Johnson & Johnson

The health-care giant's diversification strategy continues to pay off.

by Heather Brilliant
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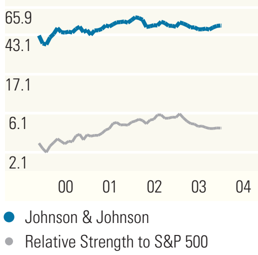
As of the date of this report Heather Brilliant does not have a position in this stock.

Morningstar Rating	★★★★
Business Risk	Below Avg
Fair Value	$59.00
Price as of analysis	$53.05
Economic Moat	Wide
Industry	Drugs
Sector	Healthcare
Economy	Services
Ticker	JNJ

Current Price ($)



Update

A strong fourth quarter demonstrated that Johnson & Johnson's diversification strategy continues to pay off. We're raising our fair value estimate to $59 per share from $56 because we expect new and follow-on products to help offset the impact of patent expirations and competition over the next few years.

Sales rose 19.7% in the fourth quarter from the prior-year period, driven by 14.1% operational growth and a 5.6% currency benefit. This strong quarter helped propel full-year sales growth of 15.3%. The company's drug-eluting stent, Cypher, contributed to this strong performance, generating about $1.4 billion in sales. As the only drug-coated stent available in the United States, Cypher was used in more than 50% of coronary angioplasty patients in the fourth quarter and constituted 76% of total dollar spending on stents. J&J also demonstrated significant growth in some of its top pharmaceutical products, including Aciphex for gastrointestinal disorders, pain patch Duragesic, and Topamax for epilepsy and migraines.

The picture is not all rosy at J&J, though. Cypher could face competition from Boston Scientific's Taxus stent within the next few months, and anemia drug Procrit continues to lose share to Amgen's Aranesp. J&J also faces a number of patent expirations over the next two years that could affect more than $3 billion in sales.

However, the diversity of the company's revenue stream is likely to mitigate the impact of these events. Several newer products are showing strong potential to become solid contributors to revenue, and J&J has a number of new and follow-on products in its late-stage pipeline. We believe J&J will weather the storm and continue to demonstrate strong performance over the long term.

Thesis

Johnson & Johnson is an exemplary pharmaceutical company, with year after year of double-digit revenue and earnings-per-share growth, annual dividend increases since 1988, and substantial cash-flow generation.

With more than half of its revenue coming from consumer-health products and medical devices, J&J's diversification helps insulate it from typical pharmaceutical industry issues like patent expirations and generic competition. Decentralized management helps the company maintain strong positions in each of its key areas; with visionary leaders heading each of its divisions, there is no lack of focus.

This decentralized approach has served the company well: Over the past 10 years, J&J improved its operating margins from 14.8% to 25%. We think these margins can continue to creep up as pharmaceuticals, with operating margins in excess of 33%, become a larger piece of the revenue pie. For a company its size--$42 billion in sales for 2003--J&J has shown a remarkable ability to increase revenue at a steady clip, with average annual growth of 11% over the past five years.

J&J's greatest feat is generating cash. In 2003, the company produced more than $8 billion--19% of sales--in free cash flow (cash flow from operations less capital expenditures). Best of all, free cash-flow growth has outpaced EPS growth over the past five years. This gives the company substantial cash to reinvest in the business, something investors can get excited about since we expect J&J to earn an average return on invested capital in excess of 25% over the next five years.

A key risk the company faces is a substantial decline in sales of its largest product, Procrit/Eprex for anemia, which currently generates $4 billion in revenue. Competition from Amgen's Aranesp, which is longer-lasting than Procrit/Eprex, is likely to continue to eat away at J&J's dominant share. Growth will have to come from the company's other products, which shouldn't be hard as 70% of sales come from products in which J&J holds the number-one or -two market position, and the company expects to file more than 50 new products or line extensions for review by the Food and Drug Administration over the next five years.

We remain convinced that J&J's record of earnings growth and dividend increases is a tribute to the firm's long-term business plan and execution.

Close Competitors

	TTM Sales $Mil	Market Cap $Mil
Johnson & Johnson	40,011	157,697
Novartis AG ADR	—	108,775
Merck	30,777	107,354
Eli Lilly & Company	12,073	82,489

Morningstar data as of March 05, 2004.

