Western Capital Markets

An Introduction to Business Strategy

Sample Educational

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I. Crash Course in Competitive Advantages

What Makes a Good Business?

Qualities of a Good Business

1

Economic Moat / Competitive Advantage

2

Growth Potential

3

Strong Management Team

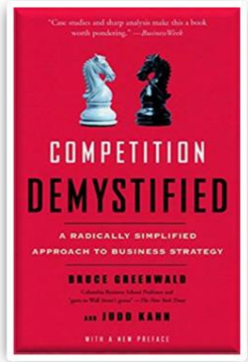
A good *investment* is a quality business at a **good price** with a 20%+ **margin of safety.**

Rivalry & Competitive Advantages

Understanding Defensible Advantages

- A **competitive advantage** is a unique business characteristic that allows a company to operate in a superior position when compared to its peers
  - May also be referred to as a **barrier to entry**
- Competitive advantages need to be **sustained** by the businesses adapting to external factors and through strategic decisions
  - Competitors will try to replicate the business if it is achieving above average returns on capital

Recommended Reading:
Competitive Demystified by
Bruce Greenwald & Judd Kahn



Why Does It Matter?

Investing

- Buying quality businesses for less than they are worth, and capitalizing on a difference between **market price** and **intrinsic value**
- Value investing aims to preserve capital, and grow it at a faster rate than the market

Market Knowledge

- Provides **context** for strategic decisions
- Provides a **framework** for analyzing current events
- **E.g.** Why did Facebook want to acquire WhatsApp in 2014?

Valuation

- When determining the inputs used in valuations, your perception of the competitive advantages affect your **assumptions**
- If you think Uber can achieve economies of scale, the margins in your projections will improve

Entrepreneurship

- Important for making business decisions if you have your own venture or your helping your employer assess strategic decisions
- **E.g.** Should Nick start a lemonade stand if Caitlyn can copy his recipe?

Strategy & Competitive Advantage

Testing for Competitive Advantages

- Not all markets allow for barriers to entry
- Companies must identify if competitors in the market have a competitive advantage, by testing for **two common attributes**

1

Stable Market Share

Market share shifts < 2% over 5-8 years

2

High Return on Capital

15 – 25% after-tax returns

Market Scenarios & Appropriate Strategies

#1: No Barriers To Entry	#2: One Firm Dominates	#3: Multiple Firms Have Competitive Advantages
Strategy: Minimize Costs	**Strategy:** Sustain Advantage or Leave	**Strategy:** *Varies*

Types of Competitive Advantages

Three Types of Competitive Advantages

1. Supply Advantages
2. Demand Advantages
3. Economies of Scale

Advantage #1 - Supply Advantages

What Creates a Supply Advantage?

- A supply advantage enables a company to deliver its good more cheaply than competitors
  - Complicated industries have natural barriers due to **learning & experience** and being able to reduce costs through time
  - **Patents** that protect output or critical processes
  - **Proprietary access** to inputs
- Simple product and processes (innovation) are not fertile ground for proprietary technology advantages (hard to patent and easy to transfer)
- Access to cheap capital, raw materials typically aren't strong either
  - Exception: Privileged access to raw materials, exceptional talent, low cost inputs that are local
- E.g. Semiconductors & computing in the 1990s

Example: Nick's Lemonade Stand

- Nick already has the perfect lemonade recipe while Caitlyn has to experiment with getting the right recipe portions
- Nick submitted a **patent** that protects his family's specialty lemonade recipe
- Nick has a **special agreement** with Aron's Lemon Farm where he receives a 10% discount on lemons (an input)

Advantage #2 - Demand Advantages

Types of Customer Captivity

Habit

- Customers become captive when purchases are **frequent and virtually automatic**
- If customer needs to think/research extensively, or is spending large amounts of money, likely *not* habitual

Examples

Searching Costs

- Cost to **locate an acceptable replacement**
- **3 Cs: C**ustomized, **C**omplicated and **C**rucial
- More powerful if total cost to customer is low relative to other expenses – customer will be unwilling to take the time to find alternatives
- Can be very impactful with experiential goods (e.g. Hairdressers, Lawyers)

Switching Costs

- Substantial **money, time and effort to switch** between suppliers of goods
- Can be inherent in product (software) or can be generated from structure of contracts and exit fees (mutual funds)
- Switching costs are most powerful when reinforced with network effects (Facebook)
- Costs are often strategically increased by encouraging more frequent payments or spreading payments over time

Advantage #3 - Economies of Scale

What Are They?

