Brian Feroldi

If you invest, you **MUST** know how to identify a moat.

Here are 9 financial "**rules of thumb**" that **Warren Buffett uses** to tell if a company has one:

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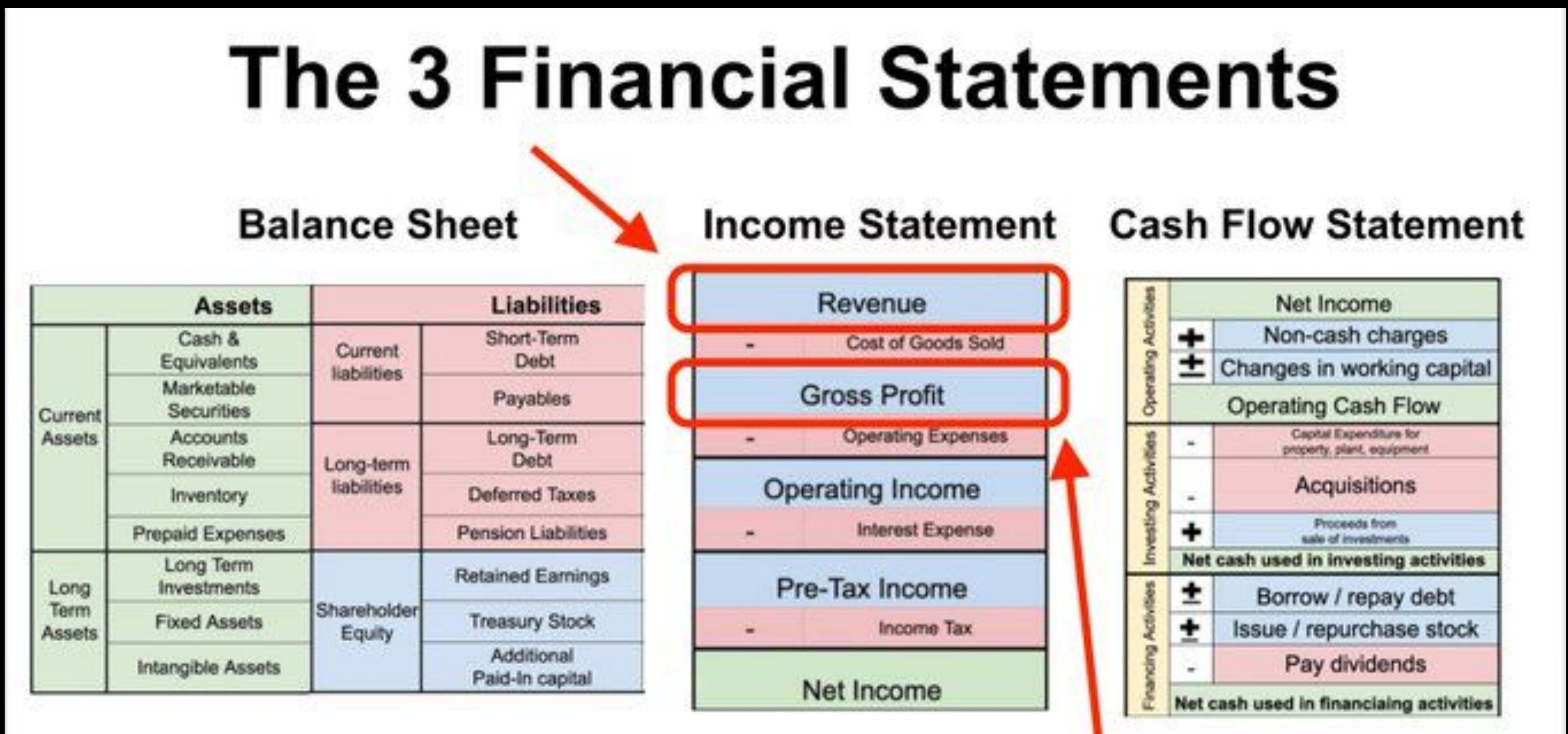
1. Gross Margin

Found: **Income Statement**

Formula: **Gross Profit / Revenue**

Moat: Consistently above **40%**

No Moat: Under **40%** & **volatile**



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Buffett's logic:

A **consistently high gross margin signals** that the company isn't competing exclusively on **price.**

A **high gross margin** also **provides** ample gross profit to **pay expenses and leaves money for shareholders.**

