Johnson & Johnson - Good defensive stock with strong fundamentals

**Stock Price Analysis -** Johnson and Johnson (J&J) at market price of $64.45 is trading at Price/earning(P/E) multiple of 13.48x of its 2010 trailing diluted EPS of 4.78. While most of its peers i.e Abbott labs and Novartis are trading at premium comparatively at 18.7x and 14.6x respectively. to J&J. So based on the relative valuation approach, J&J at the time is undervalued stock and could generate average return in the near term.

With market value of $173 billion and 3 months average volume of 12,022,500 , the stock also ensures good market capitalization and enough liquidity in the stock to provide opportunity to investors to exit as per their sweet will.

Apart from that stock is less sensitive compare to index having beta of 0.55. It ensures it would not correct significantly even overall index correct sharply. For that the stock never broke the level $57 in last one year and maintained a range between $ 57.50-68.05 proving the above statement. So investing in this stock would preserve your capital in this volatile market and looking at current turmoil in world equity market it is advisable to invest in such defensive stock.

**Stock Price Performance**

Historically stock remained very defensive preserving capital for the investor rather eroding it. Stock traded at the levels of $62 in last 5 years monthly average reflecting that stock is very strong at the present level. Further company is engaged in the business of health care which is a defensive sector and free from the impact of any downturn in economy. This implies that investors have confidence on the stock and they knew investing in this stock would preserve their capital in future which is very essential in this uncertain environment. Below is the monthly price chart of the stock for past five years.

Source: Yahoo finance

We have projected the next 12 months price by using 9 months moving average and derived that stock at the end of December 2012 should be around $64.67, implying an upside of 0.6% from current level ($64.45). However, based on the P/E multiple we expect the stock to reach $67.07 by 2012. The difference here is because of the valuation method. While the moving average is just a theoretical method of calculation, the P/E is more justified and relevant method to estimate the target price taking in consideration the market scenario and fundamental of the company.

Also, stock had traded in the range of $50 to $70 between the period of 2006 to 2011, implying that stock has strong support at the level of $50 and strong resistance at level of $67. Even in 2008 recession stock did not break this mentioned level, thus we expect stock would remain defensive and there would be not much upside from current level due to uncertain economic environment across the World. Based on the share price movement, we could say that the stock in next one year would generate ~1.0% (as mentioned above 0.6%) return from current level by reaching at $64.67 but as mentioned, based on valuation matrix, it may generate 4.1% return.

**Key points that would fuel company’s future performance and its stock price**

Company remained consistent in paying dividend. Company had increased its dividend payout ratio in regular interval, which has increased from 39% in 2008 to 44% in 2010 (Check Sheet “Income statement” Cell D33 and E33) and we expect company would maintain this trend in coming years also. In uncertain market where companies are under stressed to sustain its profitability, there J&J paying dividend consistently is offsetting investors loss which had eroded in these uncertain market. Company had maintained its dividend yield at 3% in last 3 years (Check “Income statement” Cell D37, E37 and F37), reflecting company’s strong performance in its business operations. Dividend yield at 3% is quite impressive which would lure investors to take long position on this stock in future.

**Dividend per share with dividend yield**

Source: Company’s income statement & yahoo finance

Company has maintained its capital structure flexible without over leveraging its balance sheet. Long term debt/equity ratio remained well below 1x (Check "Balance Sheet” Cell D42 and E42)(Check 7, E37 and F37) , reflecting company’s ability to operate its business along with its expansion without raising too much of debt. Less debt in the books had reduced company’s interest cost and thus enhanced profitability of the company. Besides, it also leaves room for J&J to raise debt in future to fund its future expansion plan without downgrading its credibility.

Company has networth of $ 56,579 in 2010 which would support any type of expansion plan in future. So company could easily fund its future expansion from its internal accruals. We further expect that increase in profitability in coming years would enhance its networth more. This would attract investors to be bullish on this stock, expecting good return generated from it without any further capital erosion.

