# Sustainable Competitive Advantages: Consumer Preference

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*"Our approach is very much* ***profiting from lack of change*** *rather than from change. With Wrigley chewing gum, it's the lack of change that appeals to me."* – Warren Buffett (emphasis ours)

*"If you gave me $100 billion and said, 'Take away the soft drink leadership of Coca-Cola in the world', I'd give it back to you and say it can't be done."* – Warren Buffett on challenges one would face in trying to overcome the moat of Coca-Cola

In one of the earlier articles in our series, we identified six distinct sources of competitive advantages. This is the fourth article and focuses on consumer preference as the source of a sustainable competitive advantage.

**Defining consumer preference**

Moats driven by consumer's preference are widely thought of as brand-based moats or intangible assets-based moats. In some industries, there is a strong preference from the customer for brands, for example, with colas and cigarettes. Brand preference can emerge as an indicator of various things, including uniqueness or consistency of the product, status symbol and product quality.

**Analysis framework: Consumer preference and sustainable competitive advantages**

The reason we use the term consumer preference as opposed to brand- or intangible assets-based moats is because of a key factor behind these moats: consumers' preference for a specific product at the expense of others. By terming businesses driven by consumer preference as "brand moats," investors set themselves up for behavioral errors.

Not all brands are created equal. Indeed, even the most well known of brands may fail to endow its owners with any competitive advantage, let alone a sustainable one. For a consumer preference to lead to a sustainable competitive advantage, two elements need to be present: customer captivity and pricing power.

1. **Customer captivity**

The key for consumer preference-driven moats is customer captivity – the consumer's preference for the product should lead to some form of customer captivity requiring very strong incentives that deter the customer from switching. As highlighted in Buffett's comments on Wrigley, customer captivity refers to a lack of willingness on the part of the consumer to change. Indeed, it is the customer's continued preference for "a" specific brand at the exclusion of all others that is the basis of such a moat.

As discussed earlier, customer captivity may emanate from different factors, including uniqueness, quality and an association with happy memories. The important factor is that there should be a strong preference that the consumer should have for the brand in question.

2. **Pricing power**

The other important element for the existence of consumer preference-based competitive advantages is pricing power. Unless the consumer's preference for a specific brand endows its owner with pricing power, the competitive advantage of the brand is limited to non-existent.

So, what do we mean by pricing power? The pricing power we are talking about does not refer to an unlimited or unchecked ability of the business to raise prices at any rate that it desires. Indeed, we would suggest that if you have a product or service for which you can raise prices at any rate that you desire, you either have a Picasso at your hands – a rare product – or you have a Valeant at your hands – a source of trouble for your portfolio!

The pricing power of a business should manifest itself in two elements: the ability of the business to charge a higher price for its product as compared to a similar product that is not associated with a similar brand preference endowing the business with the ability to generate supernormal returns on capital; and the ability of the business to pass on any cost inflation to the consumer through price increase,letting the business maintain that supernormal profitability through business cycles.

Figure 1 summarizes the key elements of our analytical framework concerning consumer preference moats. C3P refers to the internal ranking term used at MAEG to define consumer preference businesses.

**Figure 1: MAEG's Analytical Framework for Consumer Preference Moats**


**Analysis framework: Ancillary elements**

In addition to the primary components of the analytical framework discussed above, additional elements should be considered as well. What follows is not an exhaustive list of ancillary factors.

1. **Differentiated products**

The products in question should be differentiated products and should not be truly commodity products. Consider the case of two tobacco products: one, the tobacco leaf and the other, cigarettes. In some parts of the world, for example, in north India, consumers buy loose tobacco leaves that are then cut into smaller pieces, which the consumer uses to make chewable tobacco. In case of these tobacco products, there is no product differentiation and thus none of the producers enjoy competitive advantages. As against that, when you look at a brand of cigarette, especially ones like Marlboro, a very strong customer preference is at work.