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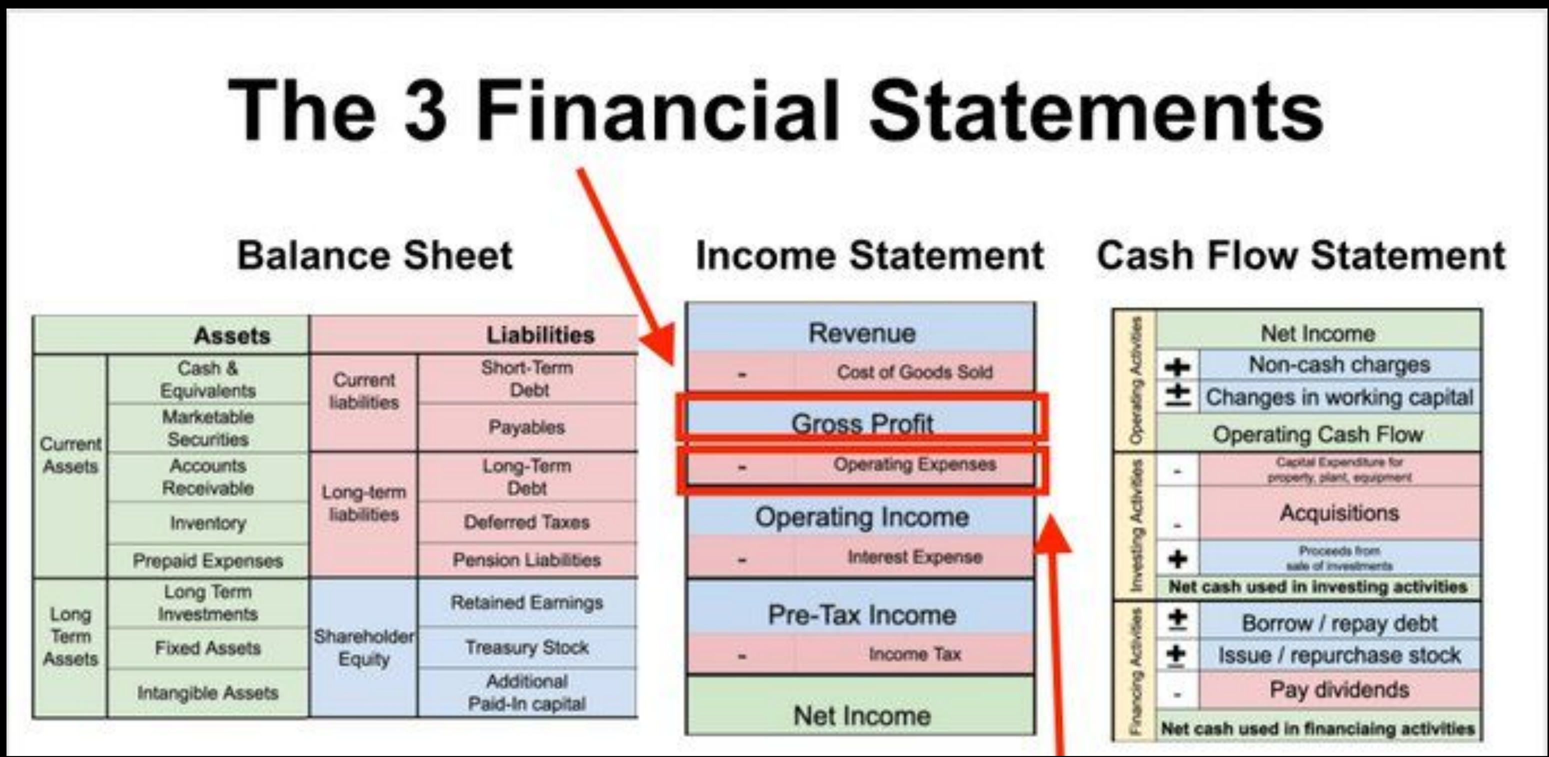
2. Sales, General, and Administrative Expenses

Where: **Income Statement**

Formula: **SG&A / Gross Profit**

Moat: Consistently under **30%**

No Moat: Over **80%** & **volatile**



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Buffett's logic:

Wide moat companies don't need to spend a lot on overhead to operate. **No moat businesses do.**

Buffett looks for companies that **consistently spend under 30% of their gross profit on SG&A.**

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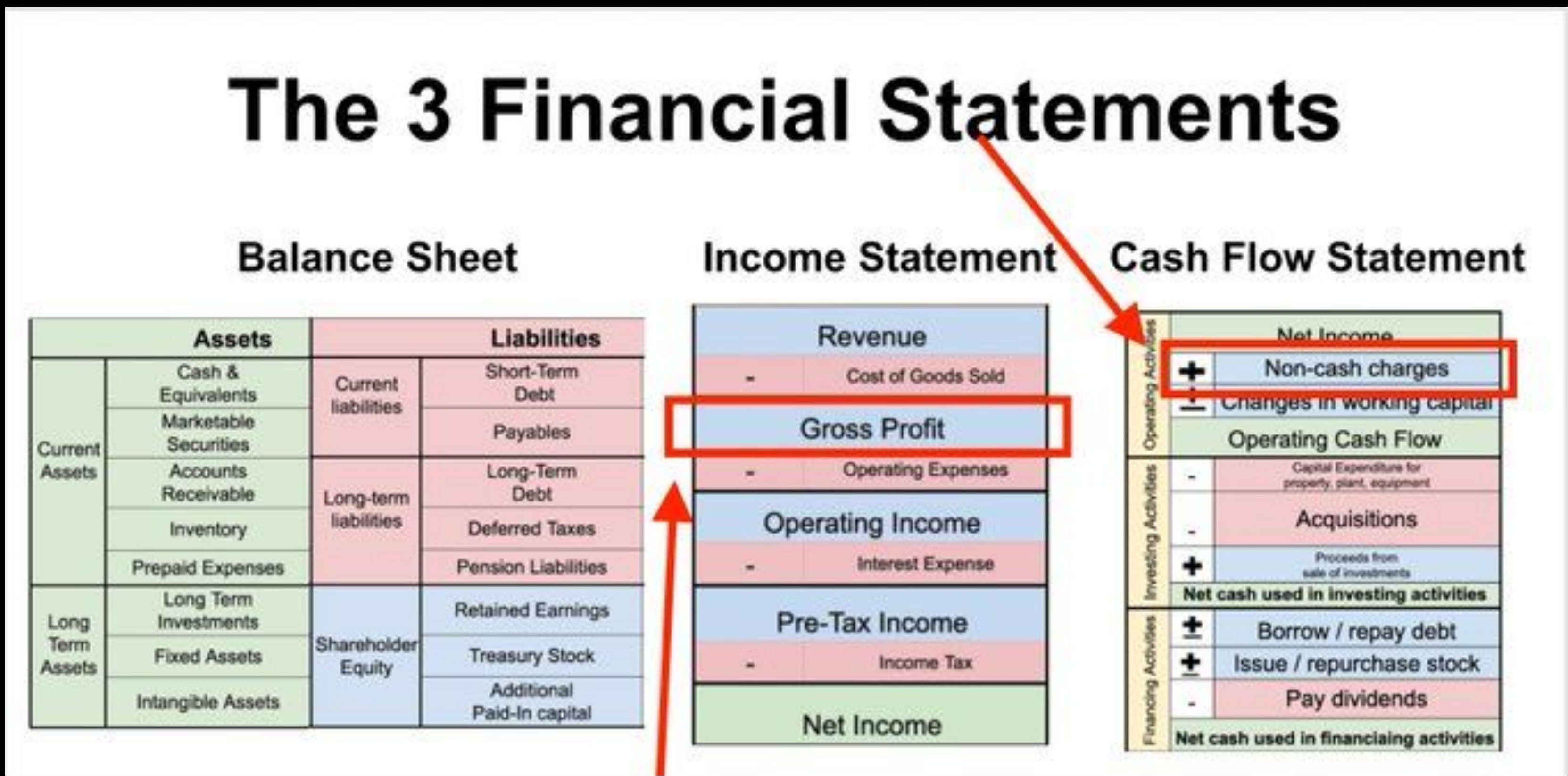
3. Depreciation Expense

