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Identifying Franchises

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Warren Buffett, Michael Price, Mario Gabelli, Walter Schloss, and Charles Royce are not the typical guest lecturers at a business school class. Then again, the Columbia University Graduate School of Business isn't just any business school, and professor Bruce Greenwald's class is anything but ordinary. Greenwald teaches the value investing course at Columbia and also authored *Value Investing: From Graham to Buffett and Beyond*. In part four of this five-part series, Greenwald talks with Fool contributor Matt Logan about the old Buffett partnership and identifying franchises.

TMF: I have one question that goes back to the old Buffett partnership. In those days, Buffett made a lot of money through investments he categorized "relatively undervalued." Are you familiar with what his strategy was?

Greenwald: No. I've got the old partnership letters, and I've read them. The interesting thing about his strategy in the old days is he played it pretty close to his vest. If you read the old partnership letters, you'll see that he has a lot of blind -- he says a company and then he sort of describes it, but he doesn't tell you what it is.

I'll tell you what I think went on there. Don't forget, those were the days of the "Nifty Fifty." Even second-tier company stocks were pretty illiquid. So that, for example, for years if you just shorted **General Motors** (NYSE: GM) and bought **Ford** (NYSE: F), that was a good investment, just in dividend yield along. Ford was like 7%, and General Motors was like 3.5%. In the long run, you know they're not that different. They're both big auto companies. The economy of scale went away for both of them at the same time.

So I will bet you that if you look closely at what he was doing, he was shorting the big glamour stocks that were overbought. And this goes back again to these three legs of value strategy. He's looking at the ones that everybody is looking at, that everybody is piling into, where the herding is taking place, and he's shorting those. And he's buying sort of the second-tier companies in that area. The only word of caution I would offer is that Ben Graham used to try to do that. It didn't work out as well for him. He'd do railroads, but railroads then, some had lots of natural resources, they had a lot of real estate that was differentially valued. So you have to be pretty careful, I think, to do that properly.

TMF: You mentioned earlier -- and your book says it, too -- you first look at the asset value, then the earnings power, and then you see if there's any value in the growth of the business. Can you talk about that? In your book you say a lot of times growth is not worth paying for.

Greenwald: The way to think of growth in the simplest possible terms is *growth requires investment*. Everybody on Wall Street sort of talks about scalability and growth without investment, but if you look at the history of any growing firm, the amount of capital they put in grows with the growth in the firm. It just tends not to be scalable.

So now I'm going to grow. Let me not look at the growth in sales. Let me just look at the process of putting in money. So I'm growing and I put in $100 million to fund the growth. Now, there are three possibilities. One is that I'm beating my head against a highly competitive market where other people are frankly better positioned than I am. Suppose my cost of capital, what I had to pay to raise that $100 million, was 10%. Well, I'm going to earn a lot less than that 10% in that market. So I'm going to pay 10 million a year, which is 10% of 100 million to raise the money. I'm going to invest it at 8%, which is 8 million a year. I'm going to lose 2 million a year. So the growth destroys value in that case for the existing shareholders. And the way it gets disguised, of course, is that they are taking it away from themselves. They don't go out and raise the money. They just reinvest their earnings in a way that loses money. Anyway, but it still dissipates value.

So if you're growing at any kind of competitive disadvantage, you're going to lose money. That's value-destroying growth. What people are going to earn in a competitive market is the cost of capital. If the returns are above it, there'll be a lot of entry, and returns would be driven down. So now I invest the 100 million. I have to pay these people who provided at 10 million a year. I earn 10%, because I'm going to earn my cost of capital. So I earn 10 million on the new business, the growth. I pay 10 million to fund the growth. And I'm left with nothing. So growth without a competitive advantage has zero value.

The only growth that has value is if I put in the 100 million, I make 20 million a year, and I only have to pay 10 million to the investors. Well, when do you make 20 million a year on a $100 million investment? It has to be where people can't copy you. Because if everybody could do that, everybody would do that, and those investments would not earn 20 million a year. So the critical thing is that if you're going to buy the growth, there better be a franchise there. There better be some protection against entry that's going to eliminate the value.

TMF: Are franchises harder to find these days? I just want to share a little fact and that's that **Wal-Mart's** (NYSE: WMT) own brand of dog food right now is the best-selling dog food in the world, according to *Fortune*. It beat out Purina. Wal-Mart's doing the same thing in other categories with its other private-label brands. What that means to me is that low cost and distribution means a lot more than brands in a lot of cases.

