**Abbott Laboratories**  ABT

**Abbott's new hepatitis C drugs offer growth potential when Humira faces potential generics.**

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**Analyst Note**

[Abbott Reports In Line 2Q Buoyed by Robust Humira Growth; Company Breakup Remains on Track](http://library.morningstar.com/stock/analyst-notes?id=560374)
by Damien Conover, CFA, 07-18-12

**Analyst Note** 07/18/12

Abbott [ABT](http://library.morningstar.com/service/Switch?t=ABT) reported second-quarter results that largely matched our expectations as well as consensus expectations and we don't expect any significant changes to our fair value estimate of $70 per share. On the top line, total sales increased 7% operationally versus the prior-year period as strong sales from nutritionals and immunology drug Humira posted solid gains. On the bottom line, earnings per share increased 10% year over year, outpacing sales growth as we believe cost-cutting drove higher gross margins. Also, Abbott reiterated its full-year 2012 earnings-per-share guidance range of $5.00-$5.10, which we expect the company to easily meet.

Sales growth in the quarter largely came in as expected with continued strong growth from nutritionals, Humira, and testosterone gel AndroGel. We continue to believe Humira will post double-digit growth over the next two years based on the drug's leading efficacy and safety profile, despite new competition likely from Pfizer's [PFE](http://library.morningstar.com/service/Switch?t=PFE) tofacitinib in August. We expect Pfizer's competing drug will initially target patients who don't respond to Humira or another anti-TNF alpha therapy.

Turning to earnings, Abbott continues to make solid strides in increasing its efficiency. Gross margins increased more than 300 basis points year over year, largely driven by improvements in the nutritional, diagnostic, and vascular businesses as well as changes in currency. However, we don't expect this trend to continue through 2013 because the near-term patent losses on high-margin cardiovascular drugs Tricor and Niaspan will likely weigh on profitability for the company. Offsetting some of the expected gross margin impact from the loss of these drugs is the likely cuts in variable spending around supporting the marketing of the drugs.

Regarding the split of the company into two separate firms, everything looks on track for the completion of the split by the end of the year. We expect more details on the structure of the balance sheet and in particular debt holdings of each of the new companies in the third quarter. With these expected disclosures, a more complete valuation perspective of the two new companies should be possible.

**Thesis** 02/16/12

On the foundation of a wide lineup of patent-protected drugs, a leading diagnostics business, a strong nutritional division, and a top-tier vascular group, Abbott Laboratories has dug a wide economic moat. We expect these operating lines will continue to generate strong returns and drive growth. Further, the company's decision to split itself into two is likely to result in two well-positioned companies (a drug company and a diversified health-care company) with strong competitive advantages.

Existing drugs and new pipeline products should propel long-term growth. Abbott's pharmaceutical division contains a diverse set of growing blockbusters across many therapy groups. Autoimmune agent Humira, HIV/AIDS drug Kaletra, and cardiovascular treatments Tricor and Trilipix lead the group with more than $8 billion in annual sales (27% of total sales). Humira continues to be the workhorse of the group with 21% growth in 2011, as new indications help propel the drug. The company's active research and development efforts are creating the next potential blockbusters with several hepatitis C drugs and kidney disease drug bardoxolone showing particularly strong clinical data.

Outside the pharmaceutical group, Abbott runs top-tier diagnostic and nutritional segments that generate more than 25% of total sales, helping to insulate the company from patent losses in the drug group. The diagnostic group is well positioned as disease therapy becomes more patient-specific.

Complementing the pharmaceutical, diagnostic, and nutritional segments, the firm's recently expanded vascular line is poised for rapid growth. Favorable clinical data on the company's new drug-coated stent Xience versus entrenched Boston Scientific [BSX](http://library.morningstar.com/service/Switch?t=BSX) stent Taxus has resulted in fast market uptake.

In addition to strong internal operating lines, Abbott has a successful record of acquisitions and partnerships. The favorable acquisitions of Knoll and Kos Pharmaceuticals brought in Humira and Niaspan along with pipeline products. The acquisition of Guidant's vascular business opened the door to a new operating segment and Xience, a drug-eluting stent superior to an in-house stent. Additionally, the recent acquisitions of Advanced Medical Optics and the drug units from Solvay and Piramal should add value over the long term. The strong record and ample cash flow raise our confidence that external growth opportunities will probably augment internal growth.

[**Valuation**](http://library.morningstar.com/stock/price-ratio?country=USA&t=ABT)

We are slightly increasing our fair value estimate to $70 from $68 per share based on our increased projections for the company's hepatitis C drugs. Base on recent clinical data, we have increased our sales projection for ABT-333, ABT-267, and ABT-450, which led to the increased fair value. Our new fair value estimate implies a 2012 price/earnings multiple of 14 times. The current forward-year industry price/earnings multiple is 10 times, and we believe Abbott's industry-leading growth continues to warrant a premium multiple valuation for the company. We incorporated the recent acquisition of Piramal's drug unit into our valuation model, but acquired sales largely offset the high purchase price. Humira represents the most important driver in Abbott's valuation--we project it contributes more than 20% to our estimate of the firm's total value. While competing drugs lurk in the near future, we expect Humira to post double-digit annual growth during the next several years. Overall, during the next five years, we project 6% average annual sales growth, led by Humira, Xience, and acquisitions. During the same period, we project slightly increasing operating margins, as cost-containment initiatives offset patent losses on high-margin drugs. We estimate a 9% cost of equity and a similar weighted average cost of capital, which reflect the secure and robust cash flows derived from diverse operations.

