FINANCIAL ANALYSIS REPORT 2013 OF JOHNSON & JOHNSON FOR INVESTORS INFORMATION

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Abstract

This financial analysis report examines Johnson & Johnson, an American multinational corporations financial position from the perspective of the investor. With its presence in over 60 countries, the group has more than 275 companies under it and enjoys strong hold in three primary areas – Pharmaceuticals, Medical Devices and Diagnostics and the Consumer Segment. Johnson & Johnson (JNJ) is registered with New York Stock Exchange and is a part of all the best indexes across the globe.

The financial analysis has been done with the objective of determining the financial robustness of the company and to analyze the strategic portfolio of the company. The financial statements of the company for the year 2013 and 2012 were examinedfrom the perspective of the Investors. The financial statements examined included the balance sheets for the two years to arrive at various financial statement ratios such as liquidity, profitability, debt, operations and cash flow. The data analyzed in the process was used to arrive at conclusions with regards to financing and investment decisions. This study structure can be used by the investors as Fundamental analysis for any company of their choice.

Key words: Fundamental analysis, Horizontal analysis, Vertical analysis, Cash conversion cycle, ROE, ROA, Short Term Debt Coverage Ratio

About Johnson and Johnson (JNJ)

1.1 Introduction

Founded more than 120 years ago, Johnson and Johnson is an American multinational company and a household name today. It was in 1886 that three brothers came together to create ready to use surgical dressings. Today it’s a group of more than 275 operating companies present in over 60 countries and employs more than 128,700 people. With headquarters in New Brunswick, New Jersey, USA the company enjoys the status of being the world’s largest and most diverse medical devices and diagnostic company and the world’s sixth largest company in consumer health, pharmaceuticals and biologics. It is one of the first few countries to expand their operations into China nearly 28 years ago. Locally based businesses ensure that the company understands the unique challenges that the health care sector poses in the country. All businesses in China are unified under JNJ China resulting in creation of new opportunities in a rapidly growing economy (Johnson & Johnson, 2014a)

In 2013 the company delivered strong results. The pharmaceutical sector performed exceptionally well gaining from the strength of the key brands in over the counter medicine business. Synthes Inc. was integrated into the Medical Devices and Diagnostic Business. Innovation and efficient execution of solutions in the global health care market has further bolstered its growth. The worldwide sales of the company for the years 2012 and 2013 stood at USD 67.2 billion and USD71.3 billion (Johnson & Johnson, 2014b) respectively.

In the year 2013:

- Pharmaceuticals accounted for 39% of the total sales with an operational growth of 12% (Johnson & Johnson, 2014c)
- Medical Devices and Diagnostics accounted for 40% of the total sales with an operational growth of 6.1% (Johnson & Johnson, 2014c)
- The Consumer Segment accounted for 21% of the total sales with an operational growth of 2.8% (Johnson & Johnson, 2014c)

For the last 70 years the company has been strictly adhering to its credo that lays out business ethics and recognises the responsibility that JNJ has towards its customers and society in general. The company and its employees have stood up to challenges and complexities with passion and boldness.

1.2 A Diverse Product Line

The company’s business is divided into three primary segments – Pharmaceuticals, Medical Devices & Diagnostics and Consumer Products. In 2013 the three segments contributed 39%, 40%, and 21% respectively towards the total revenue (Johnson & Johnson, 2014c).The consumer care segment includes baby care, oral care, wound care, skin care, and women's health care fields, nutrition, OTC (over the counter) pharmaceutical products and wellness products.

The Consumer segment includes a 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, and wellness and prevention platforms. Baby line products of the company, Clean and Clear, Neutrogena, Listerine, Band-Aid, Neosporin, Carefree panty liners, o.b.tampons, Stayfree sanitary napkins, Pepcid Acid Controller and Zyrtec are just some of the leading products in this segment. The pharmaceutical segment has products in a variety of areas like, antipsychotic, anti-infective gastrointestinal, contraceptive, immunology, haematology, neurology, infectious diseases, pain management, oncology, thrombosis and vaccines areas. The company produces a large range of products in the Medical Devices and Diagnostics Segments which are used by medical professionals in various fields including general surgery, cardiovascular surgery, orthopaedic, glucose monitoring and delivering, diagnostic products and infection prevention products. (Johnson & Johnson, 2014c).