- **Cost per unit declines as volume increases** because fixed costs make up large share of total costs
- Does NOT depend on absolute size of company but rather size difference between company and its rivals
- Common for low margin, high volume businesses where goods are commoditized (e.g. natural resources)

Key Terms

- **Variable Costs**: Costs that varies with the level of output. (e.g. lemons, cups)
- **Fixed Costs: C**osts that are constant whatever the quantity of goods or services produced (e.g. salary, depreciation)
- **Operating Leverage:** The degree to which a firm or project can increase operating income by increasing revenue
  - Increases in companies with a high % of fixed costs

Volume (Units Sold)	1	10	100	1,000	10,000
Sales	$10	$100	$1,000	10,000	100,000
COGS	(7.5)	(75)	(750)	(7,500)	(75,000)
Gross Profit	2.5	25	250	2,500	25,000
Margin (%)	*25%*	*25%*	*25%*	*25%*	*25%*
Operating Expenses (Fixed)	(20,000)	(20,000)	(20,000)	(20,000)	(20,000)
As a % of Sales	*200,000%*	*20,000%*	*2,000%*	*200%*	*20%*
Operating Profit	(19,998)	(19,980)	(19,800)	(18,000)	5,000
Margin (%)	-	-	-	-	*5%*

Advantage #3 - Economies of Scale

Cost Structure Examples

Putting It Together

Key Takeaways

1. Competitive advantages based on economies of scale must be defended
   - Any market share lost to rivals narrows the leader's edge in average cost
   - Competitive advantages based on customer captivity or cost advantages are not affected by market share losses

2. Pure size is not the same as economies of scale
   - Share of relevant market that company can spread fixed costs – easier to stay fixed when local (geography or product)

3. Growth of market is generally the enemy of competitive advantage
   - As a market grows, fixed costs remain constant while variable costs increase (fixed costs decline as a proportion of total cost)

Common Misconceptions Around Competitive Advantages

What are not sustainable competitive advantages?

Branding & Product Differentiation	The "First-Mover" Advantage	Regulatory Barriers to Entry
Why Not? Branding can be replicated through marketing and initiatives. Similar products can be developed.	**Why Not?** Unless accompanied by cost advantages, rapid accumulation of scale, or customer captivity, an early market leader can fall.	**Why Not?** Governments—and their policies—can change. Relying on politics, especially in less stable democracies, is dangerous.

Reflection: Which is the best business?

Which of the following has the strongest business model? Why?

II. Applying Business Strategy: Game Theory

What is Business Strategy?

Understanding Strategic & Tactical Decisions

Strategic Decisions

Management Level: Top Management, BoD

Resources: Corporate

Time Frame: Long-term

Risk: Success, *survival*

Examples:

What business do we want to be in?

How are we going to deal with competitors?

Tactical Decisions

Management Level: Mid-level, functional, local

Resources: Divisional, departmental

Time Frame: Yearly, monthly, daily

Risk: Limited

Examples:

How do we improve delivery times?

How big a promotional discount do we offer?

Strategic decisions depend on the **actions and reactions** of other entities.

What is Business Strategy?

Quiz: Which is the Strategic Decision?

Should Coca-Cola enter the energy drink market?	**OR**	**Should Pepsi switch to paper packaging?**

Introduction to Game Theory & Strategy

Business Strategy Based on Competitive Advantage

- **Are there competitive advantages?**
  - Yes → **Are there competitive advantages?**
    - Yes → **Strategy:** Manage Competitive Advantage
    - No → **Strategy:** Varies
  - No → **Strategy:** Operational Efficiency

What is Game Theory?

