# Abbott Laboratories ABT | ★★★★★



## Abbott plans to split into two to unlock value.

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Analyst Note
Abbott Announces Breakup Into Two Companies, In-Line 3Q Results
by Damien Conover, CFA, 10-19-11

**Thesis** 11/04/11

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.

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 $8 billion in annual sales (27% of total sales). Humira continues to be the workhorse of the group with 19% growth in 2010, 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 and kidney disease drug bardoxolone 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 recently expanded vascular line is poised for rapid growth. Favorable clinical data on the company's new 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 recent 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.

### Valuation

Despite the company's decision to split itself into two pieces, we're maintaining our

## Morningstar's Take ABT

| **Price** 11-04-2011 | **Fair Value Estimate** | **Uncertainty** |
|---|---|---|
| 53.33 USD | 68.00 USD | Low |
| **Consider Buy** | **Consider Sell** | **Economic Moat** |
| 54.40 USD | 85.00 USD | Wide |

**Stewardship Grade**
C

**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 recent 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-3 inhibitor for rheumatoid arthritis has shown strong efficacy in Phase III trials relative to Humira. If the drug holds up well in late-stage trials, it could take significant market share from Humira based on the drug's oral dosing. Also, Roche's RA drug Actemra is poised to reported head-to-head data versus Humira in late 2011 or early 2012. Strong Actemra data could translate into Humira market share losses.

## Competitors ABT

More...

| Name | Price | % Chg | TTM Sales $ mil |
|---|---|---|---|
| **Abbott Laboratories** | **$54.53** | **1.08** ↑ | **38,442** |
| Pfizer Inc | $19.99 | 1.01 ↑ | 68,785 |
| Johnson & Johnson | $65.25 | 1.76 ↑ | 64,419 |

fair value estimate of $68 per share, which implies a 2011 price/earnings multiple of 15 times. The current forward-year industry price/earnings multiple is 10 times, and we believe Abbott's industry-leading growth continues to warrant a premium multiple valuation for the company. We incorporated the recent acquisition of Piramal's drug unit into our valuation model, but acquired sales largely offset the high purchase price. Humira represents the most important driver in Abbott's valuation--we project it contributes more than 20% to our estimate of the firm's total value. While competing drugs lurk in the near future, we expect Humira to post double-digit annual growth during the next several years. Overall, during the next five years, we project 6% average annual sales growth, led by Humira, Xience, and acquisitions. During the same period, we project slightly increasing operating margins as cost-containment initiatives offset patent losses on high-margin drugs. We estimate a 9% cost of equity and a similar weighted average cost of capital, which reflect the secure and robust cash flows derived from diverse operations.

| | | | |
|---|---|---|---|
| Baxter International Inc. | $54.66 | 1.84 ↑ | 13,797 |

## 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

Miles White took the helm as CEO in 1998 and chairman of the board the following year. His tenure with the company dating back to 1984 provides the experience needed in handling the many operating lines of the company. Under his leadership, the company executed several value-enhancing acquisitions. After the split, Miles 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 firms. We believe both executives have strong records that bode well for future leadership.

Overall, the company promotes solid stewardship. We like the policy of cumulative voting rights in the election of directors, as this gives more clout to minority shareholders. Compensation for top executives is well balanced between cash and equity and in line with industry practices. However, we would like the company to take a page from the major European pharmaceutical companies and split the roles of CEO and chairman.

## 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 slightly less than 60% of revenue from pharmaceuticals.