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Abbott Laboratories ABT |

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We see opportunities for Abbott to increase profitability.



by [Debbie S. Wang](#)

Thesis 01/08/13

New Abbott faces the task of whipping a flabby company into shape. After removing the contributions of AbbVie, we now have a clearer picture of how profitable the remaining segments--nutritionals, devices, diagnostics, and established pharmaceuticals--really are. The picture is not pretty. Even though Abbott competes in businesses that are characterized by attractive margins, it appears to lag key rivals on profitability measures.

Abbott's cost structure reflects a poor combination of its individual segments. For example, Abbott's consolidated gross margin around 54% is comparable with Roche's [RHHBY](#) gross margin in diagnostics--one of the

lower-margin businesses in Roche's portfolio--despite significant contributions from coronary stents and pediatric nutritionals, where competitive gross margin is 60%-65%. On the other hand, new Abbott's consolidated operating expenses are on par with those of medical devices and nutritionals, which must typically spend more on sales and marketing than the diagnostic segment. While it is not clear to us why these Abbott segments have generated such dismal margins, we suspect Humira's success may have covered a multitude of sins in the other divisions. We are heartened to see that Abbott has already taken some steps to improve efficiency, including streamlining its distribution channels and building facilities in lower-cost locations like China and India. Management has already committed to raising margins in the nutritionals business by at least 500 basis points by the end of 2015. We think this emphasis on margin improvement should pay off over the next five years.

We think the nutritional business is one of the moatiest parts of new Abbott, where it wields a leadership position in this highly consolidated market that is estimated to be \$35 billion worldwide. Aside from strength in developed markets, the firm faces brighter growth prospects in emerging markets, where the growth of middle-class families has spurred demand for pediatric and adult nutrition products. Thanks to the strong Similac and Ensure brands, Abbott is in an advantageous position to introduce new formulations, line extensions, and penetrate new markets. We also note that Abbott made substantial investments early on to build out its infrastructure in emerging markets. The firm should reap the rewards of this investment as it expands the nutritional business.

These building blocks and experience with nutritionals should also play out well when applied to Abbott's established pharmaceutical product segment, which is mainly sold outside the United States. This business, frequently called branded generics, operates more like a consumer business than traditional branded drugs. For example, Abbott's

Morningstar's Take ABT

Price 01-08-2013	Fair Value Estimate	Uncertainty
33.35 USD	34.00 USD	Low

Consider Buy	Consider Sell	Economic Moat
27.20 USD	42.50 USD	Narrow

Stewardship Rating
Standard

Bulls Say

- Abbott's Xience stent remains a powerhouse in the drug-eluting stent market, thanks to its well-established record of safety and efficacy.
- Aggressive cost-cutting plans should propel Abbott's bottom-line growth much quicker than top-line growth.
- Abbott's investments in building out its emerging-markets infrastructure should give the firm a head-start in penetrating those geographies.
- Abbott enjoys the benefits of its extensive roster of well-known, reputable nutritional brands.

Bears Say

- Clinical data on drug-eluting stents and alternative therapies have put a crimp in percutaneous coronary procedures, as medical therapy and coronary bypass have gained favor.
- Abbott faces an uphill battle in the diagnostics arena where it must go head-to-head against market leader Roche, along with energetic upstarts like Qiagen and Hologic.
- Considering the heterogeneity involved in mitral valve disease, we are skeptical MitraClip will move beyond niche use for certain inoperable patients.
- Abbott's nutritional segment is unlikely to see much growth in the developed markets.

Competitors ABT

More...

Name	Price	% Chg	TTM Sales \$ mil
Abbott Laboratories	\$32.74	-0.85	39,414
Johnson & Johnson	\$72.53	0.22	65,921
Boston Scientific, Inc.	\$6.47	-0.69	7,276
Mead Johnson Nutrition Company	\$67.25	-2.87	3,832
C.R. Bard, Inc.	\$101.92	-0.08	2,947

branded generics will mainly be sold in less developed markets that often lack a well-developed infrastructure for distribution. Instead, Abbott must sell its products directly to pharmacy chains and physicians. As a result, brand recognition and reputation are key factors that Abbott can leverage. Selling to a fragmented market also translates into less pricing pressure for Abbott. This could change over the longer term once more emerging markets turn to the tender system that characterizes developed nations. However, that change remains far off.

