



*Johnson & Johnson*

**Student Managed Fund Analyst Report**

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Team Gilson

# Stock Highlights

*Johnson & Johnson (NYSE: JNJ)*

*Sector: Healthcare*

*Date: April 25<sup>th</sup>, 2019*

*Ticker: NYSE: JNJ*

*Recommendation: Buy*

*Current Price (as of 11/1/18): \$140*

*Target Price: \$156 - \$176*

## *Johnson & Johnson at a Glance*

Market Capitalization	\$366.18 B
Beta	0.90
Dividend Yield (%)	2.62%
52-Week Price Range	\$119 to \$149
P/E Ratio	22.00

## *Five Year Price Chart*



# Investment Summary

We recommend a *buy* rating for Johnson & Johnson based on a target price range of \$156 - \$176, with a margin of safety of between 11% and 23% given November 1<sup>st</sup>, 2018's share price of \$140. The following factors contribute to the future success of the company:

## *Innovation*

At the center of Johnson & Johnson is its dedication to innovation. As the healthcare industry continues to become digitized and technologically advanced, Johnson & Johnson remains committed to pursuing new lines of innovation. For example, with the help of AI and similar technology, Johnson & Johnson will better cater its products to meet individual consumer needs.



## *Competitive Edge*

One of Johnson & Johnson's segments, The Johnson & Johnson Institute, is the leader of its industry. The Institute provides its affiliated healthcare professionals with the most current medical and ethical practices training. With Johnson & Johnson's ability to provide educational and technical services for the company's products, they can provide better care to their physicians, doctors, and patients, and ultimately remain competitive within the industry.

## *Brand Value Strength*

Johnson & Johnson's century - long success has resulted in unmatched stream of consumer brand loyalty. Consumers continue to pick Johnson & Johnson products when it comes to brand preference. Throughout many generations, Johnson & Johnson retains its reputable brand and continues to be one of the leading choices for consumers.



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# Company Overview

## Company History

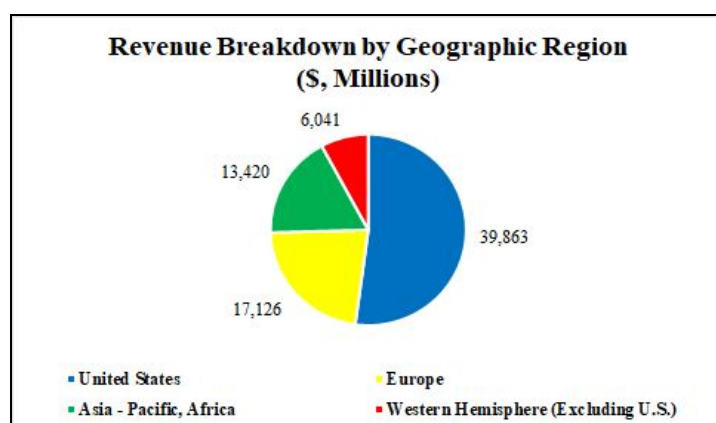
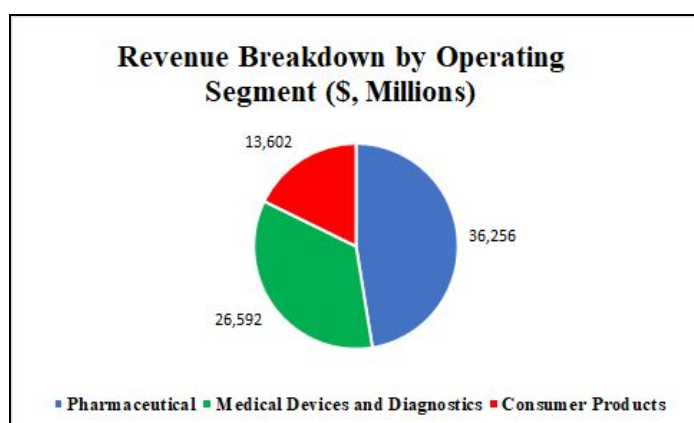
Founded in 1886, Johnson & Johnson is the premier healthcare and consumer goods company in the world. The company strives to provide affordable and accessible products to consumers, with the purpose of improving health and wellness. At its inception, the company first began by selling manuals on sterile surgery techniques, first aid kits, and maternity kits for safe childbirths (including baby powder). The company also developed many known products still prevalent to consumers today, such as dental floss, and Band-Aids in 1921. In 1931, Johnson and Johnson released the first pharmaceutical drug into the market. By 1949, the company began to develop various medical devices such as sterile sutures.