**Risk**

While Abbott maintains diverse operations, it depends heavily on Humira and Xience for future growth. Further, the company's pipeline isn't as large as those of rivals, making any failures with late-stage candidates very costly. Also, the company faces typical industry risks including drug delays or nonapprovals, as well as an increasingly aggressive generic and managed-care industry.

**Management & Stewardship**

Miles White took the helm as CEO in 1998 and chairman of the board the following year. His tenure with the company dating back to 1984 provides the experience needed in handling the many operating lines of the company. Under his leadership, the company executed several value-enhancing acquisitions. After the split, White will continue as the CEO of the diversified company, and longtime Abbott executive Richard Gonzalez will take the CEO spot at the pharmaceutical-focused firms. We believe both executives have strong records that bode well for future leadership.

Overall, the company promotes solid stewardship. We like the policy of cumulative voting rights in the election of directors, as this gives more clout to minority shareholders. Compensation for top executives is well balanced between cash and equity and in line with industry practices. However, we would like the company to take a page from the major European pharmaceutical companies and split the roles of CEO and chairman.

**Overview**

[**Financial Health**](http://library.morningstar.com/stock/income-statement?country=USA&t=ABT)**:** Thanks to its acquisitions, Abbott holds less cash than its peers. However, Abbott's robust and relatively stable cash flows should easily meet interest expenses with ample reserves left for share repurchases, increases to dividends, and small acquisitions.

**Profile:** Abbott manufactures and markets pharmaceuticals, medical devices, blood glucose monitoring kits, and nutritional health-care products. Products include prescription drugs, coronary and carotid stents, and nutritional liquids for infants and adults. Following the Advanced Medical Optics acquisition, Abbott also markets eye-care products. Abbott generates slightly less than 60% of revenue from pharmaceuticals.

S&P 500 index data: S&P 500 Copyright @ 2012

**Morningstar's Take**

ABT

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| **Price**02-16-2012 | **Fair Value Estimate** | **Uncertainty** |
| 55.85 USD | 70.00 USD | Low |
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| **Consider Buy** | **Consider Sell** | **Economic Moat** |
| 56.00 USD | 87.50 USD | Wide |
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| **Morningstar Credit Rating** | **Stewardship Rating** |
|  |  | NA  |
| **Stewardship Rating** |
| NA |  |  |
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| **Bulls Say** |
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| • | Strong clinical data on safety and efficacy give Abbott's stent Xience a leg up in the drug-eluting stent market. |
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| • | Aggressive cost-cutting plans should propel Abbott's bottom-line growth much quicker than top-line growth. |
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| • | International markets and indications in Crohn's disease and psoriasis for Humira should further propel sales growth for the company's leading pharmaceutical product. |
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| • | The recent acquisition of Piramal's drug unit increases Abbott's exposure to the rapidly growing Indian market. |
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| • | The decision to split the company into two could increase the transparency of each unit, which could help investors see the value in the different operations. |
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| **Bears Say** |
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| • | Splitting the company into two could create distractions for management as well as reverse cost synergies such as increasing duplicative areas of operations. |
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| • | Lack of robust internal development casts a shadow on the company's ability to create blockbusters in-house. |
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| • | Clinical data on drug-eluting stents have recently presented unclear benefits versus bare-metal stents and other treatments. Stent operations and use of drug-eluting stents could fall without supportive new data. |
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| • | To prepare for more tuck-in acquisitions, Abbott is probably going to add cash to its balance sheet rather than pursue aggressive share buybacks. The investment community could react negatively toward decisions in favor of acquisitions over returning cash to shareholders via share repurchases. |
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| • | Pfizer's JAK-3 inhibitor for rheumatoid arthritis has shown strong efficacy in Phase III trials relative to Humira. If the drug holds up well in late-stage trials, it could take significant market share from Humira based on the drug's oral dosing. Also, Roche's RA drug Actemra is poised to reported head-to-head data versus Humira in late 2011 or early 2012. Strong Actemra data could translate into Humira market share losses. |
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| Name | Price | % Chg |   | TTM Sales$ mil |
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| Abbott Laboratories | $66.11 | 0.59 |  | 39,458  |
| [Johnson & Johnson](http://library.morningstar.com/stock/quote?t=JNJ) | $68.64 | 0.47 |  | 64,874  |
| [Pfizer Inc](http://library.morningstar.com/stock/quote?t=PFE) | $23.94 | 0.29 |  | 64,858  |
| [Baxter International Inc.](http://library.morningstar.com/stock/quote?t=BAX) | $58.84 | 0.10 |  | 14,033  |

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