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Brands with Moats will Thrive

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 Posted July 27, 2011 by **Denise Yohn** with **5 reads**

Last week David Ristau, the analyst who publishes daily stock recommendations in The Oxen Report, weighed in on the fast/casual dining industry with **predictions for 10 fast/casual companies in the coming year.** Chipotle, McDonald's, and Domino's were among the companies he analyzed based on growth, profitability, financial health, value, and management.

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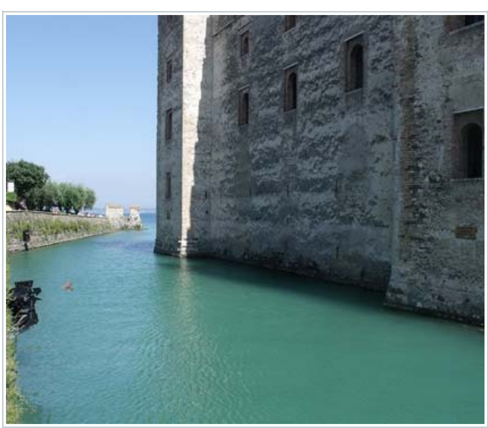

His write-up, which highlighted several factors that really drive performance in the category, got me thinking about **the role of brands as financial drivers.** I've written and spoken on this topic before, explaining that a **brand creates value across the Balanced Scoreboard** quadrants of customer, internal business process, learning and growth, and financial. Ristau's analysis clarified – and supported – my thinking.

He talked about **economic moats.** This concept, coined and popularized by the Oracle of Omaha Warren Buffett, refers to a business' ability to maintain a competitive advantage in order to protect its long-term profits and market share. Ristau commented that, "*The problem for any dining institution is severe competition and lack of economic moats.*"

But he praised Chipotle as having created "*a small, economic moat around its brand-name, ease of ordering, and quality ingredients that allow it to appear healthier than some of the fast food competition.*" And he was willing to give the benefit of the doubt to Sonic, the 3,500 unit drive-in concept, hypothesizing that Sonic "*may be able to leverage its unique offerings into a better moat.*"

It's clear **a brand is a critical determinant of the size of a company's economic moat**. A brand provides **differentiation** and it **engenders customers' preference and trust**. And a strong brand is comprised of some **intangibles** which are difficult for competitors to imitate and for customers to compare. That robin egg blue box from Tiffany's signals something extraordinary about the brand that no other company could copy.

There are other means by which to create economic moats – including customer switching costs, distribution or market monopoly, and patents – but **brand strength is the most sustainable and the least costly**.

Which leads to the next performance factor Ristau called out: **profitability**. He praised McDonald's for having "*done an amazing job improving operating margin over the past five years*" and Tim Hortons, the donut chain based in Ontario, Canada, as having "*top-notch*" profitability. But he expressed concern over Panera Bread's margins and profitability and criticized Starbucks for significantly increasing SG&A (selling, general, and administrative expenses which includes payroll and advertising) over revenue.

Although real estate, materials, and labor costs have the greatest impact on profitability, **brands certainly play a role in this factor as well**. A strong brand enables a company to charge a **price premium**. That's why Hyundai's cars may be made at Mercedes' quality level, as its ads claim (not saying I believe them), but people will never pay as much for them. And higher premiums means greater potential for higher operating margins.

Brand strength can also affect **cost negotiations** with vendors and business partners, such as a shopping mall developer who is looking for high-profile tenants or a supplier whose wants to associate his ingredient brand with a strong consumer brand.

Growth potential is the other factor Ristau repeatedly factored into his valuations of the companies. His focus was on geographic growth, indicating that the upside he sees in Yum! Brands which owns KFC, Taco Bell, and Pizza Hut, is based on its "*good deal of prospects internationally with significant growth capabilities in China and abroad*." And on the other hand he dinged Domino's for simply being in a market share war with Papa John's, with little growth potential.

Brands impact growth in a few ways. Generally speaking the higher the **brand awareness and equity in existing markets**, the easier it is to enter new ones since the company is starting from a base of a little familiarity with and interest in the brand even if it's small.

Strong brands also **attract quality franchisees, distributors, and other business partners** usually needed for successful expansion – not to mention **employees** who increasingly want to work for companies that have the better consumer image and higher purpose that comes with a good brand.

Finally a **brand can facilitate the stakeholder alignment and engagement** a company needs as it grows. By making clear the values that guide behavior and filters through which all decisions should pass, a brand guides successful execution, as proven by Virgin, the consumer brand conglomerate owned by Richard Branson, which uses its brand identity in a sense of competitive challenge to guide which sectors it should launch businesses in.

Given the power of brands on the fundamentals of financial performance, I wonder if it would make sense for analysts like Ristau to include brand strength as its own factor in their assessments? It would be highly subjective one but, frankly, the other factors seem to be as well – and after all, God created stock analysts in order to make weather forecasters look good, right?!

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About Denise Yohn

Denise Lee Yohn has been inspiring and teaching companies how to operationalize their brands to grow their businesses for over 20 years. World-class brands including Sony, Frito-Lay, Burger King, and Nautica have called on Denise, an established speaker, author, and consulting partner.

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