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Why Moats Matter

- Written by our co-founder, Charolyn Pedlar

A strategy designed to produce consistent long-term returns

Our investment strategy is to buy quality stocks, at prices that provides us a margin of safety, with the intention of holding them forever. We believe that trading too often, increases the probability of mistakes being made.

So, what are quality stocks?

At Platinum Portfolios, we look for the following three key qualities:

1. A business that generates strong and predictable cash flows,
2. A business that has a strong and competent management team,
3. A business that has a solid capital allocation plan that achieves a high return on invested capital (ROIC).

Why is this important?

Strong and predictable cash flows enable companies to return capital to shareholders in the form of buybacks and dividends. At the same time, a company should be able to reinvest capital back into the business, preferably with a high ROIC to fuel future growth. The company's ROIC gives us a sense of how successfully a company can generate cash flows from reinvesting capital into the business.

Why are moats essential for a business to generate good long-term returns?

Quality companies are protected by economic moats. The term, economic moat was first coined by the Oracle of Omaha, Warren Buffett to describe a company's competitive advantage over rivals due to deeply ingrained benefits. Like a castle having a wide surrounding moat to protect it against attack, an economic moat protects a company's competitive advantage over rivals due to deeply ingrained benefits like owning a great deal of intellectual property, enjoying a lower cost of capital, a network effect, or brand recognition.

This combination of tangible and intangible assets can support and protect a company's market share for years or even decades, as competitors struggle to cross the metaphorical economic moat. All the reasons why we prefer our quality companies to have wide economic moats.

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Two case studies that perfectly demonstrate a company with - and a company without, a moat. And importantly, why the distinction really matters.

Case study 1: Zoom Video Communications Inc.

Zoom is one of the tech names that won big during the pandemic. Zoom's business model perfectly met the needs of the work-from-home environment the pandemic demanded of businesses and enterprises. But as demand normalised after COVID and increased competition penetrated the market, Zoom will face increased churn. Zoom does not have a competitive edge and connecting people through video does not have an economic moat?

Think about one of its competitors Slack for a moment, this platform allows you to instantly send a message, or connect on a video call, or an audio call in seconds. Typically, people use Slack throughout the day, whereas they may only use Zoom for a meeting that is scheduled. There are many competitors with products that are the same or better, including Microsoft teams, and Cisco's Webex.

The rise and fall of Zoom

Trading at \$559 on 16 October 2020, Zoom had a good run, but now people are questioning what is next for Zoom. Having no competitive advantage over its competitors or moat to protect it, has resulted in Zoom's share price declining to around \$87 per share and it could dip further as competition eats into its market share.

Case Study 2: Microsoft Corporation

Microsoft Corporation is an example of a company with a moat. In fact, it has multiple moats. Aside from the obvious brand recognition, economies of scale, switching costs and the network effect. Microsoft has a large user base across multiple platforms which, when combined, give the company a wide moat. Microsoft 365 had 54 million subscriptions in fiscal 1Q22, Microsoft Teams had 250 million monthly active users as of July 2021, LinkedIn currently has nearly 800 million accounts.

Combined with its clearly dominant share in office productivity (48% versus Google Docs 46%), operating systems (45% versus MacOS at 29%), servers (11.2% which is 5x more than its nearest rival), gaming (50% share of US market *per Statistica*), Microsoft's segments show solid growth and profitability. Its market share in all but search is strong and defensible, proven by stable share over many years. (Source: Forbes)

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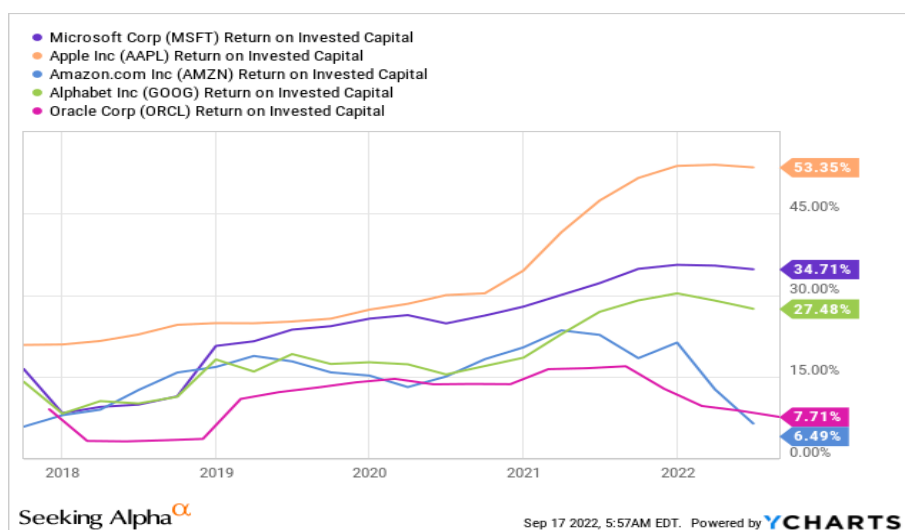
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Microsoft has proven to be a worthy competitor over the years; the company has maintained its position in each segment for decades despite concerted efforts by rivals to unseat them. We expect this to continue.

Do Microsoft's moats translate into great financials?

The graph below shows that Microsoft has a great EBITDA margin, which has been constantly growing due to the growth of cloud and subscription services. This translates to strong and predictable cash flows. Microsoft's EBITDA margin is also significantly higher compared to its main competitors.

Microsoft participates in some major growth trends, including digitalisation, the on-going shift to cloud, and gaming. This provides opportunities to reinvest the cash flows back into the business. Looking at the graph below, Microsoft has achieved a ROIC of over 30% in the previous two fiscal years, so it is able to drive high returns on every dollar invested. Among Microsoft's main competitors, only Apple managed to achieve a higher ROIC. Apple is also a company with a wide economic moat.



Microsoft does an excellent job of returning capital to its shareholders through its share buyback programme and dividend payments. Including this year's September increase, Microsoft has increased its dividend for eighteen consecutive years.

There is a lot to like about Microsoft. The company has some interesting growth levers across its three business segments, it has multiple moats, it has great cash flow and profitability, an impressive growth

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track record, and pristine balance sheet. In the case of Microsoft, their moats ensure that for long-term investors like us, at Platinum Portfolios, the company will have a growth path that will continue well into the future.

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