We think Abbott can tread water with its device segment, but the jury is still out on its ability to innovate in this area. Abbott has demonstrated its competence at launching next-generation products that are the lifeblood of the device business, but we are less enthusiastic about its attempts at greater leaps of innovation. For example, Abbott recently obtained Food and Drug Administration clearance for its Xience Xpedition stent. Considering the quick product cycles and relatively high interchangeability of various drug-coated stents, it is critical for Abbott to continue rolling out next-generation stents on time to ward off price declines and defend its leadership position in coronary stents. We are confident that Abbott can keep the next-generation products rolling in vascular and diabetes (mainly glucose monitors and test strips).

On the other hand, we are skeptical about the ABSORB resorbable stent and MitraClip for mitral valve regurgitation. Although management has touted these products as examples of Abbott's innovation, we think they have limited potential through the midterm. After nearly selling its diagnostics division to General Electric GE in 2007, Abbott turned around and decided to invest in the business again. As a result, the firm has been able to maintain a substantial presence in the immunoassay segment, but it has yet to make significant inroads in the growing molecular diagnostics market. While we are confident that Abbott can defend its position in the core diagnostics category, we think it faces an uphill battle in the molecular realm.

Valuation

We have pegged new Abbott's valuation at \$34 per share. We assume the firm will increase revenue at an average of 4.8% annually through 2016, fueled by strength in pediatric nutrition, adult nutrition outside the U.S., molecular diagnostics, and vascular sales. Importantly, we see much potential to improve the profitability of Abbott's remaining businesses, and this turns out to be the key factor in our valuation. On a consolidated basis, Abbott's gross margin significantly trails that of its key competitors in various business segments. The good news is that Abbott competes in several markets that offer relatively high margins, including nutritionals, branded generic drugs, and cardiovascular devices. Additionally, Abbott has already begun efforts to improve productivity and efficiency, as it streamlines distribution channels and builds new facilities in lower-cost locations like China and India. We expect Abbott can partially close that gross margin gap and project 500 basis points of improvement over the next four years. While this would still leave Abbott's profitability lagging key rivals in various business segments, it would offer a substantial boost to Abbott's gross profit that could drop to the bottom line. We do not expect much reduction of selling and marketing expenses because the firm will need to maintain and enhance the distribution infrastructure it has built out for penetration of emerging markets for its nutritionals and established pharma products, in particular. Additionally, Abbott will need to fortify its salesforce for the device business, which is usually a relatively expensive proposition, and investment in advertising and merchandising is also key to the nutritional segment.

Risk

Like any company involved with medical technology, Abbott is vulnerable to the threat of revolutionary innovation from competitors. This is particularly an issue with

its medical devices and diagnostic business. Product quality issues or recalls could damage the firm's brands and its relationships with medical professionals. With hospital customers and payers tightening purse strings, Abbott could see greater pricing pressure. Finally, Abbott operates under the scrutiny of the FDA (as well as other regulatory agencies overseas), which can lead to delays in product approvals or production.

Management & Stewardship

Overall, we rate Abbott's stewardship as standard. While the company has made some impressive acquisitions over the past decade, including Knoll, which was purchased for \$6.9 billion in 2001 and brought in Humira, several of the more recent acquisitions, such as Advanced Medical Optics and Piramal, remain promising but have yet to fully match up to the purchase prices. Now that proprietary pharma products have been spun off, we hope management's new focus on the remaining businesses will result in greater efficiency and profitability. We'll be watching carefully to see if Abbott is able to realize the potential of the acquisitions it has made.

Miles White took the helm as CEO in 1998 and chairman of the board the following year. His tenure with Abbott dating back to 1984 provides the experience needed in handling the many operating lines of the company. We find it somewhat worrisome that White allowed the non-AbbVie related businesses to become flabby on his watch, and we will be looking for evidence that he is improving the efficiency of operations in 2013. The 11-member board is heavily weighted toward independents and former executives of other publicly traded firms in the Chicago area. There's room for improvement in compensation policies--moving away from benchmarks involving adjusted earnings per share and EBIT to other measures focused on return on invested capital.

Overview

Financial Health: Now that Abbott has spun off its proprietary pharmaceutical business, the firm received proceeds that were largely used to tender debt. It is now sitting on approximately \$2 billion in net debt, leading to financial leverage that is manageable at 1.9. Abbott's 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 medical devices, blood glucose monitoring kits, nutritional health-care products, diagnostic products and equipment, and branded generic drugs. Products include coronary stents, catheters, infant formula, nutritional liquids for adults, vessel closure devices, and LASIK equipment. Abbott derives approximately 60% of sales outside the United States.

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