
The Power of Moats: Competitive Advantages Drive Superior Performance



Alex Morozov, CFA

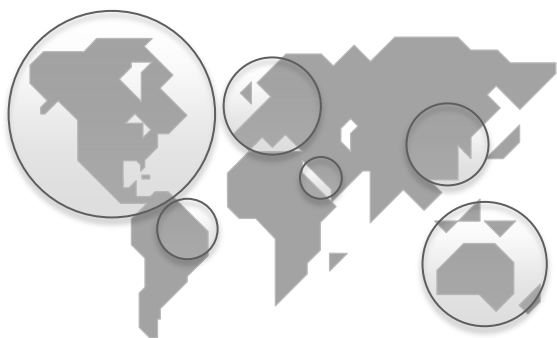
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April 26, 2014

Morningstar Equity Research Comprehensive Equity Coverage

By Region, Market Cap, and Sector



Regional Coverage

Asia	81
Australia/New Zealand	219
Europe	255
Latin America	34
Middle East/Africa	39
North America	817
Total Global Coverage	1,445

Market Cap Coverage

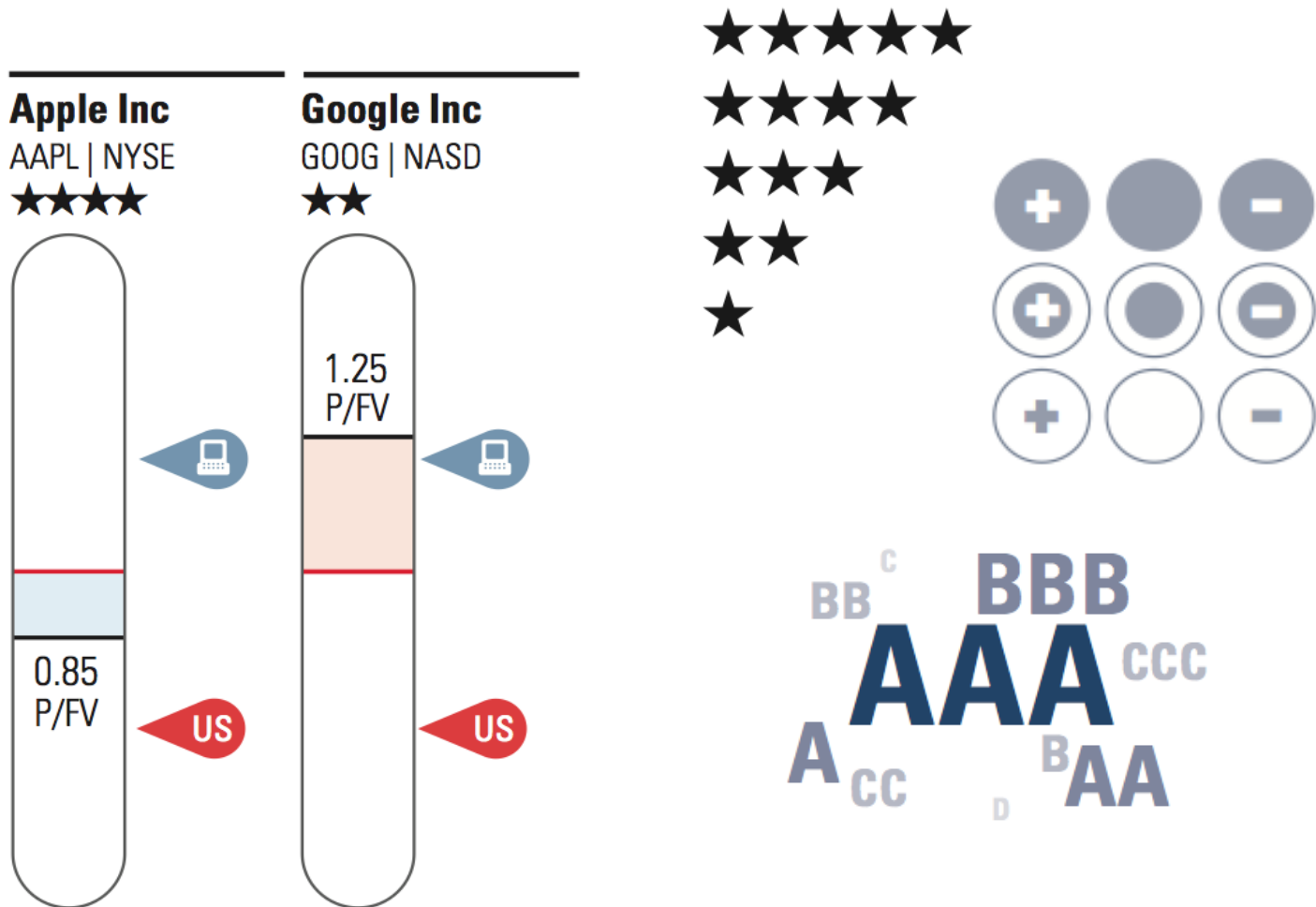
! Large-cap Stocks (10+ Bil USD)	684
@ Mid-cap Stocks (2-10 Bil USD)	545
# Small-cap Stocks (0-2 Bil USD)	216

Market cap data as of 02/2014
Regional and Sector data as of 02/2014

Sector Coverage

h Cyclical	
r Basic Materials	136
t Consumer Cyclical	211
y Financial Services	194
u Real Estate	45
j Sensitive	
i Communication Services	62
o Energy	130
p Industrials	204
a Technology	137
k Defensive	
s Consumer Defensive	106
d Health Care	137
f Utilities	83

Morningstar Research – What Is It?



