
The Power of Moats within the EU Industrial sector



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Morningstar Equity Research
The power of Moats within EU Industrials

Agenda

- ▶ Overview Morningstar
- ▶ Power of Moats
- ▶ European Industrials Best Idea: Safran
- ▶ Q & A

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Methodology

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Long-Term Oriented, Fundamental Analysis Works!

- Evaluate stocks as small pieces of business
- Perform primary, fundamental research
- Take a long-term perspective
- Assess competitive advantages
- Calculate appropriate margin of safety

**Invest in companies with strong and growing competitive advantages
(Moats), trading at reasonable prices**

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Economic Moat Concept

Basic Capitalism Premise – Profits Attract Competition

- Capital flows to the areas of highest potential return, so all firms face competition that seeks to force down high returns on capital.
 - But some firms generate high returns for a very long time.
 - How? By creating economic moats around their businesses.
- An economic moat is a structural business characteristic that allows a firm to generate excess economic returns for an extended period.
 - Firms with moats have ability to invest incremental capital at high rates of return = faster earnings growth and/or higher free cash flow.
 - Firms with moats have more predictable cash flows, limiting the risk.

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Economic Moat Concept

What's an Economic Moat?

- *"Companies generating high economic returns will attract competitors willing to take a lesser, albeit still attractive, return which will drive down aggregate industry returns to the opportunity cost of capital."* – Michael Mauboussin
- *"I want a business with a moat around it. I want a very valuable castle in the middle and then I want the Duke who is in charge of that castle to be very honest and hard working and able. Then I want a moat around that castle. The moat can be various things... want to throw crocs, sharks and gators—I guess—into the moat to keep away competitors..."* – Warren Buffett



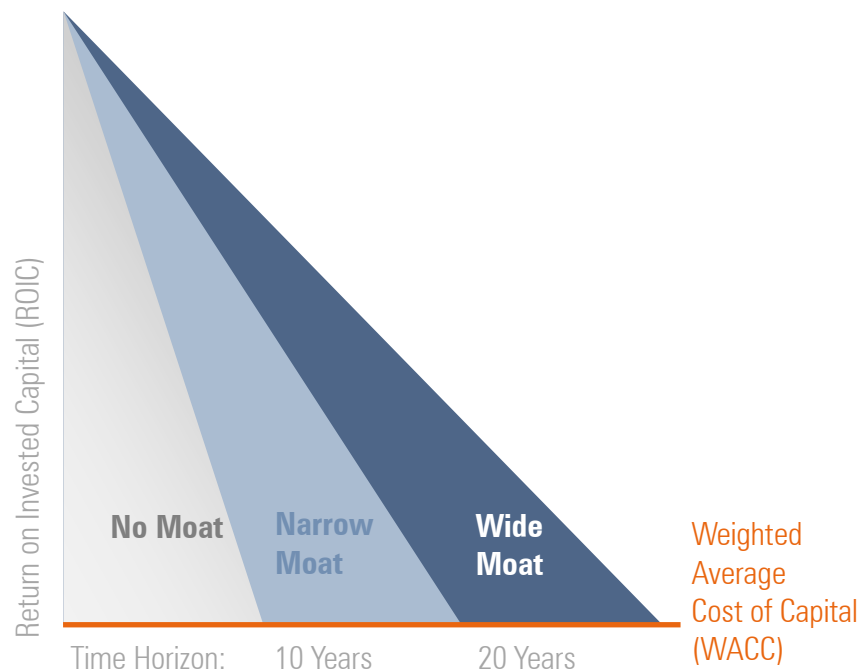
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Measuring a Moat

Moat (Quantitatively): Return On Invested Capital (ROIC) Is Key

- Use Cash Flows not Earnings
 - Cash is King!
- IC: Compare apples to apples
 - Adjust IC when needed
- Estimate appropriate cost of capital

