NORTHERN TRUST

June 5, 2020

Johnson & Johnson (JNJ)

Rating: 2/A

QUARTERLY EARNINGS
Pharmaceuticals

Analyst: Erick Noensie

Current Rating		2/A
Previous Rating		P/A
Last Rating Change		1/24/2019
Previous Close		$146.73
Projected 12 Mo Trading Range		
Low	$124.00	-15.49%
High	$165.00	12.45%
52w Hi/Low	$157.0	$109.2
YTD % Change		0.59%

	2019a	2020e	2021e
EPS ($)	8.68	7.74	8.98
% chg		*-10.83%*	*16.02%*
P/E	25.88	19.09	16.29
Consensus		7.72	9.04
Fiscal Year End			12/31/2020

Market Cap ($m)	386,574.1
Shares Out (m)	2,634.6
Annual Dividend	$4.04
Dividend Yield	2.75%
Book Value/ Shares	$22.59
Price/Book Value	6.45
Price/Sales	4.76
Debt/Total Cap (%)	30.87
LT Growth Rate (%)	5.92

Source: FactSet Research Systems Inc.

Publishing Analyst Disclosure: The analyst does not have a positon in the security

Johnson & Johnson is a holding company, which engages in the research and development, manufacture and sale of products in the health care field. It operates through the following segments: Consumer, Pharmaceutical, and Medical Devices. The Consumer segment includes products used in the baby care, oral care, beauty, over-the-counter pharmaceutical, women's health, and wound care markets. The Pharmaceutical segment focuses on therapeutic areas such as immunology, infectious diseases ad vaccines, neuroscience, oncology, cardiovascular and metabolism, and pulmonary hypertension. The Medical Devices segment offers products used in the orthopedic, surgery, cardiovascular, diabetes care, and eye health fields. The company was founded by Robert Wood Johnson I, James Wood Johnson and Edward Mead Johnson Sr. in 1886 and is headquartered in New Brunswick, NJ.

UPDATING MODEL; PHARMA RESILIENT, DEVICE RECOVERY ANTICIPATED

Conclusion

1Q revenues of $20.7B were above consensus of $19.7B (+4.8% operationally), and EPS of $2.30 was above consensus of $2.02. Pharmaceuticals grew 4.8% and appeared resilient with some products coming in ahead of expectations. The consumer group grew 11% in the quarter, including a 700bp stocking benefit mostly from OTC flu-related products. JNJ lowered guidance for full year organic revenue growth to a midpoint of -1.25% from +5.5% prior, based almost solely on the pandemic hit to the medical device segment, which declined 7% in the quarter. We anticipate a majority of elective procedures are being deferred and will return over the next 12-18 months. JNJ is developing a vaccine for COVID-19, and although the company is not a market leader in vaccines, it does have a presence in the category, which includes some advanced technologies. While management believes it could have Emergency Use Authorization by early 2021, we are more cautious on overall vaccine development timelines and its financial significance, as the company anticipates offering the vaccine on an emergency non-profit basis. Guidance for cash flow was lowered to “teens”, which implies a reduction of $2-3B from prior guidance; however, management raised the dividend by 6.3%, demonstrating the company’s strong balance sheet. We believe the recovery in elective procedures will be the key area to watch over the near- to mid-term as it pertains to JNJ earnings. We lower our EPS estimates but maintain our valuation range and we do not yet believe the stock is positioned to significantly outperform the overall healthcare sector.

Reported EPS: $ 2.30 Consensus: $ 2.02

Thesis

Although we are positive on JNJ’s diversification and stability, we see a mixed outlook to the overall business and we watch for signs of improvement. In its pharmaceutical division, JNJ has a solid group of therapeutic growth drivers, but this is offset by increasing price pressure and patent expirations. JNJ’s Device group appears to have durable growth, but is also curtailed by price pressure and a lack of strong innovation. Our valuation analysis suggests JNJ shares are valued, with only modestly positive risk/reward to our expected trading range. We believe the fundamentals at JNJ have the potential to improve during 2019 and we would watch for more signs of a positive turn or a more attractive entry point to turn constructive on the shares.