Valuation

We're increasing our fair value estimate to $59 per share from $56 as we incorporate the cash flows from the fourth quarter and incorporate slightly higher sales growth assumptions and modestly lower operating margin assumptions. We expect 7% average annual revenue growth over the next five years, and we continue to anticipate incremental increases in operating margins, with some minor deterioration in gross margins because of changes in product mix. This revenue growth assumes Procrit/Eprex will continue to lose market share, seeing sales decline 5%-8% per year. However, we believe J&J's strong product portfolio in pharmaceuticals and medical devices and diagnostics will compensate for the decline. We expect Cypher to face competition beginning in 2004, offset to some extent by market growth in drug-coated stents.

Risk

J&J's biggest breadwinner, Procrit/Eprex, faces new competition in the United States and international markets from Amgen's Aranesp. The firm is also dealing with the pure red-cell aplasia scare in Europe.

Bulls Say

- J&J is well positioned to take advantage of the convergence of medical devices, diagnostics, and pharmaceuticals. Few companies have all these divisions under one roof.
- A study revealed that 94% of patients treated with Cypher drug-coated stents went a year without heart trouble, while 71% of patients with uncoated stents returned to the hospital for heart procedures.
- Remicade, a monoclonal antibody used to treat rheumatoid arthritis and Crohn's disease, showed positive results in the treatment of moderate to severe psoriasis, which afflicts more than 7 million Americans.
- J&J's decentralized management approach has helped propel the company to leadership in many of the areas in which it operates.

Bears Say

- Amgen's longer-lasting Aranesp threatens J&J's Procrit in the United States, where Procrit previously had no competition in the chemotherapy-induced anemia market.
- J&J's Risperdal faces competition from Bristol-Myers Squibb's newly approved Abilify. Also, Abbott's monoclonal antibody for rheumatoid arthritis, Humira, may eat into Remicade's sales.
- The consumer segment typically does not grow as fast as the pharmaceutical and medical-device and diagnostic segments. Consumer segment sales growth has averaged just 4.6% over the past four years.
- Eprex is suspected of causing a deadly disease in a small number of patients. The drug's method of delivery was changed to correct the problem, but even though the adverse responses have stopped, legal action could ensue.

Financial Overview

Growth: With its biggest product (Procrit/Eprex) facing tough competition, we expect growth to slow. However, J&J's diversified revenue stream should help maintain sales and earnings growth in the midsingle digits longer-term.

Profitability: J&J is very profitable. Operating margins are in the high 20s, and net margins usually come in just below 20%. Margins have improved markedly; operating margins for 2003 were 25%, up from 18% just five years ago.

Financial Health: J&J remains one of a handful of companies with a triple A credit rating, thanks to its pristine balance sheet. The company ended 2003 with $5.4 billion in net cash (cash less debt), even after completing $3 billion in acquisitions.

Company Overview

Profile: Johnson & Johnson is a diversified health-care company with three divisions: pharmaceutical, medical devices and diagnostics, and consumer.

Pharmaceutical is growing the fastest and now represents 47% of total revenue. Medical devices and diagnostics represents 36% of revenue. The remaining 17% comes from well-known consumer products like Band-Aids, Johnson's Baby Shampoo, and Tylenol.

Strategy: Johnson & Johnson is decentralized, with more than 200 operating companies. It has made pharmaceuticals its top priority but remains committed to its slow-growing consumer segment because its brands inspire consumer trust and provide a healthy amount of cash flow. Acquisitions are an essential driver of J&J's revenue growth.

Management: In April 2002, Bill Weldon took the reins from Ralph Larsen, who led the company through more than a decade of double-digit growth. Weldon is only the sixth chairman in J&J's 117-year history. His ultracompetitive nature and salesmanship propelled him through the ranks at J&J, where his attitude matches the company's credo. Weldon started with J&J as a sales rep right out of college. He ran the endo-surgery and pharmaceutical units before ascending to the top job. J&J's board has consistently been rated one of the best in America, and the firm regularly earns one of the top spots on Fortune's Most Admired Companies list. J&J's long-term management incentive plan is innovative: the value of the awards is not determined (or awarded) until retirement and is fully performance-driven.