## Operating Segments

The company has three main operating segments:

1. **Consumer Products** (18% of FY 2017 Revenue): This segment includes products such as baby care, oral care, beauty, over-the-counter pharmaceutical, women's health and wound care.
2. **Medical Devices and Diagnostics** (35% of FY 2017 Revenue): This segment is focused on key areas such as immunology, infectious diseases and vaccines, neuroscience, oncology, cardiovascular and metabolism, and pulmonary hypertension.
3. **Pharmaceutical** (47% of FY 2017 Revenue): This segment includes products focused on orthopaedic, surgery, interventional solutions (cardiovascular and neurovascular), diabetes care and eye health.

Furthermore, with over 260 subsidiaries operating in more than 60 countries, Johnson & Johnson has a brand name that is recognizable by many around the world.



## Industry Overview

Considering each of the operating segments of Johnson & Johnson, we find overall trends which benefit the company. Though the consumer products market is nearing the maturity stage of its cycle, its growth outlook will be driven by a demand for organic, natural skincare and beauty products. Within the medical devices segment, we expect to see high growth rates as the U.S. population continues to age as the costs of inputs for manufacturing only grow slightly. Lastly, we expect to see strong growth in pharmaceuticals as the demand for biologic (homeopathic) drugs increases, along with general international demand, especially in emerging markets.

Considering the markets of buyers, we expect to see overall growth, primarily due to a strong economy, as well as growth in disposable income. The pharmacy and drug store revenue to grow at approximately 2% annually. The same growth is anticipated for supermarkets and grocery stores. Lastly, revenue from hospitals will grow steadily at about 3.5% annually. Some other economic drivers of note are an increase in brand name drug sales, estimated to grow at about 2% annually for the next five years.






Within the strong, growing industries that Johnson & Johnson belongs in, it outperforms its peers in a variety of different metrics:

Metric	Johnson & Johnson	Industry/Peers
EPS (\$)	6.57	4.47
Debt/Equity Ratio (%)	57.5	63.8
P/E Ratio	22.0	23.8
Average YOY Revenue Growth (%)	6.34	7.77
Annual Dividend Yield (%)	2.60	2.37
Source: Bloomberg		

Against the industry, Johnson & Johnson has a better EPS, over \$2.00 than the industry average. In addition, the company has a lower Debt/Equity Ratio and P/E Ratio than other companies in its industry. Though its average annual revenue growth is slightly lower, Johnson & Johnson has a higher dividend yield.

## Growth Factor: Innovation

Within each of Johnson & Johnson's operating segments, consider how the following propels the company to be a leader of innovation:

<p style="text-align: center;"><u>Consumer Products</u></p> <p>Currently in development is the Neutrogena Skin360 &amp; Skin Scanner. Through equipping an image scanner onto your phone, the product taps into dermatologist's technology to analyze a user's face and show how it's changing. This is done to ensure an individual's regimen is achieving results. Most importantly, this can all be done seamlessly through its mobile application. The mobile application uses integrated AI to analyze user's skin, and allows users to consult with dermatologists.</p>	
<p style="text-align: center;"><u>Pharmaceutical Drugs</u></p> <p>Within Johnson &amp; Johnson's development pipeline is a variety of biologic drugs. These are drugs which use complex molecules from microorganisms to treat a variety of chronic illnesses. For instance, one popular biologic drug produced by the company is Remicade, which is one of Johnson &amp; Johnson's most profitable drugs on the market currently. It is important to note that generic companies are not allowed to produce and sell biologic drugs, so they compete through offering "biosimilar" drugs.</p>	
<p style="text-align: center;"><u>Medical Devices</u></p> <p>One of Johnson &amp; Johnson's subsidiaries, DePuy Synthes, recently unveiled next generation technology purposed for spinal fusion surgery. The Concorde Lift, an expandable spacer, allows for a more stable, precise placement for fuzing vertebrate than a traditional spacer currently being used. In fact, by 2020, it is estimated that 3.4 million people annually will undergo spinal fusion surgery.</p>	

## Growth Factor: Competitive Edge

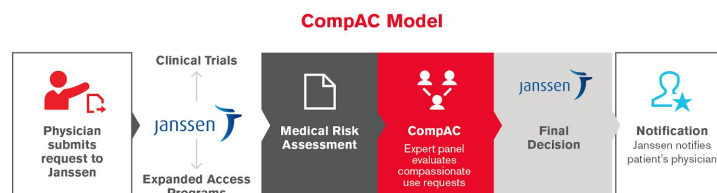
Johnson & Johnson's competitive edge stems from the initiatives of the Johnson & Johnson Institute. With over 20 centers across five continents, the objective of the Institute is to provide excellent patient care by providing a professional education to over 125,000 healthcare providers.