Duration of excess returns is far more important than absolute magnitude



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Economic Moat Concept

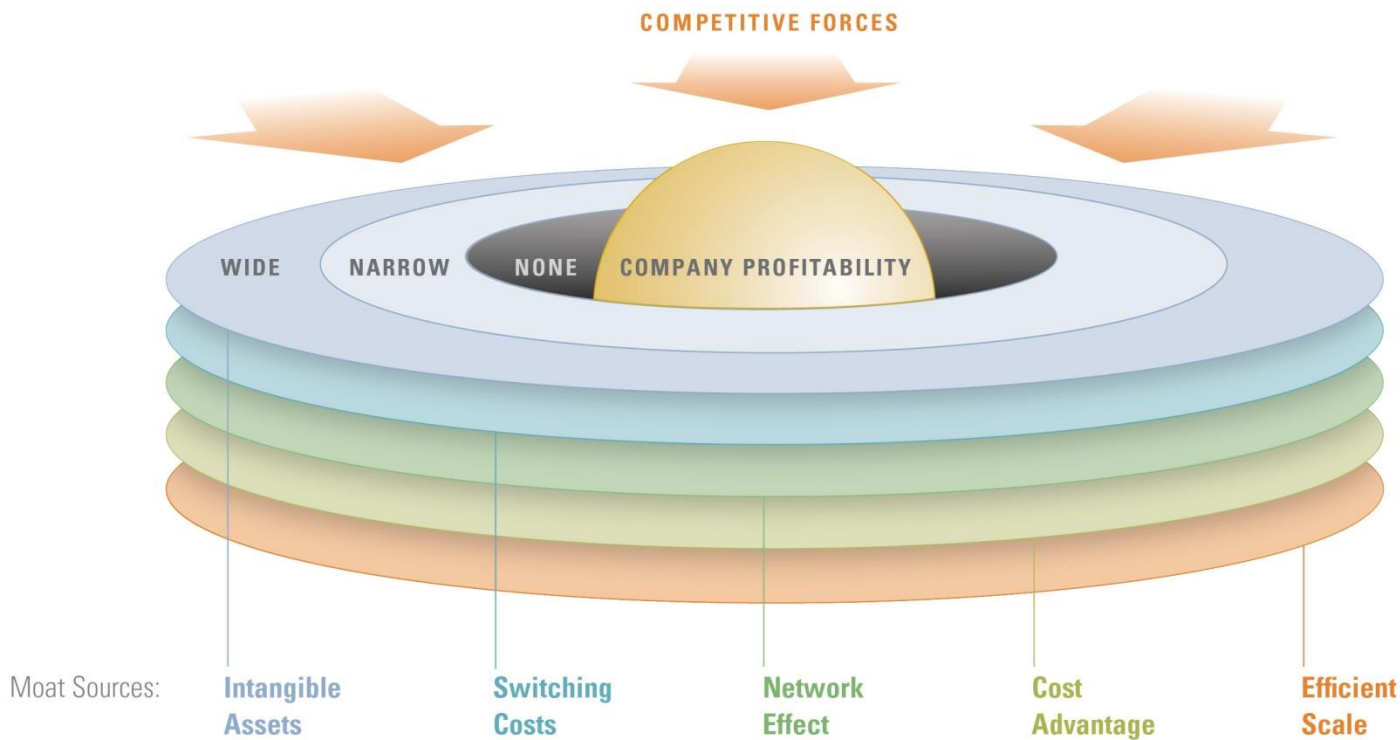
What about Management?

- In our view, management is not a moat by itself, but smart (or dumb) managers can create (or destroy) a moat over time.
 - "Go for a business that any idiot can run – because sooner or later, any idiot probably is going to run it." – Peter Lynch
 - "When management with a reputation for brilliance tackles a business with a reputation for poor economics, it is the reputation of the business that remains intact." – Warren Buffett

