

## MOAT STOCKS INVESTMENT FOR ALL SEASONS AN EMPIRICAL STUDY

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### ABSTRACT

*Equity investors, from time to time, are faced with contingent events and shocks that threaten to shake, rattle and roll the markets. The impact in the initial phase of such events or shocks on investors' sentiment is such that investors start believing this may well be the end of a good run for the markets and that there may be no treatment for such a malaise*

*Over the past few years, we have seen markets being impacted by various shocks emerging from different parts of the world. At times the market correction is triggered due to local events while at times this may happen due to a combination of both local and global events. Good market conditions or poor market conditions, 'risk on' or 'risk off' mood in the market – the hunt for quality stocks is always on. One of the most popular investment terminologies used while identifying quality stocks is 'stocks with an investment moat'.*

*It is a dream of any value investor to identify stocks that have some sort of moat in it. For companies to fall in the wide moat category they should enjoy a high market share and operate at high profitability levels. One of the best ways to understand stocks with growth momentum is to identify those stocks that reflect higher current RoEs than the five-year average RoEs.*

**KEYWORDS:** *Moat, ROCE, ROE, PE*

### INTRODUCTION

In this intensely competitive world it is fairly presumed that the gap between the top enterprises is low and it's just a matter of time when one topples the other. However, there are some companies that have created a gap or should we say a 'moat' that is meant for preventing other companies to catch up. With the US and Iran almost rushing into a war-like scenario, the markets were bound to suffer. However, post the comments made by US President Donald Trump and face-off between the nations having eased to some extent, the domestic as well as global markets have recovered for now.

The Indian stock market has continued to touch new highs since November 28, 2019. As of now, the Nifty has reached new peaks seven times in the last one and a half months. After breaking down from the narrow range flat base, it bounced back with a gap up and continues to rise. At times the markets may have taken longer to recover than usual but the fact remains that they have always recovered. This is something that every long-term investor should bear in mind.

Good market condition or poor market condition, 'risk on' or 'risk off' mood in the market – the hunt for quality stock is always on. One of the most popular investment terminologies used while identifying quality stocks is 'stocks with an investment moat'.

## MOAT INVESTMENTS

What is the moat after all and why should investors continue identifying it in stocks? Literally speaking, moat is nothing but a hole dug around a castle, which is later filled with water for 'safety arrangement'. Safer the arrangement i.e., wider and deeper the hole is, bigger the moat is, and hence more protected is the castle. In those days of yore when kings and dukes ruled regions and lived in castles, a big moat would make it tough for attackers to gain access into the castle. Similarly, in the business world any company with a wider and deeper safety arrangement or in other words a bigger moat will always tend to be safer relatively and hence profitable in the long term, devoid of competitive pressure, relatively speaking. Such companies with bigger safety arrangements are also known as companies with investment moat. You will find that companies with bigger or wider investment moats are the ones which are actually well-protected from competitive pressures and remain relatively profitable while enjoying larger market share, which of course is crucial in the long run since it proves to be a key determinant of profit margins and consistent growth in profits while also keeping the company in business for longer periods.

Here is what ace investor Warren Buffet has to say about the concept of moat: "I don't want a business that's easy for competitors. I want a business with a moat around it with a very valuable castle in the middle. And then I want the duke who's in charge of this castle, to be honest, and hard-working and able. And then I want a big moat around the castle, and that moat can be of various things. The moat in a business at GEICO is low-cost. I mean people have to buy automotive insurance, so everybody's going to have one insurance policy per car basically, or per driver. And I can't sell them 20 policies but they have to buy one. What are they going to buy it on? They are going to buy it based on service and cost. Most people will assume the service is fairly identical among companies, or close enough, so they are going to do it on cost, and therefore I have to be low-cost producer. That's my moat. To the extent my costs get further lower than the other guy. I have thrown a couple of sharks in to the moat.

### Value of Moat

Companies with an investing moat are the ones which have higher earnings power, higher profitability, and higher returns on capital invested. A company with an investment moat ideally should not be afraid of increasing its product prices fearing loss of customers to competitors. For example, assume that Tata Motors is a company with an investment moat and has recently announced increase in prices for its key models such as Harrier, Nexon, Tiago and Tigor anywhere between Rs. 5000 to Rs. 55,000. If such an increase in prices does not lead to slump in sales in a hyper-competitive segment such as the automobile industry, especially in the passenger vehicle sub-segment, we can say that Tata Motors has some quotient of investment moat built around its company and the brand. It can thus be said that companies with investment moats may not face exodus of customers just because the competitors have reduced their product prices. The competitors in this case are selling similar products and or services with different prices.