1.3 Future Prospects

JNJ enjoys a robust product line leading to it enjoying a leading position in diverse healthcare segments. Some of the factors that work towards the company's growth are a diverse sale base, high margins, and exceptional cash flow along with exceptional understanding of local needs leading cost effective and quality products.

A global player it meets its customers' expectations in new and innovative ways. By focusing on new geographical areas and new products it plans to maintain its leadership position in the various sectors. In the year 2013, USD 8.2 billion amounting to 11.5% of sales, was invested in Research & Development (R&D) indicating the company's commitment to deliver differentiated products in health care and maintaining the company's long term goals of growth. In 2012 and 2011 USD 7.7 billion (11.4% of sales) and USD 7.5 billion (11.6% of sales) respectively was invested in R&D.

	2013		2012		2011	
(Dollars in Millions)	Amount	% of Sales*	Amount	% of Sales*	Amount	% of Sales*
Consumer	$590	4.0%	622	4.3	659	4.4
Pharmaceutical	5,810	20.7	5,362	21.2	5,138	21.1
Medical Devices and Diagnostics	1,783	6.3	1,681	6.1	1,751	6.8
Total research and development expense	$8,183	11.5%	7,665	11.4	7,548	11.6
Percent increase/(decrease) over the prior year	6.8%		1.6		10.3	

Research and Development Expense (Segment wise) (Johnson & Johnson, 2014c)

As per the annual report in 2013 (Johnson & Johnson, 2014c) nearly 25% of sales came from products introduced in the last five years. Three new major medicines were launched and novel products approved by the US Food and Drug Administration (FDA). New products were launched in the consumer segment and innovation centres started in London, Shanghai, San Francisco and San Diego. With its eyes set on efficient execution, the company has unified its businesses in China, implemented new operating models for ensuring quality and safety. The company is committed towards the success of United Nations Millennium Development Goals (2014) focusing on the well-being of mothers and children around the world. The company is committed to make enhancements in its products by the end of 2015.

2. Financial Analysis for investment decisions:

Financial analysis has been done with a view to determine the financial robustness of the company and in order to analyse the strategic portfolio of the organisation. A useful management tool, it helps acquire an understanding of financial performance of a company and trends over a period of time. While managers use them to determine the strengths and weaknesses of the business, investors use it to determine a company's ability to meet its financial robustness and ability to meet future commitments (Financial Ratio Analysis, 2013).

As per the 2013 annual report JNJ (Johnson & Johnson, 2014c) intends raising money for the following projects:

- **Creation of Innovation Centres:** JNJ has announced the creation of innovation centres with locations spread globally - London, Shanghai, Boston, San Francisco and San Diego. These collaborations are a component of the company's strategy to bolster an international system. The company states that the objective behind setting up these innovation centres is to ensure access to world class laboratory facilities and scientific knowledge.

- **Continuing with R&D:** It intends to continue investing in R&D with a focus on key areas that are still unaddressed with respect to patients.

- **Approval for new products and extension of in-market products:** JNJ has announced in the Pharmaceutical Business Review that it plans filing for approval of ten new molecular entities (NMEs) between 2013 and 2017. There are also plans for extending 25 products already existing in the market (Johnson & Johnson, 2014c).

2.1 Methodology

For an in depth financial analysis, all three tools – ratio analysis (RA), horizontal analysis (HA) and vertical analysis (VA) were used. To start with, various ratios are briefly defined and formulas applied to arrive at the figures. This has then been discussed in detail in individual sections in the analysis section.

2.2 Analysis

2.2.1 Horizontal Analysis (HA)

Horizontal Analysis uses a minimum of two consecutive year's financial statements in order to identify the variance in the accounting periods (Michigan State University, 2014). From the horizontal analysis of JNJ we can see that there is a 6% growth in revenue on a year to year basis. The gross profit margin has increased although by only 0.89%. Consequently the net profit ratio before tax has also marginally improved by 1.2%. Owing to less provision for taxes the net profit after tax has considerably improved by 3.26%. Working for the horizontal analysis is attached along as Appendix-2.