2. **Extent of pricing power**

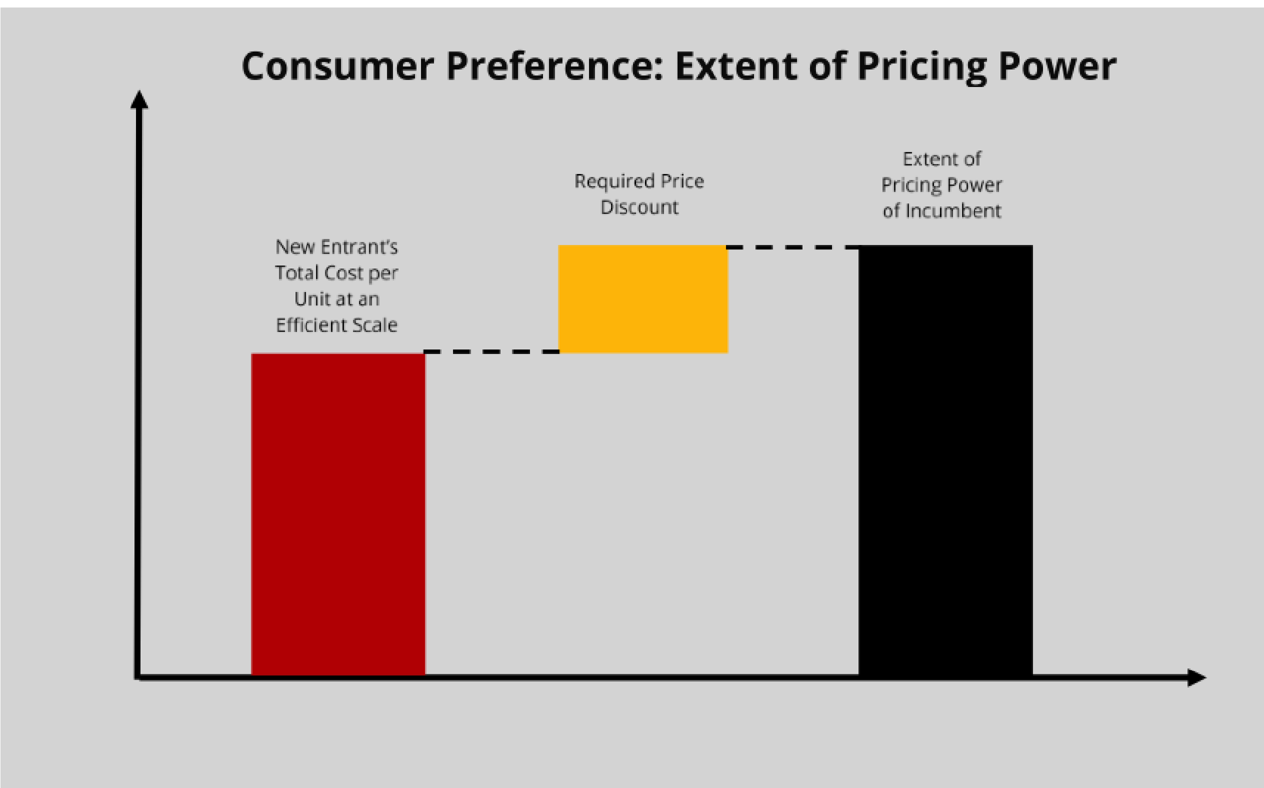
As we discussed earlier, pricing power does not refer to an unlimited ability of the business to raise prices. Even the strongest of the consumer preference businesses will almost always have a price point which will cause the consumer to switch to a competing product. It is of utmost importance that the managers of such businesses have a reasonable understanding of where that price point lies and ensure that their product is priced under such a price point and not above it. While raising prices above that point could result in stronger earnings in the near term, it will guarantee a weakening of the competitive advantage of the firm over long term.

Of course, the important question here is how to determine that price point. Let's explain with the help of an example, that of Parle-G biscuits, a brand of biscuits that most Indians are likely familiar with. As we write this article, a 70 gram pack of these biscuits is priced at INR 5 (approximately USD 0.075) in the state of Maharashtra, a price point that allows the business to generate superior underlying business returns.

As is almost always true when capitalism is functioning relatively efficiently, supernormal returns earned by a business will likely attract other entrepreneurs. The relevant question then is whether or not potential investment returns are sufficient enough for an entrepreneur to put capital at risk. For the purposes of our analysis, let's assume that the total cost per pack, including production and distribution costs of a new entrant who is operating at an efficient scale, will likely be INR 4. Additionally, assume that the consumer will require at least a 25% discount to the price of Parle-G as the incentive to switch. Clearly, by pricing its product at INR 5, Parle-G is prohibiting new competition from entering, as the new entrants will need to sell their products at a price of INR 3.75; a price point that will generate a guaranteed loss.