### Wide Moat Stocks

For companies to fall in the wide moat category they should enjoy a high market share and operate at high profitability levels. Also, wide moat companies are the ones that improve their profitability with time. One can identify the growth momentum by comparing the profitability growth with historical averages. To understand growth in profitability, the historical return on equity (RoE) should be studied. One of the best ways to understand stock with growth momentum is to

identify those stocks that reflect higher current RoEs than the five-year average RoEs. Usually it is a norm that the stocks with moat will reflect higher RoEs than the sector average RoEs

## INVESTMENT MOAT

**Usually Companies with Investment Moats are those with the following Competitive Advantages, Termed Economic Moats.**

- Better products, as for example, Apple
- Intellectual capital in terms of patents and copyrights, as for example, big pharmaceutical companies
- Economies of scale and lower cost structure, such as Tata Steel
- Captive customers. This is observed when the switching cost is high as in banks and sophisticated technology like ERP systems
- High entry barriers to business, as for example companies like RIL, ONGC, Microsoft, etc.,
- Distribution network, examples being HUL, Flipkart, Amazon, etc.,
- Brands such as Nestle (Maggi, Nescafe), Pidilite (Fevical), eicher Motors (Royal Enfield), Bisleri, etc.,

Companies with economics moats are the ones with better products and those that reinvest the profits earned into intellectual capital. Moat companies are found to enjoy economies of scale and lower cost structure compared to their competitors. It is a common observation that customers of banks find it difficult to switch to new banks; hence a greater number of captive customers are seen depending on the same banking services. This leads to a wider moat for the bank, which in turn contributes to its higher profitability.

### Stocks With High Roe (Current Roe Higher than the Average 5 Year Roe and Sector Roe)

| Company Name         | Market Cap | Sector                  | ROCE (%) | ROE (%) | ROE sector (%) | ROE last 5 years (%) | Returns (%) |
|----------------------|------------|-------------------------|----------|---------|----------------|----------------------|-------------|
| Gujarat Gas          | 17958.69   | Trading                 | 18.70    | 20.69   | 12.51          | 17.31                | 93.97       |
| Manappuram finance   | 14736.42   | Finance                 | 14.34    | 19.40   | 12.74          | 17.19                | 85.33       |
| JK Cement            | 9925.88    | Construction Materials  | 14.27    | 12.89   | 12.46          | 11.55                | 79.76       |
| BalrampurChini Mills | 4094.20    | Agri                    | 19.89    | 31.10   | 13.24          | 18.31                | 72.88       |
| SRF                  | 19665.62   | Diversified             | 13.40    | 14.04   | 13.36          | 13.70                | 71.12       |
| AstrazenecaPharma    | 6329.00    | Healthcare              | 26.53    | 20.03   | 15.22          | 6.46                 | 70.79       |
| Adani Gas            | 18812.25   | Trading                 | 23.94    | 21.40   | 12.51          | 17.40                | 68.61       |
| Abbott India         | 27068.64   | Healthcare              | 37.88    | 24.66   | 15.22          | 24.60                | 68.37       |
| APL Apollo tubes     | 4597.21    | Iron & Steel            | 16.36    | 13.31   | 13.07          | 12.11                | 60.82       |
| ICICI Lombard        | 63114.34   | Insurance               | 329.57   | 21.28   | 15.92          | 19.99                | 60.71       |
| Bajaj Finance        | 241120.88  | Finance                 | 14.69    | 22.13   | 12.74          | 20.99                | 56.99       |
| Bata India           | 22064.32   | Retailing               | 30.54    | 20.44   | 14.89          | 18.81                | 52.68       |
| Rites                | 7630.00    | Capital Goods           | 29.71    | 19.40   | 18.46          | 18.32                | 47.16       |
| Muthoot Finance      | 30094.71   | Finance                 | 16.22    | 22.45   | 12.74          | 19.29                | 46.72       |
| Inox Leisure         | 3852.02    | Media & Entertainment   | 21.89    | 15.75   | 8.13           | 11.13                | 46.06       |
| Ipca Laboratories    | 14414.25   | Healthcare              | 16.76    | 15.60   | 15.22          | 9.76                 | 46.00       |
| Tube Investments     | 9108.71    | Automobile& Ancillaries | 21.68    | 18.55   | 17.17          | 10.48                | 39.31       |
| Godrej Properties    | 24457.64   | Realty                  | 9.48     | 10.22   | 9.49           | 6.97                 | 35.93       |
| Adani Enterprises    | 22441.62   | Trading                 | 14.50    | 13.62   | 12.51          | 7.27                 | 35.13       |

