Should you invest in Monopoly or Dominant businesses?

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We are all familiar with those Do-it-Yourself investing principles that are supposed to make investing simple and profitable, so simple that the man or woman on the street can do it easily and effortlessly to make super normal Returns.

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, 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.

For one, when a company is the dominant player in the business, 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 60 or 70% market share in a business, as Bajaj Auto did in scooters or Maruti in cars before new foreign players came in, it is a given fact that the new players will take away some sales from the incumbent.

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

This is the reason why growth projections for smaller players have very little to do with what is happening to the economy at a macro level, or even for that particular industry.

When a small regional player launches a biscuit brand or inexpensive washing powder, it is not banking on overall market growth but on only nibbling away the share of 'The Big Daddy' in the business.

When Tata Motors took over Jaguar Land Rover (JLR) and introduced some great new models in Jaguar, it was able to grow sales far faster than its competitors. This was something we had bet on as we realised that it had only 4-5% global market share in luxury cars at that time. Hence, it was not that dependent on the overall growth in the luxury car market.

Another issue is that a new player can target niches. For example, in a paint or dyes 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 can even tailor their product according to the preferences of that particular region.

That is how many players have made dents in market shares of larger players in these businesses. Oftentimes, this story ends with bigger players like Hindustan Unilever or Dabur or Marico having to then pay a premium price to acquire these brands and their market share, as otherwise their own market share keeps getting chipped away.

What also happens is that often the new player cuts prices, gives 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 dominant player in the business would or should do? The student said it would match the discounts. The professor than asked us to calculate how much of a hit the bigger player would take on its large revenue base if it goes to match the pricing of the smaller player and it became clear that the impact 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 legacy costs over a period of time. Their pay structures are higher, they may be using more expensive equipment and have better facilities and offices in keeping with their reputation and history.

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.

It is, in any case, a good exercise to see how the so called brand value of a company is getting captured in the financials. For example, 20 years ago the FMCG companies in India like Hindustan Unilever, Nestle, P&G etc did not have very high EBITA margins but their brand value was captured in their leverage over the distribution chain where they got money in advance from the distributors and had a negative working capital cycle. Now, margins are higher but as retail gets more organised in India, the bargaining power of the manufacturers versus the trade is reducing.

Often, the biggest player in a market has a choice in terms of pricing and companies can opt for different options that determine their profit and margin trajectory.

Amazon, for instance, deliberately keeps pricing and margins extremely low, specially in new businesses it enters. For example, when it entered cloud computing, it did so at prices which did not appear to make economic sense. The reason? It did not want to make the business too attractive for other entrants...and the strategy worked!

A business that is growing well or has high margins is a double-edged sword as it becomes attractive for new players as well.

Look at Nyaaka, for instance. As I write this in 2023, it is the dominant player in the beauty D2C (Direct to Consumer) business but after they have created the business, it is far easier for other players to enter. The exception to these rule is platform businesses, where when a large community of buyers and sellers are on a platform that in itself becomes an entry barrier.

Whichever way you look at it, it is virtually impossible for the dominant player in a market to 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 destruction of its current cash generating business.

A famous example of this: Kodak had the digital camera technology but could never scale it up as it would have destroyed their existing business. It was making most of its money in selling and processing films rather than selling cameras and this business would have taken a crippling hit had they scaled up the digital technology.

Of course, we know how that story played out with their business getting disrupted anyway and their going out of business.

There is also some inertia when you have a substantial profitable business and the new business is too small to get top management focus. When your main business is generating billions, how do you get adequate focus on something which is only a couple of millions at the moment. Whereas some smart group of youngsters with their startup maybe giving their all to that small nascent business.

Microsoft, for instance, with its cash generating existing businesses missed out opportunity after opportunity in 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 of business issues which can derail the story for a dominant company in a business. An additional complexity as an investor, arises when you buy a big 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 of time.

A good example of this is Coke which, over a period as long as 30 years (1993-2023), has gone up only 12 times - when 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 that underperformed massively from 1999-2010...a period during which its business also showed very low growth.

Or Colgate India that saw a stock price decline of 75% over the 9 years from 1993 to 2002!

Or Bata, which gave zero returns over a 15-year period from 1994 to 2009.

Moral of the story: Buying companies with large market share and established brands will not lead you to investment Nirvana. A whole lot of additional analysis is needed.

And remember, a large market share can actually be a vulnerability, rather than a strength.