# Abbott Laboratories ABT



## Abbott's breakup into two pieces should draw more attention to the company's undervalued assets.

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**Analyst Note**

Abbott's Breakup Yields Two Less Competitive Companies
by Damien Conover, CFA, 11-15-12

**Thesis** 11/20/12

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, but likely not as strong as the consolidated company.

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 $10 billion in annual sales (28% 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 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 vascular line is poised for steady growth. Favorable clinical data on the company's drug-coated stent Xience versus entrenched Boston Scientific 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 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.

### Morningstar's Take ABT

| Price 11-20-2012 | Fair Value Estimate | Uncertainty |
|---|---|---|
| 63.08 USD | 72.00 USD | Low |
| **Consider Buy** | **Consider Sell** | **Economic Moat** |
| 57.60 USD | 90.00 USD | Wide |
| **Stewardship Rating** | | |
| Standard | | |

**Bulls Say**

- Strong clinical data on safety and efficacy give Abbott's stent Xience a leg up in the drug-eluting stent market.
- Aggressive cost-cutting plans should propel Abbott's bottom-line growth much quicker than top-line growth.
- International markets and indications in Crohn's disease and psoriasis for Humira should further propel sales growth for the company's leading pharmaceutical product.
- The acquisition of Piramal's drug unit increases Abbott's exposure to the rapidly growing Indian market.
- 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.

**Bears Say**

- Splitting the company into two could create distractions for management as well as reverse cost synergies such as increasing duplicative areas of operations.
- Lack of robust internal development casts a shadow on the company's ability to create blockbusters in-house.
- 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.
- 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.
- Pfizer's JAK inhibitor for rheumatoid arthritis has shown strong efficacy in Phase III trials relative to Humira, which could enable the drug to take significant market share from Humira based on the drug's oral dosing. Also, Roche's RA drug Actemra reported positive head-to-head data versus Humira, which could translate into Humira market share losses.

### Competitors ABT

More...

| Name | Price | % Chg | TTM Sales $ mil |
|---|---|---|---|
| **Abbott Laboratories** | **$65.93** | **1.12** | **39,414** |
| Johnson & Johnson | $70.95 | 0.01 | 65,921 |

| | | | |
|---|---|---|---|
| Pfizer Inc | $25.64 | 1.12 | 62,225 |
| Baxter International Inc. | $66.95 | 0.93 | 14,031 |

**Valuation**

We are increasing our fair value estimate to $72 from $70 per share based on the sum of the independent valuation analysis of both AbbVie and new Abbott, which we peg at $38 and $34 per share, respectively. Accounting for more than half of AbbVie's projected 2012 sales, Humira is the key driver of AbbVie's valuation and outlook. We believe Humira's leading efficacy and relatively clean side effect profile in underpenetrated treatment areas, including rheumatoid arthritis, psoriasis, and inflammatory bowel disease, will drive an 11% five-year compound annual growth rate for the drug. However, we expect Humira sales will begin to decline approximately 20% beginning in 2018 as generic biologics increase and greater branded competition intensifies, which lowers our 10-year CAGR for the drug to negative 4%. Aside from Humira, AbbVie holds several drugs that are losing patent protection over the next five years, which offsets the near-term Humira growth and results in a total sales five-year CAGR of 5%. For the new Abbott, we assume the firm will increase revenue at an average of 5% annually through 2016, fueled by strength in pediatric nutrition, adult nutrition outside the United States, molecular diagnostics, and vascular sales. Also important, 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 for this company.

**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**

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. Despite the uncertainty surrounding these more recent acquisitions and whether the decision to break up into two pieces will bring more value to shareholders, the company has been a better steward of capital than many of its peers in the drug industry.

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. 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 firm. Gonzalez brings many years of experience to the post, having joined Abbott in 1977 and serving in many manager roles across the company, including pharmaceuticals, medical products, and Abbott's medical technology investment arm, Abbott Ventures.

**Overview**

**Financial Health**:

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 close to half of its revenue from pharmaceuticals.