

Seeking Alpha <sup>α</sup>

## A Final Look At Combined Abbott Before The Split

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by: Valuentum

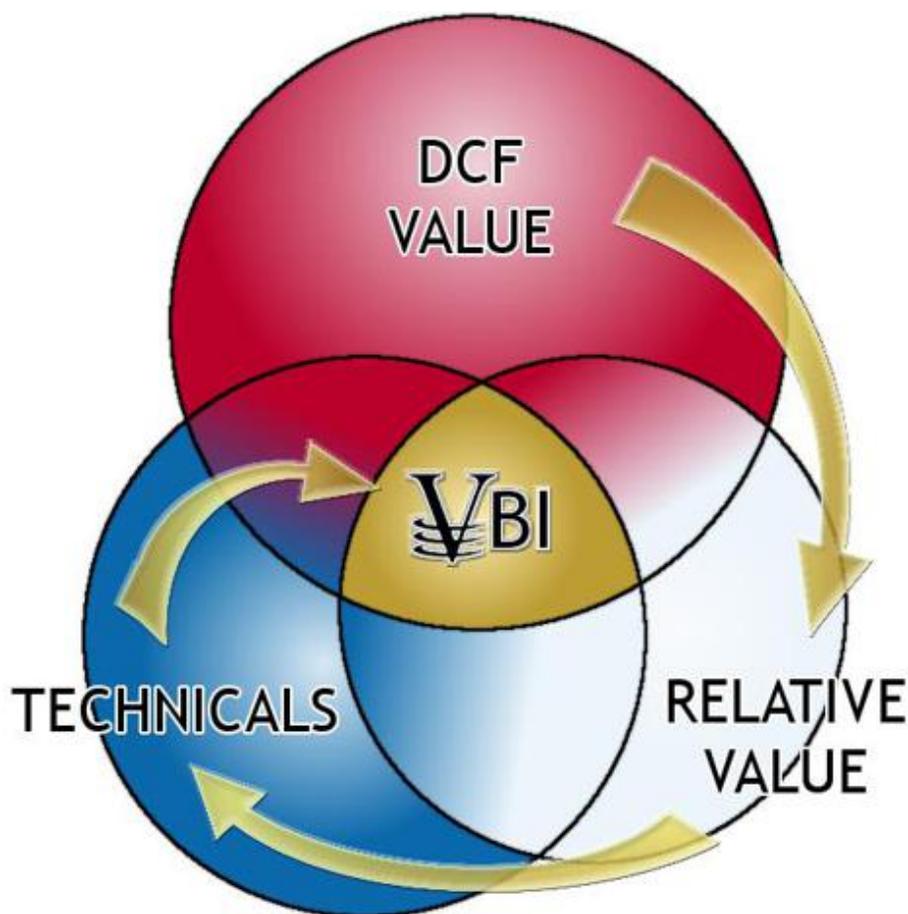
| about: [ABT](#)

**Disclosure:** I have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours. Some of the firms above may be included in the portfolio of our Best Ideas Newsletter. **(More...)**

As part of our process, we perform a rigorous discounted cash-flow methodology that dives into the true intrinsic worth of companies. In the combined Abbott's ([ABT](#)) case, we think the firm is fairly valued at \$76, higher than where it is currently trading.

At [Valuentum](#), we think a comprehensive analysis of a firm's discounted cash-flow valuation, relative valuation versus industry peers, as well as an assessment of technical and momentum indicators is the best way to identify the most attractive stocks at the best time to buy. This process culminates in what we call our Valuentum Buying Index, which ranks stocks on a scale from one to 10, with 10 being the best. Essentially, we're looking for firms that overlap investment methodologies, thereby revealing the greatest interest by investors (we like firms that fall in the center of the diagram below). We like stocks that score nine or 10 on our scale.

*Click to enlarge images.*



If a company is undervalued both on a DCF and on a relative valuation basis and is showing improvement in technical and momentum indicators, it scores high on our scale. Abbott Laboratories posts a VBI score of four on our scale, reflecting our "fairly valued" DCF assessment of the firm, its attractive relative valuation versus peers, and very bearish technicals. We compare Abbott to peers Eli Lilly ([LLY](#)), Merck ([MRK](#)), and Pfizer ([PFE](#)).

