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Can investing in a monopoly business get you investment nirvana?

Synopsis
When a company is a dominant player, even if it does nothing wrong at all, any new player in the business will end up taking share and sales away from it

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Devina Mehra, Chairperson and Managing Director of First Global, is a gold medalist from IIMA as well as from Lucknow University where she broke several records. She had a seven-year-long stint at Citibank in Investment Banking & Corporate Credit/ Risk before becoming a member of the Bombay Stock Exchange in 1993 - her proprietorship which later corporatised and became India's leading institutional brokerage firm, First Global. She spearheaded First Global's globalisation over two decades ago, making First Global the first Asian (ex-Japan) firm to become a member of the London Stock Exchange and then the NASD.

First Global has since become a leading quantitative global asset management firm managing both PMS schemes in India as well as global funds.

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We all know these do-it-yourself investing principles that are supposed to make investing simple and profitable. One of the favourites in this genre is -- "Buy monopoly businesses. Buy the largest company in the sector with the strongest brand. You can't go wrong with the 800-pound gorilla in the business."

But what does history show? Remember Nokia, Kodak, and BlackBerry (Research in Motion) - all dominant businesses where magazine covers used to be about whether anyone could ever catch up with them. Where are they now?

You may say that this is the nature of technology businesses. But it is not as simple as that. In any case, when Kodak was running its film-based business, nobody thought this was a fast moving high tech area. The issue is far more fundamental than that.

For one, when a company is a dominant player, even if it does nothing wrong at all, any new player in the business will end up taking share and sales away from it.

When you have a 60-70% market share in a business, as Bajaj Auto NSE -0.01 % did in scooters or Maruti NSE 1.23 % in cars before new foreign players came in, it is a given that the new players will take away some sales from the incumbent.

For the largest player in the market, it is near impossible to grow faster than the market, whereas for a new or smaller player taking away 1, 2, or 5% share is not such a big deal.

When Tata Motors NSE 0.35 % took over JLR and introduced some great models to Jaguar, it was able to grow sales far faster than its competitors as it had only a 4-5% market share in luxury cars.

Another issue is that a new player can target niches. For example, in a paint or dye business, a new entrant can target a particular type of dye or paint - let us say an exterior paint only, rather than compete with the dominant player across segments.

In other businesses like detergent, hair oil, tea, or confectionery, small players can target certain states or regions and even tailor their products according to the preferences of that particular region.

That is how many players have nibbled away share in these businesses where bigger players like Hindustan Unilever NSE -1.36 % or Dabur NSE -1.36 % or Marico NSE -0.38 % have to pay a premium price to acquire these brands and their market share, as otherwise, their market share keeps getting chipped away.

What also happens is that often the new player cuts prices, offers discounts or gives freebies like free service on vehicles or appliances. This becomes an issue for the Number One company in the business, which has to decide whether to follow.

This became clear during a case discussion back in my MBA days, where the case study was about a new entrant in a business cutting prices. The professor asked one of us what the largest player would or should do. The student said it would match the discounts. The professor then asked us to calculate how much of a hit the bigger player would take on its large revenue base if it matched the pricing of the smaller player, and it became clear that the hit would be huge.

It also happens that smaller and later entrants often have lower cost structures and overheads compared to the old established companies, which tend to accumulate costs over time. Basically, it becomes a big decision for the incumbent to either follow the smaller player and take a hit on its margins and lose a hefty amount of profits on its high revenue base or cede the market share to the new entrant.

In any event, the dominant player in a market can't grow faster than the market itself, whereas that is not a constraint for its small competitor.

It is also mostly true that the big disruptions in a business come from new entrants or smaller players. It is extremely difficult for a giant to do this, especially when it involves the destruction of its current cash-generating business.

Kodak had the digital camera technology but could never scale it up as it would have destroyed their existing business. Of course, we know how that story played out with their business getting disrupted anyway and going out of business.

There is also some inertia when you have a substantial profitable business and the new company is too small to get top management's focus. Microsoft, with its cash-generating existing businesses, missed out on opportunity after opportunity in the internet browser, search, cloud computing, and more - it has caught up only recently in some of these under Satya Nadella's leadership.

Until now, we have only been talking about business issues. Additional complexity arises when you buy a dominant company at the wrong price.

Even if there are no big disruptions to its business, it may still be an underperformer, even over a long period.

A good example of this is Coke which, over a period as long as 30 years, has gone up only 12 times, while the S&P 500 has gone up 16.5 times over the same period and Pepsi 19.5 times.

In India, too, large branded companies have underperformed for lengthy periods - a good example being Hindustan Unilever which underperformed for the first decade of this century, or Colgate NSE 0.25 % India, which saw a stock price decline of 75% over 9 years from 1993 to 2002! Or Bata NSE -0.23 %, which gave zero returns over 15 years from 1994 to 2009.

Moral of the story: Buying companies with large market shares and established brands will not lead you to investment nirvana. A whole lot of additional analysis is needed. And a large market share can actually be a vulnerability rather than a strength.

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