Morningstar Research – What Is It?

Sector: [Healthcare](#) > Industry Group: [Biotechnology](#)

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Novo Nordisk A/S

<http://www.novonordisk.com>

Analyst(s)

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[Email](#)

Economic Moat™ **Wide** | Moat Trend **Stable** | Uncertainty **Medium** | Equity Stewardship **Exemplary** | Morningstar Credit Rating **AAA** | Market Cap (DKK Bil) **634.43** | Domicile **DK**

LATEST ANALYST RESEARCH:

- [Healthcare Observer: Drug Distributors: Not a Normal Distribution of Returns](#)
Observer Series | Vishnu Lekraj | 09 Apr 2014
- [Healthcare Observer: Hematological Cancers: There Will Not Be Blood](#)
Observer Series | Karen Andersen, CFA | 27 Mar 2014
- [Novo Reports In Line 2013; Stock Looks Undervalued Despite Headwinds in 2014](#)
Stock Analyst Notes | Karen Andersen, CFA | 30 Jan 2014
- [Morningstar Healthcare Sector Report](#)
Select Presentation Healthcare | Debbie S. Wang | 31 Dec 2013
- [Global Diabetes Market: For Sanofi and Novo Nordisk, Innovation and Demographic Trends Trump Price Concerns](#)
Select Presentation Healthcare | Karen Andersen, CFA | 05 Dec 2013

[Novo Reports In Line 2013; Stock Looks Undervalued Despite Headwinds in 2014](#)
Company Report | Jan 30 2014

[Novo Nordisk A/S Cash Flow Model](#) | 03 Feb 2014

[Transcripts](#) [Filings](#)

More...

NVO US: ★★★ | NOVO B DK: ★★★ | [Compare](#)

Last Price **233.00** DKK | Day Change **2.30** | 1.00% | As of Apr 16, 2014 3:29:38 AM EDT (XCSE) | Last Close **230.70** DKK | Fair Value **246.00** DKK | Consider Buy **172.20** DKK | Consider Sell **332.10** DKK | [Add To Watchlist](#) | [Set Alerts](#)

▼ Research

- [Analyst Note](#)
- [Investment Thesis](#)
- [Bulls Say / Bears Say](#)
- [Price/Fair Value Chart](#)
- [Valuation](#)
- [Scenario Analysis](#)
- [Economic Moat™](#)
- [Moat Trend](#)
- [Risk](#)

Analyst Note | Jan 30 2014 | Karen Andersen, CFA

Novo Nordisk reported full-year 2013 results that were in line with our estimates, and our 6% top-line growth estimate for 2014 is in line with the firm's guidance, including the foreign exchange headwind. Although our operating profit growth assumption for 2014 looks bullish after factoring in foreign exchange, our overall free cash flow assumptions look in line, and we're not making any changes to our fair value estimate. We continue to think that shares look attractively priced, give our solid long-term demand outlook for insulin as well as Novo's strong late-stage pipeline. The firm's wide moat looks stable to us, given significant economies of scale in the insulin business

Bulls Say

The increased prevalence of obesity and patient conversion to pricier modern insulin offerings should expand the branded diabetes-care market by 12% annually over the next five years.

With a promising pipeline full of next-generation insulins, Novo is well positioned to defend its formidable diabetes market share in the long run.

Novo's prowess developing therapeutic proteins has led to the creation of a highly profitable line of biopharmaceutical products for hemophilia and other disorders, helping to diversify its top

Morningstar[®] Economic Moat[™] Rating

Morningstar Strategy

Basic Premise: Long-Term Oriented, Fundamental Analysis Works!

- Evaluate stocks as small pieces of business
- Perform primary, fundamental research
- Take a long-term perspective
- Access competitive advantages
- Calculate appropriate margin of safety

Invest in companies with strong and growing competitive advantages (Moats), trading at reasonable prices

Morningstar[®] Economic Moat[™] Rating

Economic Moat Concept

So, What is a Moat?



Morningstar[®] Economic Moat[™] Rating

Economic Moat Concept

OK, What is an Economic Moat?

