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LONG IDEA
4/27/22

Focus on Fundamentals in Stormy Markets – Part 2

As the MOMO, YOLO, and BTFD days sink deeper into the past, we remind investors to focus on fundamentals. Fundamental research might seem boring, but it is the only way to find companies that generate real profits and have stocks that carry less risk. Boring investments can be very rewarding.

Johnson & Johnson (JNJ: $185/share) is one of this week's Long Ideas. The other Long Idea is CarMax (KMX: $88/share), which we cover in a separate report here.

Learn more about the best fundamental research

Fundamentals Are as Important as Now as Ever

In the midst of economic uncertainty and market volatility, investors should make sure – now more than ever – their portfolios are filled with companies that generate Core Earnings and trade at cheap valuations.

After years of pouring easy money into popular growth companies, the market is no longer tolerating bottom-line losses no matter how strong the top-line growth.

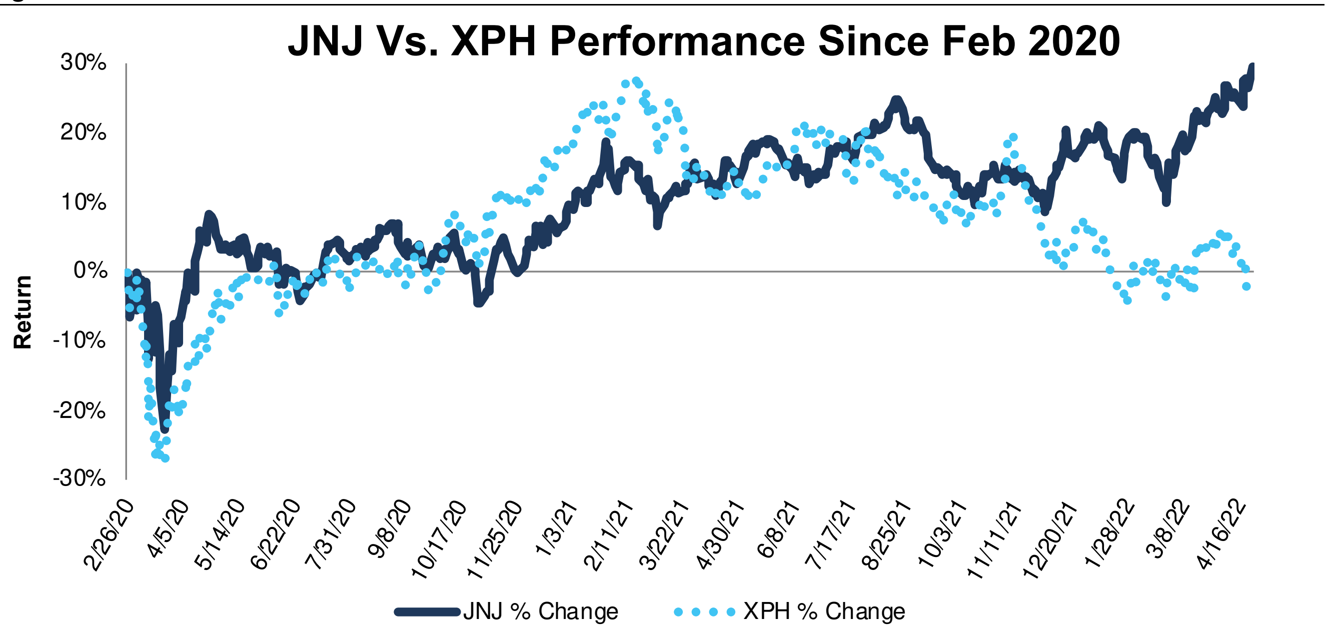
Investors should focus on companies with the following characteristics, regardless of the economic outlook:

- consistent Core Earnings growth
- high return on invested capital (ROIC) compared to peers
- rising economic earnings
- strong free cash flow (FCF)
- low price-to-economic book value (PEBV)

JNJ Outperformed Pharmaceuticals ETF by 33%

We made Johnson & Johnson a Long Idea on February 26, 2020 and since then JNJ is up 30% compared to a 3% decline for pharmaceutical-focused SPDR S&P Pharmaceuticals ETF (XPH).

