For professional investors only

What happens when 'growth at any price' goes wrong?

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Over the last 12-18 months, during meetings with existing and prospective clients, Novo Nordisk has been one of the stocks we have been asked about the most. There are two reasons for this level of interest. First, we don't own it and it is one of the biggest index constituents. Second, it is a stock that has performed really well and is found in many of our competitors' portfolios.

The conversation tends to start with the question: 'It's a great business and has performed really well so why don't you own Novo Nordisk?' Typically, being grilled on why we haven't held such a stock is an uncomfortable experience. In Novo's case, however, our response is one that allows us to reinforce key elements of our philosophy.

Back to basics

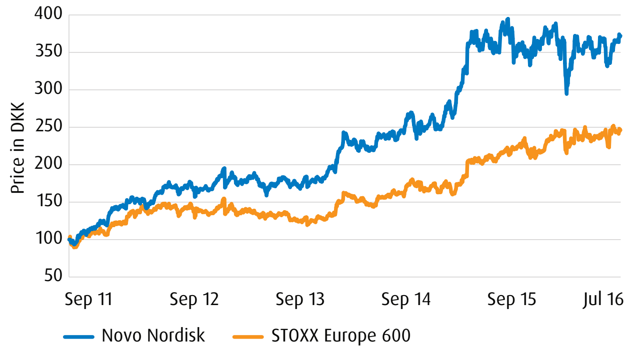
Before outlining the specifics relating to Novo Nordisk it is worth re-emphasising the basic principles of our approach.

We want to buy quality companies run by good management teams. Crucially, however, we believe that the price we pay – even for high quality companies – is equally important. We're not the first (and we won't be the last) to make this assertion but such is the importance of the 'price you pay' on returns potential that it is worth restating again and again. Buy a quality business whose share price fully reflects that impressive performance and if disappointments emerge you are likely to lose money. This is where we introduce the concept of 'margin of safety' – a key element of our process and one that explains our reticence about investing in Novo Nordisk.

A great company – but priced for perfection

Undoubtedly, Novo Nordisk is a quality company. It has generated high returns and strong cash flow. The prospects are also seemingly bright as its focus on healthcare – primarily in diabetes – bode well for future growth, especially in emerging markets.

Novo Nordisk – an impressive performer



Source: BMO Global Asset Management, Bloomberg as at 31.07.16

So what's not to like? What is our problem? First, it is very well-liked. Current analyst recommendations stand at 18 buys, 16 holds and just 4 sellers. Second, we believe this was a stock priced for perfection, at the end of July it was trading at 25x price to earnings (p/e). At this rating we had to factor in aggressive growth, use a very low discount rate and record margins in order to find a small amount of upside.

But this is a great company so isn't a 'premium price' fair? This brings us back to the one of the key elements of our investment philosophy – the margin of safety. What happens if something goes wrong?

In our response to a 'why don't you hold it' grilling we point out that although Novo Nordisk is the biggest diabetes company, the largest gold standard diabetes drug – Lantus – is sold by Sanofi and is off patent. The result is a therapeutic area that has seen years of price rises now seeing declines. Novo's new competing (and arguably superior) offering – Tresiba – is not listed on many of the pharmacy benefit managers in the US because they do not believe it is worth the higher price. It isn't for sale at all in Germany for the same reason.

But Novo has a great pipeline of new drugs which will help? Yes they will but these are already factored into analyst forecasts.

Minor disappointment triggers major share move

So what happens if there is no (or limited) margin of safety and something goes wrong or simply disappoints? In the last reporting season, Novo Nordisk didn't issue a huge profit warning. Its Q2 results saw a business with 6% growth and 45.5% operating margin and earnings revised down by 2-3%. Nothing too earth shattering here. They did, however, revise down the guidance for 2016 and pointed to a more difficult outlook in the US in 2017 due to pricing pressure. Just look at the impact on the share price...

Novo Nordisk – a disappointing performer

Source: BMO Global Asset Management, Bloomberg as at 17.10.16

True to label – quality AND valuation matter

We haven't written this note to point out how clever we have been to not own Novo Nordisk in recent months. Frankly, it's a great business and strong share price performance in recent years has reflected that. The issue we had is that Novo – like a number of companies benefiting from bond proxy flows – was priced for perfection. Not owning many of these type of quality businesses has hurt our relative performance over the last twelve months but we have been very clear in our message. We want to own good quality businesses but will not hold them at a price that allows for insufficient margin of safety. For us, successful long-term investment is as much about protecting capital from moves like that above as it is about participating in share price appreciation.

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