- Game theory is the study of **mathematical models of strategic interactions** among rational decision-makers
- Game theory sets up “games” with multiple “players” that follow the same rules with the same information to achieve an optimal outcome
- A **Nash Equilibrium** occurs when no player can gain an advantage by unilaterally changing their strategy

Three Common Games

1. The Prisoner’s Dilemma
2. Entry / Pre-Emption
3. Cooperation

Scenario #1: The Prisoner's Dilemma

Introduction to the Prisoner's Dilemma

- **Two bank robbers (A & B) are arrested and charged, but they can only be prosecuted if one testifies against the other**
- Each robber is provided a choice: remain silent, or testify
- If both remain silent, they will each receive only 1 year in jail for petty crimes
- If one testifies while the other remains silent, the prisoner testifying will receive 0 years while the defendant will receive 3 years
- If both testify, each will get 2 years in jail for sharing responsibility for the crime

What does this teach us?

- This is a paradox in which two individuals acting in their own self-interests do not produce the optical outcome in **equilibrium**
- The prisoner's dilemma is a key case used in **game theory**, a framework designed to analyze social situations amongst competing players
- This same framework is often applicable to businesses' strategic actions

The Payoff Matrix

	B stays silent	**B testifies**
A stays silent	**Both** serve 1 year	**A** serves 3 years, **B** goes free
A testifies	**A** goes free, **B** serves 3 years	**Both** serve 2 years

Scenario #1: The Prisoner's Dilemma

Necessities to Maintain a Cooperative Equilibrium

- Most competitive interactions revolve around two issues: **price** or **volume**
  - Price competition is the most common form among a small number of competitors
- Maintaining a cooperative outcome, with everyone charging higher prices, is ideal

1

Stability of Expectations

All players will adhere to present choices

2

Stability of Behaviour

No competitor can improve its outcome further

Ways to Structurally Avoid the Prisoner's Dilemma Game

1. Avoid Direct Product Competition
2. Customer Loyalty Programs
3. Limit Output Capacity
4. Universal Cost Clauses
5. Narrow Decision Window
6. Incentivize Profit Over Growth

Scenario #1: The Prisoner's Dilemma

Case Study: Fox's Entry into Network Broadcasting

FOX

Which Competitive Advantages?

Captive Customers? ✓

Better Technology? ✗

Economies of Scale? ✓

Production Companies:
Warner Bros.
Columbia
Paramount
Universal
Etc.

Distributors:
ABC
CBS
NBC

Advertisers

Local Stations:

Owned & Operated:
WNBC-TV
WCBS-TV
KABC-TV

Affiliates
Westinghouse
Metromedia
KRON
MFAA

Advertisers

Audience

Scenario #2: Entry / Pre-Emption

How is Entry / Pre-Emption Different from the Price Competition?

- The other most common decision is whether to enter a market or expand in an existing market (**capacity**)
- The main players in an entry / pre-emption game are:
  - The **entrant**, who attempts to make inroads
  - The **incumbent**, who aims to preserve their market share

1. **Timing**
   Decision requires significant lead time
2. **Clarity**
   Strategies of aggressor & defender differ
3. **Longevity of Mistakes**
   Lasting consequences

General Strategies for the Entrant

Avoid Head-to-Head Competition → Limit Capacity, Finance Idiosyncratically → Spread Impact of Entry Widely Across Market → Move Slow & Steady

Scenario #2: Entry / Pre-Emption

How is Entry / Pre-Emption Different from the Price Competition?

- The other most common decision is whether to enter a market or expand in an existing market (**capacity**)
- The main players in an entry / pre-emption game are:
  - The **entrant**, who attempts to make inroads
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1. **Timing** — Decision requires significant lead time
2. **Clarity** — Strategies of aggressor & defender differ
3. **Longevity of Mistakes** — Lasting consequences

General Strategies for the Incumbent

Maintain Large Excess Capacity for Confrontation → Maintain a War Chest for Financing → Maintain Focus on Given Product