- Capital flows to the areas of highest potential return, so all firms face competition that seeks to force down high returns on capital.
 - But some firms generate high returns for a very long time.
 - How? By creating economic moats around their businesses.
- An economic moat is a structural business characteristic that allows a firm to generate excess economic returns for an extended period.
 - Firms with moats have ability to invest incremental capital at high rates of return = faster earnings growth and/or higher free cash flow.
 - Firms with moats have more predictable cash flows, limiting the risk.

Morningstar[®] Economic Moat[™] Rating

Economic Moat Concept

What is NOT an Economic Moat?

- Size / Dominant Market Share: High market share does not give a firm a moat. (Ask Compaq – or GM.)
- Technology: What one smart engineer can invent, another engineer can make even better.
- Hot Products: Can generate high returns on capital for a short period of time, but sustainable returns are what make a moat.
- Process: Can be imitated with time. Witness Dell.

Morningstar[®] Economic Moat[™] Rating

Economic Moat Concept

What about Management?

- In our view, management is not a moat by itself, but smart (or dumb) managers can create (or destroy) a moat over time.
 - "Go for a business that any idiot can run – because sooner or later, any idiot probably is going to run it." – Peter Lynch
 - "When management with a reputation for brilliance tackles a business with a reputation for poor economics, it is the reputation of the business that remains intact." – Warren Buffett

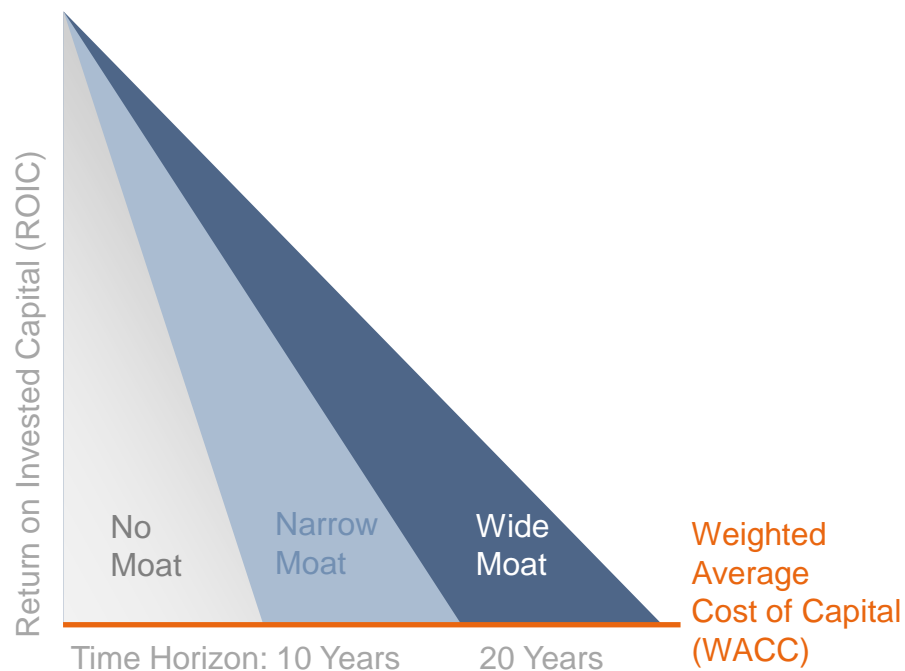
Morningstar[®] Economic Moat[™] Rating

Measuring a Moat

Moat (Quantitatively): Return On Invested Capital (ROIC) Is Key

- Use Cash Flows not Earnings
 - Cash is King!
 - Lack of IFRS/GAAP earnings now not hindrance to moat creation
- IC: Compare apples to apples
 - Adjust IC when needed
- Estimate appropriate cost of capital

Duration of excess returns is far more important than absolute magnitude



Morningstar[®] Economic Moat[™] Rating

Economic Moat Concept

History of Morningstar Moat's Rating

- Warren Buffett in a 1999 Fortune magazine article wrote:
 - *The key to investing is not assessing how much an industry is going to affect society, or how much it will grow, but rather determining the competitive advantage of any given company and, above all, the durability of that advantage. The products or services that have wide, sustainable moats around them are the ones that deliver rewards to investors.*
- Morningstar initiated economic moat rating in late 2002, subdividing entire coverage universe into three moat buckets: none, narrow, wide. This system remains in place today.
 - *Our approach to equity analysis builds on the Ben Graham and Warren Buffett school of investing. It would be hard to find two better mentors – and we're grateful and indebted to them for all that they have done for investors... concepts such as 'Margin of Safety' and 'Economic Moats'.*