Where: **Income Statement & Cash Flow Statement**

Formula: **Interest Expense / Operating Income**

Moat: Consistently under **10%**

No Moat: Volatility & high



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Buffett's logic:

If **depreciation is consistently less than 10% of gross profit**, it's a sign that the company **doesn't need a lot of capital expenditure assets** to maintain its competitive advantage and has a moat.

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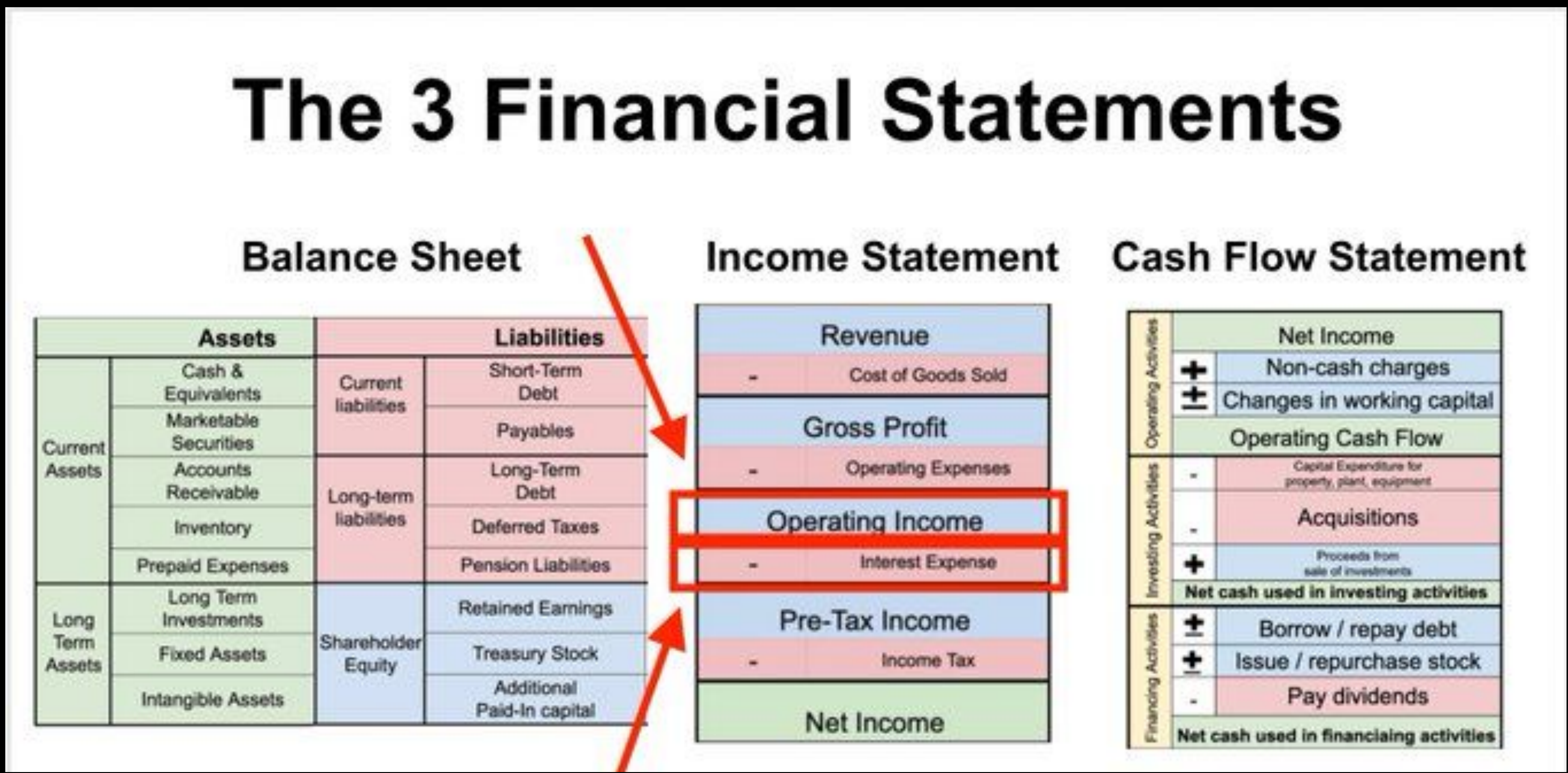
4. Interest Expense

Where: **Income Statement**

Formula: **Interest Expense / Operating Income**

Moat: Consistently under **15%**

No Moat: Over **50%** & **volatile**



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Buffett's logic:

Great businesses have such wonderful **economics** that they are don't need to rely on debt.