This example leads to our rule of limit to the pricing power of the incumbent. The pricing power of a C3P moat is limited to the price point that is the sum total of the cost per unit of a new entrant operating at an efficient scale and the price discount that is required to entice existing customers to switch. Figure 2 summarizes this framework.

***Figure 2: Limits to the Pricing Power of a Consumer Preference Moat***



3. **Customer interaction delta**

The strength of the competitive advantage of most customer preference moats is affected by two related factors: the number of customers and the number of times on an average that a customer uses the product. In general, a business that is experiencing growing number of customers and/or is able to increase the number of times its customers use the product will witness expansion of its competitive advantage.

4. **Consumption life per customer**

Another important factor in analyzing a consumer preference moat is the average consumption life of a customer. In general, the longer the period during which a typical customer continues to use the product, the stronger the sustainability of the competitive advantage. Consider the example of two products that we start using early in our lives: toothpastes and diapers. If Colgate is able to get you to use its toothpastes early on, chances are that they have a customer who will be using their product for a long time. On the other hand, no matter when you get into those diapers, you are not likely to use them for an extended part of your life. Indeed, if you are like most of us, in the sense that you weren't gifted with exceptional childhood memory, you likely do not remember which brand of diapers you were crawling around in!

5. **Mature versus emerging markets**

One of the commonly touted reasons for investing in emerging markets and specifically consumer companies operating there is that the higher economic growth rate and the resultant affluence of the consumer will lead to higher business value growth. The idea here is that the higher economic growth will improve the economic wellbeing of the populace and in turn will make available a larger customer base to the existing business. However, as with most things in life, it is almost never that simple. Indeed, that growth is a double-edged sword and one needs to treat it with caution.

It is true that as per capita incomes rise, it allows for higher consumption expenditure. However, this same improved income spells trouble for some consumer products. This is especially true if the product in question is catering to lower income consumers and consumers are aware of existence of other upper-end products – products they associate with better quality. In such cases, improved per capita incomes result in up-trading as consumers who were earlier buying cheaper products switch to upper-end products as their affordability improves.

**Application of the framework: Colgate Palmolive (India) Limited**

Colgate Pamolive India Ltd (CPIL) is a leading player in the oral-care business in India with market leadership in toothpaste, toothpowder and toothbrushes. CPIL was incorporated as a wholly owned subsidiary of Colgate Palmolive USA in 1937. We classify CPIL as a business that possesses sustainable competitive advantage driven by consumer preference.

Figure 3 and Figure 4 show CPIL's market share over the years in the toothpaste and toothbrush markets, respectively. Clearly, CPIL has been able to improve or maintain its market position over the years. In fact, even after P&G reentered the market with its Oral-B brand in June 2013, CPIL was able to maintain or grow its market share. These market share trends reflect consumer's preference for CPIL's products. The same conclusion is also verified by a qualitative check of the consumption pattern of consumers with consumers associating the Colgate brand with quality. Having said that, the consumer preference associated with CPIL's products is stronger in the toothpaste business and is weaker in the toothbrush business.