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Economic Moats

The Five Sources of Sustainable Competitive Advantage

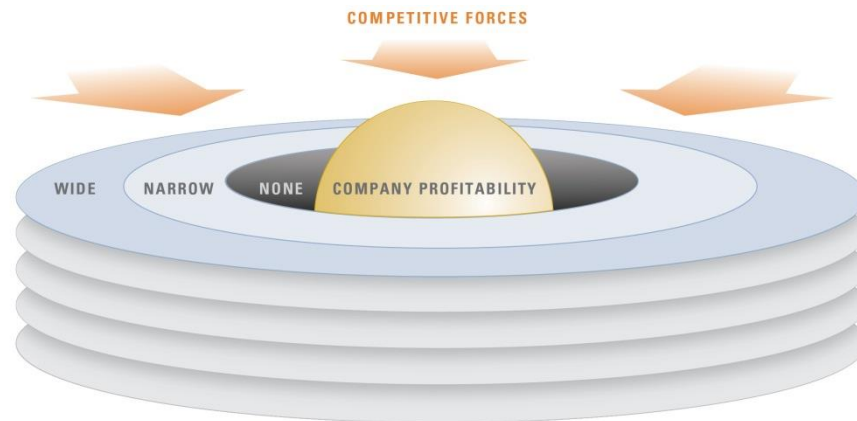


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Sources of Moats

Intangible Assets – Brands, Patents, Licenses

- Brand increases the customer's willingness to pay – don't give customers reason to switch! Protect image at all costs!
- Patents - diversify your risk, focus on internal R&D
- Government regulations - can be fickle, so pay attention to changes

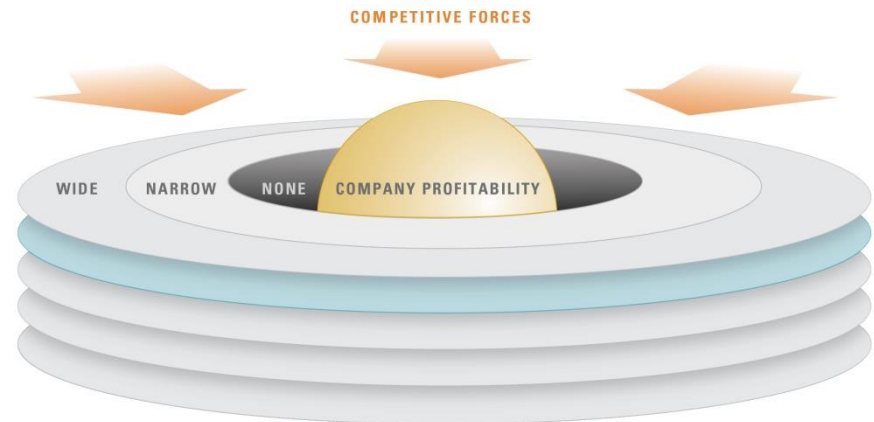


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Sources of Moats

Switching Costs

- Time = Money and vice versa
- What is the value of switching? Cost?
Integrate with customer business processes –
leading to high renewal rates
- Razor and blade model entrench customers
- Sell a solution that includes ongoing service,
and not just one-time product purchase



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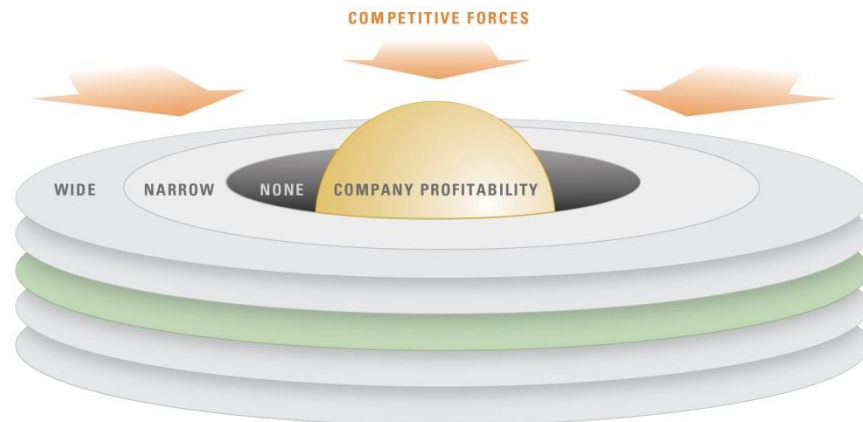
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Sources of Moats

Network Effect

- The value of a particular good or service increases for both new and existing users as more customers use that good or service.
- With each additional node, the number of potential connections grows exponentially
- One of few areas where “first-mover advantage” can actually be worthwhile, but not a guarantee – MySpace anyone?