While this number varies greatly from industry to industry, **it's a great sign if a company consistently spends less than 15%** of its operating income on interest.

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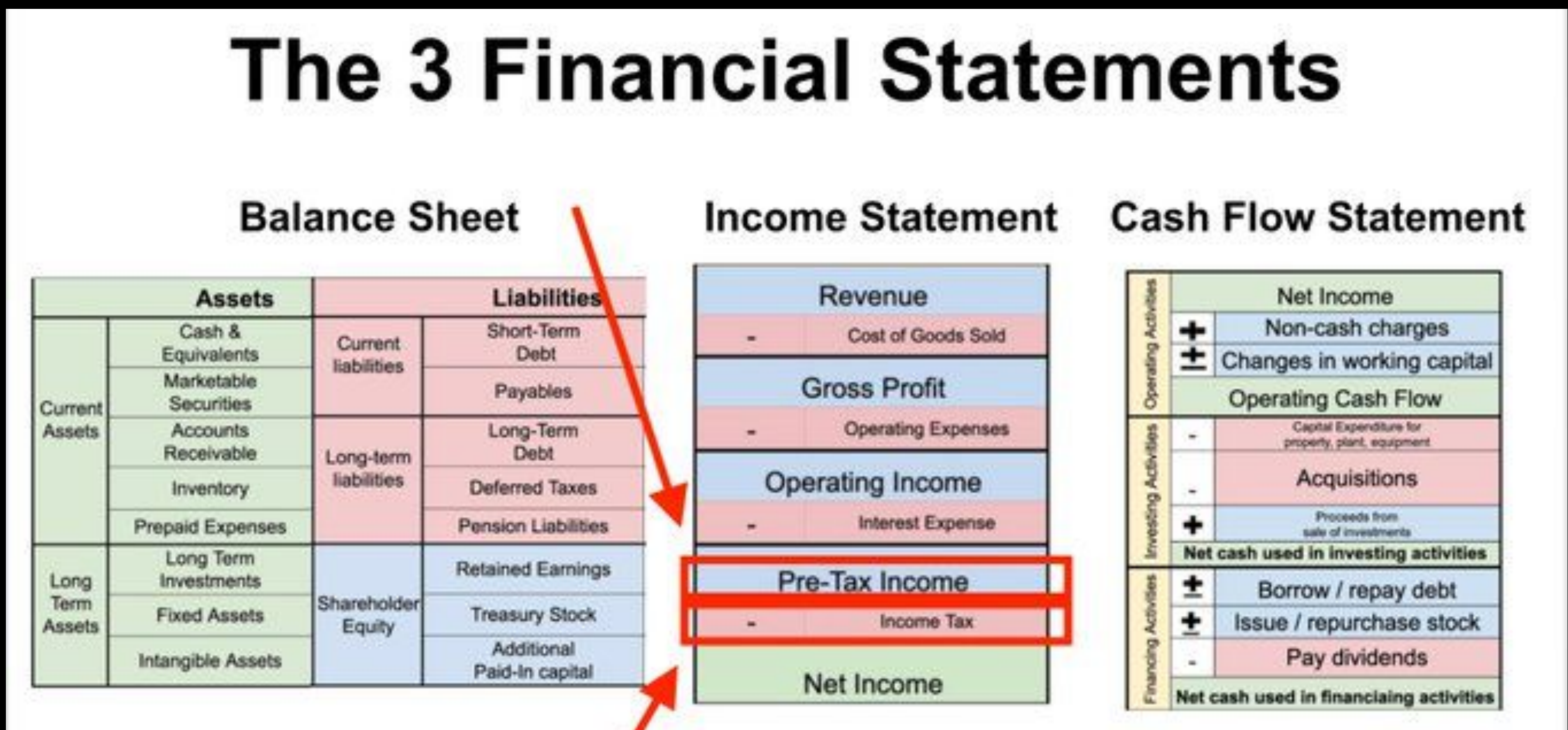
5. Income Tax Expense

Found: **Income Statement**

Formula: **Income Tax Paid / Pre-tax Income (Earnings Before Tax)**

Moat: Consistently pays the full amount **(~21% in U.S.)**

No Moat: Negative, erratic



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Buffett’s logic:

Wide moat businesses **make so much money** that they are consistently forced to pay their full share of **taxes.**

Companies that **consistently have negative or an erratic income tax bill** aren't as likely to have a **durable moat.**

