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GLOBAL IDEAS

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Johnson & Johnson — just the right medicine

Business Overview
The company is engaged in the manufacture and sale of a broad range of products in the healthcare field. With over 190 operating companies it conducts business in virtually all countries of the world. Johnson & Johnson's primary interest, both historically and currently, has been in products related to human health and well-being. The company was organised in 1887. Its common stock is listed on the New York Stock Exchange under the symbol JNJ and it is headquartered in New Brunswick, New Jersey.

JNJ's metrics are as follows:

Spot ($)	73.23
Mkt Cap ($mn)	202,940
12M trailing P/E	14.5
12M fwd P/E	13.3
10-year average P/E	16.7
10-year average DY	2.38
FYE	01-Jan
P/Book ratio	3.17
12M trailing DY	3.28
12M fwd DY	3.21

Source: Bloomberg, Anchor Capital

JNJ's worldwide business is divided into three segments: Consumer, Pharmaceutical and Medical Devices & Diagnostics.

The Consumer segment's principal products are personal care and hygienic products including non-prescription drugs, adult skin and hair care products, baby care products, oral care products, first aid products and sanitary protection products. Major brands include Aveeno skin care products; Band-Aid Brand Adhesive Bandages; Benecol food products; Carefree Panty Shields; Clean & Clear teen skin care products; Imodium A-D, an antidiarrheal; Johnson's Baby line of products; Johnson's pH 5.5 skin and hair care products; Lactaid lactose-intolerance products; Monistat, a remedy for vaginal yeast infections; adult and children's Motrin IB ibuprofen products; Mylantagastrointestinal products and Pepcid AC Acid Controller from the JNJ - Merck Consumer Pharmaceuticals Co.; Neutrogina skin and hair care products; o.b.Tampons; Penaten and Natsuan baby care products; PIZ Buin and Sundown sun care products; Reach toothbrushes; RoC skin care products; Shower to Shower personal care products; Splenda, a non-caloric sugar substitute; Stayfree sanitary protection products; the broad family of Tylenol acetaminophen products; and Viactiv calcium supplements. These products are marketed principally to the general public and distributed both to wholesalers and directly to independent and chain retail outlets.

The Pharmaceutical segment's principal worldwide franchises are in the antifungal, anti-infective, cardiovascular, dermatology, gastrointestinal, haematology, immunology, neurology, oncology, pain management, psychotropic, urology and women's health fields. These products are distributed both directly and through wholesalers for use by health care professionals and the general public. In 2001, sales to three distributors, McKesson HBOC, Cardinal Distribution and AmerisourceBergen Corp. accounted for 10.4%, 10.3% and 10.2%, respectively, of total revenue. These sales were

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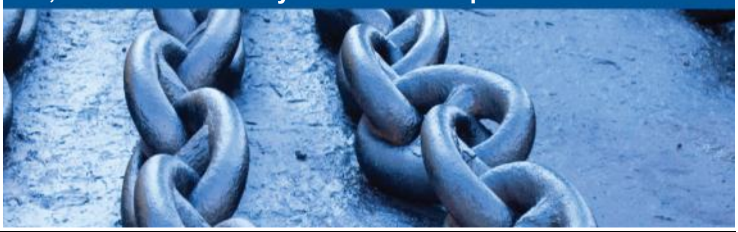
We scan the globe looking for good opportunities. We provide our model portfolios, as well as news and views on our watch-list, which is continually reviewed and updated.



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concentrated in the Pharmaceutical segment.

The Medical Devices & Diagnostics segment includes a broad range of products used by or under the direction of health care professionals, including, suture and mechanical wound closure products, surgical equipment and devices, wound management and infection prevention products, interventional and diagnostic cardiology products, diagnostic equipment and supplies, joint replacements and disposable contact lenses. These products are used principally in the professional fields by physicians, nurses, therapists, hospitals, diagnostic laboratories and clinics. Distribution to these markets is done both directly and through surgical supply and other dealers. The international business of JNJ is conducted by subsidiaries located in 54 countries outside the US, which are selling products in more than 175 countries throughout the world. The products made and sold in the international business include many of those described above under 'Business -- Consumer, Pharmaceutical and Medical Devices & Diagnostics.' However, the principal markets, products and methods of distribution in the international business vary with the country and the culture. The products sold in the international business include not only those which were developed in the US but also those which were developed by subsidiaries abroad.