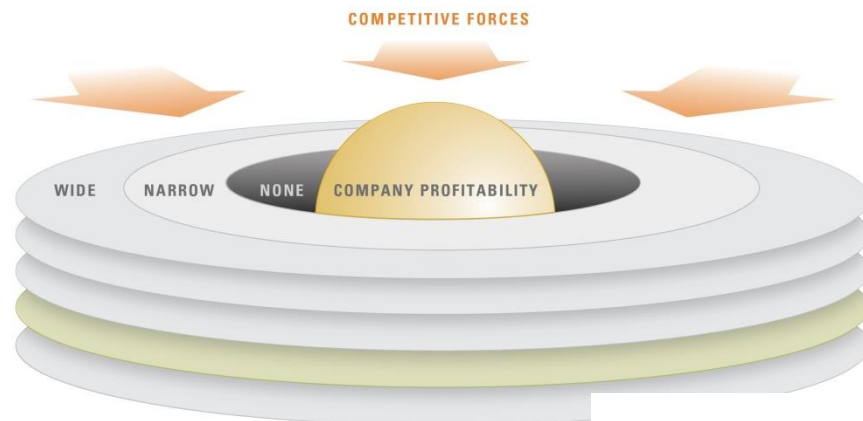


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Sources of Moats

Cost Advantage

- Sustainably lower costs than competitors
- Irreplaceable process advantages – watch for erosion of structural barriers that prevent incumbents from replicating processes!
- Superior location
- Hard-to-amass scale is important but don't confuse size with advantage
- Access to a unique asset



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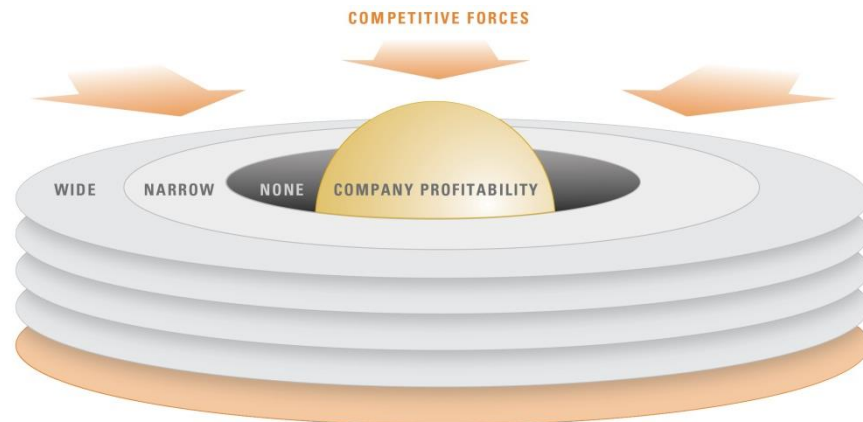

AB InBev

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Sources of Moats

Efficient Scale

- Dynamic in which a market of limited size is effectively served by few companies
- Incumbents generate economic profits
- Newcomers discouraged from entering because returns in the market fall below the cost of capital