## Our Report on Abbott Laboratories

Abbott Laboratories ABT		FAIRLY VALUED		Buying Index™ 4		Value Rating 	
Last Close	Estimated Fair Value	Fair Value Range	Investment Style	Sector	Industry		
\$66.15	\$76.00	\$61.00 - \$91.00	LARGE-CAP VALUE	Health Care	Pharmaceuticals		

## About Abbott

Abbott is a healthcare company that is dedicated to discovering new medicines/therapies and new and innovative ways to manage health. The firm's product lineup spans the continuum of care, from nutritional products through pharmaceutical therapies.

## Investment Considerations

Investment Considerations	
DCF Valuation	<b>FAIRLY VALUED</b>
Relative Valuation	<b>ATTRACTIVE</b>
ValueCreation™	<b>EXCELLENT</b>
ValueRisk™	<b>LOW</b>
ValueTrend™	<b>NEGATIVE</b>
Cash Flow Generation	<b>STRONG</b>
Financial Leverage	<b>MEDIUM</b>
Growth	<b>MODEST</b>
Technical Evaluation	<b>VERY BEARISH</b>
Relative Strength	<b>NEUTRAL</b>
Money Flow Index (MFI)	<b>NEUTRAL</b>
Upside/Downside Volume (U/D)	<b>BEARISH</b>
Near-term Technical Resistance, 10-wk MA	<b>68.00</b>
DCF = Discounted Cash Flow; MFI, U/D = Please see glossary. MA = Moving Average	

## Investment Highlights

- Abbott Laboratories' business quality (an evaluation of our ValueCreation™ and ValueRisk™ ratings) ranks among the best of the firms in our coverage universe. The firm has been generating economic value for shareholders with relatively stable operating results for the past few years, a combination we view very positively.
- The firm is trading at attractive valuation multiples relative to peers, but our DCF process indicates a less compelling opportunity. We'd wait for a clearer signal on valuation before jumping into the firm's shares.
- Abbott Laboratories has a good combination of strong free cash flow generation and manageable financial leverage. We expect the firm's free cash flow margin to average about 22.8% in coming years. Total debt-to-EBITDA was 1.6 last year, while debt-to-book capitalization stood at 38.7%.
- The firm's proprietary pharmaceuticals segment will become AbbVie on Jan. 1, and we think powerful sales from Humira (under patent protection until 2016) and AndroGel (protected until 2021) will provide the firm with plenty of cash to invest in its pipeline when it becomes a standalone business.
- The new Abbott, also to be formed Jan. 1, will have some strong businesses of its own. For example, the nutritional segment is home to some well-known brand names such as EAS, Myoplex and ZonePerfect.

## Business Quality

Business Quality ValueRisk™	ValueCreation™			
	Very Poor	Poor	Good	Excellent
Low				
Medium				
High				
Very High				

Firms that generate economic profits with little operating variability score near the top right of the matrix.

Relative Valuation	Forward P/E	PEG	Price / FV
Eli Lilly	15.4	1.9	105.7%
Merck	12.2	2.6	127.1%
Bristol-Myers Squibb	17.2	3.5	112.7%
Pfizer	11.5	1.6	85.9%
Peer Median	13.8	2.3	109.2%
<b>Abbott Laboratories</b>	<b>13.0</b>	<b>1.5</b>	<b>87.0%</b>

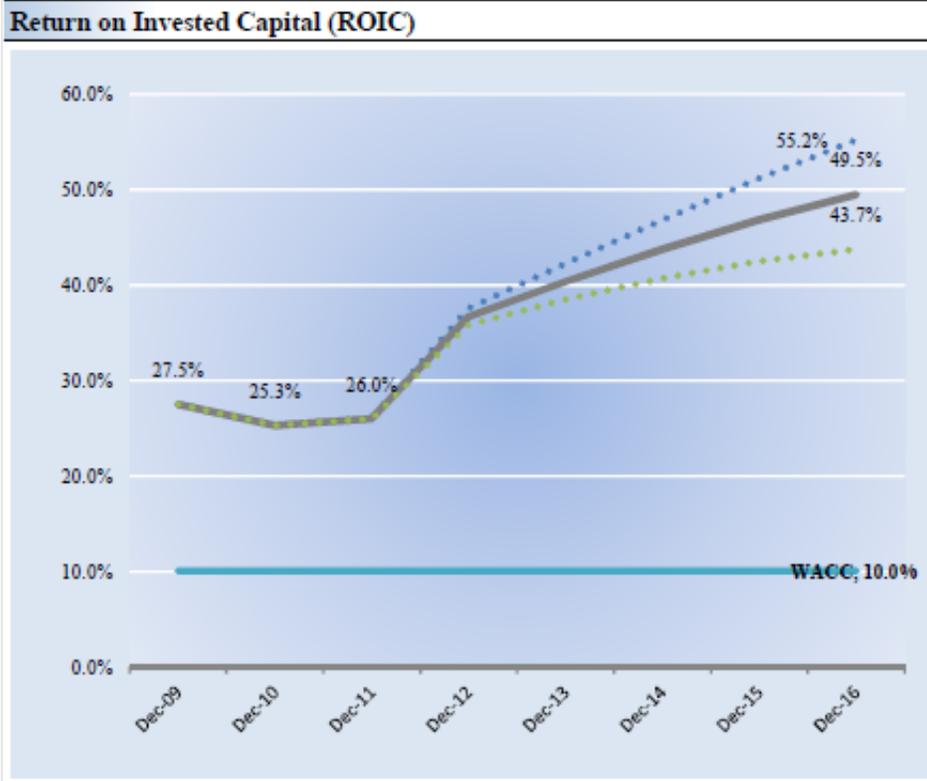
Price / FV = Current Stock Price divided by Estimated Fair Value