2.2.2 Vertical Analysis (VA)

In vertical analysis every item of the financial statements is changed to percentage. It converts dollar values to percentages (Colby University, 2006). The company has a gross profit margin of 68.67% which is indicative of its ability to sell its products with high margins. The selling, marketing and administrative expenses are at 30% of the revenue which can be considered on the higher side. This is the major expenditure and the company should aim to reduce it. The company spends 11.5% towards developing new products and R&D. This indicates the company's commitment to innovation and a spirit to continuously update its products. Working for the vertical analysis is attached along as Appendix-3.

2.2.3 Ratio Analysis (RA)

For the purpose of consideration of granting loans we shall use liquidity measurement ratios, profitability ratios, debt ratios, operating performance ratios and cash flow indicators and to some extent investment valuation ratios. The working for various ratios is attached along as Appendix-1. The ratios have been interpreted in detail below:

2.2.3.1 Analysis of Liquidity Measurement

Liquidity reflects a company's ability to satisfy its short term obligations from assets that can be easily converted to cash. These assets, referred to as 'Liquid Assets', are listed as 'Current Assets' in the financial statements. These represent the day to day resources that a company requires for its operations (Drake, 2007).

- **Current Ratio (CR):** The current ratio is the ratio of current assets to current liabilities and reflects a company's ability to meet its current liabilities using the current assets (Drake, 2007). It can be arrived at by calculating:

Current Ratio=Current Assets/Current Liabilities

Working of CR is provided along in Appendix-1. The CR of the company is 2.2 in 2013 which is a marginal increase from 1.9 in 2012. The company's current assets are more than twice its current liabilities indicating its strong position to repay its current liabilities. Howsoever, the high ratio also indicates non-utilization of its resources.

- **Quick Ratios (QR):** The quick ratio is the ratio of quick assets to current liabilities and reflects the company's potential to meet current liabilities from the most liquid assets (Drake, 2007). It can be arrived at by calculating:

Quick Ratio=Current Assets-Inventory/Current Liabilities

Working of QR is provided along in Appendix-1. The quick ratio of JNJ has also improved from 1.34 to 1.59. The company has a high quick ratio. This is indicative of the company's cash and equivalents, short term investments and accounts receivable are sufficient to cover the current liabilities. It also represents its strong position in respect of meeting its current liabilities.

- **Cash Conversion Cycle (CCC):** The cash conversion cycle takes into consideration the number of days a company's cash is tied up in production and the process of sales and the benefits that it enjoys from this payment term from creditors (Drake, 2007).

Cash Conversion Cycle=Days Inventory Outstanding(DIO)+ Days Sales Outstanding(DSO)- Days Payable Outstanding (DPO)

The working of CCC is provided along in Appendix-1. The cash conversion cycle for JNJ has increased from 78 days to 86 days. The cycle has increased which is not good for the company.

2.2.3.2 Analysis of Profitability Ratios

Profitability ratios, also known as profit margin ratios, is the ratio of components of income with sales. These ratios provide an insight into factors making up the company's income (Drake, 2007).

- **Gross Profit Ratio (GPR):** The GPR represents the ratio of gross profit to sales and represents the margin that the company charges over its cost of products.

Gross Profit Margin=Gross Profit/Sales*100

The working of GPR is provided in Appendix-1. The gross profit ratio has improved though marginally from 67.93% to 68.67% which is a healthy sign of the company's position. The high GPR also means the company's strength in terms of quality of its products.

- **Net Profit Ratio (NPR):** The NPR represents the ratio of net income to sales and represents the left-over sales after making the expenses (Drake, 2007).

Net Profit Margin=Net Profit/Sales*100

The working of NPR is provided in Appendix-1. The net profit ratio after taxes has improved from 16.14% to 19.4% which is good. On deeper analysis and comparison with horizontal analysis, it comes to light that there has been considerable improvement due to lesser provision for taxes. Otherwise there has been only an increase of 1.2% in net profits before tax ratio.

- **Return on Assets (ROA):** ROA refers to the amount of profit generated by every dollar of asset. It can be calculated using be the formula: (Michigan State University, 2014).