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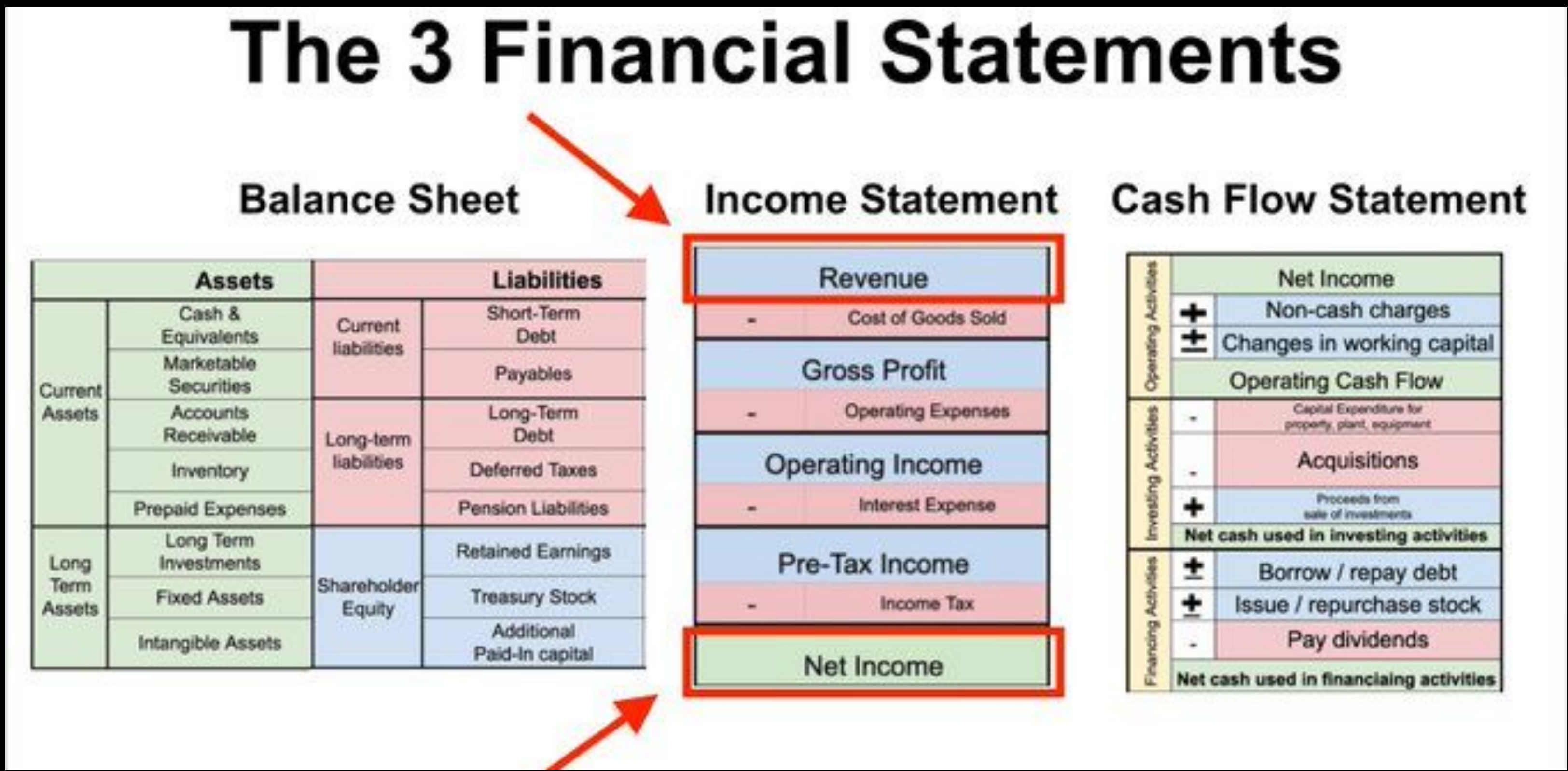
6. Profit Margin (Net Margin)

Found: **Income Statement**

Formula: **Net Income / Revenue**

Moat: Consistently above **20%**

No Moat: Below **10%**, negative, and volatile



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Buffett's logic:

Companies that consistently **convert 20%** of their **revenue** into net income likely have a moat.

If this number is **under 10%, negative, or volatile,** it's an **indication that competition is fierce.**

(There's plenty of nuance between 10% and 20%).

