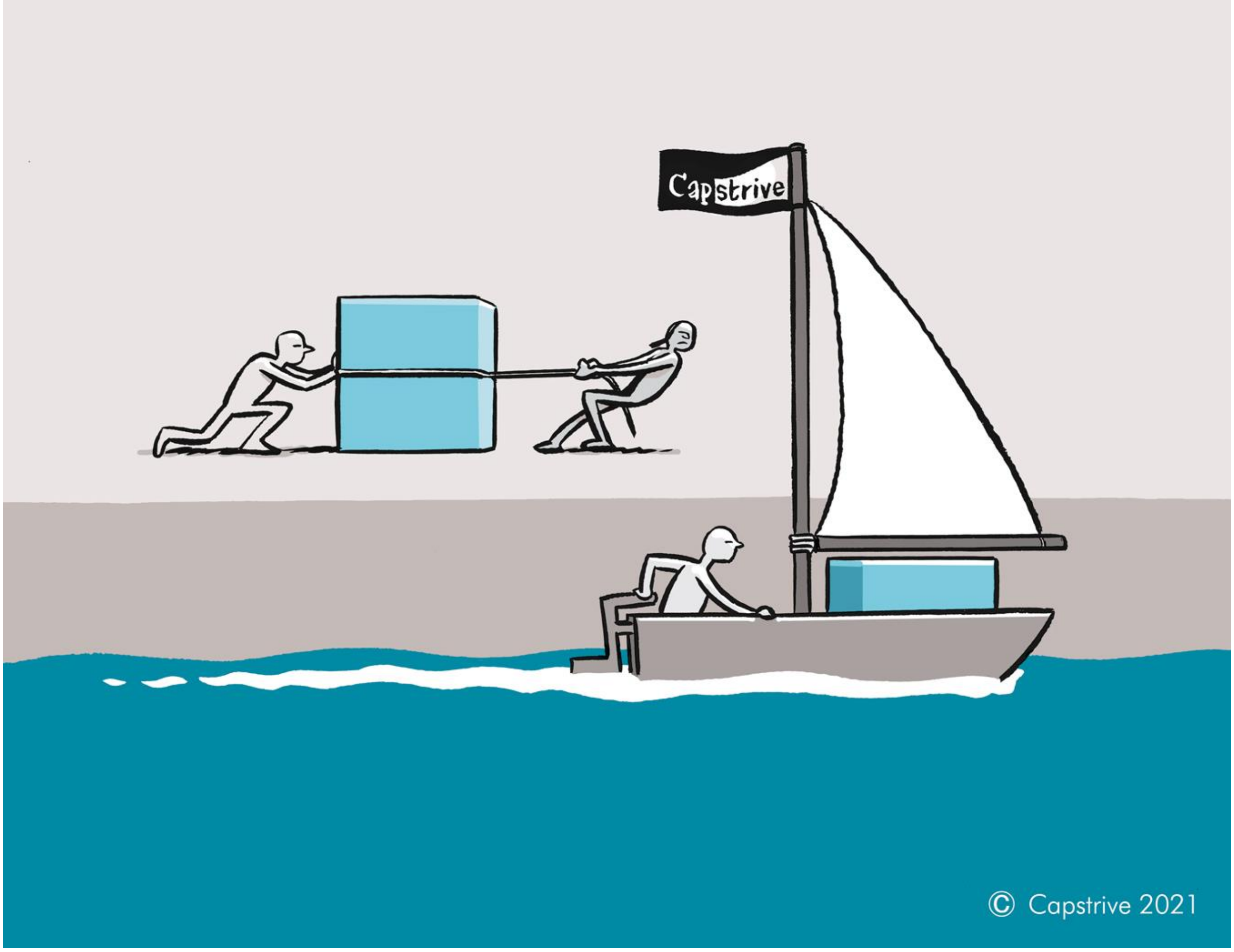

Introduction:

Some business models are simply better than others. There is something intrinsic to the nature of the business model itself, that, all else being equal, is a source of advantage. These businesses are durable by design. They have a Structurally Advantaged Business Model ('SABM').

To explore this topic in more detail I felt it would be helpful to attempt a classification of SABMs, and to do so in such a way that would make the categories memorable. In this sense it might help with pattern recognition in identifying fertile ground for compelling investments. For example, when Nick Sleep coined the phrase 'scale efficiencies shared', he forever seared a rich seam of fruitful situations in his own mind, and in the minds of many others since.

The categories that follow are a mix of the familiar and no so familiar. In some cases, I've done no more than use different language for an existing model, but this can be useful in recall and comparison.

A few other comments before we delve in:

1. This is an evolving work in progress.
2. The categories will overlap. The real world is far more nuanced and interdependent than my classifications suggest.
3. I would love feedback of what resonates, what's missing and what's wrong.