***Figure 3: CPIL Toothpaste Market Share in Volume Terms. Source: CPIL Analyst Presentation 2016***

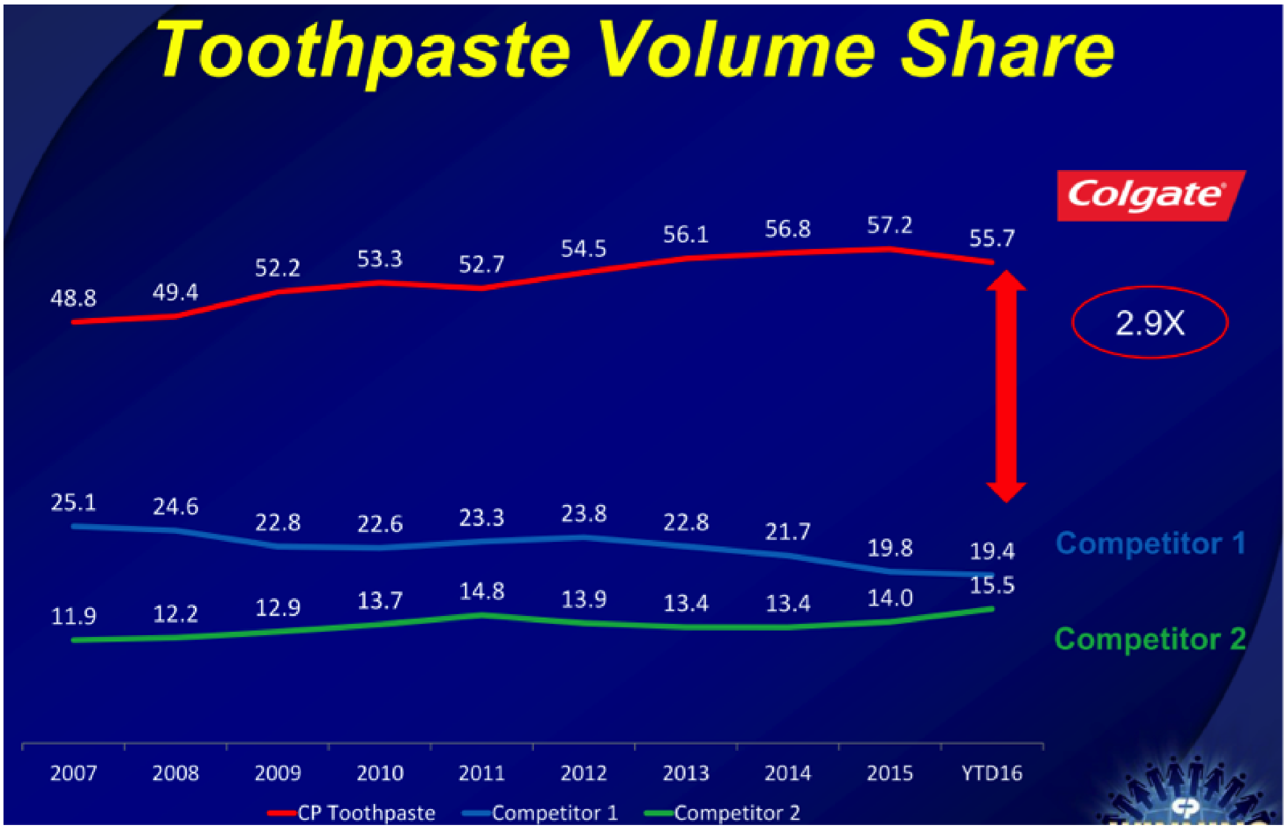