The company had a couple of large acquisitions in 2001 including Inverness Medical Technology Inc., the supplier of LifeScan's electrochemical products for blood glucose monitoring following the spin-off of the non-diabetes businesses; Heartport Inc., a company that develops and manufactures products for less invasive open chest and minimally invasive heart operations, including stopped heart and beating heart procedures; TERAMed Corporation, an early-stage medical device company that is developing endovascular stent-graft systems for the minimally invasive treatment of abdominal aortic aneurysms and peripheral occlusive disease; BabyCenter, L.L.C., an internet content and commerce company devoted to supporting a community of expectant and new mothers; and the Viactiv product line, a chewable calcium supplement, from the Mead Johnson Nutritionals Division of Bristol-Myers Squibb. Inverness Medical Technology was acquired to enhance control of the primary supplier of LifeScan blood glucose monitoring products and will allow for the achievement of operational synergies. The acquisition also provides key technology for the development of future products. Approximately $105mn has been identified as the value of IPR&D associated with the Inverness Medical Technology and Teramed Corporation acquisitions. The IPR&D charge is primarily related to Inverness projects for minimally invasive testing, continuous monitoring and insulin delivery. The value of the IPR&D was calculated with the assistance of a third-party appraiser using cash flow projections discounted for the risk inherent in such projects using probability of success factors ranging from 25%-40%. The discount rate used was 12%. On June 22, 2001, JNJ and Alza Corporation (Alza) completed the merger between the two companies. This transaction was accounted for as a pooling-of-interest. Alza had approximately 239mn shares outstanding (286mn on a fully diluted basis) that were exchanged for approximately 234mn shares of JNJ.

***Adapted from Infront: Peresys**

Introduction

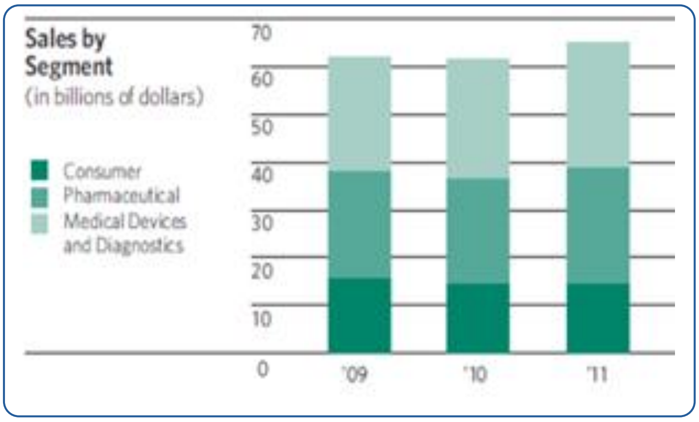
JNJ is one of those world-class companies that would be well suited to a blue chip portfolio. Of course it comes down to the price you pay, but JNJ is looking quite attractive now. At a 13.3x P/E on forward earnings and the opportunity cost of foregone interest when bond yields are so low, it is very appealing and yields a dividend of 3.4%. We expect earnings growth at the 5% level for the next two to three years, followed by a few years of double-digit growth.

JNJ has its own risks and problems, like everything else at present. It is almost certain that you won't find a company of this quality on a 13x P/E that doesn't have its challenges. The approach therefore is to attempt to understand the risks and quantify the problems so that we can decide whether the probabilities are in JNJ's favour.

