Implied competitive advantage period (I-CAP)

Implied competitive advantage period and the stock selection process

When will cash flow generation start to fade?

Closing an important information gap

Our standardized metrics capture the implied competitive advantage (I-CAP) captures the outlook for sustained cash flow generation into the long term, as implied in management guidance/consensus forecasts and the company's cost of capital. It captures that future value component of stocks valuation as implied in management guidance/consensus forecasts.

It brings two critical insights to the stock selection process as to what Mr Market expects in terms of the duration of cash flows.

On the one hand, it indicates the potential for upside due to the prospect of sustained value creation. On the other hand, it indicates the risks attached to the stock if a significant part of the valuation is due to the future value component.

A high I-CAP value suggests that high rates of cash flow generation is expected to be sustained over a long duration. Stocks with high I-CAP and strong incremental shareholder value creation prospects (as measured by I-EVA) are likely to enjoy higher valuation.

Assessing the future value component is the most critical part of equity valuation and this, in our view, represents the essence of all successful equity investing. It is also the component that is the hardest to estimate because long terms competitive dynamics are impossible to predict and, in general, long-term forecasting is a thankless task anyway.

What it is

I-CAP captures that (implied) future value component of stocks valuation as implied in management guidance/consensus forecasts. It gives an idea of how much of the equity valuation is "unexplained" (the bit that is normally lumped in the terminal value component of DCF model). Are estimates/forecasts too bullish, or bearish?

Competitive advantage is normally discussed in qualitative terms. For example, superior brand strength, technological edge and dominant market share is cited as features which provide competitive advantage to companies.

Looked at another way, competitive advantage represents the length of time it will take for competitive forces to erase the company's excess returns to zero. Companies with a long competitive advantage are expected to have better visibility and predictability in cash flow generation, which is likely to persist over a longer duration.

Why it's useful

An understanding of competitive advantage is critical to the stock selection process. Our calculations of I-CAP allow investors to make a judgement call on whether the implied sustainability and duration of cash flow generation are plausible, particularly using inter-peer or inter-sector comparisons. The outlook for this component should become one of the definitive pillars of a stock selection process.

We subscribe to that conceptualisation of equity valuations as consisting of two parts - the steady state component and the future value component. The steady state component reflects any annuity-like cash flow generation characteristics the firm may possess, and this is mostly a short-term factor. This may arise from, for instance, current product superiority, strong near-term end-market fundamentals etc.

In contrast, the future value component of the valuation is the "option" component in a stocks' valuation - the possibility that the forecast cash flow generation could persist, perhaps even with potential for upside over the longer term as the company's fortunes expand considerably.

Establishing the value of this component requires an assessment of the point at which cash flow generation will fade (or accelerate). The challenge, in other words, lies in determining the likely length or duration of the competitive advantage enjoyed by a firm; or the length of time it will take for competitive forces to erase the company's excess returns to zero.

Companies with strong competitive advantage are also expected to have better visibility and predictability in cash flow generation, which is likely to persist over a longer duration. And these companies can command a higher valuation.

Using the I-CAP metric

A low I-CAP value implies that a stock has little chance of delivering sustained expansion in cash flow growth? Can the management, by implementing a fresh strategy, change this perception?

Stocks enjoying high I-CAP could well be investing for market dominance and are expected to deliver sustained cash flow growth in the future? Or is this likely to be a set of value destroying capital allocation policies?

Are the risks from competitive threats to top line and margins from competitors, or even due to unexpected declines in end markets overstated, or being understated, by the I-CAP scores?

I-CAP also captures that (implied) future value component of stocks valuation as implied in management guidance/consensus forecasts. It gives an idea of how much of the equity valuation is "unexplained" or "not reasoned". Are estimates/forecasts too bullish, or bearish? In this sense context the I-CAP become a measure or proxy of "duration risk".

What it is

Competitive advantage is normally discussed in qualitative terms. For example, superior brand strength, technological edge and dominant market share is cited as features which provide competitive advantage to companies. However, measuring or quantifying competitive advantage has been a challenge and one proposed metric has been that of Competitive Advantage Period (CAP). This term was first coined by Michael Mauboussin and Paul Johnson* and is the term over which a company is expected to generate returns on invested capital that exceeds the cost of such capital.

Looked at another way, CAP represents the length of time it will take for competitive forces to erase the company's excess returns to zero. Companies with a high CAP are also expected to have better visibility and predictability in cash flow generation, which is likely to persist over a longer duration.

Estimating CAP - the sell-side approach

In investment banking research reports the competitive advantage enjoyed by a company is often discussed in the Porter framework of strengths, weaknesses, opportunities, and threat, which tends to be qualitative discussion. Quantitative estimations of CAP by the sell-side tends to be rare.

When it is done, typically, most calculations of CAP will use a discounted cash flow method to discover a point in time; defined in terms of the number of years - the period after which the cash flow generation will start to fade dramatically.

For example, in a competitive industry sector with low barriers to entry and persistent pricing pressure may be deemed to have a CAP of, say, five years. On the other hand, an industry with high barriers to entry and enjoying strong pricing power may be thought to have a highly competitive advantage of, perhaps, 15 years.

To quantify these periods, cash flow projections are modelled over the long term and discounted cash flow techniques are used to compute the implied CAP metric.

While such estimates can look appealing for their elegance, the models carry the same flaws that affect DCF models. Predicting cash flows of companies even into the near term is a hazardous business. Over the longer term, the questionable assumptions underlying such models make the results for CAP to be of dubious value.