Financial Summary	----- Actual -----		Projected	
	Fiscal Year End:	Dec-10	Dec-11	Dec-12
Revenue		35,167	38,851	40,017
Revenue, YoY%		14.3%	10.5%	3.0%
Operating Income		6,088	6,424	9,963
Operating Margin %		17.3%	16.5%	24.9%
Net Income		4,626	5,401	8,037
Net Income Margin %		13.2%	13.9%	20.1%
Diluted EPS		2.97	3.45	5.09
Diluted EPS, YoY %		-22.3%	15.9%	47.7%
Free Cash Flow (CFO-capex)		7,721	8,151	9,093
Free Cash Flow Margin %		22.0%	21.0%	22.7%

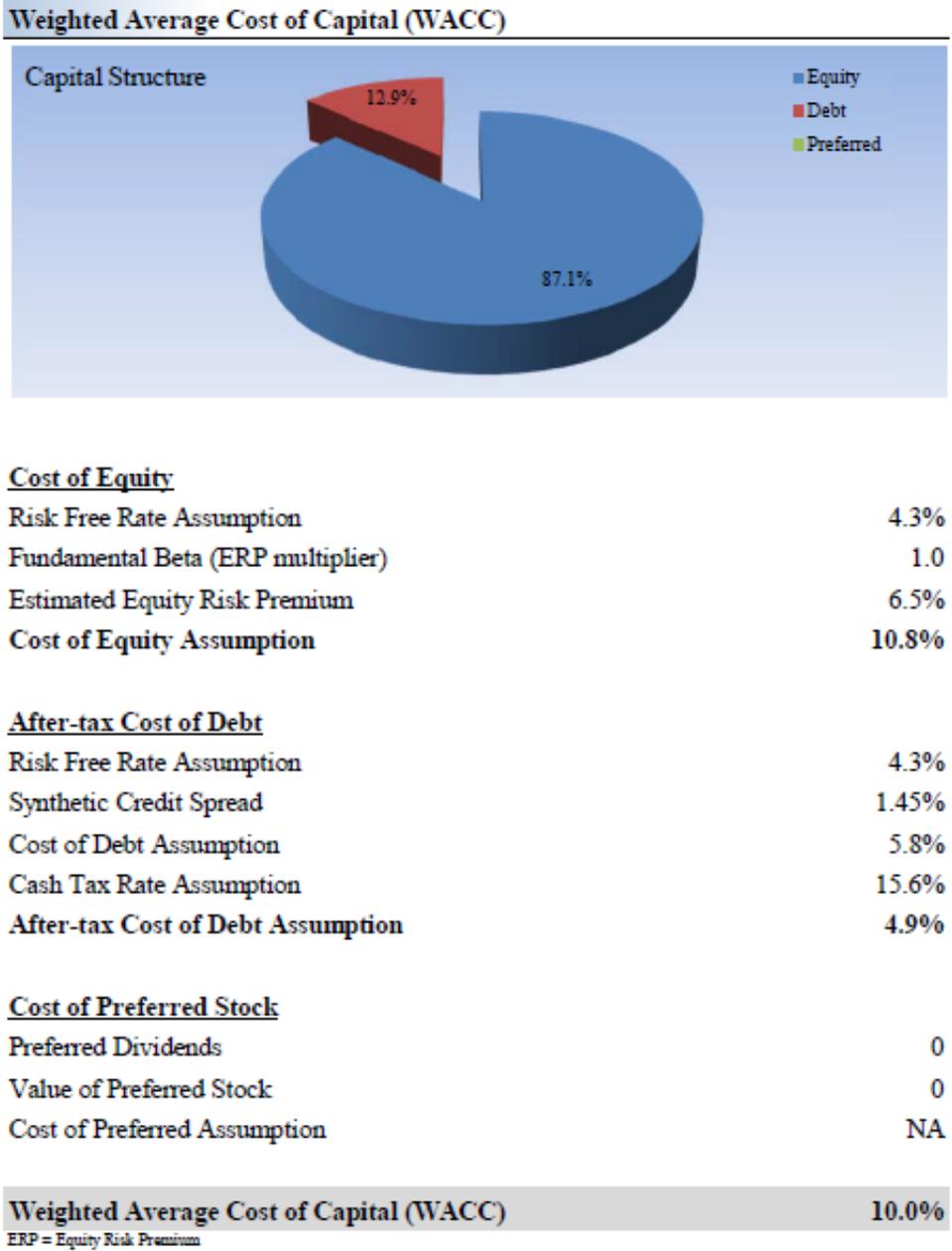
In Millions of USD (except for per share items)