SABM #1 – Friendly Financial Leverage

Leverage, in the broadest sense, is fundamental to building anything of scale. All great business models employ some form of leverage, with scaled distribution (either physical e.g., Coke, or digital e.g., Microsoft) being especially powerful. There is however a small cohort of business that derive strength from their liabilities, i.e., from the way in which they are funded.

Insurance float is the classic source of friendly financial leverage. Berkshire Hathaway, Markel Corporation, and Fairfax Financial all benefit from float as they run growing profitable insurance businesses and invest a component of their float in profitable fixed income assets, and, to a lesser degree given regulatory capital constraints, equity securities. Their success in accessing this friendly source of leverage has not gone unnoticed and many investment managers have sought (mostly unsuccessfully) to emulate the model. Running a profitable insurance business is harder than it looks, so this source of leverage is only available to those with the competence to run a profitable business in what is a commoditised industry.

The business model of asset managers is highly leveraged to financial assets under management, provided by third parties. This external investor capital is affectionately known in the industry as OPM, i.e. Other People's Money, and it is one of the friendliest sources of financial leverage there is. In a sense this is a type of royalty on the success/growth of others and is similar to franchisor economics.

Negative working capital (e.g., supermarkets paid upfront with 60 to 90 day supplier credit), deferred tax, and non-recourse debt (e.g., securitisations) are also sources of friendly financial leverage.

SABM # 2 – Critical Non-commoditised Components

This is a business that supplies a critical component, while facing limited competition and, at the same time, it doesn't abuse its position as a critical supplier. The price paid by the purchaser is fair in the scheme of its value chain.

For example, semiconductor manufacturer TSMC supplies leading edge chips to Apple. The cost to Apple is small in the context of its iPhone margins. TSMC has arguably no competition in leading edge chips, having developed an earned monopoly.

Other examples include Genus plc which manufactures and distributes genetically enhanced semen for livestock producers, and Chr. Hansen which produces the cultures and enzymes that enable food companies optimise taste, texture, and shelf life.

Suppliers into highly regulated industries where safety is paramount, like pharma and aviation, often find themselves in an attractive duopoly or oligopoly. There is little incentive to purchase relatively inexpensive components in mission critical applications from a second or third tier supplier as the financial saving is minuscule in the context of potential component failure. Costs of failure often go beyond financial loss to loss of life. It would be nuts to skimp on quality.

Holders of scarce or unique resources also fall into the category of non-commoditised critical components.

SABM # 3 - Scale Efficiencies Shared

Articulated by Nick Sleep as 'scale efficiencies shared', this is one of the strongest sources of structural advantage as it is exceptionally hard to compete with. When Jeff Bezos says, 'your margin is my opportunity', he is not addressing the small cohort of firms that obsess about delivering extreme customer value.

In the US, Amazon, Walmart, Dominos, Costco, Vanguard, and Southwest Airlines have all pursued strategies of sharing scale benefits with customers, predominantly through lower prices[1].

European low-cost airlines Ryanair and Wizz Air have pursued similar strategies and in so doing have relentlessly taken market share from traditional airlines.

Microsoft practices a variation of this theme through continually adding new features to its office suite without commensurate increases in price.

The scale efficiencies shared model continually embeds substantial latent pricing power (or consumer surplus) and builds customer loyalty. It's pretty close to a 'win/win' model (except perhaps for the pressure it puts on suppliers). One would be hard pressed to find many examples where maximising consumer surplus has worked out badly.

SABM # 4 - High ROIC Cookie Cutter

The ability to reliably re-invest free cashflow at a high ROIC is a wonderful structural advantage.

McDonalds, Dollar General, Walmart, Dominos, Home Depot, Starbucks, and Chipotle are all great US examples of relatively predictable re-investment machines, which some have supercharged by developing a franchising option. Franchisers also get to leverage the growth of their franchisees.

A recent European example is 3i Group plc's investment in the non-food, discount retailer Action. Store investments payback in eighteen months, and notwithstanding what has been a 50x for 3i so far, Action is still growing strongly.

Companies that are very disciplined acquirers also fit the high ROIC cookie cutter categorisation. Examples include Constellation Software, Roper, and DCC. Their path may be less predictable than underpenetrated retail rollouts, but their value accretion rests on a similar premise of a strong degree of repeatable re-investment at high returns.

SABM # 5 – User Generated Content

Consider the differences in the content cost structures of Spotify, Netflix, and Facebook.

For Spotify, most of its subscription revenue is paid away in royalties every time a song is played resulting in gross margins in the twenties. Netflix is in a better position as it pays for its content once and can amortise it over a growing subscriber base in perpetuity. Netflix is currently generating gross

[1] There are also brand advantages at work here, in terms of the trust built with customers.

margins approaching 50%. Facebook's content is user generated and its gross margins are a mouth-watering 80%.