Divisions and diversification

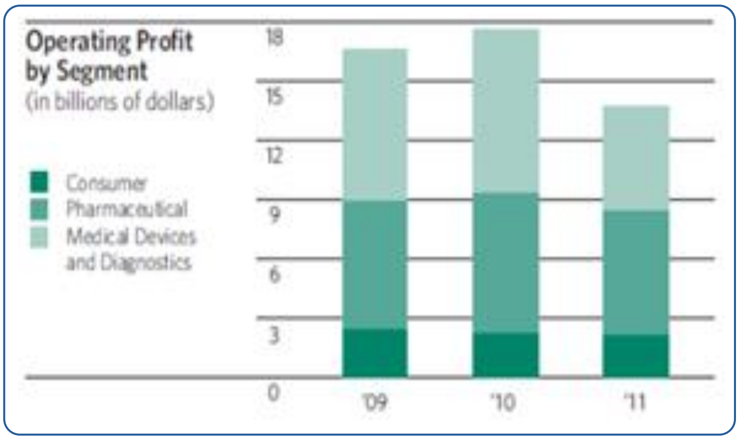
JNJ consists of three broad divisions. First, consumer products consists of baby care, skin care, oral health, nutrition, woman's health, etc and is the smallest of the three divisions (around 15% of operating profits). Second, the pharmaceutical products division largely comprises products that are medical/therapeutic in nature and contributes 35% of operating profits (this is the division which is susceptible to an erosion of patent rights). Third, medical devices and diagnostics sells products that are mostly used by medical professionals. It is the largest division within JNJ comprising 50% of operating profit (our impression of this division is that it is the technical complexity of products and the JNJ brand that would defend market share, as opposed to institutionally protected patent rights).

Sales by segment ($bn):



Source: Company reports

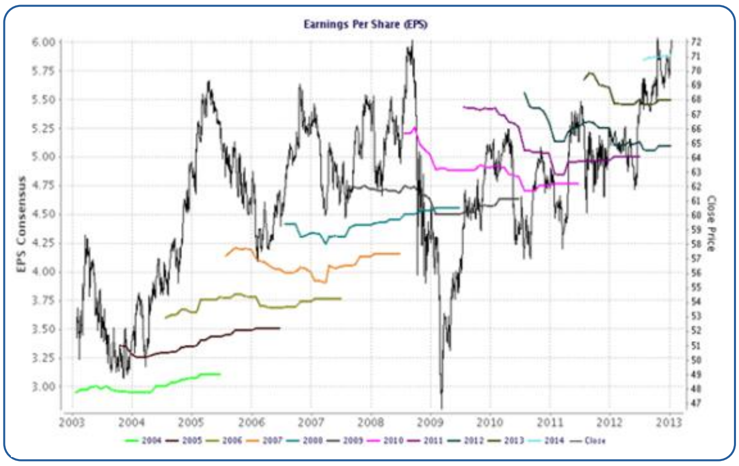
Operating profit by segment ($bn)



Source: Company reports

This diversification is attractive, not simply as diversification *per se*, but also because the component which is patent protected seems to be not more than 30% of earnings. So, given the concerns over patent litigation, JNJ's exposure to this risk is probably limited to 30% of their business. It is also worth noting that the CEO has frequently commented on the importance of product diversification within their portfolio of products and it is encouraging to see their explicit cultivation of this diversification.

Company earnings



Source: Infinancials

The underlying business is still in a growing phase, albeit modestly at present. The CEO communicated an expectation that earnings (before 'special items') will grow in the low to mid-single digits until the economy recovers, thereafter he expects stronger growth. Without delving into whether our present economic malaise is the 'new normal' and therefore no 'recovery' is on the way, this communication at least gives some confidence that earnings are not expected to decline sharply as a result of patent-expiries. Our view is that we can have strong confidence in modest single-digit growth in operating EPS before special items. Below is a consensus of 25 estimates provided by *Infinancials* – backing up our argument.