## Economic Profit Analysis

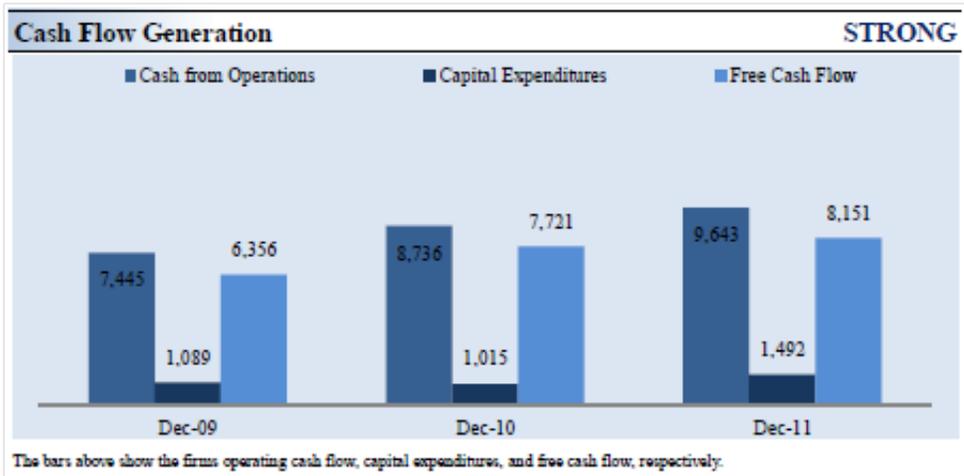
The best measure of a firm's ability to create value for shareholders is expressed by comparing its return on invested capital (ROIC) with its weighted average cost of capital (WACC). The gap or difference between ROIC and WACC is called the firm's economic profit spread. Abbott Laboratories' three-year historical return on invested capital (without goodwill) is 26.3%, which is above the estimate of its cost of capital of 10%. As such, we assign the firm a ValueCreation™ rating of Excellent. In the chart below, we show the probable path of ROIC in the years ahead based on the estimated volatility of key drivers behind the measure. The solid grey line reflects the most likely outcome, in our opinion, and represents the scenario that results in our fair value estimate.



The graph above shows the firm's ROIC (excluding goodwill) compared with historical averages and its WACC.



### Cash Flow Analysis



Firms that generate a free cash flow margin (free cash flow divided by total revenue) above 5% are usually considered cash cows. Abbott Laboratories' free cash flow margin has averaged about 21.2% during the past three years. As such, we think the firm's cash flow generation is relatively strong. The free cash flow measure shown above is derived by taking cash flow from operations less capital expenditures and differs from enterprise free cash flow (FCFF), which we use in deriving our fair value estimate for the company. (For more information on the differences between these two measures, please visit our website at [Valuentum.com](http://Valuentum.com).) At Abbott Laboratories, cash flow from operations increased about 30% from levels registered two years ago, while capital expenditures expanded about 37% over the same time period.