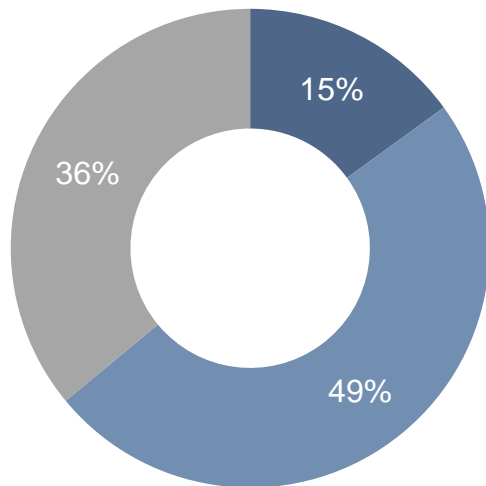
Joe Mansueto, Morningstar's Founder

Morningstar[®] Economic Moat[™] Rating Moat Rating Distribution

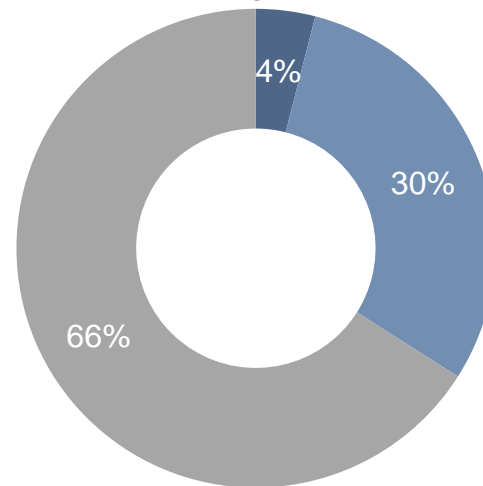
Our coverage universe skews toward companies with economic moats, though in the overall economy, most firms do not have an economic moat.

Morningstar Coverage Universe Moat Rating Distribution | Wide Moat | Narrow Moat | No Moat

Analyst Coverage



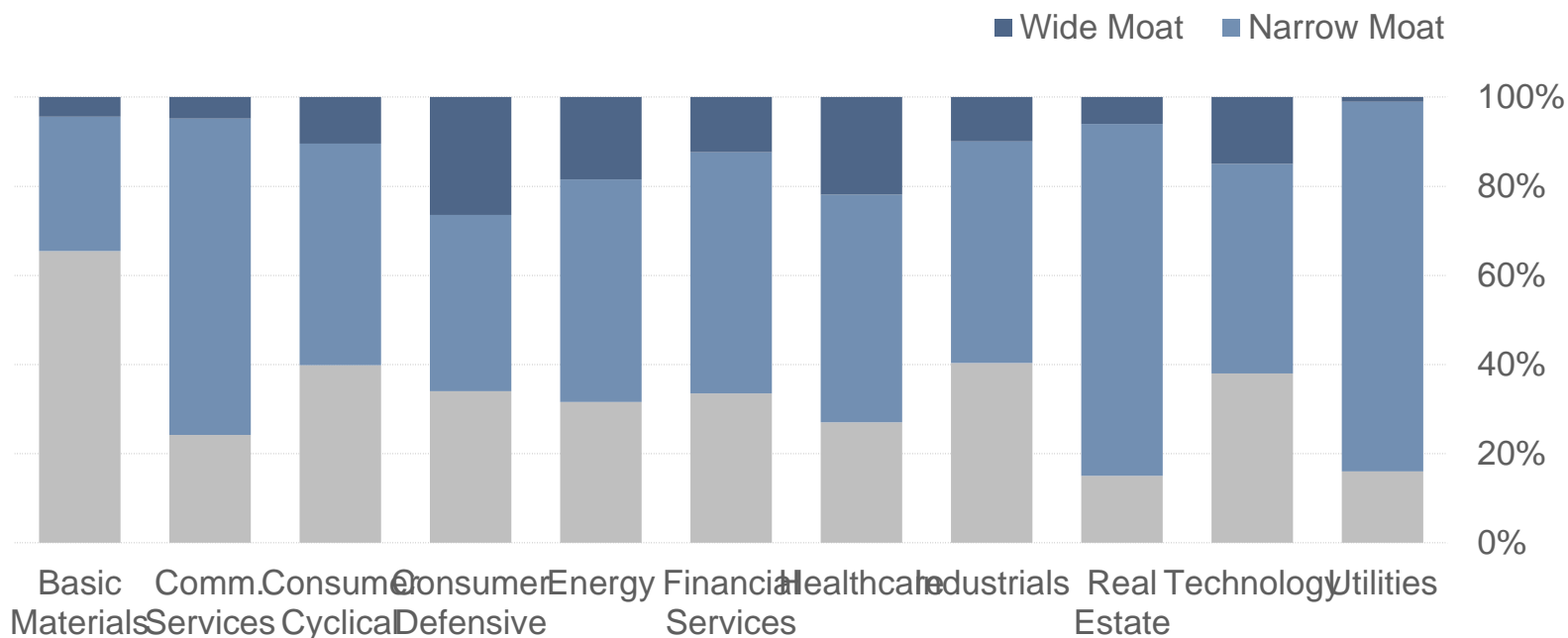
Quantitative Research Coverage



Morningstar[®] Economic Moat[™] Rating

Moat Rating Distribution

Moats are not equally distributed across sectors. Highly commoditized or competitive industries will have fewer companies with moats.