This is achieved through a variety of different learning methods, including virtual reality simulators, online video seminars, and within a classroom setting. One way that Johnson & Johnson is revolutionizing how doctors are trained across the world is with a personalized performance management platform called C-STATS, which has enabled the company to save immensely on costs.

Founded by one Johnson & Johnson's employees—the VP of Performance Improvement—this platform allows surgeons who specialize in robotic, laparoscopic and open surgery to get instant detailed feedback about their technical skills after performing a procedure. C-STATS enables surgeons to have better patient outcomes; in addition, more operations go successfully when the doctors perform them using this platform.

Also, Johnson & Johnson is the first company to have a Compassionate Use Advisory Committee (CompAC). To provide some context, for patients with unique illness, doctors often times resort to non - FDA approved drugs knowing that well-established version may not be an effective cure. The CompAC is a external committee comprised of medical ethicists, physicians & patient advocates; it provides recommendations, either an approval or denial, for each request to use a non-approved drug. Typically, the committee advises on matters regarding oncology, infectious diseases, and neurological health.





## Growth Factor: Strong Brand Value

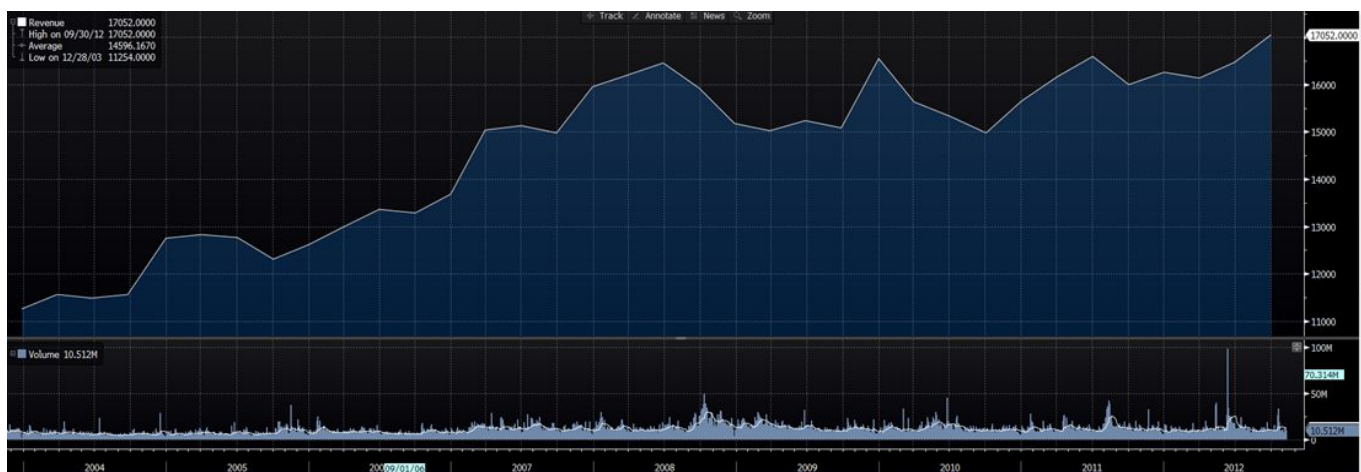
Johnson & Johnson is a company, and brand that consumers trust. Having existed for over 130 years, it has established itself as a company that strives only to merchandize high - quality products, especially ones that are easily identifiable. For instance, the Band-Aid product, has become synonymous with bandages and similar medical dressings, analogous to Google and the search engine.



In addition, the Johnson Baby Brand is the most trusted among families with newborn kids, a testament to the consumer's perception of value which Johnson & Johnson offers.