JNJ forecast results ($mn)

Forecast Results (in millions USD) — LOCAL EUR USD

	NTM Next 12 Mths	2012(e)	No. Est	2013(e)	No. Est	2014 (e)	No. Est
Net Sales	72 410	67 342	25	72 322	25	75 254	17
Growth				7.4%		4.1%	
EBITDA	23 571	21 246	15	23 530	15	24 899	13
Margin	32.6%	31.5%		32.5%		33.1%	
EBIT	19 445	17 670	22	19 402	23	20 834	17
Margin	26.9%	26.2%		26.8%		27.7%	
Net Income	15 385	14 239	23	15 352	23	16 435	17
Margin	21.2%	21.1%		21.2%		21.8%	

Source: Infinancials

JNJ forecast results ($mn) JNJ US

FYE Dec	2010A	2011A	2012E (Prev)	2012E (Curr)	2013E (Prev)	2013E (Curr)	2014E (Prev)	2014E (Curr)
EPS ($)								
Q1 (Mar)	1.29	1.35	1.37A	1.37A	1.39	1.43	-	-
Q2 (Jun)	1.21	1.28	1.30A	1.30A	1.41	1.40	-	-
Q3 (Sep)	1.23	1.24	1.25A	1.25A	1.33	1.34	-	-
Q4 (Dec)	1.03	1.13	1.18	1.14	1.27	1.23	-	-
FY	4.76	5.00	5.10	5.06	5.40	5.40	5.78	5.74
Bloomberg EPS FY ($)	4.76	4.96	-	5.10	-	5.49	-	5.87

Source: Company data, Bloomberg, JP Morgan estimate, s. Bloomberg above denotes Bloomberg consensus estimates

It is very important to take note that currency also has a very large impact on their earnings. Given the low constant currency growth rate, a strengthening of the dollar by only a couple percentage points has often erased all of what otherwise would've been growth. Currency sensitivity is approximately: 1% change in the dollar= change in sales of $350mn (½ %); Income $75mn (0.8%).

Special items problem

'Special items' are quantitatively very significant. Take CY11's earnings, for example: EPS after special items was $3.54 putting JNJ on a P/E of 19.5x. EPS before special items (or after stripping special items out) was $5.00 putting JNJ on a 13.8x P/E [note the post-special items EPS number is diluted but the dilution effect is small, c. 1%].

The quarterly EPS run-rate for the first three quarters of CY11 was c. $1.15 but 4Q11 delivered only USc0.08/share because of significant 'special items' (product recall, litigation & restructuring costs). A similar disappointment happened in 2Q12 where EPS after special items was only $0.5 (50% down on 2Q11) because of 'special items' (in this case a large impairment of R&D expenditure, further litigation costs and costs associated with an acquisition). Before special items EPS was $1.30, so operationally very strong.

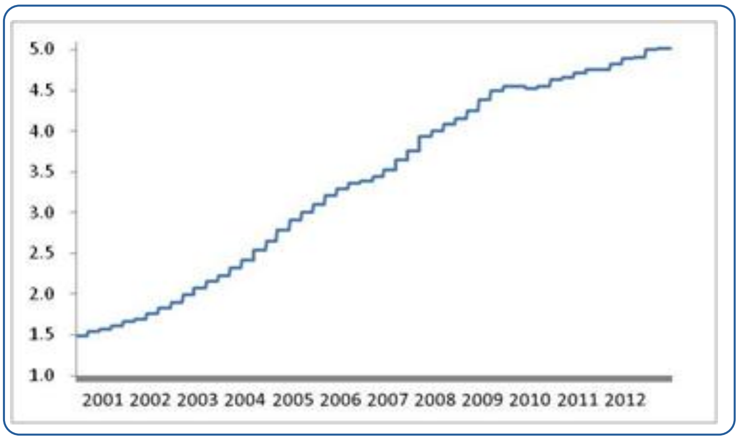
How we interpret these 'special items' is an important question. Do we treat these as simply one-off events and focus on the cleaner EPS before special items? For forecasting purposes this probably makes sense because it is the basis of the company's guidance. However for valuation purposes we should consider whether some of these special items don't perhaps represent a new environment – where litigation, patent challenges and draconian government standards are part of business as usual for pharmaceutical companies in future.