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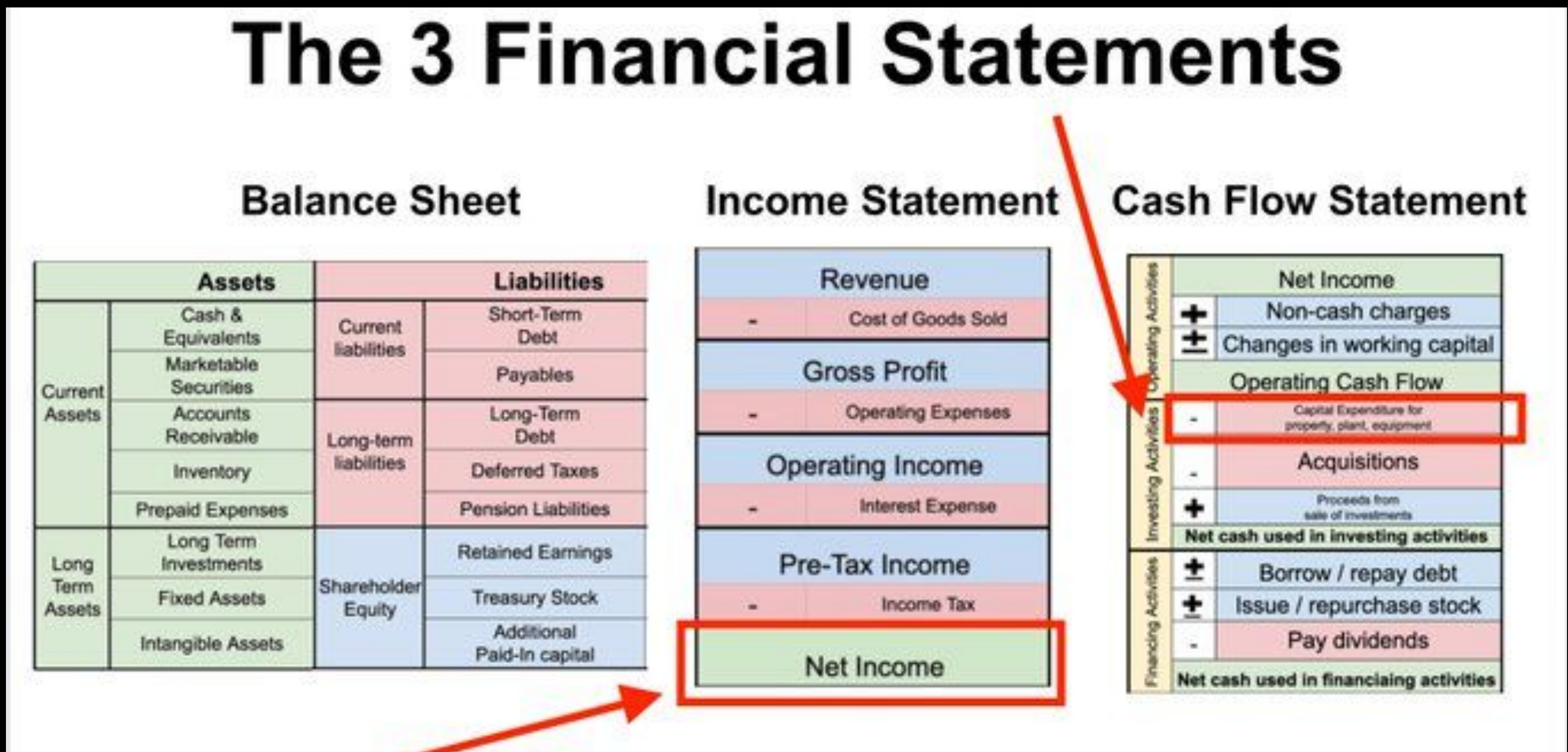
7. Capital Expenditures

Found: **Income Statement & Cash Flow Statement**

Formula: **Capital Expenditures / Net Income**

Moat: Consistently under **25%**

No Moat: Consistently above **75%**



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Buffett's logic:

Capital expenditures eat into **profits.** Companies that **don't** have to spend big on capex have more money to **reward shareholders.**

Important: Capital **Expenditures** can vary greatly from year to year. Averaging the result over **10+ years** is best.

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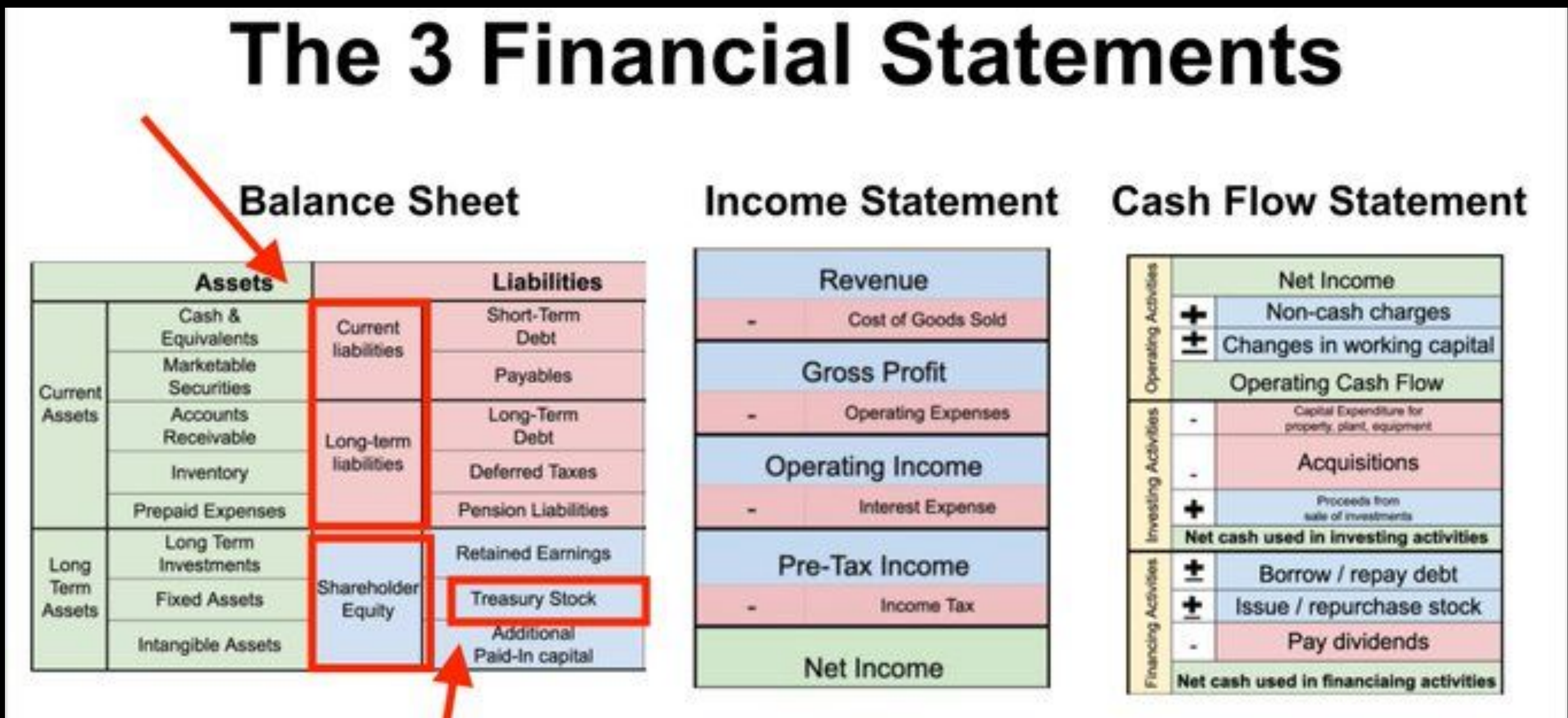
8. Total Liabilities to Adjusted Shareholder Equity