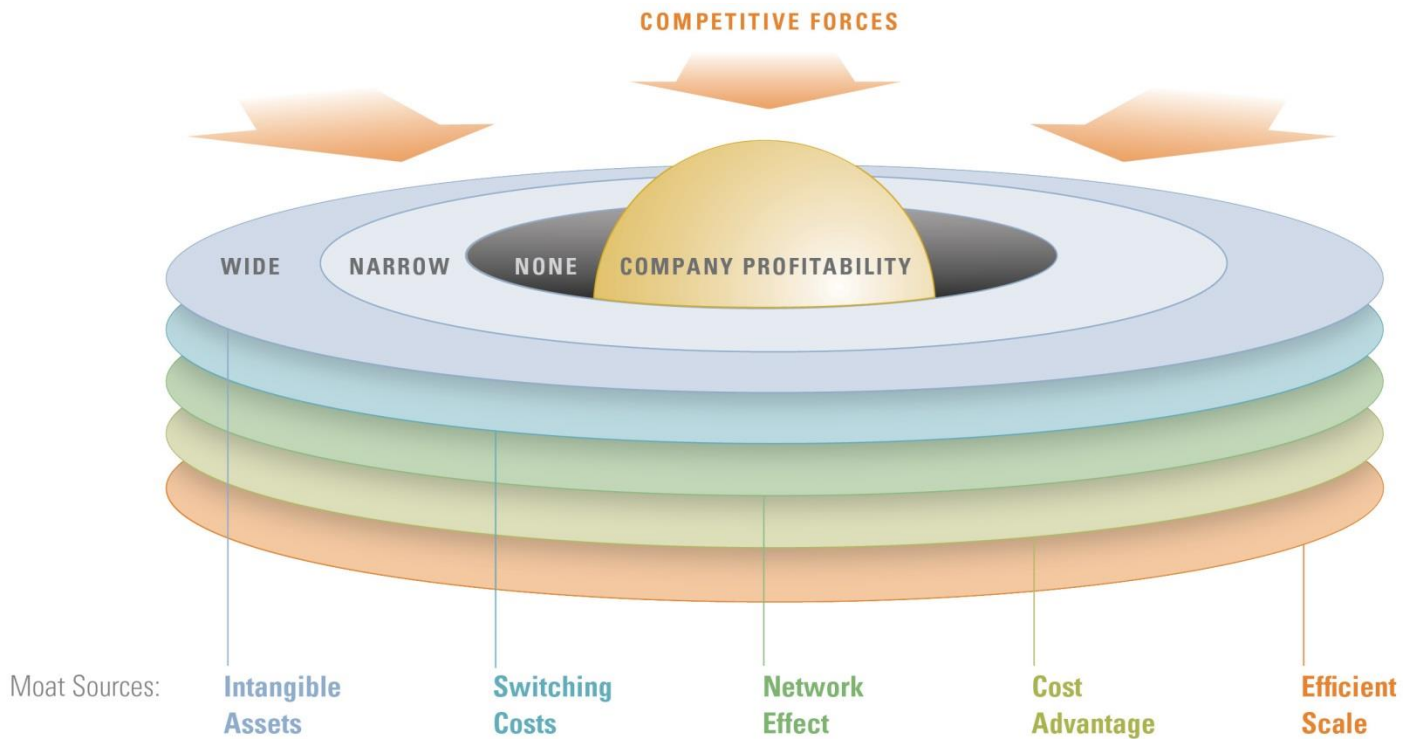


Data as of March, 2014

Morningstar[®] Economic Moat[™] Rating

Economic Moats

The Five Sources of Sustainable Competitive Advantage

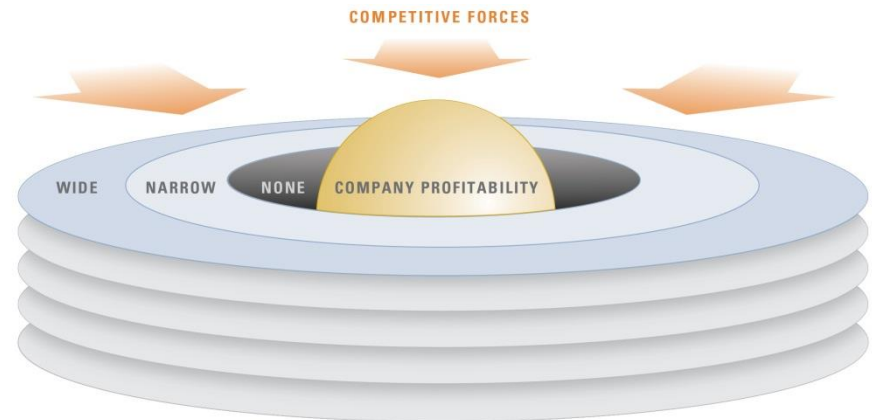


Morningstar[®] Economic Moat[™] Rating

Sources of Moats

Intangible Assets

- Includes brands, patents, and regulatory licenses
- Brand increases the customer's willingness to pay
- Patents protect pricing power legally barring competition
- Government regulations hinder competitors from market.