Greenwald: I'll tell you what a franchise is. A franchise is clearly something that you can do that your competitors can't. And there are really only three possibilities. In the sense I'm using it, I don't think they're disappearing, but I think people are going to have to look more closely at where they are. The first thing that is increasingly rare in a rapidly changing world is that I've got technology that they can't match. That I can do it at a lower cost than they can. Those things go away very quickly, because people can copy technology. It's usually only in very complicated process industries that you have -- and some pharmaceuticals where you're patent protected, that you have technological advantages.

The second possibility -- we talked about the cost side -- is the demand side. Remember, it must be something that somebody else can't replicate. People can replicate brands. So what it means is -- what a franchise means is you have to have captive customers. Customer captivity is probably going down a little. The Internet makes it very easy to compare prices. It's the enemy of profitability in that sense. But if you look at repeat purchase behavior, it probably hasn't changed all that much. So the second thing is customer captivity.

The third thing that they can't match, which is the absolutely crucial thing, is they can't match my cost, even though they've got the same cost structure, because I have economies of scale and they don't.

TMF: And that just compounds in their favor.

Greenwald: And that compounds. The smaller the competitors are and the bigger you are -- but the thing about economies of scale is you also have to have customer captivity to some degree. The reason for that is if there was no customer captivity, people could just come in and steal your scale.

So the real franchises are cases where there's some customer captivity, and you've got a competitor in there who has big-scale advantages in a particular market and is aggressive about keeping everybody else out. Now the question is, where are economies of scale achievable? The answer is: increasingly rarely on a global scale. The economies of scale that you can achieve now -- and this is essentially both the Wal-Mart and the **Microsoft** (Nasdaq: MSFT) story -- are local.

Wal-Mart started dominating local areas; its fixed costs were determined by the distribution infrastructure in that area. If it had the dominant share in that area, it was very hard to compete with. Their distribution is a classic case of local economies of scale. And then they just metastasized. They spread out from Arkansas, and like an inkblot, they took over the world.

Now, just as Wal-Mart and a lot of other profitable can do it in geographic space -- and by the way, as services become a bigger and bigger part of the economy, services tend to be produced and consumed locally. So you want local dominance in distribution and advertising and in management. Microsoft did the same thing in product space. And the good thing to think about is the comparison between Microsoft and **Apple** (Nasdaq: AAPL), that Apple tried to do the whole PC industry, and there was no way they could dominate the whole thing. Microsoft started with a very small part of it, with the Arkansas of it, which was the operating system. And it dominated that. And then it moved to the adjacent states -- to Excel, to Microsoft Word, and out.

So I think the answer is that franchises are different now, but I don't think they're any less present. And people aren't as good at managing them. So the irony is that where these franchises are concerned, where you've got a dominant market position, that in a global world -- because it's almost impossible to dominate big global markets (the example people got undermined are the auto companies) -- but in a big global world, you have to think locally. Because the only markets that you're going to be able to dominate are local markets. And the only exception to that that I can think of, is -- I'm going to talk about telecommunications in a second, because it bears this out -- is **eBay** (Nasdaq: EBAY). Because everybody wants to come to eBay, because that's where the people agglomerate. On the other hand, if you were going to compete with eBay, the obvious way to do it would be to pick a specialty. It's not widely known, but eBay makes a lot of money in a small number of categories that they dominate. And they protect those pretty fiercely. They know what they're doing.

If you look at telecommunications, if you look at cellular -- the most profitable cellular companies are the old Baby Bells -- **Southwestern Bell** (NYSE: SBC) [Cingular] and **Verizon** (NYSE: VZ). Because they have the fixed infrastructure in the Northeastern United States. And they have 40% of the customers to bear the cost of that infrastructure. Whereas the national companies, like **AT&TWireless** (NYSE: AWE), which is a disaster, have the same costly infrastructure. And they've got like 3% of that market to bear the cost.

The only exception to that rule, that the most profitable are the most concentrated, is **Nextel** (Nasdaq: NXTL), and they've picked a market concentration. They've gone after the business customers with features. It'll be interesting to see if they can sustain that advantage. The landline companies are much more profitable than the long-distance companies. So even in leading-edge, like telecommunications, what people don't seem to have learned, and the Cingular acquisition of AT&T [Wireless] is just the most recent example of this, is that franchises are increasingly going to be based on the Wal-Mart model, which is local dominance.

TMF: And it's probably not a coincidence that Bill Miller is a big shareholder of Nextel.

Tomorrow: Bruce Greenwald names his favorite investment manager.

Read Matt Logan's complete interview with Bruce Greenwald:

- Value Investing 101
- To Hold Cash or Not?
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Fool contributor Matt Logan owns shares in Berkshire Hathaway, but none of the other companies mentioned. The Motley Fool has a disclosure policy.

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