Found: **Balance Sheet**

Formula: **Total Liabilities / Shareholder Equity**

Moat: Below **0.80**

No Moat: Over **2.00**



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Buffett's logic:

Wide **moat businesses finance themselves with profits**, not debt.

However, **stock buybacks can throw off this equation.**

Adjust for this by **adding back any treasury stock** to the shareholder equity number.

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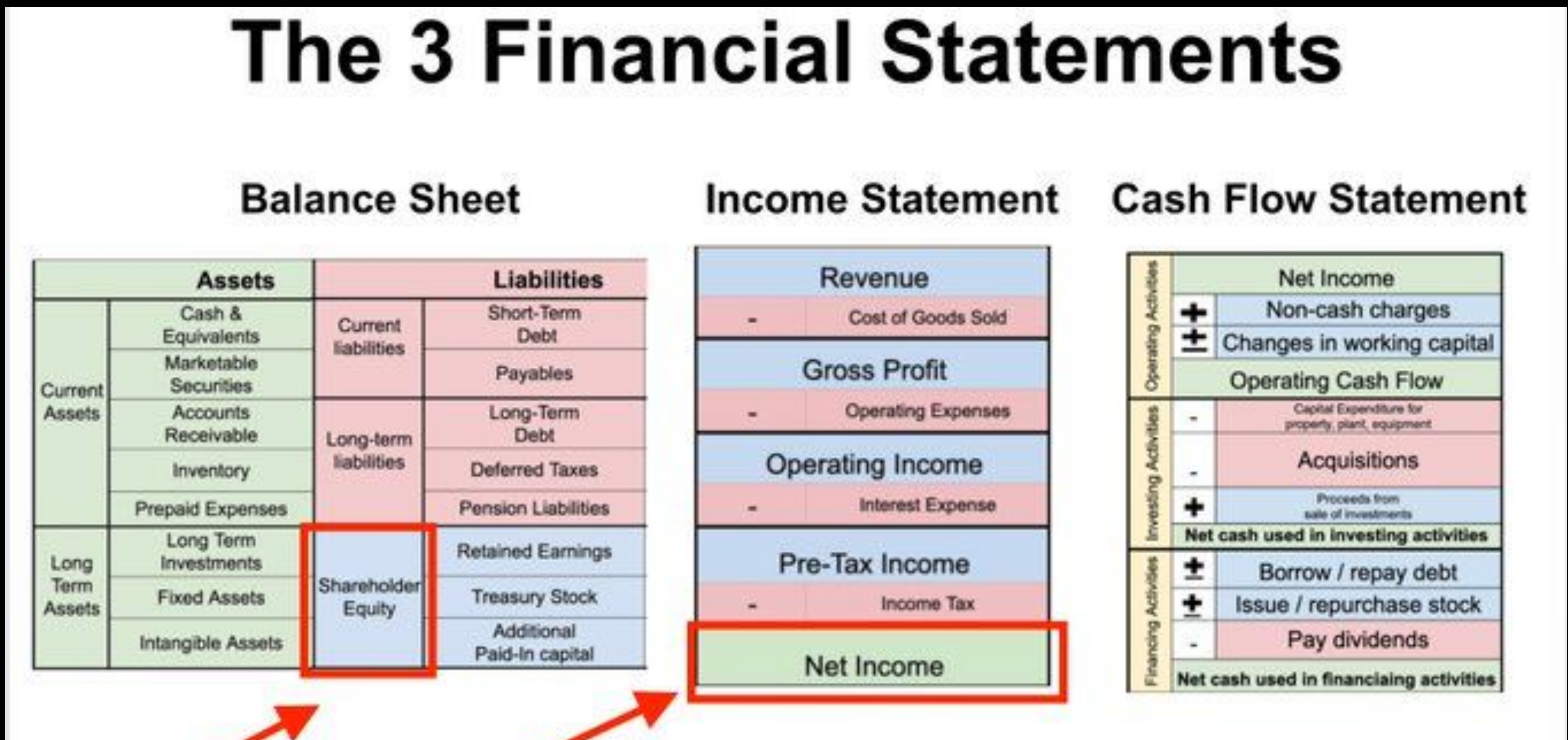
9. Return on Shareholders' Equity

Found: **Balance Sheet & Income Statement**

Formula: **Net Income / Shareholder Equity**

Moat: Consistently above **15%**

No Moat: Below **10%**, negative, or volatile



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Buffett's logic:

Return on equity shows **how effectively management is reinvesting its profits.** A number consistently over 15% **indicates that the business has a moat.**

Under 10%, negative, or volatile indicates that the business is **struggling with competition.**

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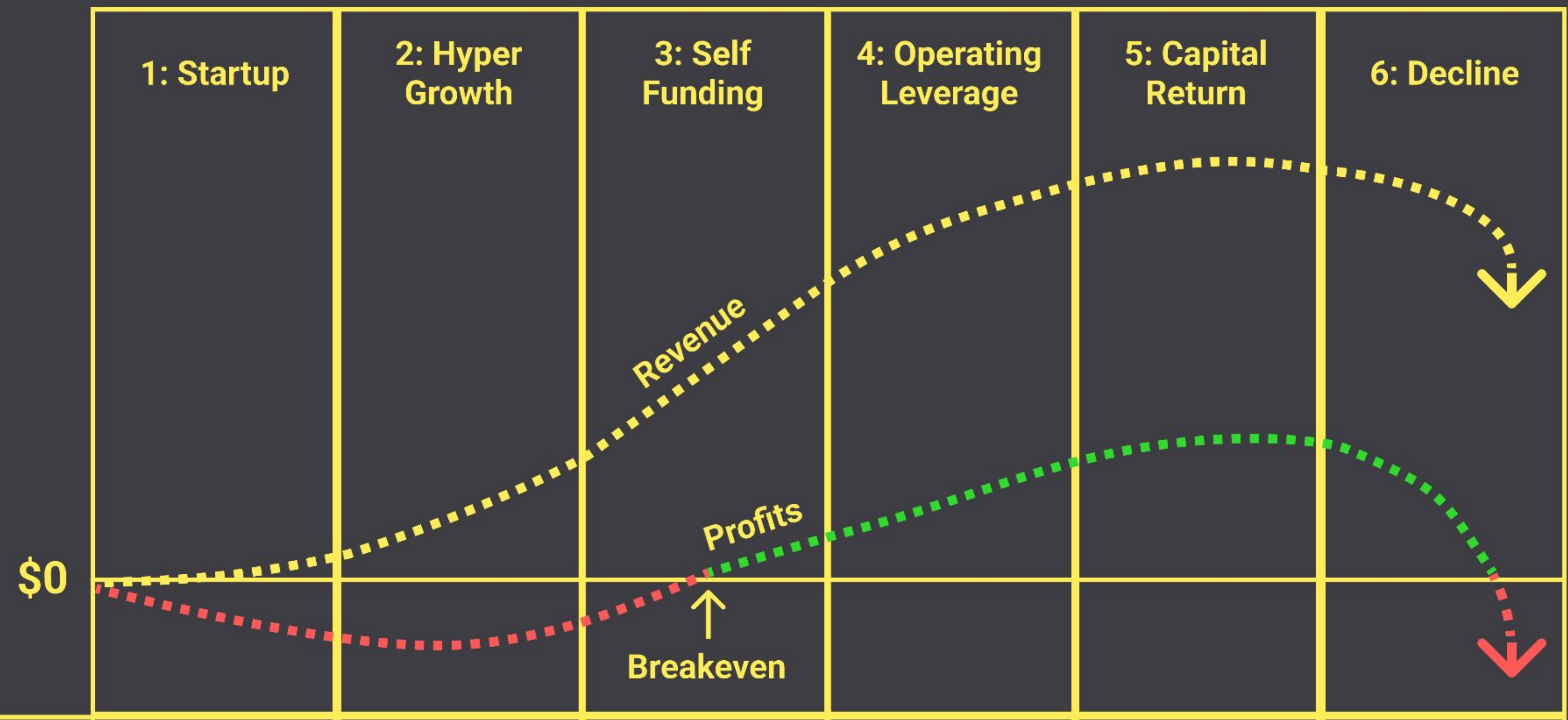
These “**rules of thumb**” only work when a company is **optimized for profits (phases 4 & 5).**

Many of them **don’t work at all** when a company is in phases **1, 2, 3, or 6**



	1: Startup	2: Hyper Growth	3: Self Funding	4: Operating Leverage	5: Capital Return	6: Decline
Total Addressable Market:	Total Addressable Market	Total Addressable Market	Total Addressable Market	Total Addressable Market	Total Addressable Market	Total Addressable Market
Current Multiple:	Price To Sales	Price To Sales	Price To Sales Price To Gross Profit	Price To Forward Earnings Price To Free Cash Flow	Price To Trailing Earnings Price To Free Cash Flow	Price To Trailing Earnings Price To Free Cash Flow
Discounted Cash Flow:	Discounted Cash Flow	Discounted Cash Flow	Discounted Cash Flow	Discounted Cash Flow	Discounted Cash Flow	Discounted Cash Flow
Reverse DCF:	Reverse DCF	Reverse DCF	Reverse DCF	Reverse DCF	Reverse DCF	Reverse DCF

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CONSISTENCY is also key

The real **test** is if a **company generates good numbers** over multiple years & various economic cycles.

There are PLENTY of exceptions & nuances to these rules, too!

Many of **Buffett's** largest holdings do not pass every rule of thumb.

That's because **investing & accounting** have **TONS** of nuances.

Still, **rules of thumb are very helpful.**

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If you invest, you **must** understand financial statements & valuation.

Want help?

Join me in August for my cohort-based course,

Valuation Explained Simply

Direct message me for a coupon code