Figure 1: Price Performance: JNJ Vs. XPH Since 2/26/20



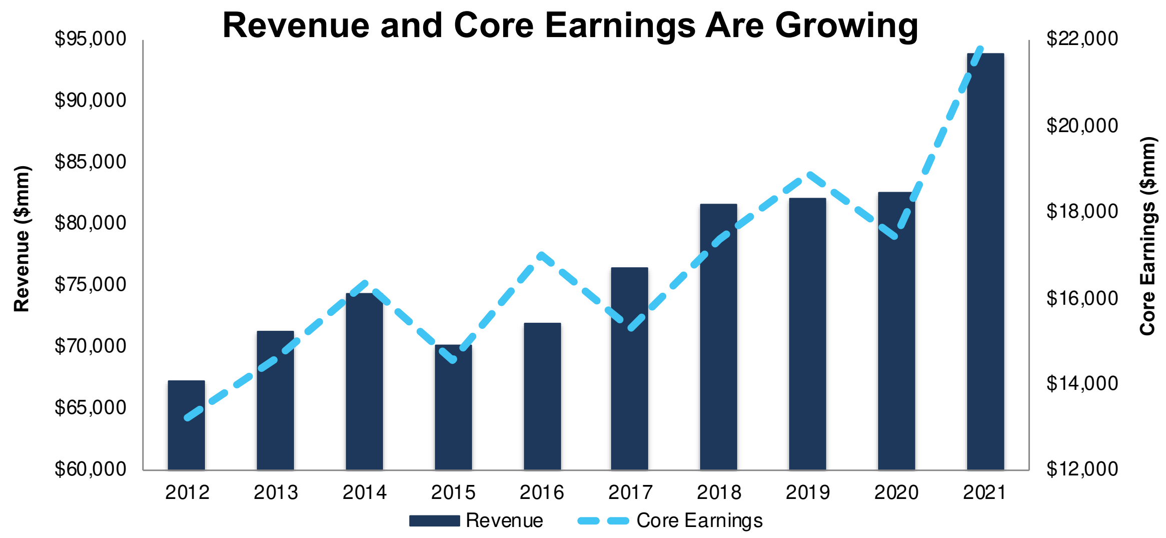
Sources: New Constructs, LLC and company filings

History of Strong Core Earnings Growth

Johnson & Johnson's scale and diversified business greatly reduce the risk generally involved when investing in pharmaceutical stocks heavily dependent on a handful of products and clinical trials. Since 1998 (earliest date of our model), Johnson & Johnson has generated positive Core Earnings each year and Core Earnings have grown 8% compounded annually over the same time.

Per Figure 2, over the past decade, Johnson & Johnson's Core Earnings rose from $13.2 billion in 2012 to $22.0 billion in 2021.

Figure 2: Johnson & Johnson's Revenue and Core Earnings Since 2012

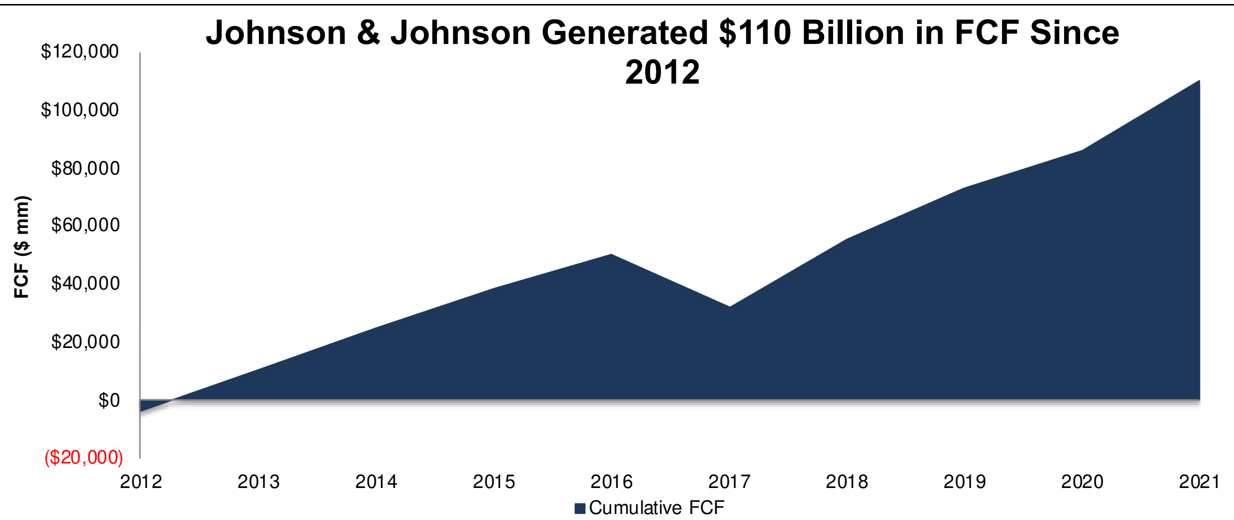


Sources: New Constructs, LLC and company filings

Johnson & Johnson Generates Strong FCF

Johnson & Johnson generates significant FCF, which is a critical in the pharmaceutical industry given the need to front massive research and development costs. In 2021, Johnson & Johnson's research and development expense rose 20% year-over-year (YoY) to $14.7 billion. Over the past decade, Johnson & Johnson generated $110.1 billion (23% of market cap) in FCF. The company's current FCF yield of 5% dwarfs the 1% FCF yield of SPDR S&P Pharmaceuticals ETF and the 2% FCF yield of the S&P 500, as measured by the State Street SPDR S&P 500 ETF (SPY).

Figure 3: Johnson & Johnson's Cumulative FCF Since 2012



Sources: New Constructs, LLC and company filings

Economic Earnings Are Amongst the Best

Johnson & Johnson's ROIC of 15% is higher than XPH's ROIC of 11%. The company's high ROIC contributes to its strong economic earnings. Over the past five years, Johnson & Johnson generated more economic earnings than 20 of 21 publicly traded pharmaceutical, medical device, and consumer health companies in its peer group[1].

