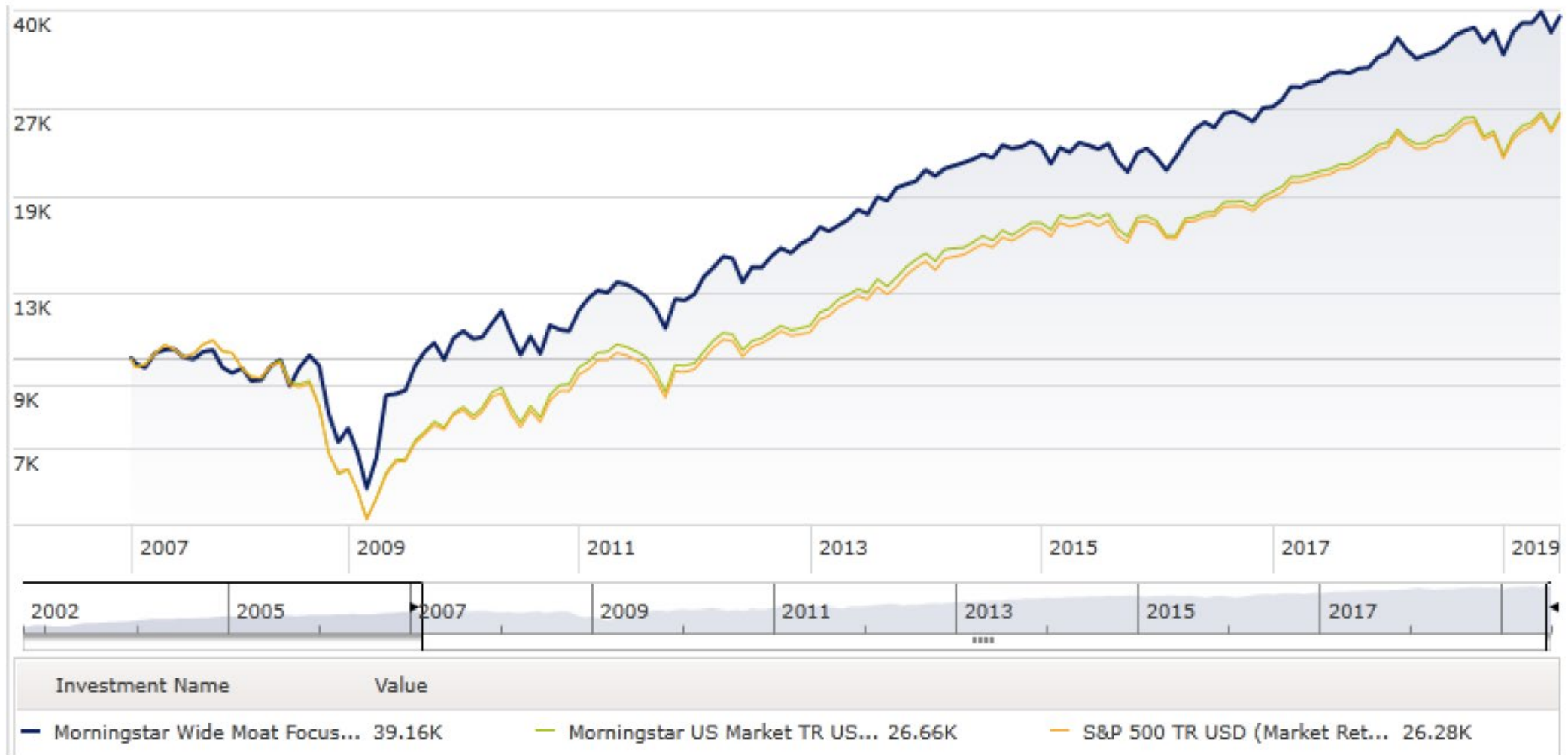
No Moat Example: Afterpay

- Market share has built very quickly – nearly three million customers in Australia and New Zealand, more than 30,000 merchants.
- What's the moat though? Switching costs do not appear to be high – either for merchants or customers – and competition is growing.
- What about the risk of regulation longer-term? How will no credit checks and a reliance on debt and equity markets for funding play out?

Key questions for investors?

- Does the business generate attractive returns?
- What underpins those returns and can they be sustained?
- Does the business have the ability to reinvest to compound earnings?
- Is Mr. Market feeling optimistic or fearful – i.e. is the price attractive?

Wide Moat Focus Index: Combines Moat and Valuation



Source: Morningstar Direct. Data from Feb. 14, 2007, live inception date through June 30, 2019.

Four and five star moat rated companies

Code	Company Name	Market Price* (AUD)	Fair Value Estimate (AUD)	Price/Fair Value	Mkt Cap (AUD Billion)	Moat Rating	Fair Value Uncertainty	Morningstar Analyst Rating
ABC	Adelaide Brighton Ltd	2.94	4.00	0.74	1.92	Narrow	Medium	★★★★★
AGI	Ainsworth Game Technology Ltd	0.75	1.14	0.66	0.25	Narrow	Very High	★★★★★
ANN	Ansell Ltd	26.55	32.00	0.83	3.51	Narrow	Medium	★★★★★
API	Australian Pharmaceutical Industries Ltd	1.35	1.80	0.75	0.67	Narrow	High	★★★★★
CPU	Computershare Ltd	15.49	19.40	0.8	8.41	Narrow	Medium	★★★★★
CWN	Crown Resorts Ltd	12.08	14.50	0.83	8.18	Narrow	High	★★★★★
DMP	Domino's Pizza Enterprises Ltd	47.72	52.00	0.92	4.09	Narrow	Medium	★★★★★
IVC	InvoCare Ltd	13.50	16.00	0.84	1.58	Wide	Medium	★★★★★
LNK	Link Administration Holdings Ltd	5.57	8.10	0.69	2.97	Narrow	Medium	★★★★★★
PDL	Pendal Group Ltd	6.90	8.30	0.83	1.96	Narrow	Medium	★★★★★
PGH	Pact Group Holdings Ltd	2.31	3.90	0.59	0.79	Narrow	Medium	★★★★★★
TLS	Telstra Corp Ltd	3.40	4.40	0.77	40.44	Narrow	Medium	★★★★★

Source: Morningstar Direct. Pricing as at October 3, 2019