Details

Key Metrics Analysis:

- **EPS:** JNJ reported 1Q20 adjusted EPS of $2.30 (9.5% q/q reported), beating consensus of $2.02.
- **Revenue:** JNJ reported 1Q20 revenue of $20.7B (5.6% q/q organic), above consensus $19.7B. COVID-19 had a -80bp impact to growth, with headwinds in the Medical Device segment offsetting benefits in Pharmaceuticals and Consumer Health. Currency negatively impacted sales by -1.5%.
- **Operating Margin**: 1Q20 operating margin was 35.0%, an improvement of 70bps q/q. Margin expansion was driven by milestone payments in the Pharmaceutical sector, partially offset by a decline in the Medical Device margin related to COVID-19 and tough comps from a one-time gain during 2019 in Consumer Health.
- **Segment Details:**
  - Pharmaceutical revenues of $11.1B (10.2% q/q organic), beat consensus $10.5B, and were driven by double-digit growth across nine key products. Stocking by healthcare providers and wholesalers in preparation for the impact of COVID-19 added 100bps to growth. US sales grew by 8.7% q/q and international sales increased by 12.0% q/q. Immunology grew 13.1% q/q driven by Stelara in Crohn's disease, Tremfya, and Simponi. Oncology grew 21.8%, driven by Darzalex, and Imbruvica. Infectious Diseases grew 11.0% q/q and Neuroscience was up 3.1% q/q. Cardiovascular revenue declined -13.1% q/q, due to increased rebates on Xarelto, partially offset by longer scripts due to COVID-19 demand. Pulmonary Hypertension revenue increased 14.7% q/q, driven by market share gains from Opsumit and Uptravi, in addition to increased demand due to COVID-19.
  - Medical Device revenues of $5.9B (-4.8% q/q organic), was above

consensus of $5.6B. The delay of elective procedures reduced growth by an estimated -750bps to -800bps which was partially offset by stocking in the Asia Pacific in anticipation of procedures returning. Vision sales of $1.1B declined -4.5% q/q. Double digit US growth in daily disposables was offset by the impact of COVID-19 and the last of the negative impact of forward buying in Japan during previous quarters. Interventional Solutions revenue increased 0.4% q/q. Surgery sales of $2.1B declined -10.5%. Orthopedic sales of $2.0B fell -6.5% q/q and were a little lighter than consensus of $2.1. JNJ estimates COIVD-19 had a -750bp impact on orthopedic growth. Knee sales declined by -6.1% q/q, and hips were down -5.6% q/q. Trauma sales declined -3.5% and Spine fell -10.6% q/q with JNJ noting that they lost share in Spine during the quarter. JNJ continued to see pricing pressure in all orthopedic categories, with hip pricing down -2% and knees down -1%. US Medical Devices sales declined -4.3% q/q, and international sales fell -5.3% q/q, excluding acquisitions and divestures.

- Consumer sales of $3.6B (11.0% q/q organic) were above consensus of $3.4B. Consumer growth experienced a 700bp benefit related to stocking, primarily in the US OTC business. This is expected to partially reverse throughout the remainder of the year. Skin Health/Beauty increased 3.5% q/q, driven by Neutrogena e-commerce growth in the US, while sales in China and Japan declined due to COVID-19. Baby Care declined -4.9% q/q, due to the Baby Center divesture, SKU rationalization, and COIVD-19. OTC was up 25.8%, primarily due to COVID-19 pantry stocking, and a strong flu and allergy season. Oral care grew 9.8% q/q, Women's health grew 9.2% q/q and Wound Care increased 11.8% q/q. Consumer growth in the US was up 21.0% q/q, while international revenue was up 3.9% q/q.

Key Product Metrics (actual vs. consensus):
Oncology
- Imbruvica: $1.03B vs. $945M (34% q/q)
- Darzalex: $937M vs. $928M (52% q/q)
- Zytiga: $690M vs. $695M (4% q/q)

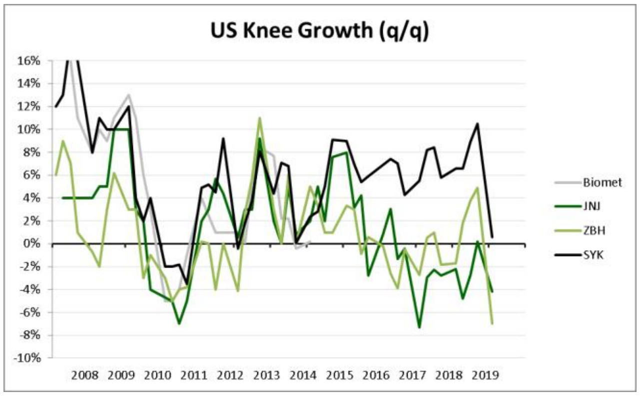
Immunology
- Stelara: $1.8B vs. $1.5B (31% q/q)
- Remicade: $990M vs. $904M (-9% q/q)

