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Moats

What is a moat? In medieval times, a moat was the water-filled ditch that surrounded a castle, an impediment to attacks. It didn't render a wall breach impossible, but it did make it much more difficult.

Warren Buffett has discussed numerous times his preference for businesses that are protected by moats. What constitutes a moat in a business? It is essentially when a company's competitive position allows it to earn higher than average profits. As one of the most efficient ways to move all types of products from one side of the country to the other, Canada's railway industry is a strong example of the moat concept.

We can use Professor Michael Porter's five forces of competitive dynamics to identify the key strengths of an industry's competitive positioning. The forces include the threat of substitute services or products, the threat of increased competition from rivals in the market, the threat of new entrants, the bargaining power of suppliers and the bargaining power of customers.

1) **Threat of substitute products** - If I am a producer of hockey skates located in Halton Hills, Ontario, how do I get my skates to the sports chain warehouse in Calgary? My options are to send them by truck, ship, train or plane. The plane is too expensive and the ship isn't feasible, leaving truck or train. Over longer distances, it is much more economical to ship by train. A train uses approximately one gallon of fuel to move one ton of freight 471 miles. Using the same amount of fuel, a truck could only take the one-ton load 135 miles. Because there are only two railways in Canada, there are no cheaper substitutes for the skate manufacturer's long-haul shipment.

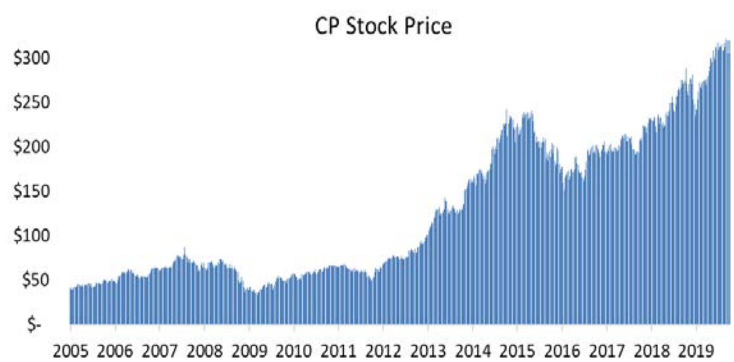
2) The **threat of increased competition** is limited in the railway business. Over short distances, trucks move freight more quickly and the cost differential isn't as material. However, it would be impossible for a trucking company to drop its price enough to make a long-haul trip across the country cheaper than rail. This competitive dynamic is why the Canadian railways have been able to increase prices at a higher rate than inflation. While some customers may switch between the two Canadian railways, pricing has remained disciplined.

3) The **threat of new entrants** is very low as it costs between $1-2 million USD to build one mile of track. At the midpoint, this means it would cost $18.8 billion USD to replicate Canadian Pacific (CP) Railway's 12,500 miles of track. This also doesn't include the cost of other critical components such as computer systems and locomotives. This isn't a business you start in your garage!

4) **Bargaining power of suppliers** - One of the biggest input costs for a railway is fuel. The fact that fuel can be purchased from a variety of different vendors allows the railways to negotiate better prices.

5) The **bargaining power of customers** is closely related to the threat of substitute products. Customers do not have a lot of choice if they want to ship a product over a long distance. Customers are price takers, allowing the railways to earn a high return on their capital.

In our investment analysis, these strong competitive characteristics signal that companies in this industry are of high quality, with revenues and profits that are likely to be relatively stable outside of difficult economic environments. You can see how strong positioning and cost discipline have allowed our holding, CP Rail, to grow its share price over the last 15 years.



Source: Bloomberg & QV Investors

Not all sectors are as fortunate to have such high barriers to entry. This is one of the main reasons why we own both of the Canadian railways in our Canadian large cap strategy.