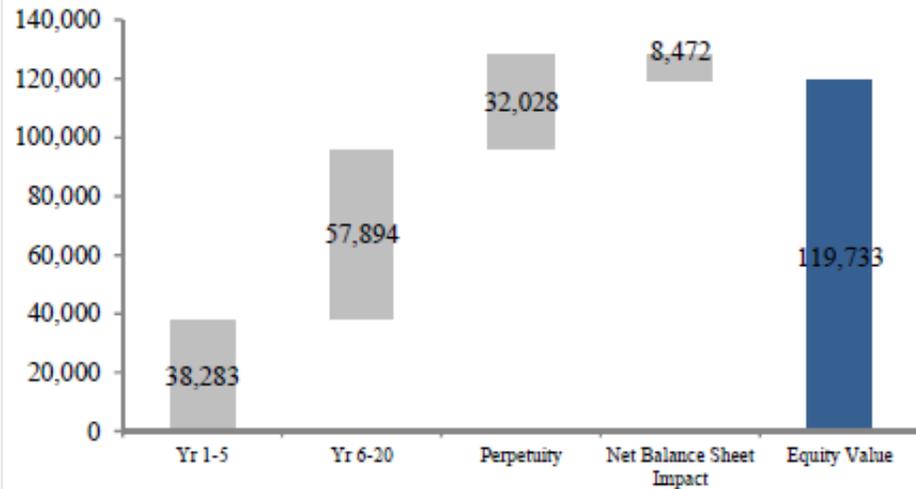
## Valuation Analysis

Our discounted cash flow model indicates that Abbott Laboratories' shares are worth between \$61.00 and \$91.00 each. The margin of safety around our fair value estimate is driven by the firm's low ValueRisk™ rating, which is derived from the historical volatility of key valuation drivers. The estimated fair value of \$76 per share represents a price-to-earnings (P/E) ratio of about 22.1 times last year's earnings and an implied EV/EBITDA multiple of about 13.5 times last year's EBITDA. Our model reflects a compound annual revenue growth rate of 3.4% during the next five years, a pace that is lower than the firm's three-year historical compound annual growth rate of 9.6%. Our model reflects a five-year projected average operating margin of 26.2%, which is above Abbott Laboratories' trailing three-year average. Beyond year five, we assume free cash flow will grow at an annual rate of 2.1% for the next 15 years and 3% in perpetuity. For Abbott Laboratories, we use a 10% weighted average cost of capital to discount future free cash flows.

<b>Valuation Assumptions</b>		
In Millions of USD (except for per share items)	<u>5-year Projections</u>	
Revenue CAGR %	3.4%	
Avg. EBIT Margin %	26.2%	
Avg. Cash Tax Rate %	15.6%	
Earnings Before Interest CAGR %	10.5%	
Earnings Per Share CAGR %	12.8%	
Free Cash Flow to the Firm CAGR %	3.3%	
<i>Earnings before interest = Net operating profits less adjusted taxes</i>		
	<u>Long-term Projections</u>	
Phase II --> III FCFF CAGR %	2.1% (II)	3% (III)
Cost of Equity %	10.8%	
After-tax Cost of Debt %	4.9%	
Discount Rate (WACC) %	10.0%	
<i>Synthetic credit spread = 1.453%</i>		
	<u>Results</u>	
Phase I Present Value	38,283	
Phase II Present Value	57,894	
Phase III Present Value	32,028	
Total Firm Value	128,205	
Net Balance Sheet Impact	-8,472	
Total Equity Value	119,733	
Diluted Shares Outstanding	1,567.4	
Fair Value per Share	\$76.00	

### Valuation Breakdown

In the chart below, we show the build up to our estimate of total enterprise value for Abbott Laboratories and the break down to the firm's total equity value, which we estimate to be about 119.73USD billion. The present value of the enterprise free cash flows generated during each phase of our model and the net balance sheet impact, which considers the firm's pension, is displayed. We divide total equity value by diluted shares outstanding to arrive at our \$76 per share fair value estimate.