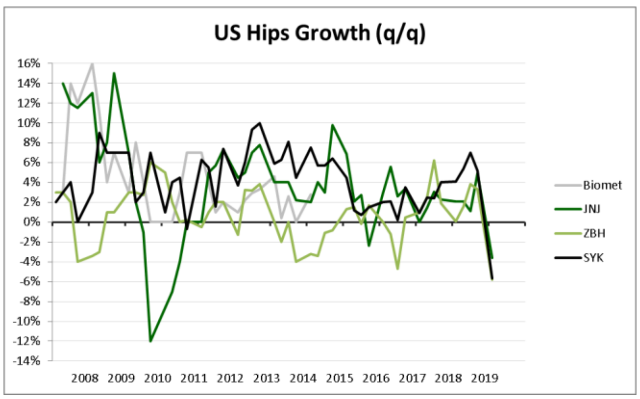
Cardiovascular/ Metabolism/ Other
- Invokana: $175M vs. $158M (-13% q/q)
- Xarelto: $527M vs. $438M (-3% q/q)

Guidance: JNJ reduced FY20 adjusted EPS guidance to $7.50-7.90, from prior expectations of $8.95-9.10, compared to consensus of $7.94. The new EPS guidance represents a reported decline of -13.6% to -9.0% y/y, compared to prior expectations of 3.1% to 4.8%y/y growth. On an operational basis adjusted EPS is expected to fall -11.9% to -7.3% y/y. FY20 sales are now expected to be between $77.5-80.5B, down from previous sales guidance of $85.4-86.2B, but bracketing consensus of $79.4B. The updated revenue guidance represents organic sales growth of -3.0% to +0.5% y/y, compared to prior expectations of +5.0-6.0% y/y organic growth. The bulk of the revision was driven by the Medical Device segment where JNJ estimates a $4.0-7.0B negative impact on operational sales from COVID-19. The pharmaceuticals business is expected to be resilient with a small impact from delayed doctor visits and new patient starts. JNJ is maintaining the expectations set for the Consumer Health segment in January, as the benefit from stocking in 1Q20 is not expected to continue throughout the year, and JNJ sees upside in OTC offsetting weakness in other areas. Adjusted pre-tax margins are expected to decline -100bps during the year driven by higher manufacturing costs related to COVID-19, partially offset by $2B in spending reductions. The effective tax rate guidance was widened to 16.5-18.0%, due to uncertainties around the timing of the economic recovery. Guidance for cash flow was lowered to “teens”, which implies a reduction of $2-3B from prior guidance. Guidance assumes COVID-19 has a short-term impact with the largest impact to sales occurring in 2Q20.

Medical Devices:
All three main competitors in the orthopedics hips and knees segment, JNJ, Stryker (SYK, 2/A) and Zimmer (ZBH, 1/B), were hit in 1Q20 and we expect similar declines in 2Q20. However, we expect a majority of these procedures to be deferred and should return over the next 12-18 months. Note that during the financial crisis in 2008-2010, the decline in knee procedures was relatively short-lived, and hip procedures were relatively resilient, supporting the prospect of a recovery in this case.

Quarter-over-quarter growth shows steep declines in 1Q20 for all major competitors in hip and knee replacements (Source: company reports).





BASE CASE MODEL

A basic model reflecting management's guidance for organic sales growth of -3% to +0.5% in 2020 (corresponding to reported y/y change of -5.5% to -2%), suggests that 2020-2022 estimates are achievable. The downgraded guidance included a $4-7B hit to revenues based on the medical device segment, which will be the key segment to watch during the recovery period. Consensus 2022 sales estimates have been reduced to $91.9B from $94.0B suggesting a lowered bar going forward.