Our interpretation is as follows. On the one hand there does seem to be a more hostile legal environment in the industry and the question of whether this is a passing phase or whether it solidifies into the 'new normal' remains to be seen. Ultimately it will depend on political, legal and even cultural developments. If it does become the new normal that would be negative for the industry, but JNJ is amongst those companies best equipped to deal with this challenge. One should also take the psychological impact of such challenges into account - that people/companies 'feel the pinch' and raise their games.

The nature of most of these special items seem to be temporary – JNJ has had a high level of corporate action of late; the large impairment charges has complex explanations relating to accounting consolidation rules so, again, it is probably at least partially an accounting fiction. The component that seems to be more enduring (and hence not really a 'special item') is the litigation costs. The whole pharmaceutical industry has spoken of the "increasing hostility" of their environment and it may be more accurate to treat this as a more enduring shift.

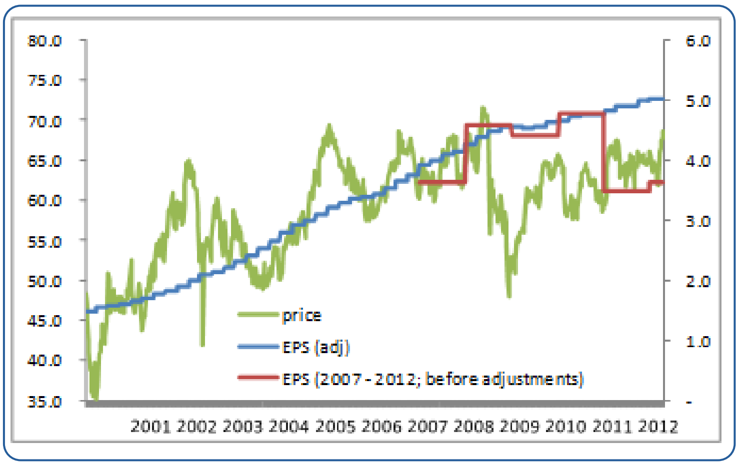
If this is indeed the case it raises an estimation complexity – how does one forecast the magnitude of higher legal costs in future? It is of course not an exact science, but the easiest approach would be to say 'core' or 'normalised' earnings are probably 10%-15% lower than EPS before special items. This concern in relation to 'adjusted earnings' does not only relate to JNJ, indeed it seems that many companies are dumping their dirty washing into a 'special items' category and hoping to have a rather polished EPS number regarded as the truer picture of their earnings capacity. This is a theme that *BCA* has commented on before and it further raises concerns about the broader attractiveness of equities. Not only are S&P profit margins at close to record highs (therefore a cyclically adjusted P/E would actually be higher than the trailing P/E) but there has been a widening gap between basic/bottom line earnings and 'adjusted earnings' (hence a likelihood that at least a meaningful component of the adjustment is some kind of window dressing).

JNJ adjusted earnings ($)



Source: Bloomberg

JNJ price and adjusted earnings — alternative perspective ($)



Source: Bloomberg

From the above two graphs it is clear that these adjustments paint a significant different picture.

Inserted below is an extract from their five-year review, because it further illustrates the interpretive problem with earnings (the columns are CY11 [FY12] on the right [i.e. closest to the descriptive text] and CY07 on the far left). Note that while 2011 EPS, as reported, was lower than all four other years, adjusted EPS was a record.

