

About

Johnson and Johnson (JNJ) is a US based pharma and healthcare company. The company has three primary business segments – consumer products, pharmaceuticals and medical devices.

The company had a revenue of 63 billion USD in 2008. The Consumer segment includes a broad range of products used in the baby care, skin care, oral care, wound care and women's health care fields, as well as nutritional and over-the-counter pharmaceutical products. The Pharmaceutical segment includes products in the following therapeutic areas: anti-infective, antipsychotic, cardiovascular, contraceptive, dermatology, gastrointestinal, hematology, immunology, neurology, oncology etc. The Medical Devices and Diagnostics segment includes a broad range of products such as Cordis' circulatory disease management products; DePuy's orthopaedic products; Ethicon's surgical care products; Ortho-Clinical Diagnostics' professional diagnostic products and Vistakon's disposable contact lenses.

The company operates globally in a predominantly decentralized structure with over 118000 employees.

Financials

The consumer segment had a global sale of 16 Billion in 2008 with a 10.8% growth. The company also acquired the consumer healthcare business of Pfizer in 2007. The consumer segment had an operating profit of 16.7%, an increase of 1% over 2007.

The pharma segment had a sale of 24.6 billion in 2008, a decrease of around 1.2% over 2007. This business saw an increase in operating profit from 26.3% to 31% mainly due to write downs in 2007.

The medical devices segment had sales of 23.1 billion with an increase of 6.4% over 2007. The operating profit increased from 22.3% to 31.2% in 2008 partly due to some litigation settlements in 2008 and some restructuring charges in 2007.

The company has maintained a high level of R&D investment (around 10% of sales or higher) during this period. This efficiency of this investment is evident from the drug pipeline of the company which consists of around 18 drugs filed or approved and almost 25 in the stage III trails.

On an aggregate basis, the company has a very steady performance in the last 10 years and more. The ROE has ranged between 26-30% during this period. This improvement has been driven by an improvement in net margins from around 15% to 20%. The various asset ratios such as working capital turns have improved from low teens to around 30. The fixed asset turns has improved during this period too.

The company has maintained a healthy cash flow during this period and has had a dividend payout of almost 40% during this period. The balance cash has been used to pay off the small amounts of debt, invest in assets and make targeted acquisitions. The company is a zero (net basis) debt company and has a cash flow rate in excess of 10 billion per annum.

Positives

JNJ has several key positives as a business and over other pharma companies

- The company derives around 30-32% of its revenue and around 40-45% of operating profits from the pharma business segment. Although the company faces the risk of its top performing drugs going off patent, the company has a healthy pipeline to manage this risk
- The company has a medical devices division which does not face the generic or patent risk of the pharma division and is fairly profitable.
- The company has a consumer products division with strong brands and an extensive distribution network which act as a hedge to the other segments.
- The company has a deep moat in all its business segments and sustainable competitive advantage.
- The company has a decentralized operating structure with 250 operating companies across 57 countries across the globe.
- The company has strong balance sheet and consistent cash flows. The net profit and cash flow has grown at around 16% per annum for the last 10 years. In addition the company has improved its ROE and other asset ratios

Risks

The company faces the following key risks

- Several key pharma brands (in excess of 1 bn sales) such as risperdal and Topamax have lost patent protection in the recent and will face drop in sales and profits due to generics. Success of new drugs is not a given and only a few drugs in the pipeline may replace these blockbusters. In addition, there may be short to medium term dip before the new drugs replace the loss in sales.
- The global slowdown is likely to impact the topline and bottom line growth for the next 2-3 years
- The US market accounts for almost 14 bn in sales for the pharma division and 10Bn in sales for the medical devices division. Although I have not been able to find the numbers. the profitability of these divisions in the US is fairly high. This may be at risk due to the health care reforms in the US.
- The recession in the developed markets which account for major part of the sales and profit could keep the topline and bottom line subdued for the next few years.
- The company faces litigation risks related to product marketing, pricing, product side effects and patent issues. These risks are detailed over 3 pages of the annual report and are not easily quantifiable. The company has accrued liabilities against these risk and has stated that these risks in aggregate will not have a material effect on the financials.

Competitive analysis

The main competitors for the company are the other big pharma companies and the generic firms such as Ranbaxy, Sun etc. We can apply Michael porter's five factor model to evaluate the company

Barrier to entry – All the segments of the company enjoy substantial entry barriers. The pharma and medical devices have formidable barriers in the form of patents and sales and marketing network. In addition any new drug or device requires substantial R&D expenses and infrastructure. The consumer segment has barriers in the form of Brands and distribution network

Supplier power – Moderate to low in this industry. Suppliers are mainly providers of basic chemicals or contract manufacturers. The value is derived from the IPR of the drug and not from the manufacturing.

Buyer power – Low in consumer goods. However in case of Pharma and the devices segments, national programs such as Medicare have a strong leverage and with escalating cost will attempt to drive down prices.

Substitute product – none

Rivalry – There is intense rivalry in the industry from other pharma majors who are attempting to develop a similar drug and especially from the generics where the price and profits drop by as much as 90% over the course of a few years as soon as the drug comes off a patent. In addition, the generic companies are constantly trying to challenge the patents too.

Management quality checklist

- *Management compensation*: The company has almost 215 Million outstanding options which would result in 2% dilution. The options do not appear to be excessive.
- *Capital allocation record*: Fairly good. The management has maintained an ROE in excess of 25%, low debt and a dividend payout of almost 40%. In addition, the management has been engaged in acquiring other pharma companies to pull gaps in its drug pipeline and added to it too.
- *Shareholder communication*: The shareholder disclosure is good with clear explanation of the benefits assumptions and IP R&D (in process R&D) calculations from the acquisitions.
- *Accounting practice*: The overall accounting seems to be conservative. However there are some areas of concern. For example – the company has assumed long term returns on plan assets of 9%. I think that is aggressive and could result in additional charges over the years. The IP R&D (in process R&D) charges do not appear to be excessive.

Valuation

The company has approximately 12 Bn of cash flow and is selling at around 13 times earnings. The company has shown a profit growth of almost 15% per annum with high degree of consistency. At the same time the company has maintained a high level of ROE during this period too. One cannot assume such a high level of profit growth in the future as some part of this has come from the increase in net margins. However with a conservative assumption of 6-7% growth, discount rate of 8% and CAP period of 10 yrs, intrinsic value can be estimated to be between 80-85 (PE of around 20).

The current valuation assumes a growth of 0 or worse and gives no value to the competitive advantage of the company. The company is currently selling at a 5 year low and appears to undervalued by comparative and absolute standards.

Conclusion

The company has performed well in the past in terms of fundamental performance. The sales and profits have grown at a double digit rate. In addition the company has a healthy drug pipeline at various stages of approval which could help in replacing the blockbuster drugs going off patent. The medical devices and consumer division provide stability to the earnings and help in reducing the risks of the pharma division.

The management has been a rational allocator of capital which is visible via the high dividend payout, above average ROE and sensible acquisitions. The company appears

20-30% undervalued compared to the intrinsic value which in turn can be expected to grow at 7-10% in the future.

Disclaimer: This reports is my personal analysis of the company. It is not a recommendation to buy or sell and does not constitute investment advice on my part. Please do your own research in making buy or sell decisions.

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