nationalgrid



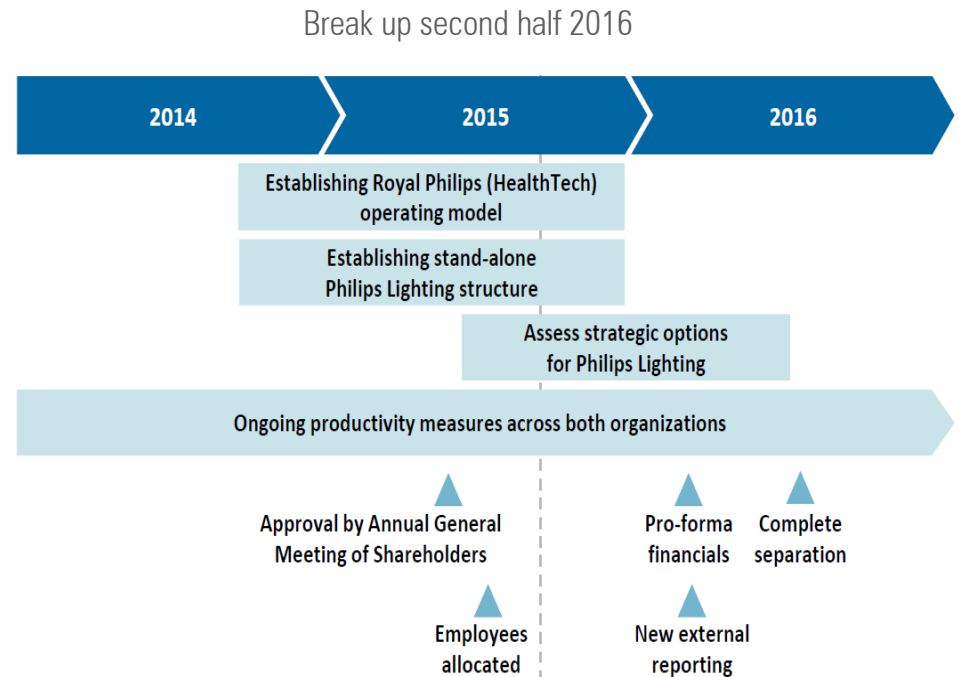
Two Examples within EU Industrials Sector

Morningstar European Industrials Coverage

Best Idea – Philips ****

Narrow moat with strong margin and growth potential and clear catalyst, namely break up in 2016

- ▶ For 2016, we expect modest sales growth and increasing margins as a result of operational performance improvements, mainly in the healthcare segment, benefiting from progress in ramping up production and shipments from the manufacturing facility in Cleveland,
- ▶ The next big catalyst is the separation of the lighting solution unit. We believe the breakup of the company has potential for shareholder value creation and better allocation of capital. We expect a trade sale or initial public offering for lighting solutions in second half 2016



Morningstar European Industrials Coverage

Best Idea – Philips****

Narrow moat rating: After separation of Lighting Solutions strong focus on Healthcare (moat source intangible assets and switching costs)

▶ **Philips moat sources**

▶ Switching costs:

- ▶ Philips healthcare products being well integrated in hospitals
- ▶ Philips strong focus on training of doctors, which ensures strong relationship
- ▶ Medical equipment has a long economic lifetime

▶ Intangible assets:

- ▶ Patents for healthcare and lighting solutions



Morningstar European Industrials Coverage

Best Idea – Safran ****

Wide moat firm is in the sweet spot of high margin aftermarket cycle and 80% market share

- ▶ One of few firms that can successfully develop and manufacture civil and defence jet engines.
- ▶ Safran, is benefiting from acceleration in the number of overhauls of installed base 30000+ CFM56 engines, which drive demand for high margin spares
- ▶ The firm has secured a leading presence in next generation commercial narrow body aircraft, as Leap engine has almost 80% market share for future narrow bodies.
- ▶ We expect the narrow and wide body platforms to produce steady demand for Safran in coming decades.

Single source on Comac C919



Morningstar European Industrials Coverage

Best Idea – Safran****

Wide moat rating: Safran sells crucial aircraft equipment and long-term annuity of after sales service revenues (moat source intangible assets and switching costs)