Furthermore, even through recessions and other poor economic conditions, consumers continue to purchase Johnson & Johnson products over generic alternatives (which are presumably cheaper). Consider the following chart which shows the company's revenue between 2003 and 2012:



Through the recession, we can see that Johnson & Johnson's total revenue is largely unaffected by any slowdowns in the economy. Furthermore, at the recession's worst periods, the company's margins remained steady.

## Valuation

### *Discounted Cash Flow*

Based on our DCF analysis, we found Johnson & Johnson to be undervalued by the market. Our model resulted in an intrinsic share price of approximately \$174, a 23% margin of safety over its current share price of about \$140 when the pitch was presented in November, 2018.

PV: Sum of 10 Years	186,688
PV: Terminal Value	295,639
<b>Enterprise Value (\$ Mil)</b>	482,328
+Cash	19,364
-Debt	36,480
<b>Value (\$ Mil)</b>	465,212
Shares Outstanding (Mil)	2,680
<b>Intrinsic Value</b>	\$173.59
<b>Current Stock Price</b>	\$140.58
<b>Margin of Safety</b>	<b>23%</b>

For our analysis, we grew revenue at just over 5%, as a weighted average growth of each of Johnson & Johnson's operating segments from its 3<sup>rd</sup> quarter earnings call (refer to Appendix). Going forward, we expect Johnson & Johnson's exceptional technological advancements to support the company's continual growth. We held a variety of factors constant as we projected into the future; for instance, we used a universal tax rate of 21%, EBIT margin of 27%, and grew depreciation & amortization at 2% annually.

## Comparables Analysis: P/E Multiple

We compared the performance of Johnson & Johnson's to the performance of the company to competitors within the same operating segments; for each segment, we compared two to three companies against Johnson & Johnson's financial metrics for the corresponding segments. We analyzed several different metrics:

Competitor Analysis								
	Market Cap. (Bil.)	Beta	P/E	EV/EBITDA	ROIC (%)	ROE (%)	Debt/Equity (%)	Dividend Yield (%)
<i>Pharmaceutical Manufacturing</i>								
Pfizer	257.1	0.90	18.6	10.8	11.4	19.7	60.7	3.5
AbbVie Inc.	131.9	1.20	12.8	14.6	20.8	168.0	733.1	2.7
<i>Medical Device Manufacturing</i>								
Abbott Laboratories	128.1	1.02	40.1	17.5	4.2	10.7	89.8	1.9
Medtronic PLC	127.9	0.91	25.3	13.7	7.2	9.9	50.7	2.3
Strkyer	64.1	0.95	27.4	18.3	14.5	22.7	72.4	1.1
<i>Consumer Goods</i>								
Bayer	74.6	0.96	20.2	9.1	11.2	10.1	38.5	2.7
Merck & Co Inc.	196.2	0.86	22.1	9.3	13.2	24.7	70.6	2.4
Johnson & Johnson	377.4	0.90	22.0	14.4	18.5	26.8	57.5	2.6
<b>Average</b>	169.66	0.97	23.78	13.34	11.77	37.99	159.39	2.37

The metric we used to value Johnson & Johnson against its competitors was the P/E ratio. Based on the table above, the company has a lower ratio than the average of the peer group we selected, meaning that the company is relatively undervalued:

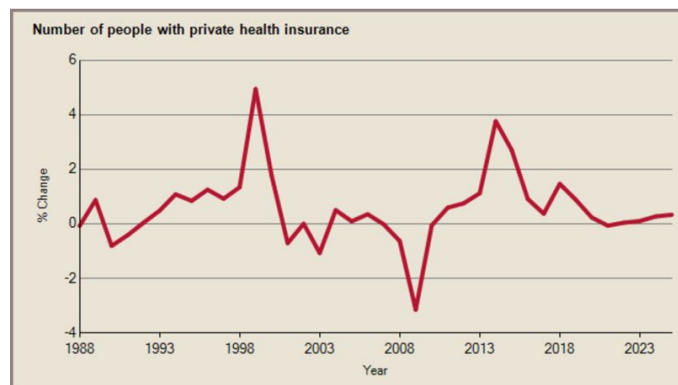
Average P/E Ratio of Peer Group	23.8
Johnson & Johnson EPS	\$6.57
<b>P/E Multiple: Value</b>	<b>\$156.80</b>
Current Stock Price	\$140.58
<b>Margin of Safety</b>	<b>11%</b>

This relative valuation resulted in an intrinsic stock price of approximately \$157, an 11% margin of safety over its current share price of about \$140 when the pitch was presented in November, 2018.