Twitter, Alphabet and Pinterest are all beneficiaries of the power of user generated content (monetised through targeted advertising).

Credit Card companies enhance their profit margins through selling user generated data as do many loyalty card companies.

User generated content can also be leveraged to provide a better customer service proposition. The Progressive Corporation has done this with telematics, enabling it to better price risk and a build a stickier customer base through offering lower insurance rates for safe drivers.

SABM # 6 – "Both Sides Now" (aka scaled two-sided networks/network effects)

I don't have anything new to add to what is one of the more powerful business models, a scaled, two-sided network.

A scaled two-sided network, commonly referred to as a platform, is extremely powerful and typically results in a winner takes all or winner takes most share of the relevant profit pool. Once both sides are scaled, these are brilliant businesses, but the barriers to entry are typically extremely high given the 'chicken & egg' problem of introducing sufficient liquidity and value to the early network members.

Visa and Mastercard are the textbook examples. Other scaled two-sided platforms include Google, Facebook, Auto Trader, Uber, Fiverr, Rightmove and Airbnb.

Sarah Taval has done great work on platforms, and Blas Moros compiled a most helpful summary of the better books on this topic.

SABM # 7 – "Privileged Perch"

This is quite a broad category that covers businesses that find themselves with limited competition as they are protected through some combination of legal, regulatory, customary, or reputational privileges.

Patents secure a monopoly for a defined period.

Testing & certification firms build a moat by building the 'gold standard', often with regulatory endorsement. Who wants to have their safety equipment certified by a second-rate tester?

Moody's Corporation and S&P Global operate within a ratings duopoly in anointing whether bond issuances are investment grade, benefitting from a standards-based moat.

The big four accounting firms enjoy a large reputational privilege, even in the face of some major hiccups. Management teams that want to engender trust with their shareholders are more inclined to choose one of the big four.

Ivy League universities and luxury goods companies fall into this category, through combining reputational/brand advantages with scarcity and federal student loan eligibility.

Philanthropist Chuck Feeney became a billionaire by building a tax advantaged duty-free shopping franchise (a fortune he quietly gave away).

State and national lotteries enjoy protected positions, as do certain 'last man standing' businesses (tobacco, cement plants or related businesses where approvals would no longer be forthcoming).

The most privileged perch of all is the exclusive right to print the worlds reserve currency, an exorbitant privilege.

SABM # 8 – "Stuck on You" (aka high switching costs)

Keeping customers is far more profitable than finding them. Businesses want customers that stick around. Sticky businesses are said to have high switching costs. Barriers to switching can come from deep integration, user training, communication network effects (as has historically been the case with Bloomberg terminals for example).

Some switching costs are better than others. Oracle customers face substantial switching costs because of its deep integration and large cost/risk of replacement, but if pricing is flexed too much (taking advantage of the difficulty of switching) it leaves itself open to being marginalised over time.

The better switching barriers are where the product or service delivers so much value that switching makes no sense. Software as a Service ('SaaS') businesses, when done well, are in a good position to build a sticky customer base as they can leverage customers usage data and patterns to continually enhance the software.

A variation on the 'stuck on you' theme is the razor/razor blade model, pioneered by Gillette (before dollar shave club tried to spoil the party). Nespresso (cheap coffee machines/expensive coffee pods) and HP (cheap printers/expensive ink) have followed the Gillette playbook.

And let's not forget the sin stocks (cigarettes, alcohol & gambling). There's dollars in dependency.

SABM # 9 – Ecosystem Enablers (aka "win/win")

A lot of the original/historical thinking on moats and valuable businesses has focussed on building advantages that a business can use against its customers through maximising pricing power.

In an age of increasing transparency, the more powerful (i.e., sustainable) models are the ones that are both financially and morally defensible. Such businesses are genuinely win/win in that they support and enable a growing ecosystem. The value they extract from the ecosystem is a mere fraction of the value they enable (perhaps 5% or less).

Companies like Shopify, Stripe, Twilio, GoDaddy, and Plaid are all ecosystem enablers. They help their customers get things done at scale, and they do so at price points that are modest in the context of the value enabled.

Conclusion

Peter Drucker said that the purpose of a business is to create and keep a customer. In essence, the embedded value of a business lies in the difference between the cost to serve a customer and the value delivered to a customer. Advantaged models are adept at allocating resources to deliver sustainable value.

I hope the above taxonomy of SABMs covers most of the valuable waterfront, and that a great business model can be benchmarked against the degree to which it fits one, or, more likely, many, of the nine categories outlined.

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