

We See Opportunities for New Abbott to Raise Profitability

By [Debbie S. Wang](#) | 12-17-12 | 06:00 AM | [Email Article](#)

➤ [Abbott Laboratories'](#) (ABT) split, planned for early January, will result in a diversified medical product company, which will keep the Abbott name and ticker, and a research-based pharmaceutical company, AbbVie. We peg new Abbott's intrinsic value at \$34 per share. With four mainly unrelated businesses left, we have a clearer picture of new Abbott, and see much potential for margin improvement. We give new Abbott a narrow moat rating, reflecting its competitive advantage in nutritionals, devices, branded generics, and diagnostics. While each of these markets offers modest growth prospects, we are more enthusiastic about the opportunity to partially close the margin gap with key competitors in the four segments. Even though Abbott competes in these markets that offer appealing margins, the firm presently trails key competitors in various segments on profitability, including Boston Scientific, C.R. Bard, Mead Johnson, Dr. Reddy, and Roche's diagnostic division. Even with relatively slow low- to mid-single-digit top-line growth, Abbott has plenty of room to raise margins and returns on invested capital. There may be upside to our valuation if new Abbott can increase profitability beyond our estimates.

New Abbott Faces Task of Whipping a Flabby Company Into Shape

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. New Abbott's cost structure reflects a poor combination of its individual segments. For example, new Abbott's consolidated gross margin around 54% is comparable with Roche's diagnostic gross margin--one of the lower-margin businesses in the Abbott's portfolio--despite significant contributions from coronary stents and pediatric nutritionals, where the competitive gross margin is in the 60%-65% range. 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 immunology drug Humira's success may have covered a multitude of sins in the other divisions. We anticipate management will focus its attention on this issue as new Abbott gets off the ground. 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.

Nutritional Business Is One of the Moatiest Parts of New Abbott

The firm wields a leadership position in the highly consolidated nutritional market,

which is estimated to be \$35 billion worldwide. Within the United States, Abbott's participation in the Department of Agriculture's Women, Infants, and Children program can be highly profitable, even though growth in the mature domestic market is slow. Thanks to how WIC policies are structured, Abbott is able to regularly raise its price and lock it in for the duration of each multiyear contract with individual states. This also cascades into higher retail prices that more affluent users (who do not participate in WIC) accept. The firm faces brighter growth prospects outside the U.S., especially 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. Also, Abbott has 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 Abbott's experience with nutritionals should play out well when applied to the established pharmaceutical product segment, which is mainly sold outside the U.S. 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 in Devices, but Jury's Still Out on Innovation

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 European regulatory approval on its next-generation Xience Xpedition stent and should receive Food and Drug Administration clearance in the 2014 time frame. 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. We doubt ABSORB will wholly change the coronary stent landscape the way drug-eluting stents did in 2003. First, we suspect interventional cardiologists have learned a hard-earned lesson about blindly embracing new technology after the danger of late thrombosis associated with DES first emerged in 2006. ABSORB has received regulatory approval in Europe, but thought leaders continue to speak cautiously of resorbable stents, which do not have the nearly 20-year record that

metal stents offer. Additionally, the unresolved questions about late thrombosis in DES have also led to multiple large-scale registries that make the DES one of the most studied medical devices ever. Also, the cumulative clinical data on ABSORB were not entirely clear--in earlier versions of the product, vessel size would expand, then contract, then expand again. This only underscores how much we do not yet know about vessel remodeling. Further, the rumored price of the ABSORB is approximately 3 times the estimated price of a metal DES. In this day of comparative effectiveness, Abbott will need very clear and convincing clinical data that demonstrate significantly better outcomes over metal drug-eluting stents before payers will climb aboard. Finally, the protocol around antiplatelet therapy for ABSORB patients is not yet established, though we suspect patients will still need some antiplatelet therapy.

We harbor similar doubts about the potential for commercial success with MitraClip. While mitral valve regurgitation offers a large market (larger than that for transcatheter aortic valve replacement), the heterogeneous nature of this condition limits MitraClip's applicability. In some cases, mitral regurgitation comes about because of a disease or worn-out mitral valve, which if left untreated can lead to more serious issues like heart enlargement or failure. However, in other cases, mitral regurgitation is a result of underlying ventricular disease, where the left ventricle is already enlarged. The heterogeneity of mitral regurgitation makes the establishment of treatment guidelines complex, and it takes time for mitral valve disease to show up in other parts of the heart, making it difficult to define endpoints for clinical studies. Additionally, at a medical conference we watched a demonstration of MitraClip being implanted. The implant seems relatively difficult to place and implant properly. The clinical data suggest MitraClip is not as effective as traditional valve repair, but it is safer. We think use of MitraClip is likely to be limited to frail patients who cannot withstand surgical repair.

Making Efforts to Catch Up in Diagnostics

After nearly selling its diagnostics division to General Electric 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 into 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. While Abbott's diagnostic segment was suffering from benign neglect, not only did powerhouse Roche consolidate its leadership position in the market, but also a number of smaller firms began encroaching. Now, Qiagen and Hologic are key competitors in the molecular area. Competitors have engineered smaller equipment systems that can handle higher throughput, and Abbott is attempting to play catch-up. We are not particularly optimistic that Abbott will be able to take share from these fierce competitors, but we applaud management's decision to concentrate on raising operating margins in this segment. Now, Abbott just needs to do the same across all its businesses.

Without Proprietary Pharma Products, Abbott Merits Only a Narrow Moat

After stripping out Humira's patent protection, AbbVie's pipeline, and the difficulty of replicating biologics, new Abbott's remaining businesses largely reflect narrow moats.

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. We think Abbott has earned a narrow moat in each of its four segments, which translates to a narrow moat for the entire company.

Although there is potential for pricing pressure from various sources across Abbott's markets (for example, a trend toward more government tenders in branded generics, declining reimbursement for vascular devices), the firm's investment in its pipeline should lead to a stream of new products that can fortify pricing power. Abbott aims to establish a significant presence in the continuous glucose monitor market, has already assembled a lineup of next-generation cardiovascular devices, and has built out its infrastructure to support the expansion of nutritional products and branded generics in the emerging markets.

Profitability the Key Factor in Our 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 key to the nutritional segment.

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