## Risks and Mitigants

### Decrease in the Number of Individuals Holding Private Health Insurance (not Medicare or Medicaid)

This risk may negative impact the Pharmaceutical and Medical Devices and Diagnostics operating segments. In addition, we may see branded drug sales fall as these individuals seek generic alternatives which may be cheaper. However, current trends show the growth to be slow, but still positive over the next five years.



### Threat of Recession

Though this risk is very prevalent in our current economic climate, this will impact the Consumer Products operating segment, the smallest of the business. Furthermore, the company has a successful history of maintaining sales through poor economic times.

### Trade War Concerns

Though this risk impacts most companies which operate internationally, we do not see this have a severe impact on the company. As of May 1<sup>st</sup>, 2018, China eliminated any tariffs regarding drug imports. This means that Johnson & Johnson's largest segment, Pharmaceutical, should be able to operate without any issues.

# Appendix

## DCF Analysis

<b>Johnson &amp; Johnson</b>																	
In Millions of USD except Per Share	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
<b>Revenue</b>	<b>65,030</b>	<b>67,224</b>	<b>71,312</b>	<b>74,331</b>	<b>70,074</b>	<b>71,890</b>	<b>76,450</b>	<b>81,382</b>	<b>85,720</b>	<b>90,290</b>	<b>95,104</b>	<b>100,174</b>	<b>105,514</b>	<b>111,139</b>	<b>117,064</b>	<b>123,304</b>	<b>129,878</b>
% growth		3%	6%	4%	-6%	3%	6%	6%	5%	5%	5%	5%	5%	5%	5%	5%	5%
- Cost of Revenue	20,273	21,658	22,342	22,746	21,455	21,640	25,266	25,228	26,573	27,990	29,482	31,054	32,709	34,453	36,290	38,224	40,262
% margin		31%	32%	31%	31%	30%	33%	31%	31%	31%	31%	31%	31%	31%	31%	31%	31%
<b>Gross Profit</b>	<b>44,757</b>	<b>45,566</b>	<b>48,970</b>	<b>51,585</b>	<b>48,619</b>	<b>50,250</b>	<b>51,184</b>	<b>56,154</b>	<b>59,147</b>	<b>62,300</b>	<b>65,621</b>	<b>69,120</b>	<b>72,805</b>	<b>76,686</b>	<b>80,774</b>	<b>85,080</b>	<b>89,616</b>
% margin		69%	68%	69%	69%	70%	67%	69%	69%	69%	69%	69%	69%	69%	69%	69%	69%
- Operating Expenses	28,517	28,534	30,013	32,831	31,734	28,114	29,654	32,063	36,003	37,922	39,944	42,073	44,316	46,678	49,167	51,788	54,549
% margin		44%	42%	42%	44%	45%	39%	39%	42%	42%	42%	42%	42%	42%	42%	42%	42%
<b>EBITDA</b>	<b>19,014</b>	<b>19,971</b>	<b>22,115</b>	<b>22,420</b>	<b>20,989</b>	<b>26,031</b>	<b>25,276</b>	<b>27,912</b>	<b>27,042</b>	<b>28,354</b>	<b>29,733</b>	<b>31,183</b>	<b>32,707</b>	<b>34,310</b>	<b>35,996</b>	<b>37,769</b>	<b>39,633</b>
% growth		5%	11%	1%	-6%	24%	-3%	10%	-3%	5%	5%	5%	5%	5%	5%	5%	5%
-D&A	2,774	2,939	3,158	3,666	4,104	3,895	3,746	3,821	3,897	3,975	4,055	4,136	4,219	4,303	4,389	4,477	4,566
% growth		6%	7%	16%	12%	-5%	-4%	2%	2%	2%	2%	2%	2%	2%	2%	2%	2%
<b>EBIT/Operating Income</b>	<b>16,240</b>	<b>17,032</b>	<b>18,957</b>	<b>18,754</b>	<b>16,885</b>	<b>22,136</b>	<b>21,530</b>	<b>24,091</b>	<b>23,145</b>	<b>24,378</b>	<b>25,678</b>	<b>27,047</b>	<b>28,489</b>	<b>30,007</b>	<b>31,607</b>	<b>33,292</b>	<b>35,067</b>
% margin		25%	25%	27%	25%	24%	28%	30%	27%	27%	27%	27%	27%	27%	27%	27%	27%
Income Tax Expense	2,689	3,261	1,640	4,240	3,787	3,263	16,373	5,059	4,860	5,119	5,392	5,680	5,983	6,302	6,638	6,991	7,364
Tax Rate		17%	19%	9%	23%	15%	76%	21%	21%	21%	21%	21%	21%	21%	21%	21%	21%
<b>Adjusted EBIT</b>	<b>13,551</b>	<b>13,771</b>	<b>17,317</b>	<b>14,514</b>	<b>13,098</b>	<b>18,873</b>	<b>5,157</b>	<b>19,032</b>	<b>18,284</b>	<b>19,259</b>	<b>20,286</b>	<b>21,367</b>	<b>22,506</b>	<b>23,706</b>	<b>24,970</b>	<b>26,301</b>	<b>27,703</b>
+ D&A	2,774	2,939	3,158	3,666	4,104	3,895	3,746	3,821	3,897	3,975	4,055	4,136	4,219	4,303	4,389	4,477	4,566
- CAPEX	186	1,358	613	-584	-221	7	1,093	350	374	233	179	288	361	411	314	308	299
- NWC	7,270	-9,651	8,878	-19	1,750	6,282	-26,194	-1,669	-2,946	-1,988	-3,541	-4,044	-4,871	-6,465	-3,646	-3,929	-4,069
<b>FCF</b>	<b>8,869</b>	<b>25,003</b>	<b>10,984</b>	<b>18,783</b>	<b>15,673</b>	<b>16,479</b>	<b>34,004</b>	<b>24,171</b>	<b>24,754</b>	<b>24,989</b>	<b>27,702</b>	<b>29,259</b>	<b>31,236</b>	<b>34,063</b>	<b>32,691</b>	<b>34,398</b>	<b>36,039</b>
<b>PV of FCF</b>								<b>22,199</b>	<b>20,879</b>	<b>19,357</b>	<b>19,707</b>	<b>19,116</b>	<b>18,742</b>	<b>18,771</b>	<b>16,545</b>	<b>15,988</b>	<b>15,384</b>