Incremental economic value added (I-EVA) and implied competitive advantage (I-CAP)

Central to ERI's stock selection process is the measure of I-EVA, more details of which you can find here, which captures incremental shareholder value creation, the outlook for which is the key driver of equity valuations. I-CAP indicates the extent to which that trend in I-EVA may be sustained, or at least expected to be sustained based on consensus forecasts/management guidance. Together they represent the critical factors that need to be grasped in equity investing.

Estimating CAP - ERI's approach

ERI's approach to estimating the competitive advantage enjoyed by a firm avoids the pitfalls associated with a forecasting approach. Instead, ERI evaluates the implied competitive advantage period (I-CAP) - as implied in the management guidance/consensus forecasts. It is impossible to be establish with any certainty how exactly a company's competitive advantage situation will likely to pan out into the future, but we can develop a firm idea of what sort of competitive advantage the market is attributing to the stock.

To calculate I-CAP, ERI employs a technique like estimating bond duration**. The calculated implied "future value" component becomes the proxy for the competitive advantage period. The key variables that go into the calculations include consensus forecasts for cash flow growth, tax rates and company specific WACC.

The values are standardized to enable comparison across peers. This score indicates what the market thinks of the company's ability to drive sustained top-line growth and cash flow generation.

Whether through using quantitative techniques or qualitative analysis even the greats of the industry can err in their judgements. Our calculation of the implied competitive advantage closes this information gap by providing a critical insight into what Mr Market expects in terms of the duration. ERI estimates of the implied competitive advantage period (I-CAP) captures the outlook for sustained cash flow generation into the long term, as implied in management guidance/consensus forecasts and the company's cost of capital.

A high I-CAP value suggests that high rates of cash flow generation is expected to be sustained over a long period. Stocks with high I-CAP and strong incremental shareholder value creation prospects (as measured by I-EVA) are likely to enjoy higher valuations

It is logical that the valuation multiple attached to a stock also reflects this implied-CAP. The longer the implied-CAP, and the consequent visibility in the future cash flows, the higher the multiple.

Value investing and competitive advantage

In particular, the "value investing" paradigm can often be shackled to the past and the present not just in terms of what it sees as acceptable financial growth projections, but also in terms of its unwillingness to countenance the possibility of a new business models and practices which could deliver unimaginable value creation into the future. Hence, spectacular misjudgements in terms assessing competitive advantage enjoyed by the companies can also be compounded by a valuation methodology which appears to place undue primacy on the near-term component of a company's cash flow stream.

In 2000, Professor Bruce Greenwald, "a guru to Wall Street's gurus" and "a recognized authority on value investing" expressed doubts about Microsoft's valuation.

I (Bruce C. Greenwald) used to sit on panels of money managers who managed foundations' money. Some money managers would say that they are close to Microsoft, and we know what it will do. Thank God I am not that stupid. Microsoft is impossible to value. Much of the value is in the future of the future (think of the large amount of estimation in the terminal value of Discounted Cash Flow). 85% of the value of Microsoft will come in the years 2010 to 2020! How much of the investment in 2000 you get back by 2010—15%. The other 85% value of Microsoft is beyond 2010 - (2010-2020)! Lots of luck. No one can do that. Then they say they can do it for complicated companies like Citicorp and GE? Forget it.

In 2013, he was deeply skeptical Amazon's new ventures into retail (taking on Walmart and Best Buy), and into cloud computing (taking on Microsoft & Google).

"This [Amazon] looks, to me, like a company that makes no reported profit, which I think is fair, that's trying to buy growth in all sorts of areas where, because it has no competitive advantage, the growth is going to be value-destroying, not value-creating."

In 2017 he warned, when Tesla shares traded at $50 (split adjusted), that the share price was "nuts" as "Investors believe that it's going to dominate a market that no company has dominated before". In May 2021, with the share price at over $600, Greenwald warned again that Tesla simply would significant competitive advantage.

Just as he was wary of Amazon's prospects against the incumbents in retail and cloud computing in 2013, he expressed similar caution about Tesla's prospects vs the incumbents in auto manufacturing.

The challenge of establish competitive advantage

Understanding the competitive advantage is clearly an important part of the stock selection process, not just for growth stocks, but also for value type stocks.

It is, of course, perfectly legitimate (and necessary) to take a view regarding the long-term prospects for a company while conducting equity analysis, but it would be arrogant to present any conclusions in indisputable terms simply because the bulk of the company's value is represented by the future value component. Misjudging the competitive advantage enjoyed by a company can be a fatal error investing. Spectacular misjudgements in terms of not just assessing competitive advantage enjoyed by the companies is also compounded by a valuation methodology which appears to place undue primacy on the near-term component of a company's cash flow stream. History teaches us that all great companies of their time, those that created new markets and radically transformed consumer habits and corporates practices always appear expensive through the valuation prism.

Taking a view on competitive advantage, or the future value component, is the most important component of a stock's valuation, and this is far too important to be left the mercy of a speculative guess. The future is, of course, impossible to know but we believe that an estimation of the long-term competitive advantage that is enjoyed by a company discovered in an "implied" form can help in this critical step in stocks selection.

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* Competitive Advantage Period 'CAP' The Neglected Value Driver; Michael Mauboussin and Paul Johnson

** For an academic discussion on how bond duration technique is effective in estimating equity duration please see; Implied Equity Duration: A New Measure of Equity Risk; Patricia Dechow, Richard Sloan, Mark Soliman

Disclaimers

Plain english

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