Base Case Model

		2018	2019	2020	2021	2022	2020-2022 CAGR	% of '22 Sales	Growth Attribution*
Income Statement (Mn)									
Selected Sales Items									
Pharmaceuticals		40,734	42,198	44,414	47,339	49,332	5.4%	54%	40%
	y/y	12.4%	3.6%	5.3%	6.6%	4.2%			
Medical Devices		26,994	25,963	20,614	26,184	27,136	14.7%	30%	53%
	y/y		-3.8%	-20.6%	27.0%	3.6%			
Consumer		13,853	13,898	14,049	14,603	15,012	3.4%	16%	8%
	y/y	1.8%	0.3%	1.1%	3.9%	2.8%			
Tremfya		544	1,012	1,297	1,551	1,783	17.3%	2%	4%
	y/y	nm	86.0%	28.1%	19.6%	15.0%			
Total Sales		81,581	82,059	79,540	86,675	91,948	7.5%		
	y/y	6.7%	0.6%	-3.1%	9.0%	6.1%			
Gross Profit		56,942	57,444	55,584	61,867	62,969	6.4%		
	y/y	8.8%	0.9%	-3.2%	11.3%	1.8%			
SG&A		21,843	22,169	21,349	12,800	23,639	5.2%		
	y/y	2.4%	1.5%	-3.7%	-40.0%	84.7%			
R&D		10,591	10,775	10,911	11,802	12,172	5.6%		
	y/y	16.4%	1.7%	1.3%	8.2%	3.1%			
EBITDA		31,023	28,086	26,920	30,871	32,904	10.6%		
	y/y	23.0%	-9.5%	-4.2%	14.7%	6.6%			
Net Income		22,315	23,310	20,606	23,871	26,302	13.0%		
	y/y	11.4%	4.5%	-11.6%	15.8%	10.2%			
Shares Out		2,729	2,684	2,674	2,633	2,644	-0.6%		
	y/y	-0.6%	-1.6%	-0.4%	-1.5%	0.4%			
EPS		8.18	8.68	7.71	9.07	9.95	13.6%		
	y/y	12.1%	6.1%	-11.2%	17.7%	9.7%			
Margins & Other Metrics									
Gross Margin		69.8%	70.0%	69.9%	71.4%	68.5%	-70 bp/y		
R&D / Sales		13.0%	13.1%	13.7%	13.6%	13.2%	-25 bp/y		
SG&A / Sales		26.8%	27.0%	26.8%	14.8%	25.7%	-55 bp/y		
EBITDA Margin		38.0%	34.2%	33.8%	35.6%	35.8%	95 bp/y		
Tax Rate		16.4%	17.4%	17.1%	17.4%	17.1%	-5 bp/y		
Net Income Margin		27.4%	28.4%	25.9%	27.5%	28.6%	135 bp/y		
Net Debt / EBITDA		0.4	0.4	0.3					
Cash Flow									
Capex / Sales		4.5%	4.3%	4.3%	4.3%	4.3%	0 bp/y		
Free Cash Flow		18,531	19,887	16,132	21,132	23,893	21.7%		
Dividend Payout		42.5%	42.5%	-	-	-			

** Percent of total company revenue growth generated from individual product line*

VALUATION

JNJ’s valuation is in the range with its large cap pharmaceutical and medical device peers on multiple metrics including PE, PEG, EV/sales and EV/EBITDA suggesting that there is only modestly positive upside in JNJ shares based on valuation alone.

Pharmaceuticals and medical devices comparables table:

Comparables (2021 metrics)	JNJ	MRK	PFE	ABT	MDT	Median
Market Cap ($Bn)	386.6	205.8	200.0	156.1	130.1	200.0
EV ($Bn)	396.1	226.4	242.0	170.7	143.9	226.4
PE	16.2	13.6	13.4	24.0	17.0	16.2
PEG (2 Year Growth)	1.2	1.1	6.1	1.1	0.5	1.1
EV / Sales	4.6	4.5	5.6	4.9	4.6	4.6
EV / EBITDA	13.0	10.5	13.8	19.5	13.2	13.2
FCF Yield (on EV)	5.6%	6.8%	6.3%	4.3%	5.4%	5.6%
Dividend Yield	2.9%	3.1%	4.4%	1.8%	2.4%	2.9%
Net Debt / EBITDA	0.3	0.9	2.4	1.7	1.3	1.3

Merck (MRK), Pfizer (PFE), Abbott Laboratories (ABT), Medtronic (MDT)

Probability-weighted DCF: We analyze multiple scenarios for the base business using a DCF valuation, and we then apply probabilities to those scenarios to arrive at a probability-weighted fair value. The scenarios range from a blue sky, which contemplates upside to consensus estimates down to a black swan, which assumes deterioration in the base business. We then calculate the valuation implied by our predicted fair value on our basic model estimates looking at PE, EV/EBITDA and EV/sales. Similar to the findings from our comp table, we find only modestly positive risk/reward based on valuation alone.

4 Outcome Scenarios and Fair Value

risk reward	Price	Price Δ %	Probability	weighted Δ%	discount rate	Scenario Assumptions
current price	**$147**					Base Business
scenario 1	$211	44%	15%	6.6%	8%	Blue Sky
scenario 2	$184	25%	35%	8.9%	9%	>Consensus
scenario 3	$145	-1%	35%	-0.4%	9%	<Consensus
scenario 4	$123	-16%	15%	-2.4%	10%	Deterioration
Probability-weighted Fair Value	**$165**					
Δ% from current price	13%					

Fair Value Implied Valuation	2020	2021
PE	21.6	18.4
EV / EBITDA	16.6	14.4
EV / Sales	5.7	5.2

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