

Exclusive Outlook

WEST COAST ASSET MANAGEMENT, INC.

NOVEMBER 30, 2004

Competitive Advantage: Attributes of A Winner

By Paul Orfalea, Lance Helfert, and Atticus Lowe

A friend often comments that the bitterly contested presidential election of 2000 is a case study in bad marketing. "When you focus obsessively on your competition, the best you can hope to create is parity. Only by focusing on your customers can you innovate and create competitive advantage. The candidates talked only about each other, and the country split down the middle. Failure to establish a unique, compelling position may be considered good politics, but it's bad marketing."

An interesting metaphor, as the country once again recovers from a bitterly negative election campaign, but customer-inspired innovation is but one of many ways to win in the business world. As investment researchers we are keenly interested in the attributes that make one company more profitable than its competitors over time. In other words, we want to invest in companies with unique, sustainable competitive advantage.

ATTRIBUTES OF SUPERIOR PERFORMERS

Competitive advantage exists in any organization that consistently profits more than similar companies. Many characteristics might create such an advantage, but they generally fall into one of two categories: market differentiation and cost structure.

Differentiation refers to any number of attributes that might separate one company from another, such as product

quality, customer service, intellectual property, regulatory benefits, and annuity revenue streams. Cost structures include innovations, efficiencies, contracts, distribution positions, and shrewd purchasing decisions that produce long-term cost savings unavailable to competitors.

But in either category, a true competitive advantage must be hard to copy, sustainable over time, a barrier to entry, a generator of real value, and adaptable to changing conditions.

REAL WORLD EXAMPLES

Investment legend Peter Lynch illustrates competitive advantage through the example of owning the only gravel pit in a growing community. The owner can maintain high margins because there is plenty of demand, but competition must endure the expense of shipping a very heavy product from far away.

Two of our favorite companies, Johnson & Johnson and Wrigley, maintain competitive advantage in different ways. J&J focuses on the constant reinforcement of trust, and has done so from their earliest days. Brand equity works as well for J&J as it does for anyone, and they protect their brand at all costs. Wrigley, on the other hand, leverages the large market for their product and relatively few competitors by offering a wide variety of products and thereby dominating the limited shelf space available for impulse purchases.

Like Wrigley, Hallmark's size, scope and market share



create competitive advantage. Well over half of all greeting cards sold are Hallmark cards. As a result, much of Hallmark's advertising does not even emphasize the brand, but only the emotional benefits of communicating with cards. All they have to do is encourage the use of cards; odds are very good that people will buy Hallmark.

TURNING SMALL SALES INTO BIG BUSINESS

Recurring revenues are a great source of competitive advantage. Everyone knows the concept of giving away shaving razors and selling the blades (something Gillette has been very good at doing), or low-cost ink-jet printers that use expensive ink cartridges. These are good sources of recurring revenue, but long-term contracts are even better. For example, wireless phone and Internet service providers create competitive advantage to the extent that their contracts make it difficult for customers to switch providers.

Strategic alliances also bolster competitive advantage. One company that prints and mails water bills partnered

with software developers who sell accounting programs to municipalities. Now they have expertise and endorsements unavailable to their competitors. Creative managers seek out these kinds of "tie-breakers" so they always have an edge.

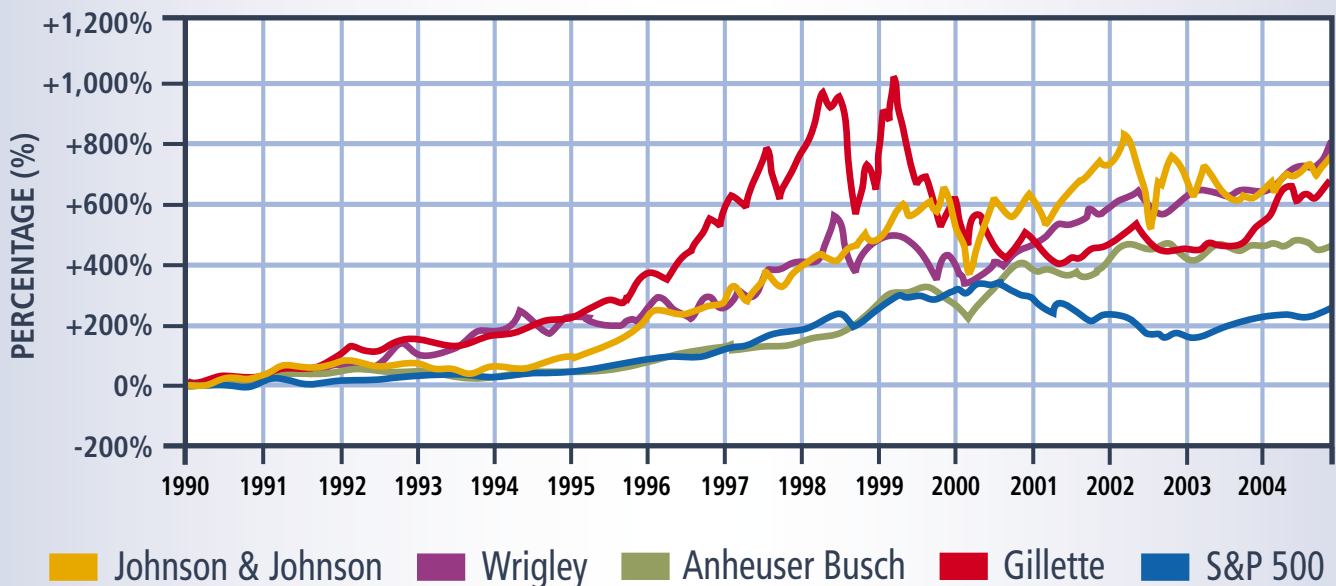
ABUSE IT AND LOSE IT?