Return on Assets=Net Earnings After Taxes /Average Total Assets

The working of ROA is provided in Appendix-1. The net return on total average assets was 4.62% in the year 2012 which can be considered to be below par. The ratio rose to 5.44% in 2013 which shows an improvement. ROA should be at least 5%.

- **Return on Equity (ROE):** This represents the amount of profit that every dollar of equity earns. The return on equity shows how judiciously the money of the shareholders has been employed to generate return (Michigan State University, 2014). It can be calculated using the formula:

Return on Equity =Net Earnings After Taxes / Equity

The working of ROE is provided in Appendix-1. The return in the range of 10% – 15% represents good investment quality. The ROE in the case of JNJ is 9.96% in the year 2013.

- **Return on Capital Employed (ROCE):** The ROCE should be above the company's average borrowing rate. It helps get a clear picture of how the use of capital affects a company's profitability. It can be calculating using the formula (Drake, 2007):

Return on Capital Employed =EBIT / Average of Total Capital

The working for ROCE is provided in Appendix-1. JNJ borrowing rates as interpreted from Note 7 of the Annual Report of 2013 (Johnson & Johnson, 2014c), is not above 4%. The ROCE of the company is 12.64%. This indicates that the company's ROCE is better than ROE.

2.2.3.3 Analysis of Debt Ratios

The debt ratios compare the total debt of a company with its total assets. It helps acquire information about the money borrowed that the company brings into use. A lower percentage represents lower dependence on borrowed capital and stronger is its position with respect to equity. The higher the ratio, the higher is the risk that a company is taking.

- **Debt Equity Ratios (DER):** These compare the company's total liability to shareholders equity. The lower the ratio the stronger is the equity position of the company. Howsoever, it's not a pure measurement of a company's debt as it includes current outside liabilities too. Large company's can push the liability to the higher side without getting into any trouble. It can be arrived at by using the formula (Drake, 2007):

Debt Equity Ratio=Total Debt/Total Shareholders Equity

The working of DER is provided along in Appendix-1. In the case of JNJ it has improved from 87% to 79%in the year 2012-13 as compared to 2011-12.

- **Interest Coverage Ratio (ICR):** This is used for determining the company's ability to service its debt (Drake, 2007). The lower the ratio the higher the debt. A ratio under 1 indicates that the company may have problems with its cash flow affecting its ability to pay its interest expenses. The working of ICR is provided in Appendix-1. In case of JNJ the ICR is highly positive at 27.36 which is a good sign for potential investors.

4. Operation Performance Ratios

- **Sales / Revenue per Employee:** The average per revenue per employee (RPE) has improved by USD 30,000 (approximately). This RPE ratio has a limitation because of being industry category specific and can only be used in comparison with its peer. The working of this is provided in Appendix-1. It can be arrived at by using the formula: (Drake, 2007)

Revenue Per Employee = Revenue/Number of Employees

- **Operating Cycle:** This is also known as cash conversion cycle and has been analysed in the liquidity measurement ratio. But here it's analysed in the perspective of the company's management of capital assets. The operating cycle is measured as (Drake, 2007):

Operating Cycle=DIO+DSO+DPO

- DIO: Days Inventory Outstanding
- DSO: Days Sales Outstanding
- DPO: Days Payable Outstanding

The company' s DSO is 59 days as compared to its DPO of 99 days which means the company is efficiently collecting its accounts receivables. The working of this is provided in Appendix-1.

- **Fixed Asset Turnover:** This is a rough measure of the productivity of a company's fixed assets. The analysis of this ratio is more fruitful when compared with historical levels of the company as well as its comparison with other companies in the same industry.

  It can be calculated using the formula: (Drake, 2007)

Fixed Asset Turnover= Revenue/Property, Plant & Equipment

The Fixed Asset Turnover for JNJ has constantly been above 4. Between the years 2013 and 2012 a marginal increase of 0.9 is observed which can be considered to be good.

Working of the calculation is provided in Appendix-1.

2.2.3.5 Cash Flow Indicator Ratios

- **Short Term Debt Coverage Ratio (STDCR):** The short term debt coverage ratio compares the sum of the company's short term borrowings and the current portion of its long term debts to operating cash flow. It can be calculated using the formula:

Short Term Debt Coverage Ratio=Operating Cash Flow/Short Term Debt

The working of STDCR is provided in Appendix-1. The higher the ratio the more is the company's ability to service its short term debts from its operating cash flow. JNJ has a good STDCR of more than 3.