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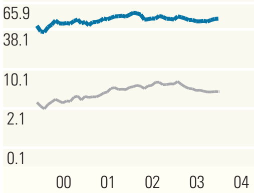

● Johnson & Johnson
● Relative Strength to S&P 500

Analyst Notes

Boston Scientific Stent Approved 03-05-04

Boston Scientific finally obtained regulatory approval of its Taxus drug-eluting stent Thursday. As a smart second-to-market contender, Boston appears to have learned lessons from rival Johnson & Johnson and the slightly rough launch of its Cypher stent last spring. To avoid the supply limitations that frustrated medical professionals during Cypher's introduction, Boston has built up Taxus inventory that is about 4 times larger than what J&J launched with. Further, Boston will offer Taxus in a full range of sizes from the get-go. Even though J&J's new alliance with Guidant to comarket Cypher might slow Taxus' uptake, we're still confident Boston can achieve market leadership by the end of this year.

Merck Sells Joint Venture to J&J 02-27-04

Merck and Johnson & Johnson announced Friday that Merck is selling its stake in the companies' European consumer joint venture to J&J. This news does not change our fair value estimate for either firm, because the joint venture constituted a small percentage of total income for each of them. At first glance, we do not believe Merck is signaling negative news, because its expertise lies in branded pharmaceuticals (as opposed to the over-the-counter consumer pharmaceuticals affected by the sale) and it has retained its North American joint venture with J&J. Separately, Merck announced Friday that it has received six more months of marketing exclusivity in the United States for its pain medication Vioxx. We view this as marginally positive because the company should be able to delay generic competition a bit longer, but it will not have an effect on our fair value estimate, which is not very sensitive to such short-term changes.

Guidant Plans to Sell J&J's Stent 02-24-04

We believe Guidant's plan, announced Tuesday, to copromote Johnson & Johnson's drug-coated Cypher stent amounts to a near-term win-win situation for both companies, although it doesn't change our fair value estimate for either one. We'd anticipated Guidant would be fourth to market with a drug-coated stent in 2006, but this agreement puts the firm in the game now. While we doubt Cypher commissions will substantially add to our Guidant sales projections, this plan provides the firm's salesforce with opportunities to reinforce existing relationships with doctors, cath labs, and hospitals--a key factor in the medical-device industry. Otherwise, Guidant would have had to sit on the sidelines for two years while competitors solidified these professional relationships. The added sales power should help J&J slow the anticipated decline in Cypher market share now that Boston Scientific's Taxus stent is expected to launch any week now. Though this cooperative agreement seems sensible in the short term, we're uncertain how the alliance might change once Guidant introduces its own Champion drug-coated stent and ostensibly reverts to head-to-head competition with J&J's Cypher.

J&J Reports Strong 4Q Results 01-20-04

Johnson & Johnson's fourth-quarter and full-year results, announced Tuesday, demonstrate the strength of the company's diversified product portfolio. We expect only a modest increase in our fair value estimate. Sales rose 19.7% in the fourth quarter from the prior-year period, driven by 14.1% operational growth and a 5.6% currency benefit. This strong quarter helped propel full-year sales growth of 15.3%, which was ahead of our expectations because of the strong currency effects. The company's drug-eluting stent, Cypher, contributed significantly to this strong performance, generating about $1.4 billion in sales. Cypher now accounts for more than 75% of the U.S. stent market, but we expect Boston Scientific's drug-coated stent will eat into Cypher's share once it's approved. J&J's earnings per share reached $2.40 for 2003, an 11% increase, despite a large charge to write off acquired in-process research and development.

J&J President to Retire 01-16-04

Johnson & Johnson announced on Thursday that Vice Chairman and President James Lenehan is retiring, effective February 1. This does not affect our fair value estimate, and the news did not come as a huge surprise because Lenehan essentially lost out on the number-one spot at J&J a couple of years ago when CEO Bill Weldon was chosen to lead the company. We continue to like J&J's decentralized management strategy, and we have confidence that Weldon was a strong choice to lead the firm.

Johnson & Johnson Halts Trials 12-01-03

Johnson & Johnson announced Thursday that it has halted some clinical trials it had been conducting to expand the use of anemia drug Procrit. We do not expect this news to have a negative effect on the company's sales, and we are not changing our fair value estimate. The company halted the trials, which were aimed at increasing hemoglobin levels in cancer patients to increase the effectiveness of cancer treatments, because more patients developed blood clots than the company had expected. We were not expecting this potential application of the drug to boost sales significantly. We expect J&J's Procrit to continue to lose share to competing drugs from Amgen and Roche but the company's diversified revenue stream should cushion the blow. We'd be buyers below $45.

