What Makes a Company an Attractive Investment?

By Julie Rains on 11 September 2013 0

Wide Economic Moat

The economic moat is the unique, sustainable advantage that keeps competitors away and allows a company to generate higher-than-average profits. (See also: Why It's So Hard to Follow Warren Buffet's Advice)

Billionaire investor Warren Buffett is credited with popularizing the term "economic moat." Investing sites such as Morningstar and The Motley Fool reference the phrase. Just as in medieval days, the moat protects its owners from situations like these:

- Attacks by upstarts offering flashier or cheaper products or services.
- Direct competitors stealing customers with high-performing products or services.
- Well-established firms entering the marketplace and capturing market share.

The wider the moat, the longer a company's financial success should last.

For example, a pharmaceutical company with a patent on a popular drug that won't expire until 2017 has a protective moat of four years. A corporation with numerous patents and more drugs in the development pipeline could have an even stronger and longer-lasting advantage.

Other examples of moats include:

- Loyal base of customers (such as search-engine users or business subscribers).
- Products and services that are difficult, costly, and time-consuming to drop for a competitor's offering (such as software embedded in various aspects of daily operations).
- Connectedness that leads to more connections (such as a network of buyers and sellers or a payment method widely accepted by merchants that becomes more and more in demand by consumers).

- Infrastructure such as an electrical grid or small package delivery service's hubs, distribution center, and trucks.
- Intellectual property, such as patents, brands, proprietary technology, and copyrighted materials.
- Low manufacturing and distribution costs obtained through methods not easily duplicated by newcomers or outsiders such as high-volume purchase contracts, partnerships with suppliers and customers, and efficient production processes.

Recognizing an economic moat is relatively easy; projecting whether it will be valuable years from now is not so simple. Demand for certain products and services may disappear or disruptive (or game-changing) technologies and business models may surface, eliminating or weakening the strength of the moat. Still, it's wise to consider whether a company has advantages that protect from invaders.

Integrated Into Our Daily Lives

A great company has products and services that you easily and gladly integrate into your daily life at home, work, or both. These may be your favorite store or materials supplier, streaming entertainment provider or online software company, search engine or database, cellphone company or telecom provider, apparel brand or uniform laundry, online broker or bank, etc.

These companies are able to fulfill needs and wants through methods that are understandable, prices that are affordable, and distribution channels that are accessible to you.

Profitable

A profitable company makes more money than it spends. The profit margin indicates how much profit every dollar of sales produces; calculate this number by dividing net income by revenue. Sure, we expect businesses to be profitable simply by being a for-profit organization, but many survive for years by securing outside financing or using excess cash. So, it's worth checking financial statements to look at profit margins. (See also: Myths Non-Business People Believe About Business)

A great company generates a profit by charging more than enough to cover its costs. Very often, a wide economic moat allows the business to 1) charge a premium for its products or services; 2) sell a high volume to customers; 3) control its costs and operate efficiently; or 4) do a combination of these.

Profit margins vary by industry. Some industries have higher margins than others, so compare profitability among competitors to identify the best companies in each category.

Free Cash Flow

Free cash flow is defined by Investopedia as "cash flow from operations (operating cash) - capital expenditures" or "how much cash a company has after paying its bills for ongoing activities and growth."
Capital expenditures, or capex, lower free cash flow, though such spending is often necessary to fortify an economic moat and desirable for continued growth. For example, a company may use cash to 1) pay for the construction of new stores in order to reach more customers or 2) upgrade systems for more efficient operations. These expenditures should eventually reap cash-generating benefits such as higher sales and higher profit margins or lower costs.

Similarly, you might use cash to renovate your home and add solar panels or similar upgrades. Your cash flow suffers in the years you make these purchases but you'll be better positioned for the future with lower energy costs, for example. The important thing is to avoid overspending on frivolous changes that don't add value.

Companies that generate a lot of cash tend to be healthy and profitable plus well positioned to take on new opportunities or defend themselves from competitive threats.

Visionary Leadership and Effective Management

Visionary leaders inspire a company to maintain its relevancy while remaining true to its core purpose as customers grow and change, culture evolves, technology advances, and competitors try to encroach on its territory. Effective managers make sure that ideas are communicated throughout the organization and assures that plans are executed properly. (See also: A 94-Year-Old Explains Good Decision-Making)
Both leadership and management are crucial to the success of a great company. In addition to setting overall direction, their values often permeate the entire organization. So, if the top-level people believe in the brand message, show commitment to quality,

value innovation, and appreciate customers, then it's more likely that the front-line employees will, too. Your experiences with a company, then, can help you detect an outstanding organization.

In my experience, no one or no company is perfect all the time. A great company generally has at least three or more (but possibly not all) of these attributes.

Note that there's a difference between a great company and a great investment. That is, a wonderful company may have characteristics that may make its stock a poor candidate for your investment dollars. But it's worth considering what makes a company great before you invest.