***Figure 4: CPIL Toothbrush Market Share in Volume Terms. Source: CPIL Analyst Presentation 2016***

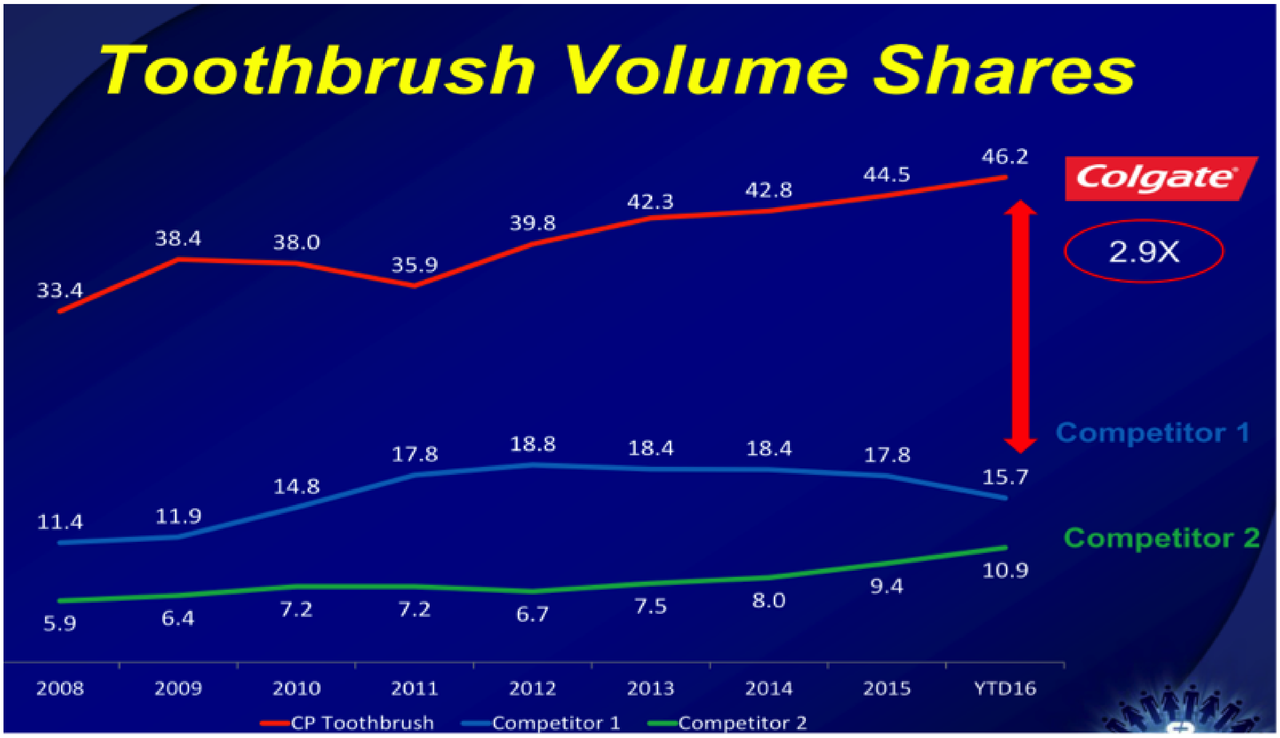
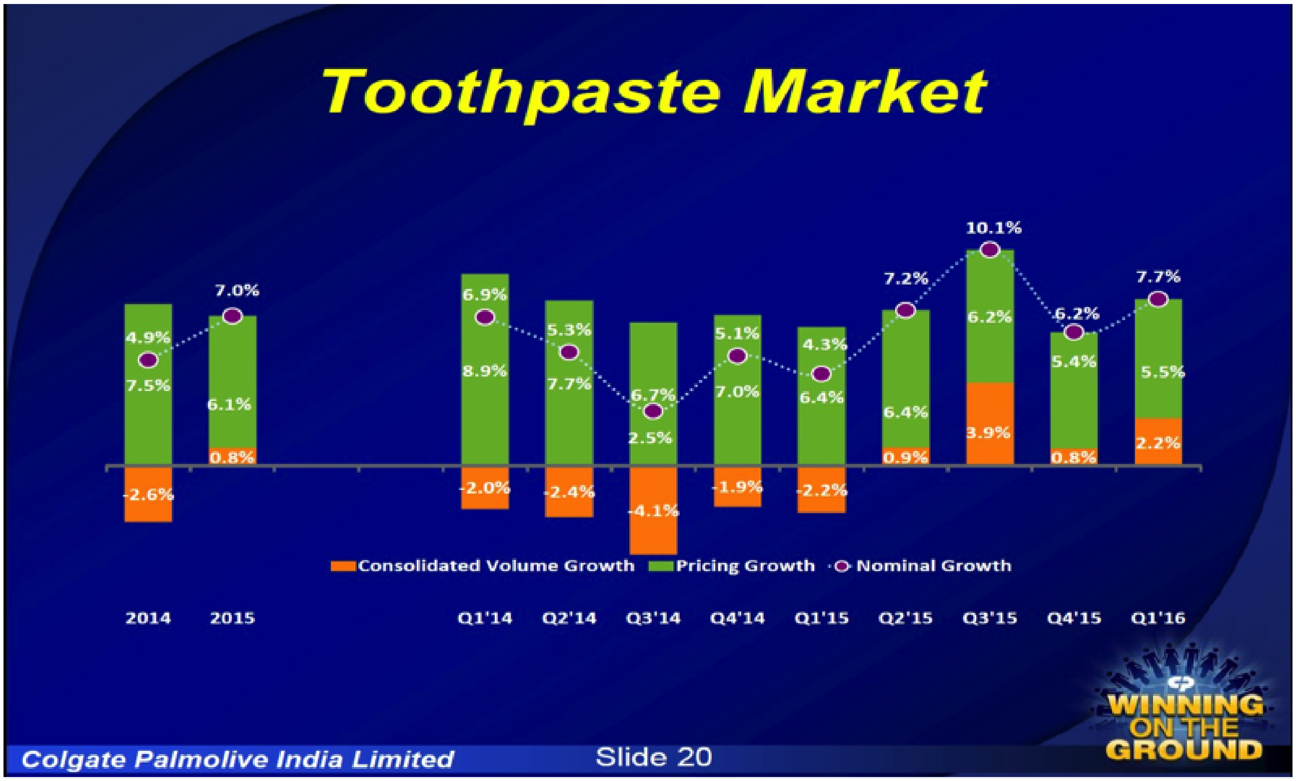