In addition to the firm's cap structure, the net balance sheet impact considers the funded status of the firm's pension (-1155). In Millions of USD

Source: Company Filings, Valuation Projections

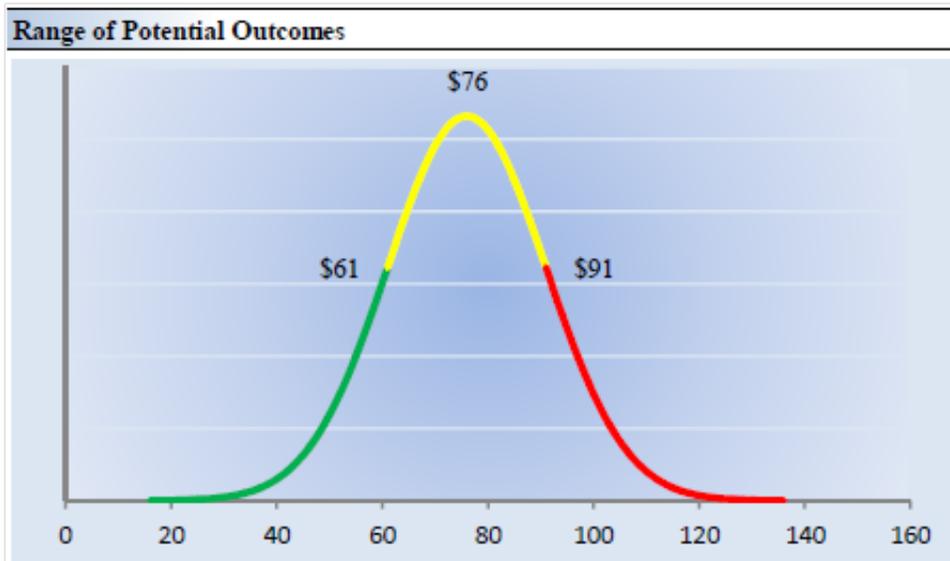
#### Company Metrics versus Peer and Industry Medians

Company Name	Valuation Buying Index™	Forward Price-to-Earnings	PE on Est. Normal Diluted EPS	Price Earnings-to-Growth (PEG), 5-Yr	Forward EV/EBITDA	EV/Est. Normal EBITDA	5-year Forward Earnings per Share CAGR	3-year Hist Avg ROIC, without goodwill	Dividend Yield %	Stock Price / Fair Value Estimate
Abbott Laboratories	4	13.9	11.6	1.8	8.5	7.6	12.8%	26.2%	3.2%	87.6%
Eli Lilly	5	15.4	13.3	1.9	9.5	8.3	9.7%	44.9%	3.7%	105.7%
Merck	6	12.2	13.5	2.6	8.1	8.7	8.8%	9.5%	3.8%	127.1%
Bristol-Myers Squibb	6	17.2	16.3	3.5	7.6	7.5	1.9%	-7.1%	4.0%	112.7%
Pfizer	7	11.5	11.4	1.6	7.3	7.0	14.4%	19.0%	3.4%	85.9%
Peer Median	6.0	13.8	11.4	2.3	7.8	7.9	5.2%	9.8%	3.8%	109.2%
Industry Median	5.5	12.4	12.4	1.6	7.7	7.4	14.3%	23.9%	0.1%	86.9%

View back of report for a full list of industry companies covered by Valuation VMI. Valuation's ranking for the attractiveness of this investment at the date of the report.

