We see opportunities for Abbott to increase profitability.

**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--nutritional, 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 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 nutritional, 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 most attractive parts of new Abbott, where it yields 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 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 nutritional 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...
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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