Figure 5 shows the Indian toothpaste market's growth over the past nine quarters segmented between volume growth and price growth. Clearly, the overall industry shows up as having pricing power, and CPIL is no different.

**Figure 5: India Toothpaste Market – Volume and Pricing Growth. Source: CPIL Analyst Presentation 2016**




Three factors should work to strengthen CPIL's moat. First, India's growing population continues to provide an increasing number of consumers. Second, per capita consumption of toothpaste continues to be low in India, which provides CPIL with possibilities to increase the number of times its customers use its product. As shown by Figure 6, the per capita consumption of toothpaste is nearly a third that of the U.S. and 25% below that of China. Lastly, as CPIL is a much more effective competitor in the middle to upper end products, the trend towards premiumization should allow it to further increase its number of consumers. Figure 7 shows that the average price per gram of toothpaste is half of China and a third of the U.S.

**Figure 6: Low Per Capita Consumption. Source: CPIL Analyst Presentation 2016**

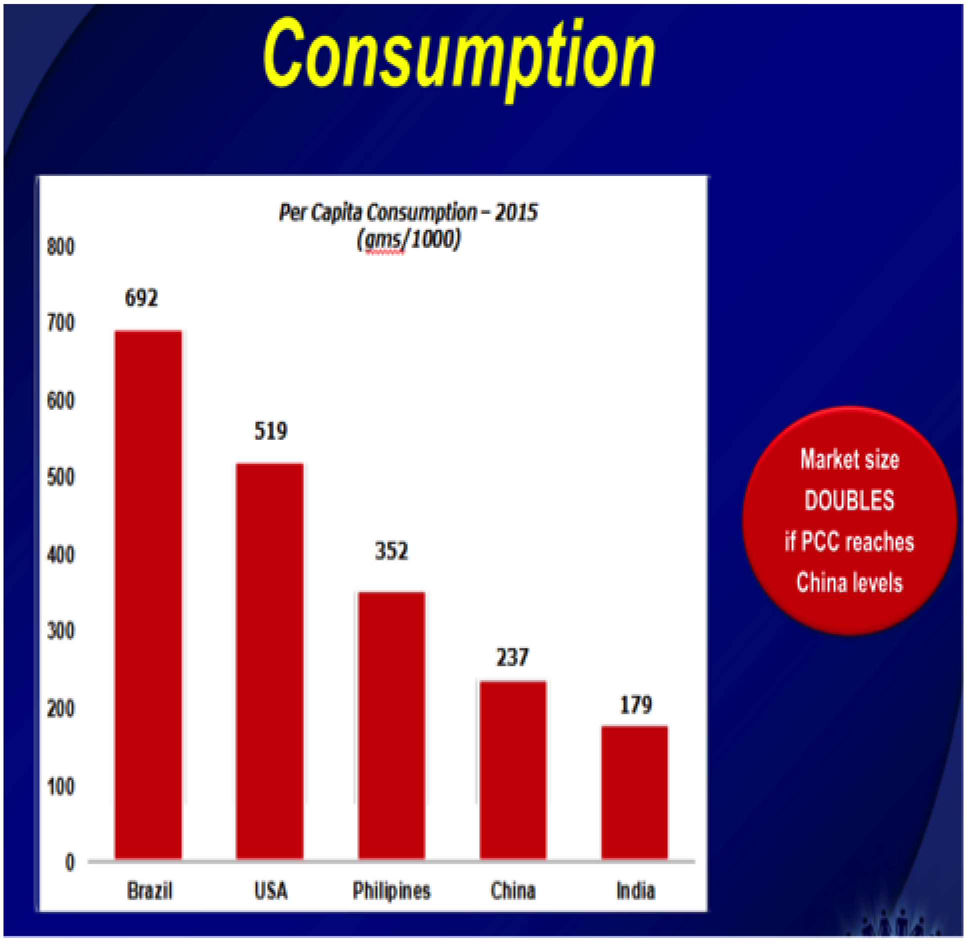
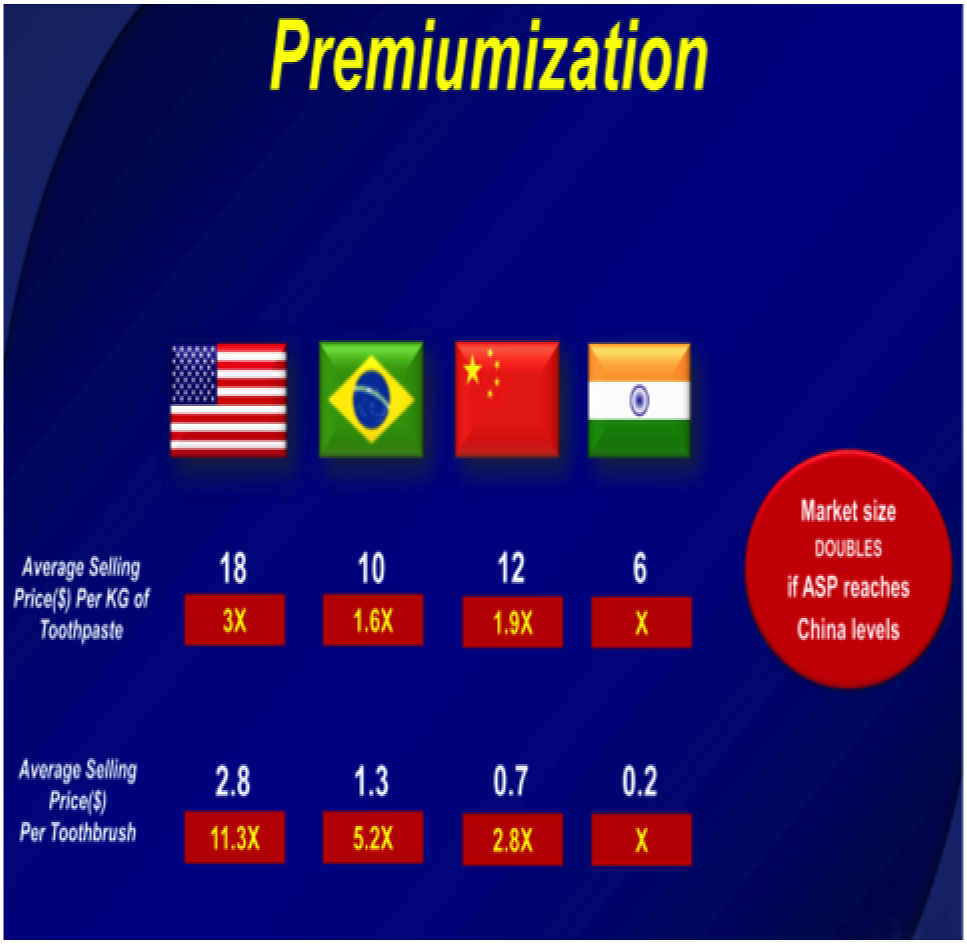



**Figure 7: Low Price Per Unit. Source: CPIL Analyst Presentation 2016**




In the case of Colgate India, we see that there is a strong customer captivity at work that is further strengthened by the presence of a strong pricing power. Additionally, CPIL ticks on most of our ancillary factors as well, with the company likely to witness further strengthening of its competitive advantage driven by increased customer interactions and very long consumption life cycle of the customer. Further, the improved affluence of the Indian consumer driven by economic growth will further help CPIL as customers shift upwards in search of quality products

**Summary**

While all consumer preference moats have brands and intangible assets as their primary driving factors, not all brands endow their owners with competitive advantages. The analyst needs to check for the customer captivity as well as pricing power of the business. At the same time, the analyst will need to develop a deeper understanding of ancillary factors that affect the business's moat and its sustainability. As in our previous article, we end this article with the assertion that it is important to have a well-defined framework in place and to ensure that it is consistently applied.

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