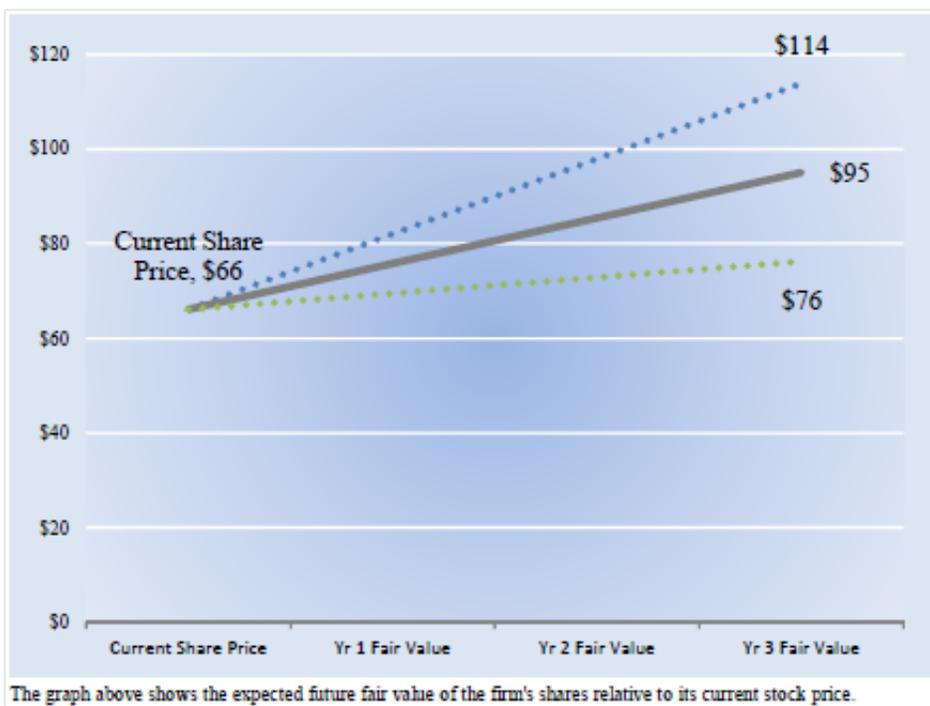
### Margin of Safety Analysis

Our discounted cash flow process values each firm on the basis of the present value of all future free cash flows. Although we estimate the firm's fair value at about \$76 per share, every company has a range of probable fair values that's created by the uncertainty of key valuation drivers (like future revenue or earnings, for example). After all, if the future was known with certainty, we wouldn't see much volatility in the markets as stocks would trade precisely at their known fair values. Our ValueRisk™ rating sets the margin of safety or the fair value range we assign to each stock. In the graph below, we show this probable range of fair values for Abbott Laboratories. We think the firm is attractive below \$61 per share (the green line), but quite expensive above \$91 per share (the red line). The prices that fall along the yellow line, which includes our fair value estimate, represent a reasonable valuation for the firm, in our opinion.



**Future Path of Fair Value**

We estimate Abbott Laboratories' fair value at this point in time to be about \$76 per share. As time passes, however, companies generate cash flow and pay out cash to shareholders in the form of dividends. The chart below compares the firm's current share price with the path of Abbott Laboratories' expected equity value per share over the next three years, assuming our long-term projections prove accurate. The range between the resulting downside fair value and upside fair value in year three represents our best estimate of the value of the firm's shares three years hence. This range of potential outcomes is also subject to change over time, should our views on the firm's future cash flow potential change. The expected fair value of \$95 per share in year three represents our existing fair value per share of \$76 increased at an annual rate of the firm's cost of equity less its dividend yield. The upside and downside ranges are derived in the same way, but from the upper and lower bounds of our fair value estimate range.



The graph above shows the expected future fair value of the firm's shares relative to its current stock price.

**Pro Forma Financial Statements**

Pro Forma Income Statement	Historical			Projected	
	Dec-09	Dec-10	Dec-11	Dec-12	Dec-13
In Millions of USD (except for per share items)					
Total Revenue	30,765	35,167	38,851	40,017	41,617
Cost of Goods Sold	13,209	14,665	15,541	14,403	14,845
Selling, General and Administrative Expenses	8,406	10,376	12,757	11,823	12,186
Other Operating Expenses	2,744	4,038	4,129	3,827	3,945
<b>Operating Income</b>	<b>6,406</b>	<b>6,088</b>	<b>6,424</b>	<b>9,963</b>	<b>10,642</b>
Unusual items	0	0	0	0	0
Operating Income, including unusual items	6,406	6,088	6,424	9,963	10,642
Interest Expense	(520)	(553)	(530)	(530)	(530)
Other Non-operating Income	1,478	178	(23)	85	85
<b>Pre-tax Income</b>	<b>7,364</b>	<b>5,713</b>	<b>5,871</b>	<b>9,518</b>	<b>10,197</b>
Income Taxes	1,448	1,087	470	1,481	1,587
<b>Income after tax</b>	<b>5,916</b>	<b>4,626</b>	<b>5,401</b>	<b>8,037</b>	<b>8,610</b>
Minority Interest and Equity Income	0	0	0	0	0
Net Income, excluding extra items	5,916	4,626	5,401	8,037	8,610
<b>Income Available to Common, excluding extra items</b>	<b>5,916</b>	<b>4,626</b>	<b>5,401</b>	<b>8,037</b>	<b>8,610</b>
<b>Diluted Earnings per Share, excluding extra items</b>	<b>3.82</b>	<b>2.97</b>	<b>3.45</b>	<b>5.09</b>	<b>5.41</b>
Diluted Weighted Shares Outstanding	1,547.0	1,556.0	1,567.4	1,578.8	1,590.4