J&J Warning Helps Boston Scientific 10-30-03

News that the Food and Drug Administration has issued a second warning letter to doctors regarding the possibility that Johnson & Johnson's drug-coated stent causes fatal blood clots hasn't changed our opinion of J&J, but it should give a boost to Boston Scientific which we expect to launch a competing product in early 2004. We stand behind our $56 fair value estimate for J&J and will probably raise our fair value estimate for Boston Scientific. Stents are only one small piece of J&J's business, accounting for less than $3 billion of the firm's estimated 2003 revenue of $41 billion. Additionally, we had already assumed that sales of the J&J Cypher stent would slow dramatically once Boston Scientific launched its competitive Taxus stent. We think Boston is already in a strong competitive position because of its impressive clinical data and because doctors seem eager to embrace a second competitor in this arena. The FDA warning may simply reinforce cardiologists' negative perceptions of J&J. All of these elements taken together make us more optimistic about Boston Scientific's ability to capture more than the 45% share we had been expecting.

Boston Scientific Posts Strong 3Q 10-22-03

Boston Scientific's strong third-quarter performance, announced Tuesday, allows us to ratchet up our expectations for the remainder of 2003. We're raising our fair value estimate slightly after increasing our 2003 top-line growth projections and lowering the firm's effective tax rate. Both major business segments delivered double-digit top-line growth, but we're particularly excited about the 25% increase in cardiovascular sales for the quarter; though reimbursement issues continue to slow the firm's drug-coated Taxus stent adoption in Europe, Boston Scientific has managed to capture a 65% share in that market. The firm's success with Taxus in Europe should sound a warning bell for Johnson & Johnson we anticipate Taxus' U.S. regulatory approval in the first quarter of 2004. Even though J&J has already announced plans to cut prices and introduce more sizes of its drug-coated stents, we believe Boston Scientific could do some real damage to J&J's stent business.

Solid 3Q for Johnson & Johnson 10-14-03

Johnson & Johnson reported strong third-quarter results Tuesday; we'll incorporate the cash flows from the quarter into our discounted cash-flow model, but we do not expect a significant change in our fair value estimate. The company generated an impressive 15% increase in sales. Cypher, the company's new drug-coated stent, was approved in the United States in the second quarter and helped generate 23% sales growth in the U.S. medical-device division. As the only drug-coated stent available in the United States, Cypher was able to garner 45% market share of stents for coronary angioplasty patients. While we view this as positive, we do not expect J&J's market dominance to last. Boston Scientific's competing stent could be approved in late 2003 or early 2004 and may carry efficacy and price advantages over Cypher. Also worth noting is the weak U.S. dollar, which boosted top-line sales growth 3.5%. J&J reported solid net income of just over $2 billion, an increase of 20% over the year-ago quarter (or 14% once a charge is removed from 2002 results).

Good Results for Boston Scientific 09-16-03

Boston Scientific's positive results from its drug-eluting stent trial, announced Monday, reaffirm our expectations that the firm can quickly build share once the cardiac device is approved. The Taxus stent's reclogging rate was about as we expected, with an incidence of 8% compared with 27% for the bare-metal control group. Though this study and Johnson & Johnson's competitive study of its Cypher stent are not directly comparable, the data suggest that Taxus performs on par with Cypher in preventing restenosis. We project Boston Scientific can garner 45% of the U.S. market by 2004, but the strong results among diabetic patients, who represent a large percentage of patients receiving stents, could provide some upside to our expectations. A Food and Drug

Administration panel is set to review Taxus on November 20, and the device could receive approval by the end of the year.