- **Dividend Payout Ratio (DPR):** The ratio represents the percentage of earnings (net income) per common share allocated to pay out cash dividends. This is an indicator of how well can the earnings bear the dividend (Libby et al, 2010). It can be calculated using the formula:

Dividend Payout Ratio=Dividends per Common Share/Earnings per Share

The working of DPR is provided along in Appendix-1. The investors of dividend paying stocks like to see a steady increase in the dividend pay-out ratio. The high DPR is however looked atsceptically. The DPR of JNJ in 2013 was 0.54 whilst it was 0.62 in 2012. Even though this shows a decrease in DPR value, the dip is not significant enough to affect the investor's decisions in a negative manner.

2.2.3.6 Investment Valuation Ratios

Investment Valuation Ratios are used whilst making decisions regarding the purchase of stocks. Our consideration in this report is to provide long term debt however these ratios have been calculated to give a bird's eye view of the company's stock trading in the market.

3. Findings

Fundamental analysis or financial analysis is the method of analyzing and evaluating equities, though it may also apply to any kind of security. A whole slew of data including, but not limited to, financial statements, economics, health, management, interest rates, production, earnings, competitive advantages, competitors and many other qualitative and quantitative factors are considered. The key information every investor would like to know as follows:

1. What is the company's revenue?
2. Is it a growing company?
3. Are they making a regular profits?
4. Are they in or paying off debt on time?
5. What are their turnover rates?
6. Is there any Agency problems?
7. Does management take care of employees and all their stakeholders?

All of this to determine a numerical intrinsic value for the security that can be compared with its current price to determine whether it is overvalued or undervalued. **Fundamental Analysis** is often mistakenly considered as a contrast of Technical Analysis. For exampleCashflow is an important measure of a business for investors because it is a way of determining a company's ability to pay dividends. This helps the investor to make investing decisions related to term of investment. The Cash conversion cycle for 2013 is 85.67 when compared to 2012 it is 7.5 points more. Which shows that the JNJ is following a clear and concrete credit policy. The table below clearly shows that 2013 is a better year for the investors.

Comparative Financial Analysis Statement for the period of 2012 and 2013:

Liquidity Measurement Ratios	**2013**		**2012**	
	Data/ Formula	Ratio	Data/ Formula	Ratio
Current Ratio	56407/25675	2.20	46117/24262	1.90
Quick Ratio	(56407-7878-3607-4003)/25675	1.59	(46116-7495-3139-3084)/24262	1.34
Cash Conversion Cycle	125.57+58.91-98.81	85.67	116.11+59.43-97.37	78.17

Profitability Ratios				
Gross Profit Ratio (%)	48970/71312*100	68.67	45666/67224*100	67.93
Net profit after tax ratio (%)	13831/71312	19.40	10853/67224	16.14
Return on Assets (%)	13831/((132683+121347))	5.44	10853/((121347+113644))	4.62
Return on Equity (%)	13831/(74053+64826)	9.96	10853/(64826+57080)	8.90
ROCE (%)	(16058/127015)*100	12.64	(14422/117495.5)*100	12.27
Debt Ratios				
Debt Equity Ratio (%)	58630/74053	79.17	56521/64826	87.19
Interest Coverage Ratio	16058/(482+105)	27.36	14422/(537+115)	22.12
Operation Performance Ratio				
Sales/ Revenue per employee	71312/128100	556690.09	67224/127600	526833.86
Operating Cycle	125.57+58.91-98.81	85.67	116.11+59.43-97.37	78.17
Fixed- Asset Turnover	71312/16710	4.27	67224/16097	4.18
Cash Flow Indicator Ratios				
Short Term Debt Coverage Ratio	17414/4852	3.59	15396/4676	3.29
Dividend Payout Ratio	2.59/4.81	0.54	2.40/3.86	0.62
Investment Valuation Ratios				
Price/ Book Value Ratio	103.21/23.73	4.35	103.21/20.77	4.97
Price/ Earnings Ratio	103.21/4.81	21.46	103.21/3.86	26.74
Price/ Sales Ratio	103.21/22.86	4.51	103.21/21.55	4.79
Dividend Yield (%)	2.59/103.21*100	2.51	2.4/103.21*100	2.33
Enterprise Value Method	291.08/20.162	14.44	291.08/18.088	16.09

4. Conclusion

On comparing the balance sheets of JNJ for the years 2013 and 2012,it is easy to observe that the company is making steady progress.