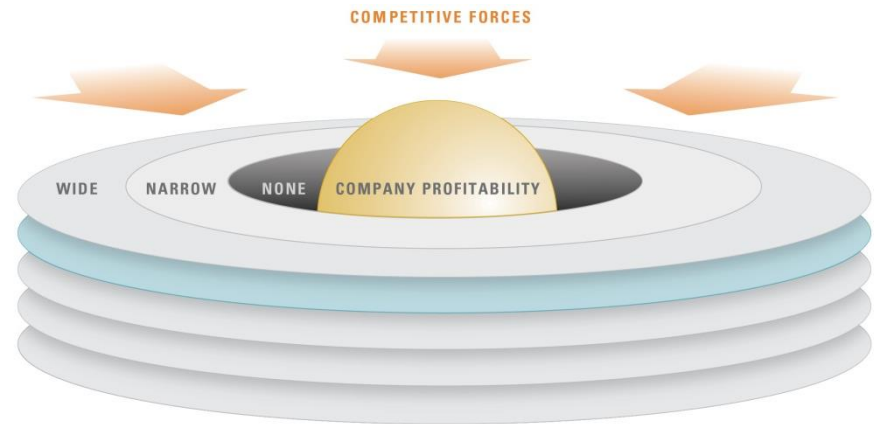


Morningstar[®] Economic Moat[™] Rating

Sources of Moats

Switching Costs

- Time = Money and vice versa
- The value of switching exceeds the expected value of the benefit
- Razor and blade model entrench repeat consumables customers
- Price not the only determinant



INTUITIVE
SURGICAL[®]



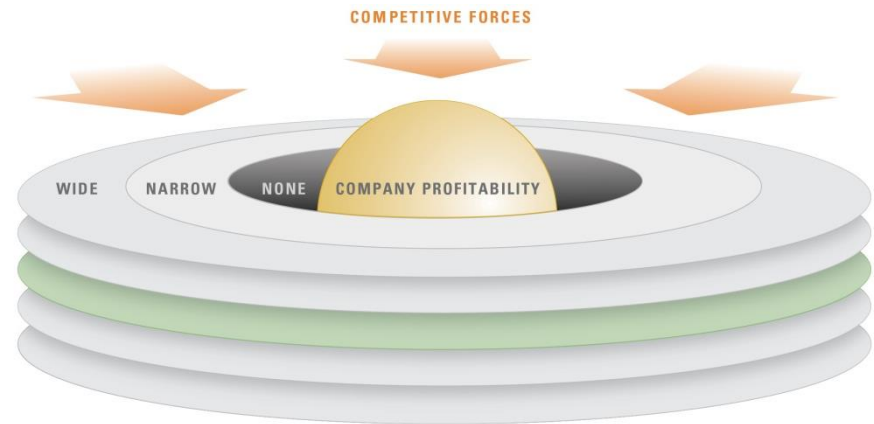
ORACLE[®]

Morningstar® Economic Moat™ Rating

Sources of Moats

Network Effect

- The value of a particular good or service increases for both new and existing users as more customers use that good or service
- With each additional node, the number of potential connect grows exponentially

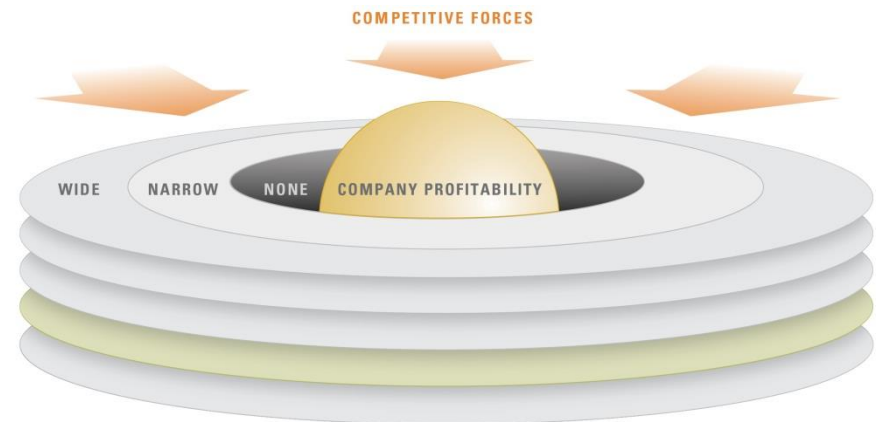


Morningstar® Economic Moat™ Rating

Sources of Moats

Cost Advantage

- Sustainably lower costs than competitors
- Irreplaceable process advantages
- Superior location
- Hard-to-amass scale
- Access to a unique asset