One of the strongest possible competitive advantages is patentable innovation. Many innovations can be copied, but strong patents, such as those in the pharmaceutical industry, can protect a company's profits for many years.

Some competitive advantages are so strong they invite attack. Microsoft's amazing history might lead some to say that sheer audacity is their primary competitive advantage, but there is no debate that their ubiquity now constitutes a powerful edge in the marketplace. Too powerful, according to the Justice Department and many States' Attorneys General.

Likewise, Anheuser Busch, which holds a dramatic advantage in distribution efficiency over its rivals, faces

Competitive Advantage Vs. S&P 500



Source: ©BigCharts.com

The above chart shows the stock performance of companies mentioned with strong competitive advantage compared to the S&P 500 Index over the past 15 years.

★ Please email info@wcaminc.com to receive *Exclusive Outlook* (specify mail or email preference), it is free to everyone. ★



legal action for certain provisions of its distribution agreements. Whether these companies crossed the line from competitive advantage to unfair competition and/or monopoly status is not for us to decide, but they clearly illustrate how far competitive advantage can carry an organization.

In general, technology companies cannot sustain competitive advantage unless they constantly reinvent themselves. Even Apple Computer, which periodically (and brilliantly) reinvents itself and its products, teeters every few years on the edge of disaster. Still, when we saw people buying Apple computers to better support their Apple iPod music players a year ago, we were reminded that competitive advantage does not depend on market share. If anything, Apple's frequent phoenix-like resurrection reflects their absolute mastery of product life cycle, whereby they always seem to have a blockbuster product waiting just as an older product loses its luster.

Nevertheless, we would not be comfortable investing in Apple because we do not have faith in the long-term sustainability of their adaptability; one failure would hurt them deeply. Two in a row could destroy them.

CAN COMMODITIES FIND COMPETITIVE ADVANTAGE?

Companies operating in so-called "price-takers" markets, such as oil and gas, wheat, and other commodities, can find competitive advantage through efficiency, exclusivity, and/or proprietary processes. The Meridian Resource Corporation (TMR) seems to benefit from all three.

Meridian is a natural gas exploration and production company that has effective control over approximately 400,000 acres in the Biloxi Marshlands of SE Louisiana.

The company possesses proprietary 3D seismic over this acreage, which is essential for identifying prospects. Concentrating their operations in one area builds efficiency, compared to competitors who are hunting for gas hither and yon, and must transport supplies and equipment wherever they find, or hope to find, a source.

Taken together, these advantages allow Meridian to drill wells that cost approximately \$2M, but which pay out 10-20 times that amount over a 3-4 year period (at current prices). The concentrated area, exclusive rights, and proprietary seismic data add up to a high rate of success in finding natural gas.

We identified Meridian as an investment candidate more than one year ago by tracking the drilling success of a private company, Manti Resources, with extensive acreage that bookends Meridian's property (Louisiana state data available at www.sonris.com). The core of a prolific natural gas trend appears to run directly through Meridian's acreage position, and the company has only drilled a small fraction of its prospects to date.

THE BEST DEFENSE IS TO PLAY YOUR OWN GAME

We've always been fond of a quotation from Mel Bay, whose music education books taught millions to play guitar: "We do not compete. We innovate." Truly, the best way to stay consistently profitable is to offer something unique and widely needed. We seek out companies that are genuinely better than their competitors, offering unique benefits if not unique products.

Politicians and other brand-obsessed marketers spend fortunes figuring out how to look better than the competition. As professional investors, it's our duty to find companies that truly are better, and know how to stay that way. ▲

OUR PHILOSOPHY— *Our primary objective is to preserve and increase our clients' wealth. We focus on the best opportunities in the stock market, and limit our investments to a small number of carefully selected companies. We proudly invest our personal assets in the same securities we choose for our clients. Every investment decision is based on our own research, and our due diligence includes a visit to most companies we invest in. We are honored by our clients' trust and spare no effort to reward that trust with outstanding results.*

Please feel free to copy and distribute the Exclusive Outlook

West Coast Asset Management is a private independent money manager serving individuals, families, trusts of all kinds, & businesses. We pride ourselves on our focus, commitment, and integrity, but also on our availability. Please don't hesitate to call us with any questions or comments.

This material is for informational purposes only, it is not a complete analysis of every material fact. These opinions are subject to change without notice. West Coast Asset Management makes no warranty or representations as to their accuracy or usefulness. Data was obtained from publicly available sources that we believe are reliable. The principals of West Coast Asset Management, or its clients may own shares in the companies we write about. Third-party trademarks and service marks are the property of their respective owners.