	2011	2010	2009	2008	2007
Diluted net EPS - as reported ($)	3.49	4.78	4.40	4.57	3.63
Net Litigation settlements loss/(gain)	0.53	-0.25	-0.08	-0.08	-
International tax gain on restructuring	-	-	-	-	-0.09
NATRECOR® intangible asset write-down	-	-	0.31	-	0.15
Restructuring expense	0.19	-	-	-	0.18
Product liability expense	0.46	0.14	-	-	-
DePuy ASR Hip recall program	0.16	0.09	-	-	-
Adjustment to the value of currency option & costs related to planned acquisition of Synthes, Inc	0.17	-	-	-	-
In-process research & development (IPR&D)	-	-	-	0.06	0.28
Diluted net EPS - as adjusted ($)	5.00	4.76	4.63	4.55	4.15

Source: Company reports

For some perspective, here's the long term P/E history (graph below). It has a familiar pattern – starting from an overly inflated P/E multiple around the year 2000 the share price has stayed flat (note that the JNJ share price is not much higher than it was a decade ago) as earnings have grown into the previously elevated P/E.

JNJ P/E rating:

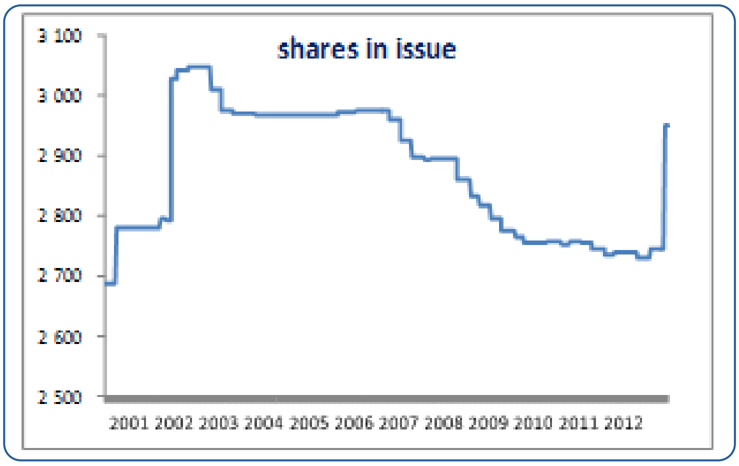
Source: Bloomberg

Corporate actions

The Synthes acquisition was completed in June 2012 at a purchase price of $21.3bn (10% of JNJ's market cap). In their words, Synthes is a *"premier global medical device company, specialized in the development, manufacturing and marketing of instruments, implants and biomaterials for the surgical fixation, correction and regeneration of the human skeleton and its soft tissues".* The acquisition enhanced 2H12 EPS by 1% (it was only acquired two weeks before quarter end).

JNJ has had 50 consecutive quarterly dividend increases which can be expected to continue and it has been gradually buying back shares over the past six years. The company had a relatively large share issue in June associated with the Synthes acquisition.

JNJ shares in issue:



Source: Bloomberg

JNJ dividends ($):