Scenario #2: Entry / Pre-Emption

Case Study: Home Depot & Lowe's

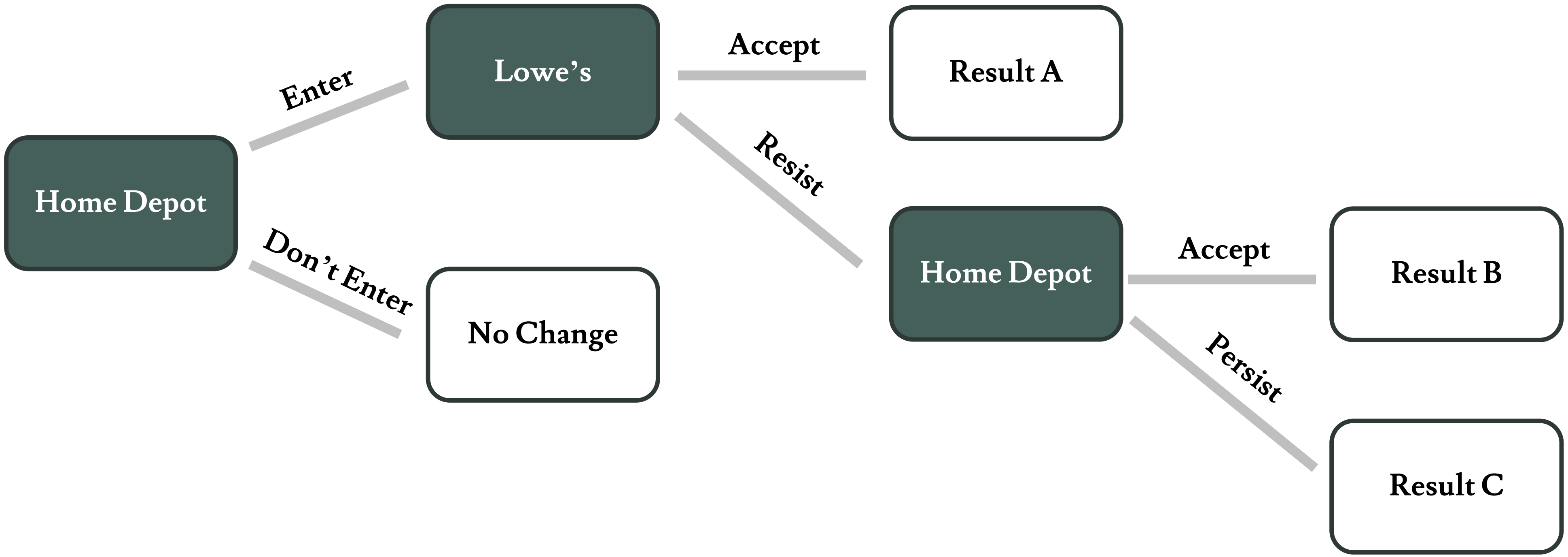
Entrant

VS.

Incumbent

Scenario #2: Entry / Pre-Emption

Case Study: Home Depot & Lowe’s



Change in Profit	
Lowe’s	HD
($2m)	$1m
($1m)	$0.2m
($3m)	($2m)

Scenario #3: Cooperation

What is Cooperation?

- Rather than maximizing reward through competitive strategy based on firm capacities, the **cooperation model** determines collective reward-sharing
- Strategic and tactical considerations become secondary considerations in this game
- However, in practice, cooperation can be difficult to implement due to **anti-trust concerns** and accusations of collusion
  - Additionally, this can be damaging to consumer rights and benefits, which can cause reputational damage

Steps in Cooperation

1. Parties determine attainable joint rewards
2. Determine optimal choice framework
3. Maximize joint rewards within the framework
4. Agree on how to divide the gains

Scenario #3: Cooperation

Case Study: Home Depot & Lowe's

Nintendo

Which Competitive Advantages?

Captive Customers?

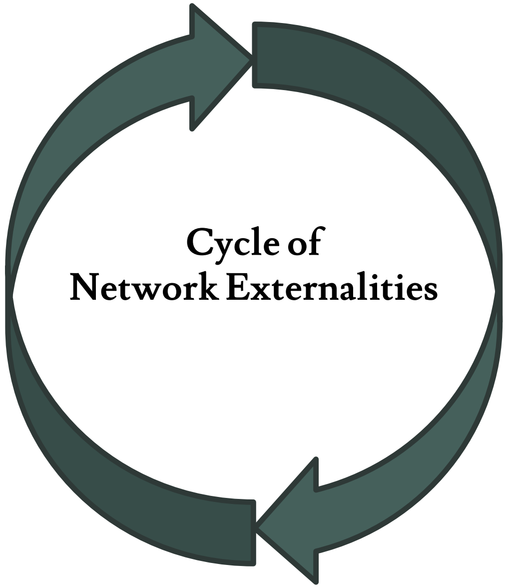
✗

Better Technology?

✗

Economies of Scale?

✗



Significant Install Base

Co-operative Relationship

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