Source: Company Filings, Xignite, Valuation Projections

Pro Forma Balance Sheet	Historical			Projected	
	Dec-09	Dec-10	Dec-11	Dec-12	Dec-13
In Millions of USD (except for per share items)					
<b>Assets</b>					
Total Cash (including marketable securities)	9,932	5,451	8,097	14,727	21,432
Inventory	3,265	3,189	3,284	3,062	3,175
Accounts Receivable	6,542	7,184	7,684	7,923	8,249
Other Current Assets	3,575	6,493	4,703	4,703	4,703
<b>Total Current Assets</b>	<b>23,314</b>	<b>22,318</b>	<b>23,769</b>	<b>30,415</b>	<b>37,559</b>
Gross Fixed Assets	16,487	17,374	18,017	20,030	22,346
(Accumulated Depreciation)	(8,867)	(9,403)	(10,143)	(13,278)	(16,538)
Net Property, Plant, and Equipment	7,619	7,971	7,874	6,752	5,807
Goodwill, Net	13,200	15,930	15,705	15,705	15,705
Intangibles, Net	6,292	12,152	9,990	9,990	9,990
Other Long-term Assets	1,991	1,092	2,939	2,939	2,939
<b>Total Assets</b>	<b>51,417</b>	<b>59,462</b>	<b>60,277</b>	<b>65,802</b>	<b>72,001</b>
<b>Liabilities</b>					
Accounts Payable	1,281	1,536	1,721	1,562	1,639
Other Current Liabilities	6,579	9,332	10,384	10,248	10,249
Current Portion of Long-term Debt	5,190	6,395	3,375	3,375	3,375
<b>Total Current Liabilities</b>	<b>13,049</b>	<b>17,262</b>	<b>15,480</b>	<b>15,185</b>	<b>15,263</b>
Long-term Debt	11,266	12,524	12,040	12,040	12,040
Other Long-term Liabilities	5,245	7,288	8,317	8,317	8,317
<b>Total Liabilities</b>	<b>29,561</b>	<b>37,074</b>	<b>35,837</b>	<b>35,542</b>	<b>35,619</b>
Preferred Stock	0	0	0	0	0
<b>Shareholders' Equity</b>					
Common Stock and Additional Paid in Capital	8,258	8,745	9,817	10,575	11,338
Retained Earnings	17,054	18,927	20,907	25,723	30,829
Other Equity	(2,456)	(5,284)	(6,283)	(6,039)	(5,735)
<b>Total Shareholders' Equity</b>	<b>22,856</b>	<b>22,388</b>	<b>24,440</b>	<b>30,259</b>	<b>36,381</b>
<b>Total Liabilities and Shareholders' Equity</b>	<b>51,417</b>	<b>59,462</b>	<b>60,277</b>	<b>65,802</b>	<b>72,001</b>

Source: Company Filings, Xignite, Valuation Projections

Pro Forma Cash Flow Statement	Historical			Projected	
	Dec-09	Dec-10	Dec-11	Dec-12	Dec-13
In Millions of USD (except for per share items)					
<b>Cash from Operations</b>					
Net Income	5,916	4,626	5,401	8,037	8,610
Depreciation and Amortization	2,090	2,624	3,044	3,135	3,261
Deferred Income Taxes	0	0	0	0	0
Operating Gains Or Losses	(219)	827	1,197	246	253
Changes in Working Capital	(341)	659	1	(312)	(362)
<b>Cash Flow from Operations</b>	<b>7,445</b>	<b>8,736</b>	<b>9,643</b>	<b>11,106</b>	<b>11,762</b>
<b>Cash from Investing</b>					
Purchase of Property, Plant, Equipment	(1,089)	(1,015)	(1,492)	(2,014)	(2,316)
Other Investing Cash Flows	(2,610)	(11,173)	1,752	0	0
<b>Cash Flow from Investing</b>	<b>(3,699)</b>	<b>(12,188)</b>	<b>261</b>	<b>(2,014)</b>	<b>(2,316)</b>
<b>Cash from Financing</b>					
Issuance (Retirement) of Stock	(318)	(538)	892	757	763
Issuance (Retirement) of Debt	3,734	2,326	(3,977)	0	0
Dividends Paid	(2,414)	(2,671)	(2,938)	(3,221)	(3,504)
Other Financing Cash Flows	0	(204)	0	0	0
<b>Cash Flow from Financing</b>	<b>1,002</b>	<b>(1,085)</b>	<b>(6,023)</b>	<b>(2,463)</b>	<b>(2,741)</b>
Foreign Exchange	119	(621)	(43)	0	0
<b>Net Change in Cash</b>	<b>4,867</b>	<b>(5,161)</b>	<b>3,837</b>	<b>6,629</b>	<b>6,705</b>

Source: Company Filings, Xignite, Valuestream Projections