Johnson & Johnson JNJ

Last Close $	Sales $Mil	Mkt Cap $Mil	Industry
$53.13	$40,011	$157,697	Drugs

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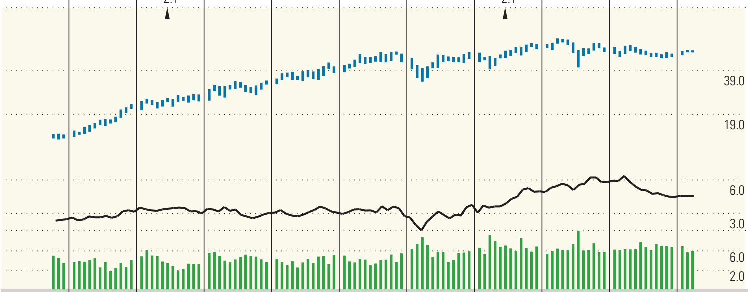
Morningstar Rating	Business Risk	Fair Value	Economic Moat	Style	Sector
★★★★ As of 03-05-04	Below Average	$59.00 As of 01-22-04	Wide	Large Core	Health

1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	YTD	
14.13	23.09	27.00	33.66	44.88	53.44	52.97	60.97	65.85	59.08	54.90	Annual Price High
12.81	13.41	20.78	24.31	31.69	38.50	33.06	40.25	41.50	48.05	50.43	Low
		2:1					2:1				Recent Splits



Price Volatility
Monthly High/Low
Rel Strength to S&P 500
52 week High/Low $ 59.08 - 48.05
10 Year High/Low $ 65.85 - 12.81
Bear-Market Rank 2 (10=worst)
Trading Volume Million

1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	YTD	Stock Performance
25.0	59.1	18.1	34.3	29.0	12.5	14.2	14.0	-7.9	-2.1	3.3	Total Return %
23.7	21.6	-4.8	0.9	0.4	-8.5	23.3	25.9	14.2	-30.8	-1.0	+/- Market
17.1	1.4	-0.6	-16.8	-13.6	25.2	-15.4	26.7	11.7	-20.8	0.1	+/- Industry
2.1	1.5	1.5	1.3	1.2	1.2	1.2	1.2	1.5	1.8	0.5	Dividend Yield %
35206	55319	66267	88603	112729	129669	146041	180141	159452	153334	157697	Market Cap $Mil

1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	TTM	Financials
14138	15734	18842	21620	22629	23657	27471	29139	33004	36298	40011	Revenue $Mil
66.1	66.3	66.9	67.5	68.4	68.3	69.3	69.6	71.1	71.2	71.3	Gross Margin %
2394	2807	3511	4303	4622	4268	5926	6456	7780	9489	9981	Oper Income $Mil
16.9	17.8	18.6	19.9	20.4	18.0	21.6	22.2	23.6	26.1	24.9	Operating Margin %
1787	2006	2403	2887	3303	3059	4167	4800	5668	6597	6736	Net Income $Mil
0.69	0.78	0.93	1.09	1.21	1.12	1.47	1.70	1.84	2.16	2.24	Earnings Per Share $
0.25	0.28	0.32	0.37	0.43	0.49	0.55	0.62	0.70	0.80	0.89	Dividends $
2608	2572	2584	2666	2739	2743	2836	2834	3099	3054	3022	Shares Mil
2.16	2.77	3.49	4.07	4.59	5.06	5.83	6.76	7.95	7.65	8.67	Book Value Per Share $
2168	2975	3382	3891	4343	4886	5677	6563	8864	8176	9170	Oper Cash Flow $Mil
-975	-937	-1256	-1373	-1391	-1460	-1728	-1646	-1731	-2099	-2272	Cap Spending $Mil
1193	2038	2126	2518	2952	3426	3949	4917	7133	6077	6898	Free Cash Flow $Mil

1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	TTM	Profitability
14.8	14.4	14.3	15.2	15.9	12.8	15.1	15.9	16.2	16.7	15.8	Return on Assets %
33.3	31.6	29.9	29.1	28.5	23.5	28.1	27.5	26.4	28.2	28.1	Return on Equity %
12.6	12.7	12.8	13.4	14.6	12.9	15.2	16.5	17.2	18.2	16.8	Net Margin %
1.17	1.13	1.12	1.14	1.09	0.99	0.99	0.96	0.95	0.92	0.94	Asset Turnover
2.3	2.2	2.1	1.9	1.8	1.8	1.9	1.7	1.6	1.7	1.8	Financial Leverage

1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	09-03	Financial Health
2005	2414	3550	4186	5280	3017	5752	8289	10429	7817	9364	Working Capital $Mil
1493	2199	2107	1410	1126	1269	2450	2037	2217	2022	3149	Long-Term Debt $Mil
5568	7122	9045	10836	12359	13590	16213	18808	24233	22697	25738	Total Equity $Mil
0.43	0.39	0.26	0.21	0.15	0.29	0.26	0.19	0.11	0.18	0.20	Debt/Equity