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AB InBev



novo nordisk®

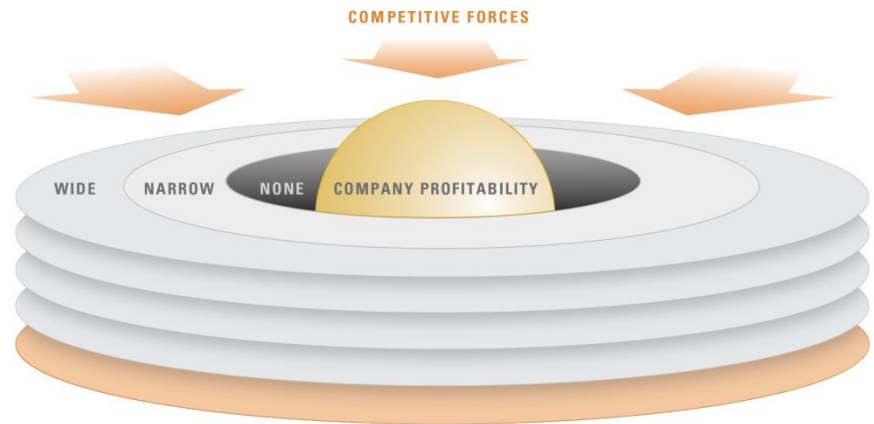


Morningstar® Economic Moat™ Rating

Sources of Moats

Efficient Scale

- Dynamic in which a market of limited size is effectively served by few companies
- Incumbents generate economic profits
- Newcomers discouraged from entering because returns in the market fall below the cost of capital



nationalgrid



Morningstar[®] Economic Moat[™] Trend

Moat Trend Concept

Moat Trend is a detectable direction of change in the competitive position of a company's businesses



Morningstar Performance

Why Moats Matter –Performance

Moat isn't always priced in!

- Two companies with similar growth rates, returns on capital, and reinvestment needs:
 - The “moaty” company has a higher value
 - Moats provide a margin of safety
 - Companies with moats likely to continue to compound in value

g Overestimating a moat = paying for unlikely value creation

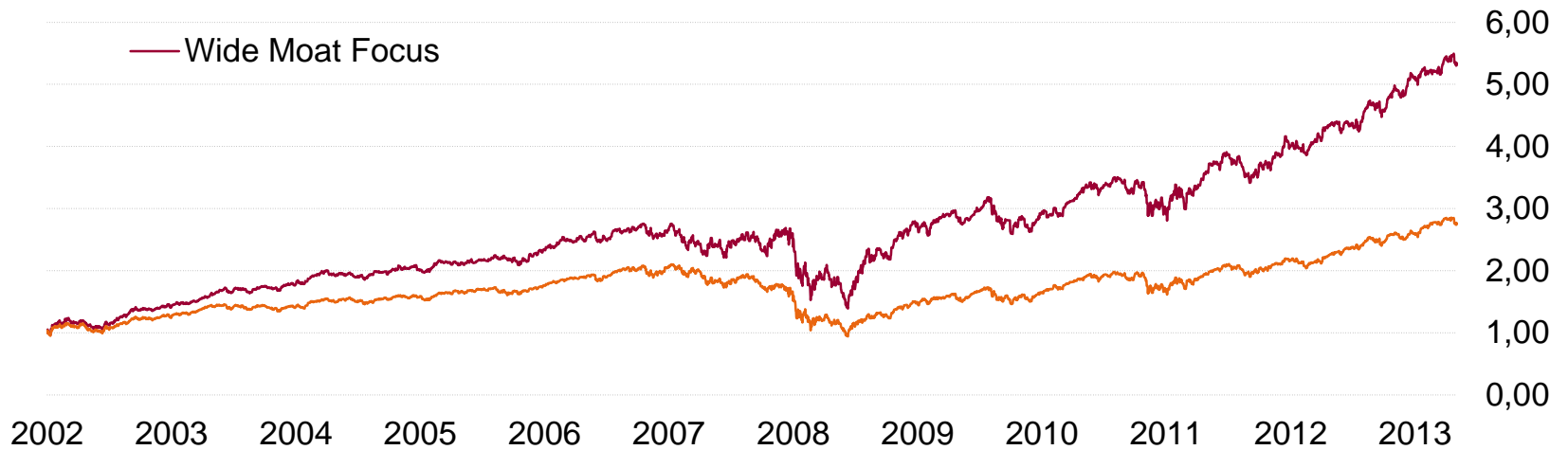
- Why isn't the moat already priced in?
 - Time-horizon arbitrage: market is myopic, and moats matter more in the long run
 - Recency bias: investors project the way the world is today much too far into the future

~~Waiting for moats, particularly wide, to get cheap pays off!~~

Morningstar Performance

The Effectiveness of Our Ratings Over Time

Focus on Moats Works!