|                     |           |                     |        |       |       |       |       |
|---------------------|-----------|---------------------|--------|-------|-------|-------|-------|
| P & G Health        | 7103.79   | Healthcare          | 100.08 | 73.79 | 15.22 | 23.44 | 34.70 |
| Nestle India        | 137776.13 | FMCG                | 70.93  | 45.30 | 28.61 | 36.02 | 32.57 |
| KEI Industries      | 3737.30   | Electricals         | 29.41  | 26.48 | 25.43 | 21.51 | 32.00 |
| Astral Poly Technik | 17277.19  | Plastic products    | 20.42  | 13.96 | 9.83  | 13.33 | 26.11 |
| Petronet LNG        | 40627.50  | Inds, Gases & Fuels | 30.33  | 21.79 | 14.75 | 19.94 | 24.73 |

Source: ACE Equity

#### Probable Stocks with Investment Moat (High Market Share)

| Company Name (1)                  | Industry (2)                  | Market capitalization (3) | Historical PE ratio – 3 years (4) | Current PE ratio (5) | YoY quarterly profit growth (%) (6) | YoY quarterly sales growth (%) (7) | Profit growth 5 years (CAGR0) (%) (8) |
|-----------------------------------|-------------------------------|---------------------------|-----------------------------------|----------------------|-------------------------------------|------------------------------------|---------------------------------------|
| Multi commodity exchange of India | Finance – stock broking       | 6921.24                   | 36.95                             | 30.14                | 100.50                              | 40.86                              | -0.97                                 |
| Avanti feeds                      | Consumer food                 | 8843.70                   | 22.14                             | 24.86                | 132.82                              | 41.05                              | 34.44                                 |
| Info edge                         | BPO/ITeS                      | 31192.61                  | 68.32                             | 79.82                | -22.42                              | 17.69                              | 71.40                                 |
| GMM Pfaudler                      | Engineering                   | 2910.93                   | 35.84                             | 43.16                | 51.10                               | 27.75                              | 21.55                                 |
| Jubilant FoodWorks                | Consumer food                 | 22701.31                  | 80.61                             | 58.99                | -3.41                               | 12.17                              | 21.88                                 |
| Asian paints                      | Paints                        | 174434.91                 | 60.27                             | 67.03                | 66.67                               | 9.43                               | 11.45                                 |
| Pidilite industries               | Chemicals                     | 72500.81                  | 53.19                             | 64.44                | 39.75                               | 2.81                               | 15.65                                 |
| Greaves cotton                    | Diesel engines                | 3212.62                   | 19.16                             | 21.14                | -11.72                              | 3.50                               | 5.68                                  |
| Bajaj auto                        | Automobile                    | 89748.63                  | 19.61                             | 18.04                | 21.84                               | -4.25                              | 7.19                                  |
| Hindustan Unilever                | Household & personal products | 434910.74                 | 53.33                             | 61.11                | 23.42                               | 6.09                               | 8.91                                  |
| Subros                            | Auto Ancillary                | 1871.61                   | 49.02                             | 22.88                | -42.69                              | -11.98                             | 29.68                                 |
| Zydus wellness                    | Consumer food                 | 8451.55                   | 47.69                             | 77.74                | -128.51                             | 135.89                             | 11.74                                 |
| Tata Motors                       | Automobiles                   | 60466.63                  | 9.76                              | 29.29                | -116.05                             | -9.16                              | --                                    |
| Solar industries                  | Chemicals                     | 9908.21                   | 58.78                             | 50.87                | 57.53                               | -2.75                              | 16.41                                 |

