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Pharmaceutical companies in a golden age for drug discovery

As new technologies such as genomics spur development of innovative drugs, European pharmaceuticals companies stand out as high-quality, defensive growth stocks

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In uncertain times it pays to own high-quality, defensive growth stocks with strong balance sheets and a record for innovation. And no group of companies exemplifies this better than Europe's pharmaceuticals. At a time of innovative drug development they are poised for growth with more launches in the pipeline than patents expiring.

While many companies are struggling for survival in the coronavirus turbulence, Europe's pharmaceutical companies – especially large players like AstraZeneca, GlaxoSmithKline, Novartis, Novo Nordisk, Sanofi and Roche – look pretty safe. On average these stocks yield 3.5%,[1] which their earnings cover twice over. Strong drug pipelines should reinforce earnings.

While these pharmaceutical companies always tend to boast robust, defensive financial characteristics, their growth is being accelerated by innovative new technologies such as genomics. This has led to a new golden age in drug discovery, and the pace is quickening with disruptive drugs for diseases such as lung and blood cancer, psoriasis, dermatitis, diabetes, multiple sclerosis and haemophilia. There are also promising pipelines for anaemia, obesity and rare diseases.

We look for the highest quality companies that are likely to outperform over the long term. Ideally they are misunderstood and undervalued, ie, where investors fail to appreciate the potential of innovation. A catalyst such as a new drug development or launch may trigger strong share price performance, and we look for businesses with strong competitive positions: a differentiated product portfolio can create an advantage. Companies need good management and attractive returns on invested capital. Finally, scoring highly on environmental, social and governance criteria is a mark of a top-quality, well-run business.

A positive backdrop

The backdrop for pharmaceuticals could hardly be more favourable, with demand rising around the globe: the world's ageing population will need more and more drugs. At the same time there are many under-treated diseases. As emerging markets like China become wealthier, so the middle classes' healthcare demands will grow.

The Food and Drug Administration, which regulates US drug development, is playing its part with a more positive stance towards new drugs and a quicker approval process.

The result is an industry with exceptionally high profit margins – earnings before interest and taxes (EBIT) margins for the sector average 33%[2] – with a low requirement for capital and organic growth generating high levels of cash boosted by in-licencing: the acquisition of more innovation from smaller biotech companies.

▶ Even Covid-19 does not threaten business models. Demand for drugs will remain resilient, though fewer doctor visits could temporarily lead to lower treatment initiations. Supply chains should prove resilient as many pharmaceutical companies can guard against supply chain shocks, including keeping six months of inventory and having more suppliers on standby.

Three key risks

Even so, Europe's pharmaceutical companies are not without risk. Firstly, there is always a danger that drug development pipelines might disappoint, or safety concerns arise over newly launched drugs. Should either happen, stock prices can fall sharply.

Secondly, pricing is controversial in the profitable US market, where a democratic president could extend Medicare and force lower drug prices.

Thirdly, there is always a danger of litigation. In the past, pharmaceutical companies have been sued over their marketing practices or the side effects of drugs.

Novo Nordisk's innovation

Novo Nordisk, Denmark-headquartered but with a global reach, is a prime example of a defensive stock with a promising growth outlook. The leading manufacturer of injectable diabetes and obesity drugs, it generates sustainable sales growth above the sector average. Given that is supplies half the world's insulin,[3] it has a big capacity advantage which, alongside its leading drug portfolio, provides a wide "economic moat" or competitive advantage which is hard for competitors to overcome.

Looking ahead, the new GLP-1 class of diabetes and weight-loss drugs will drive growth as they are more effective than older treatments. GLP-1 is growing at 30% per annum and Novo Nordisk is the only company to offer an oral version. At a time when obesity is increasing worldwide, Novo Nordisk is developing drugs that could help people shed up to 30% of their body weight.[4]

Such innovation is rewarded. The company has the highest EBIT margin of Europe's large pharmaceutical companies and the highest return on capital. Free cash flow is expected to boom from 2020 as capital expenditure dwindles, with cash returned to shareholders through dividends and share buy backs.

Businesses such as this are attractive at the best of times, but with such turbulence in financial markets and economies, they stand out for their stability. With new technologies leading to innovative new drug patents they are a rarity – companies poised for strong, steady, cash generative growth.

> "Pharmaceutical companies always tend to have robust, defensive financial characteristics, but their growth is now being accelerated by new technologies such as genomics

[1] Columbia Threadneedle Investments analysis, February 2020.
[2] Columbia Threadneedle Investments analysis, February 2020.
[3] Novo Nordisk Annual Report 2019, https://www.novonordisk.com/annual-report.html
[4] Novo Nordisk – A focused healthcare company, Investor presentation Q1 2019.

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