**Long term debt vs Networth**

 Source: Company’s balance sheet

Company’s capital structure comprise of 86% of shareholders equity and only mere 14% of long term debt taking the company near to debt free company, thus preserving profit for their share holders.

 Source: Company’s balance sheet

Low debts in balance sheet and consistent strong cash flow from operation have enhanced the credit grading of the company which has further reduced the cost of funds of the company. In spite of this challenging global economy, company has maintained discipline in its financials which aid company to retain its AAA credit rating in 2010 (Source: Annual Report 2010). In 2010, company has also executed a $1.1 billion debt offering at lower interest rate for long term corporate debt in history (Source: Annual Report 2010). All these would gain confidence on investors mind to remains safe in investing in this stock. Apart from that we expect lower interest rate in its debt due to AAA credit rating would enhance the profitability of the company in coming years, thus generating good return for its share holders.

**Cash flow from operation in last 3 years**

 Source: Company’s cash flow statement

Company has invested nearly $7 billion in its research and development (Source: Annual Report 2010) to advance its newest technologies and pipeline compounds. Company has leading product pipeline under its arsenal. Some of its leading products are like Rivaroxaban which has already filed in US for the prevention of stroke in patients with atrial fibrillation. Few other positive developments in the company include:

* Abiraterone acetate, an investigational compound for treatment of metastatic advanced prostate cancer was granted priority review in the U.S. and accepted for accelerated assessment in Europe.
* Telaprevir, for hepatitis C, an undertreated global infectious disease, has also been accepted for accelerated assessment in Europe.
* Revolutionary hemostasis product - that combines two biomaterials and two biologics to stop bleeding during surgical procedures - was filed for regulatory approval with the FDA.

Such kind of product innovations should strengthen company’s revenue visibility in future.

Not just this, the company has regularly strengthen its marketing and distribution segment through licensing partnerships and target acquisitions. It acquired Micrus Endovascular, a global developer and manufacturer of minimally invasive devices for hemorrhagic and ischemic stroke. On another move, it signed an agreement with US regulators to reopen its application for the Sedasys sedation system for endoscopy patients. In another step, J&J accompanied with Bristol-Myers Squibb Co, undertook to develop experimental treatments for hepatitis C.

In Sep 2011, J&J purchased the other half of its rights in North America to OTC heartburn drugs Pepcid and Mylanta which was half held by Merck & Co.. The deal was done at $175 million. This also gives J&J complete ownership of the joint venture's manufacturing plant in Lancaster, Pennsylvania, where Mylanta and Pepcid are manufactured.

Apart from these developments company also under took strategic acquisition to increase its overall presence across the globe and generate demand for its products. These would augment the topline of the company in coming years which would further boost return of shareholders in future.

**Valuation**

Experts downgrade world economic growth in 2012 and peg that it would grow 2.6% in 2012, where as US, the strongest economy in the world would grow 2.5% in 2012. Further US initiative to cut health care expenses for austerity measures would impact demand for company’s product. We forecast that company revenue would grow 2% in 2011 and 2012 aligning with overall growth US. We believe that company would be able to control its operating expenses as it did in 2010 and it would remain 73% of net sales. In 2012, we believe company would be able to maintain its net profit margin at 21.6% due to low interest costs which would enhance its net profitability to $ 13,872 million in 2012. We assume that there would be no further equity dilution and number of equity shares would remain same and diluted earning per share would be $4.97 in 2012.

Company is currently trading at Price/earning multiple of 13.48x on its 12 month trailing diluted EPS of $4.78. We have valued the stock on it’s Price/earning multiple and conservatively assigned the same Price/earning multiple of 13.48x on its 2012 diluted earning per share and derive a target price of $67.07. Analyzing uncertain global economic factors we conservatively valued the stock with target price of $67.07, implying an upside return of 4.1% from current level. So we recommend a “AVERAGE BUY” on this stock with investment horizon of 1 year.

**References:**

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