Trailing Annualized Returns (%)

Index	1-Year	3-Year	5-Year	10-Year	Since Inception (09/30/2002)
Morningstar® Wide Moat Focus Index SM	22.3	17.5	24.6	12.6	15.9
S&P 500 Index (cap-weighted)	21.5	13.9	19.2	6.8	9.3

Data from September 30, 2002 through January 31, 2014

Morningstar Performance Wide Moat Index

Current Composition

- Baxter International (BAX)
- Berkshire Hathaway B (BRK.b)
- BlackRock Inc (BLK)
- CH Robinson Worldwide (CHRW)
- Coca-Cola (KO)
- Core Laboratories (CLB)
- eBay (EBAY)
- Exelon Corp (EXC)
- Expeditors International (EXPD)
- Express Scripts (ESRX)
- Franklin Resources (BEN)
- General Electric (GE)
- International Business Machines (IBM)
- National Oilwell Varco (NOV)
- Philip Morris International (PM)
- Procter & Gamble (PG)
- Schlumberger (SLB)
- Spectra Energy Corp (SE)
- Sysco Corp (SYY)
- Western Union (WU)

Morningstar Performance

Morningstar Equity Research

Morningstar Indexes and Portfolios vs. S&P 500

	Trailing Annualized Returns (%)			
	1-Year	3-Year	5-Year	10-Year
Morningstar® Wide Moat Focus Index SM	22.3	17.4	24.6	12.6
Morningstar Tortoise Portfolio	17.4	14.4	16.8	7.8
Morningstar Hare Portfolio	26.4	15.7	23.5	11.5
Morningstar Dividend Builder	14.2	15.0	16.8	—
Morningstar Dividend Harvest	15.9	17.6	23.5	—
Buy at 5-Star/Sell at 3-Star	17.4	12.1	27.0	13.1
Morningstar Large-Cap Blend Mutual Fund Cat.	20.3	12.0	17.8	6.1
S&P 500 Index (cap-weighted)	21.5	13.9	19.2	6.8

Source: Morningstar
Time-weighted returns through: February 28, 2013

Morningstar® Coverage Top Picks Across Sectors

A few investment ideas to leave you with...

Company	Moat	Ticker	Morningstar Rating	Investment Rationale
Berkshire Hathaway	Wide	BRK B	QQQQ	Berkshire's ability to take excess cash flows generated by its different businesses and invest them back into projects that earn more than its cost of capital is unparalleled.
BioMarin Pharma	Narrow	BMRN	QQQQ	With a growing portfolio in an attractive rare disease niche--and a likely turn to profitability in 2015--BioMarin could be an acquisition target for pharmaceutical firms with pipelines to fill.
Core Laboratories N.V.	Wide	CLB	QQQQ	Core Labs is a cash-flow machine, and the firm's returns on invested capital are some of the highest in the industry (and the overall market).
Gilead Sciences	Wide	GILD	QQQQ	With the approval of Sovaldi, Gilead holds claim to the only all-oral hepatitis C treatment regimen. None of Gilead's competitors have other proven nucleotide analogs approaching the market, making the \$11 billion acquisition of Pharmasset look like a bargain.
Novo Nordisk A/S	Wide	NOVO B	QQQ	Entrenched in the fast growing diabetes industry, Novo should post solid growth over the next decade.
Sanofi	Wide	SNY	QQQQ	Well-positioned Lantus should lead steady and improving growth for the overall company.
Swatch Group AG	Wide	UHR	QQQQ	Swatch Group's competitive position is underappreciated; brands and technologies earn it a wide moat

Morningstar® Coverage Top Picks Across Sectors

And a few to avoid...

Company	Moat	Ticker	Morningstar Rating	Investment Rationale
Airlines ALL OF THEM	None			Just not good businesses. Stay away
Bayer AG	Narrow	BAYN	QQ	Bayer's narrow moat versus wide moats for its peers, stems from its exposure to no-moat non-healthcare sectors. The company is also trading at a premium to its better-positioned peers.
BiogenIdec	Wide	BIIB	QQ	BiogenIdec's success in MS, and positive data on key drugs have moved the stock to the positions that are hard to justify. Even a wide moat firm can be overpriced!
Netflix	None	NFLX	QQ	The market is too optimistic about Netflix's future sales growth and profitability potential. We remain extremely skeptical about Netflix's aggressive international push. Subscribers not equal to moat.
Shire PLC	Narrow	SHP	QQ	Strong growth in several drugs mask the risk of patent expirations and Sanofi's competition in rare disease therapeutics.
Vestas Wind Systems A/S	None	VWS	QQ	While focus on the only renewable energy source offers excitement for Vestas shares, competitors are investing heavily in the market and Vestas' hold on the European market is in jeopardy.