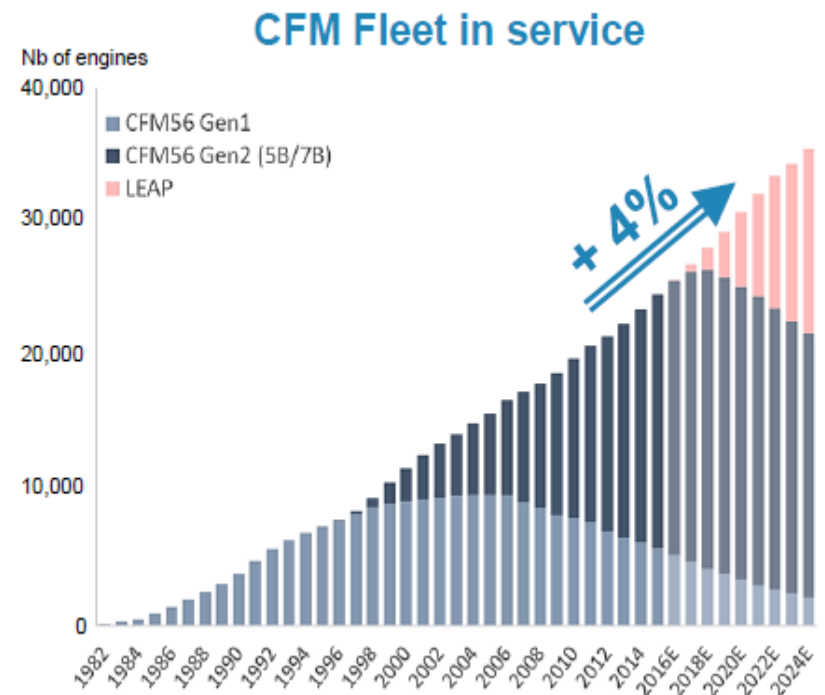
▶ Safran moat sources

▶ Switching costs:

- ▷ Firm's gas turbines and landing systems well integrated in aircraft platforms
- ▷ Airline operators are hesitant to switch due to costs, down time and training
- ▷ Warranties and guarantees related to performance may become null and void if airlines use third-party spares
- ▷ Equipment has a long economic lifetime

▶ Intangible assets:

- ▷ Patents for engines and landing gear

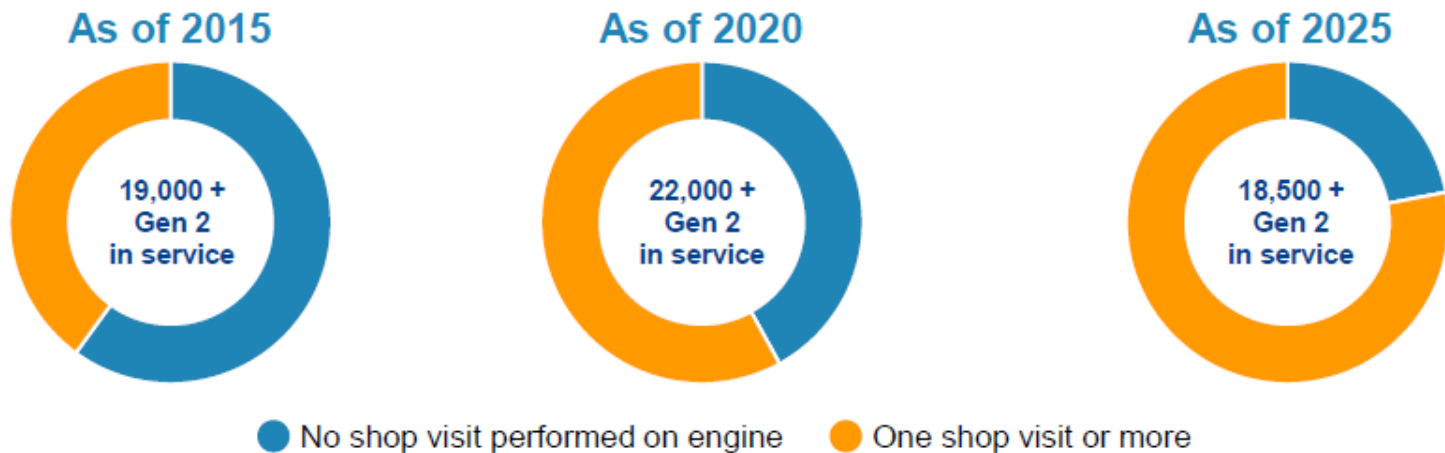


Morningstar European Industrials Coverage

Best Idea – Safran****

Safran: High margin long term growth story with attractive valuation

MAINTENANCE ACTIVITY ON CFM56 GEN 2 STILL GROWING



- 2015: more than 60% of CFM56 Gen 2 in service have never had a shop visit
- 2025: the proportion is still close to 25%