1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	TTM	Valuation
16.4	17.6	23.0	22.9	27.3	37.6	31.7	30.9	32.1	24.9	23.7	Price/Earnings
0.9	0.9	1.0	0.9	0.8	1.0	1.0	1.0	1.3	0.9	0.8	P/E vs. Market
2.1	2.2	2.9	3.1	4.0	4.9	4.8	5.1	5.5	4.5	4.0	Price/Sales
5.2	4.9	6.1	6.1	7.2	8.3	8.0	7.8	7.4	7.0	6.1	Price/Book
13.5	11.8	16.3	17.0	20.8	23.6	23.3	22.7	20.7	20.1	17.5	Price/Cash Flow

Growth Rates Compound Annual

Grade: B	1 Yr	3 Yr	5 Yr	10 Yr
Revenue	10.0	9.7	9.9	10.2
Operating Income	22.0	17.0	15.5	15.3
Earnings/Share	17.4	13.7	12.4	20.7
Dividends	15.6	14.1	13.6	13.8
Book Value/Share	-3.9	-4.3	10.7	14.5
Stock Total Return	-2.2	4.8	5.2	20.1
+/- Industry	-30.3	6.9	7.5	3.7
+/- Market	-44.0	5.5	5.7	8.8

Profitability Analysis

Grade: A+	Current	5 Yr Avg	Ind	Mkt
Return on Equity %	28.1	26.7	23.6	16.2
Return on Assets %	15.8	15.3	10.5	5.5
Fixed Asset Turns	4.6	4.3	3.9	5.8
Inventory Turns	3.3	3.0	2.5	12.5
Revenue/Employee $K	369.4	318.4*	241.5	514.3
Gross Margin %	71.3	69.9	73.7	40.5
Operating Margin %	24.9	22.3	20.5	13.8
Net Margin %	16.8	16.0	17.3	9.0
Free Cash Flow/Rev %	17.2	16.8	9.1	12.5
R&D/Rev %	13.4	0.1	16.0	12.3

Financial Position

Grade: A	12-02 $Mil	09-03 $Mil
Cash	-1687	-1148
Inventories	3303	3739
Receivables	5399	6399
Current Assets	19266	22146
Fixed Assets	8710	9245
Intangibles	9246	11679
Total Assets	40556	46659
Payables	3621	3660
Short-Term Debt	2117	2024
Current Liabilities	11449	12782
Long-Term Debt	2022	3149
Total Liabilities	17859	20921
Total Equity	22697	25738

Valuation Analysis

	Current	5 Yr Avg	Ind	Mkt
Price/Earnings	23.7	31.4	34.5	28.6
Forward P/E	18.0	—	22.4	21.8
Price/Cash Flow	17.5	22.1	23.6	17.1
Price/Free Cash Flow	23.3	30.0	29.3	—
Dividend Yield %	1.8	—	1.8	1.5
Price/Book	6.1	7.7	6.1	4.9
Price/Sales	4.0	5.0	5.2	3.3
PEG Ratio	1.4	—	1.8	2.0

*3Yr Avg data is displayed in place of 5Yr Avg

Quarterly Results

Revenue $Mil	Dec	Mar	Jun	Sep
Most Recent	9403.0	9821.0	10332.0	10455.0
Previous	8403.0	8743.0	9073.0	9079.0

Rev Growth %	Dec	Mar	Jun	Sep
Most Recent	11.9	12.3	13.9	15.2
Previous	18.2	12.2	8.8	10.2

Earnings Per Share $	Dec	Mar	Jun	Sep
Most Recent	0.46	0.69	0.40	0.69
Previous	0.36	0.59	0.54	0.57

Industry Peers by Market Cap

	Mkt Cap $Mil	Rev $Mil	P/E	ROE%
Johnson & Johnson	157697	40011	23.7	28.1
Novartis AG ADR	108775	—	—	—
Merck	107354	30777	15.4	44.6

Major Fund Holders

	% of shares
Vanguard 500 Index	0.90
Fidelity Magellan	0.80
Fidelity Dividend Growth	0.49