Your Stock Stinks Unless it has One of These 9 Competitive Advantages

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Competitive Advantage Explained

What is Competitive Advantage?

Moated Castle's Competitive Advantage | Flickr: fullon2012

Economic models often posit the existence of "perfect competition".

But in the real world, companies are often able to establish a solid competitive advantage over other companies. This enables them to either be able to charge a higher price than competitors without significantly harming or sales, or it allows them to have lower costs thereby earning them higher profits by charging the same price (or a lower price to compete out competition).

In markets that exhibit "perfect competition", these advantages should be short lived. But in reality, a **competitive advantage** can persist over long periods of time.

The key metrics to look at here are **return on capital** and **cost of capital**.

In a perfectly competitive market the two are equal. But sometimes a company can earn a higher return on capital than their cost. If this persists for a long time, it's an indication of a competitive advantage.

In ***Valuation: Measuring and Managing the Value of Companies***, the authors list a large number of types of competitive advantages.

I will reproduce the list here.

They categorize them, as I alluded to above, in two broad categories:

- Price Premium and Cost
- and Capital Efficiency

Here are more specific types of each.

Price Premium Competitive Advantages

Price premium advantages allow the company to charge a higher price than competitors. There are several different ways that this can be achieved.

1. Innovative Products

Many companies come up with innovative products. In most cases, it doesn't take long for copy-cats to find a way to make a similar product. For this advantage to work, there has to be something that prevents others from copying the product and selling it.

One way this is achieved is through patent laws. An example the authors use is pharmaceutical companies which have a patent on a particular drug for a period of time.

Innovation at its finest | Flickr Photo: zoetnet

2. Quality

Here perception is everything. But if a company can make a product that is perceived as higher quality (in excess of the higher cost required to achieve said quality) and this can persist for some time then it enables a competitive advantage.

3. Brand

The author's note that there's a relationship between brand and quality. Some will pay a higher price for a brand name when a perfectly good generic substitute is available.

You get what you pay for | Flcikr Photo: Kar]V[aN

4. Customer Lock-in

Here the cost (to the consumer) to switch to a competitors product is too much to make it worth the trouble. For example, if I have already spent time and resources learning to use a particular product, I'll be reluctant to switch to a competitor's product even if it's cheaper.

Brilliant branding | Flickr Photo: matsuyuki

5. Rational Price Discipline

This one requires an element of collusion. As an example, an industry leader may decide to charge a specific fee in addition to a product. Others in the industry may follow suit. While there isn't any direct collusion going on, it requires participation by all in the industry. As a result, this one may not persist for a very long time.

Cost and Capital Efficiency Competitive Advantages

The authors define a cost efficiency advantage as "the ability to sell products and services at a lower cost than the competition". They define capital

efficiency advantages as “selling more products per dollar of invested capital than competitors.”

They note that the two are related so they lump these together. So let’s continue with their list.

Apple fans line up during launch | Flickr Photo: brownpau

6. Innovative Business Method

Business methods can be copied. So for this one to work one of a few things need to happen. For example, if the method is kept secret so that only those working for the firm know it, this may give the company an advantage. Alternatively, if there is high switching cost (time and resources) for another firm to switch to the new method, this may allow one company to take advantage of it for a longer period of time.

It’s not about the money | Flickr Photo: Robert Couse-Baker

7. Unique Resources

Here the authors give an example that will make this more clear. To quote the text:

> *Take two nickel-mining companies, Norilsk Nickel, which produces nickel in northern Siberia, and Vale, which produces nickel in Canada and Indonesia. The content of precious metals (e.g., palladium) in Norilsk’s nickel ore is significantly higher than in Vale’s. In other words, Norlisk gets not only nickel from its ore but also some high-priced palladium. As a result Norilsk earned a pretax ROIC of 67 percent in 2007, compared with Vale’s nickel division generating 25 percent.*

Superb business acumen | Flcikr Photo: VividImageINc

8. Economies of Scale

Bigger is better? The authors rightly point out that economies of scale may only be regional. An example they use are health insurers that deal with local practices and hospitals. Having a large market share in a local market will give them advantages over a larger insurer (nationally) but not locally in terms of negotiating prices. This may enable them to offer insurance at a lower cost than a national competitor.

9. Scalable Product/Process

This works well for certain business models (many of which are IT related). Here there is a substantial initial cost. Once that initial cost is placed, selling more product adds little to no cost. As a result, the business with the biggest piece of the pie will have lower costs (relative to sales) and earning higher returns on capital. A movie, for example, has a high fixed cost. But it won't cost much more for more people to pay to see it. Software can often be another great example.

Probe for resources to win | Flickr Photo: iloveui

Concluding Remarks

So that sums up the list when it comes to competitive advantage.

Some of these are more short-term advantages that would probably get eroded by competitions.

Others, however, persist over long periods of time indicating that our markets are not as "perfect" as economists assume in their models.

Original article can be found here.

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Bigger is better | Flickr Photo: Creative Tools

Will your product scale? | Flickr Photo: moe_