## WACC Calculation

<b>Capital Structure</b>	
Market Cap.	377.41 B
% of Capital Structure	92.5%
LT Debt	30.68 B
% of Capital Structure	7.5%
βL	0.903
Tax Rate	21%
Cost of Equity	9.60%
Cost of Debt	1.30%
<b>WACC</b>	<b>8.89%</b>



### *Growth Rate Calculation*

<u>Business Segment</u>	<u>Weight of Total Revenue</u>	<u>Growth Rate of Segment</u>	<u>Weighted Growth Rate of Segment</u>
Consumer	18%	4.90%	0.88%
Medical Devices	35%	1.70%	0.60%
Pharmaceutical	47%	8.20%	3.85%
	100%		
		Growth Rate (Sum of Individual Segment Rates)	5.33%

### *Institutional Holders*

<b>Institutions</b>	<b>% of Total Shares</b>
Vanguard Group	7.8%
Blackrock Inc.	6.7%
State Street Corporation	5.6%
State Farm Insurance Co.	1.4%
Northern Trust	1.3%

*Executive Management*

		
<p style="text-align: center;"><u>Alex Gorsky</u> CEO &amp; Chairman of Board of Directors</p>	<p style="text-align: center;"><u>Joseph Wolk</u> CFO &amp; Executive Vice President</p>	<p style="text-align: center;"><u>Joaquin Duato</u> Vice Chairman of the Executive Committee</p>
<p>1988: Began at J&amp;J as Janssen Pharmaceutical sales representative</p> <p>Served 15 years in various sales, marketing and management roles with Janssen Pharmaceutical</p> <p>Owns \$49 million in company stock</p>	<p>1998: Began in the Finance Manager in the Ortho-McNeil Pharmaceutical organization</p> <p>Since joining, has held various finance positions within J&amp;J</p> <p>Owns \$1.64 million in company stock</p>	<p>1989: Began at J&amp;J in Spain</p> <p>Expanded the Pharmaceutical sector into 17 new products since 2011</p> <p>Former Trustee for Save The Children Federation</p> <p>Owns \$14 million in company stock</p>

Other Notes about Management:

- Of the 11 Board of Directors, there are 3 women
- Majority are not insiders