Abbott Laboratories ABT

Abbott has taken steps toward improving profitability.

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Morningstar's Editorial Policies

Analyst Note 07/17/13

Abbott Laboratories ABT reported solid second-quarter performance that underscored the strength of its presence in emerging markets, where robust growth continues. While second-quarter results have not spurred us to change our projections for the rest of this year or 2014, we have increased our fair value estimate to $40 per share, which was primarily driven by our lower cost of equity assumption. Considering the breadth of new Abbott's remaining businesses, the steadiness of the firm's presence in those markets and its relative resistance to system risk, we think the lower cost of equity is appropriate for this narrow-moat company. Reductions in share count and time value of money also contributed to our new valuation.

With total quarterly revenue growth clocking in at 4.2% in constant currency, Abbott was able to offset weakness in the United States with solid growth in international markets. Importantly, we note that emerging-market sales accounted for 42% of Abbott's total second-quarter revenue, which puts the firm in a good position to benefit from the double-digit growth in those geographies. Abbott's relatively early entry into emerging markets now make it an object of envy, as other medical device companies—such as Stryker and St. Jude—seek to build out footprints in those markets.

Similar to the pattern we saw last quarter, strong growth in Abbott's nutritional and diagnostic segments compensated for lackluster results in branded pharmaceuticals and medical devices. We were heartened to see that operating margin gains in the first quarter seem to have held up through the second quarter. We still think there is plenty of room for improvement on this measure and will be looking for steady gains going forward. We were disappointed to see second-quarter gross margin fall by approximately 200 basis points year over year. However, lower selling, general, and administrative costs more than offset the rise in manufacturing.

Investment Thesis 07/17/13

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

Morningstar's Take ABT

Analyst

Price 08-09-2013	**Fair Value Estimate**	**Uncertainty**
35.89 USD	40.00 USD	Low
Consider Buy	**Consider Sell**	**Economic Moat**
32.00 USD	50.00 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.

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.

Competitors ABT

More...

Name	Price	% Chg	TTM Sales $ mil
Abbott Laboratories	**$35.89**	**-0.08**	**40,101**
Medtronic, Inc.	$55.37	-0.91	16,590
Stryker Corporation	$71.01	0.16	8,792
Boston Scientific, Inc.	$11.35	0.26	7,125
St Jude Medical, Inc.	$53.85	0.88	5,446
Zimmer Holdings Inc	$82.57	-0.86	4,514

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 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 Adminstration 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.

Economic Moat 07/17/13

After stripping out Humira's patent protection, AbbVie's pipeline, and the difficulty of replicating biologics, we have downgraded Abbott to a narrow Morningstar Economic Moat Rating. In most cases, Abbott is one of three or four competitors that dominate the market, including nutritionals, glucose monitors, coronary stents, and immunoassays. In these markets, Abbott enjoys the benefits of efficient scale and participates in rational oligopolies. Additionally, Abbott's Similac, Ensure, and various drug brands are also competitive advantages in the nutritional and overseas branded generic drug markets. Finally, Abbott relies on intellectual property to ward off competitors in the device and diagnostic segments. After examining each of Abbott's four businesses, we think the firm has earned a narrow moat in each of the segments, which translates to a narrow moat for the entire company.

Valuation 07/17/13

We have have raised Abbott's fair value estimate to $40 per share from $34. The boost was primarily driven by the lower 8% cost of equity that we think better reflects the stability and breadth of Abbott's businesses. Time value of money and reduced shares outstanding were also peripheral factors. We assume the firm will increase revenue at an average of 4.2% annually through 2017, 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 640 basis points of improvement over the next five 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 believe the firm is limited in how much it can cut selling and marketing expenses because Abbott 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 07/17/13

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 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 U.S. Food and Drug Administration (as well as regulatory agencies overseas), which can lead to delays in product approvals or production.

Management 07/17/13

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

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.