Source: ACE Equity

| Company Name                      | Sales growth 5 years (%) (9) | Current ROCE (%) (10) | ROCE 3 years (average) (%) (11) | ROCE 5 yrs (average) (%) (12) | Current ROE (%) (13) | ROE 5 years (average) (%) (14) | Returns 1 year (%) (15) | Returns 3 years (%) (16) | Returns 5 years (%) (17) |
|-----------------------------------|------------------------------|-----------------------|---------------------------------|-------------------------------|----------------------|--------------------------------|-------------------------|--------------------------|--------------------------|
| Multi commodity exchange of India | -1.26                        | 9.26                  | 10.85                           | 11.46                         | 9.04                 | 8.72                           | 80.40                   | 2.96                     | 9.95                     |
| Avanti feeds                      | 25.67                        | 33.74                 | 59.00                           | 59.80                         | 22.35                | 41.59                          | 62.48                   | 49.14                    | 42.32                    |
| Info edge                         | 15.24                        | 18.22                 | 15.42                           | 15.42                         | 12.86                | 11.27                          | 61.42                   | 44.09                    | 24.16                    |
| GMM Pfaudler                      | 12.82                        | 30.95                 | 27.33                           | 27.33                         | 20.14                | 16.24                          | 58.26                   | 49.28                    | 43.53                    |
| Jubilant FoodWorks                | 15.47                        | 41.77                 | 28.89                           | 28.89                         | 27.37                | 18.44                          | 40.01                   | 60.64                    | 20.21                    |
| Asian paints                      | 8.99                         | 38.38                 | 39.32                           | 39.32                         | 25.59                | 28.91                          | 28.16                   | 24.67                    | 17.12                    |
| Pidilite industries               | 10.69                        | 35.70                 | 37.38                           | 37.38                         | 25.33                | 26.25                          | 26.88                   | 30.87                    | 22.04                    |
| Greaves cotton                    | 3.14                         | 25.88                 | 28.33                           | 28.33                         | 17.55                | 18.50                          | 14.41                   | 4.63                     | -1.92                    |
| Bajaj auto                        | 8.43                         | 32.62                 | 33.12                           | 33.12                         | 22.87                | 26.23                          | 14.14                   | 4.22                     | 5.44                     |
| Hindustan Unilever                | 6.27                         | 116.06                | 108.10                          | 108.10                        | 82.24                | 87.75                          | 9.40                    | 33.01                    | 17.74                    |
| Subros                            | 12.70                        | 18.22                 | 13.95                           | 13.95                         | 14.03                | 9.59                           | 8.29                    | 20.33                    | 32.92                    |
| Zydus wellness                    | 15.92                        | 4.53                  | 15.35                           | 15.35                         | 4.80                 | 20.09                          | 7.76                    | 18.34                    | 12.74                    |
| Tata Motors                       | 5.34                         | 10.56                 | 3.54                            | 3.54                          | 9.55                 | -6.92                          | 5.85                    | -27.50                   | -17.58                   |
| Solar industries                  | 16.94                        | 30.43                 | 26.84                           | 26.84                         | 23.29                | 21.31                          | 5.03                    | 16.57                    | 13.34                    |

*Source:* ACE Equity

When it comes to picking the best stocks, there are dozens – perhaps even hundreds – of metrics an investor can use for analysis. Many novice traders simply use the price-to-earnings ratio (PE) to compare stocks for their portfolios whereas some consider ROE to be a prime decision-making tool. Others take a step further and determine the free cash flow to a firm in order to find out how much money the company is generating. However, no discussion of important investment metrics would be complete without mentioning the Return on Capital (ROC). Every good business has to generate high returns on capital consistently because it is the fundamental driver of valuation. High ROC over a period of time is a good indicator of identifying business with competitive advantages.

The ROCE is almost always greater than the cost of capital for moat stocks. ROIC should be high along with ROEs. Investors can also focus on consistency in dividend distribution and the dividend yield.

## CONCLUSIONS

While the outlook remains strong for the equity markets in 2020 and experts recommend being optimistically cautious on markets, the best that investors can do for themselves is to identify stocks with wider economic moats and construct a portfolio of such stocks. Moat stocks are expected to deliver positive results in the long term as the moat gets wider and deeper and impacts the profitability positively. Thus, a portfolio of moat stocks should be constructed with a long-term

view. While doing so it should be remembered that not all stocks reflecting moat will be meeting investors' expectations as it is quite possible that the moat wanes instead of getting wider as time passes. This is the exact reason why investors have on to be top of their portfolio investments and need to monitor them regularly. History teaches us that very few companies are able to sustain for very long. Asian Cables, Ballarpur Industries, CEAT, Century Textile and Bombay Burmah Trading Corporation are examples of stocks that were once constituents of the Sensex. After passage of three decades, these index constituents have not grown in line with investors' expectations. Even in the history of corporate America, General Electric is the only company that has remained a constituent of its key benchmark index for over 100 years.

Thus, wider moat is great but to assume that it is going to exist forever would be a mistake. Investors thus have to exercise caution in constructing a portfolio of wider moat stocks. Identifying a company with a moat is one task and to continuously keep tracking the company for the changes in its competitive position is another essential aspect of successful investing using moat stocks. Certain quantitative aspects should be examined before investing. Those stocks showing higher gross profit margins and net profit margins indicating pricing power can be considered for further research and preference can be given to those companies that indicate minimal investment required to stay competitive.

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