In 2013, five year compounded annual growth rates for worldwide, the United States and international sales was 2.3% and 4.6% respectively (Johnson & Johnson (2014c). The company has multiple revenue streams and has a wide consumer base. According to its 2013 annual report (Johnson & Johnson, 2014c) no single customer represented 10% or more of the total consolidated revenues indicating that it's not dependent on any one or a limited customer base. This also means that the company's revenues are not likely to experience a radical dip in case of any eventuality.

Whilst a growth of 1.7% was reported in the consumer segment, it was 10.9% in the pharmaceutical segment and 3.9% in the medical devices and diagnostics segment. The sale of the ortho-clinical diagnostics business for USD 4.15 billion (Johnson & Johnson, 2014c) will go a long way in strengthening its financial ratios. Exiting from an area which is not so profitable and is non-core for the company will help increase its concentration on core businesses. On an analysis of the various ratios, it can be concluded that the proposal for part financing its expansion can be considered. However, the impact of current litigations that the company is dealing with in its day-to-day business activities requires to be delved upon. Careful analysis of the underlying assumptions of prospects expected in the future is mandatory.

The financial ratios look promising about the capacity of the company to earn and repay the debts. However, the returns on assets ratio, which is at 5%, and returns on equity ratio at 10% cannot be considered as promising. The company has profitability and the capacity to tide over any crisis by its war chest of USD 20,927 million in cash (Johnson & Johnson, 2014c) and cash equivalents. It is important for the company to increase its return on assets ratio by efficiently employing its resources. After careful analysis of the above factors and ratios, a decision to make a short-term or long-term investment in JNJ can be made.

5. References

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Appendix-1: Financial Analysis of Balance Sheets (2013, 2012)

Market price per share as per closing price of 20.08.2014 (Source: http://www.marketwatch.com/investing/stock/jnj)

Enterprise Value as on 21.08.2014 Market Cap. (Source: . http://www.marketwatch.com/investing/stock/jnj)

Appendix-2: Horizontal Analysis of Balance Sheet (2013)

Variable	2013*	2012*	Variance
Sales to Customers	71312	67224	4088
Y to Y Growth	6.08		
Cost of Products Sold	22342	21658	684
Gross Profit	48970	45566	3404
Gross Profit Ratio	68.67	67.78	0.89
Selling Marketing & Admin Expenses	21830	20869	961
Research & Development Expenses	8183	7665	518
In-process Research & development	580	1163	-583
Interest Income	-74	-64	-10
Interest Expense net of portion capitalized	482	532	-50
Other (income) expenses net	2498	1626	872
Earning before provisions of taxes	15471	13775	1696
Net profit before tax Ratio	21.69	20.49	1.2
Provisions for taxes on income	1640	3261	-1621
Net Earnings	13831	10514	3317
Add: Net loss attributable to non controlling interest		339	-339
Net earnings attributable to J&J	13831	10853	2978
Net Profit after tax ratio	19.40	16.14	3.26

* Figures are in USD millions

Appendix-3: Vertical Analysis of Balance Sheet (2013)

Variable	2013*	Ratio
Sales to Customers	71312	
Cost of Products Sold	22342	31.32993
Gross Profit	48970	68.67007
Selling Marketing & Admin Expenses	21830	30.61196
Research & Development Expenses	8183	11.47493
In-process Research & development	580	0.813327
Interest Income	-74	------------
Interest Expense net of portion capitalized	482	0.675903
Other (income) expenses net	2498	3.502917
Earning before provisions of taxes	15471	21.69
Provisions for taxes on income	1640	10.60048
Net Earnings	13831	19.39505
Net earnings attributable to J&J	13831	19.39505

* Figures are in USD millions