Dividends *(in USD)*

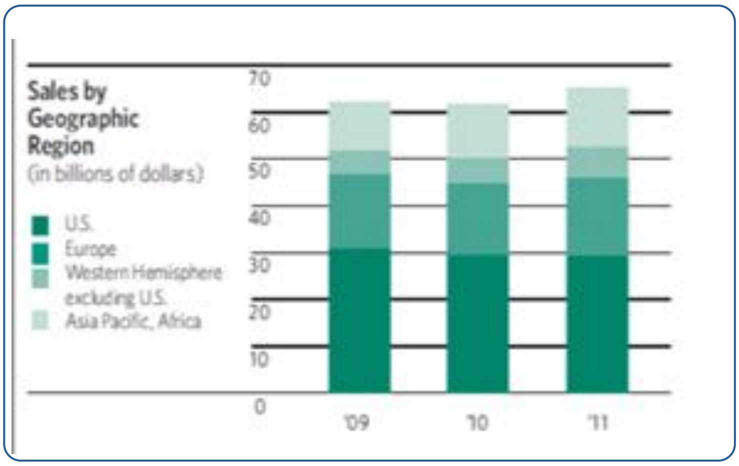
Ex-Dividend Date	Payment Date	Value
23 Nov 12	11 Dec 12	0.610
24 Aug 12	11 Sep 12	0.610
24 May 12	12 Jun 12	0.610
24 Feb 12	13 Mar 12	0.570
25 Nov 11	13 Dec 11	0.570
26 Aug 11	13 Sep 11	0.570
26 May 11	14 Jun 11	0.570
25 Feb 11	15 Mar 11	0.540
26 Nov 10	14 Dec 10	0.540
27 Aug 10	14 Sep 10	0.540
27 May 10	15 Jun 10	0.540
19 Feb 10	09 Mar 10	0.490
20 Nov 09	08 Dec 09	0.490
21 Aug 09	08 Sep 09	0.490
21 May 09	09 Jun 09	0.490
20 Feb 09	10 Mar 09	0.460
21 Nov 08	09 Dec 08	0.460
22 Aug 08	09 Sep 08	0.460
22 May 08	10 Jun 08	0.460
22 Feb 08	11 Mar 08	0.415
23 Nov 07	11 Dec 07	0.415
24 Aug 07	11 Sep 07	0.415
24 May 07	12 Jun 07	0.415
23 Feb 07	13 Mar 07	0.375
24 Nov 06	12 Dec 06	0.375
25 Aug 06	12 Sep 06	0.375
25 May 06	13 Jun 06	0.375
24 Feb 06	14 Mar 06	0.330
18 Nov 05	13 Dec 05	0.330
19 Aug 05	13 Sep 05	0.330
13 May 05	07 Jun 05	0.330
11 Feb 05	08 Mar 05	0.285
12 Nov 04	07 Dec 04	0.285
13 Aug 04	07 Sep 04	0.285
14 May 04	08 Jun 04	0.285
12 Feb 04	09 Mar 04	0.240
14 Nov 03	09 Dec 03	0.240
15 Aug 03	09 Sep 03	0.240
16 May 03	10 Jun 03	0.240
13 Feb 03	11 Mar 03	0.205
15 Nov 02	10 Dec 02	0.205
16 Aug 02	10 Sep 02	0.205
17 May 02	11 Jun 02	0.205
14 Feb 02	12 Mar 02	0.180

Source: Company reports

Global growth

Another big reason to consider JNJ is their global presence. Apart from the great portfolio diversification benefit and the value of the brand, the company is in almost every country around the world and hence has broad exposure to global growth. They have the opportunity and ability to channel capital into those regions where growth opportunities are most promising given that they already have at least a minor presence in most countries.

Sales by geographic region ($bn):



Source: Company reports

One must also not forget about the massive size of the company. In a world of increasing regulation and increasing challenges associated with patent generation, smaller companies will struggle to get the scale to cope with regulations as effectively. Smaller companies will also be pressured into make/break with their research and development in order to try and keep up.

Over the past four years JNJ's US sales have stagnated while sales in the rest of the world are growing strongly. If JNJ continues its strong growth in these markets then strong earnings will grow much more rapidly despite a slow economy. We expect for developed market sales to continue to stagnate, but for emerging markets to continue driving group-wide earnings growth.

US and International sales for 10 years ($bn):

Source: Company reports

Conclusion

General government pressure and patent expiries and challenges will probably continue putting pressure on the US and European businesses. This component is most likely 'ex-growth' until the economy transitions out of the present malaise. Emerging market growth, however, is very strong and will continue driving EPS growth in the group. We expect low-to mid-single digit EPS growth for the next two-to-four years, but much of JNJ seems to have excellent earnings growth potential and we definitely expect to see this materialise when the world eventually returns to more robust growth.

We view JNJ as a perfect candidate for a blue chip portfolio and we expect it to deliver very decent returns in the near term. We are currently prepared to buy into the JNJ story, because we see it doing very well when growth returns to the global economy. Until then, expect JNJ to deliver something in the region of 7% p.a. nominal returns - 3.4% dividend yield and 3.5% earnings growth (also note that dividends are still growing a couple of percent each year). The real kicker could come from 10%+ earnings growth down the line and the corresponding P/E rerating that would be associated with this return to growth.

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Blake Allen

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