Per Figure 4, Johnson & Johnson's five-year average economic earnings are second only to Roche Holding (RHHBY) and are nearly three times higher than the peer group average.

Figure 4: Johnson & Johnson's Economic Earnings Vs. Peers: Five-Year Average

Company	Ticker	5-Year Avg Economic Earnings ($mm)
Roche Holding AG	RHHBY	$14,131
Johnson & Johnson	**JNJ**	**$11,919**
AbbVie, Inc.	ABBV	$9,476
Novartis AG	NVS	$8,104
Procter & Gamble Co.	PG	$7,855
GlaxoSmithKline PLC	GSK	$6,753
Unilever PLC	UL	$6,747
Merck & Co., Inc.	MRK	$6,727
Amgen Inc.	AMGN	$6,649
Eli Lilly & Company	LLY	$3,487
Peer Group Average		**$3,969**

Sources: New Constructs, LLC and company filings

Spinoff Creates a More Focused and Profitable Company

In November of 2021, Johnson & Johnson announced plans to spin off its consumer health segment, which raised concerns that the company will become overly concentrated in the remaining lines of business. We view the risk from the increase in business concentration as more than offset by the benefits of focusing resources on where its competitive advantages – and profits - are greatest. Consumer health accounted for 16% of total revenue in 2021, but just 6% of total income before tax. After the segments separate, Johnson & Johnson expects pharmaceutical sales to account for ~65% of total revenue compared to 56% in 2021.

While the company's reported earnings before tax rose from $17.7 billion in 2017 to $22.8 billion in 2021, earnings before tax from the consumer health segment fell from $2.5 billion to $1.3 billion over the same time. By separating the consumer health segment from the rest of the business, Johnson & Johnson hopes to become even more profitable over the long run.

After the separation, Johnson & Johnson will remain a highly diversified business. The company's pharmaceutical and medical devices segments are focused on ten different therapeutic and product areas, the largest of which, Oncology, accounts for just ~19% of total revenue.

Long-term Tailwinds Will Drive Pharmaceutical Demand

Favorable demographic and health insurance coverage trends will drive continued demand for pharmaceuticals over the long run. The population in the U.S. is aging, and that trend will drive increased healthcare expenditures, including pharmaceuticals, for individuals 65 and over. In the U.S., the number of individuals 65 and over is expected to grow from 54 million in 2020 to 65 million by 2025.

[1] AbbVie, Inc. (ABBV), Amgen Inc. (AMGN), AstraZeneca (AZN), Boston Scientific Corp (BSX), Bristol Myers Squibb Company (BMY), Colgate-Palmolive Company (CL), Eli Lilly & Company (LLY), GlaxoSmithKline PLC (GSK), Intuitive Surgical, Inc. (ISRG), Medtronic Plc (MDT), Merck & Co. (MRK), Novartis AG (NVS), Pfizer Inc. (PFE), Procter & Gamble Co. (PG), Roche Holding AG (RHHBY), Sanofi S.A. (SNY), Smith & Nephew PLC (SNN), Stryker Corporation (SYK), The Cooper Companies, Inc. (COO), Unilever PLC (UL), and Zimmer Biomet Holdings, Inc. (ZBH).

Additionally, the growing number of people covered by health insurance contributes to higher healthcare expenditures. The number of people in the U.S. with health insurance rose from 244 million in 2001 to ~301 million in 2021 and is expected to reach ~319 million[2] in 2030.

A Strong Performer in Multiple Environments

Though threats of government price controls pressure Johnson & Johnson's stock, the company has proven to profitably operate in a variety of political environments. After Medicare Part D went into effect on January 1, 2006, Johnson & Johnson received $615 million of revenue from the plan while improving its NOPAT margin improved from 19% in 2005 to 20% in 2007.

Since the Affordable Care Act was passed into law in 2010, Johnson & Johnson's NOPAT margins rose from 21% in 2009 to 23% in 2021 as the company's NOPAT grew 67%. Even if more governmental healthcare policies are enacted, it is not a given that they would negatively impact Johnson & Johnson's profits.

JNJ Has 32%+ Upside If Consensus Is Correct

Johnson & Johnson's PEBV ratio of 0.9 means the stock is priced for profits to permanently fall 10% below 2021 levels. Such an assumption seems overly pessimistic, given the company grew NOPAT by 5% compounded annually over the past decade.

Below we use our reverse discounted cash flow (DCF) model to analyze two future cash flow scenarios and highlight the upside potential in Johnson & Johnson's current stock price.

DCF Scenario 1: to Justify the Current Stock Price of $185/share.

If we assume Johnson & Johnson's:

- NOPAT margin falls to 21.7% (five-year average vs. 23.2% in 2021) in 2022 – 2031 and
- revenue falls by 0.2% (vs. 2022 – 2024 consensus estimate CAGR of +3%) compounded annually from 2022 – 2031, then

the stock is worth $185/share today – equal to the current stock price. In this scenario, Johnson & Johnson earns $19.5 billion in NOPAT in 2031, which is 10% below its 2021 NOPAT.

DCF Scenario 2: Shares Are Worth $244+

If we assume Johnson & Johnson's:

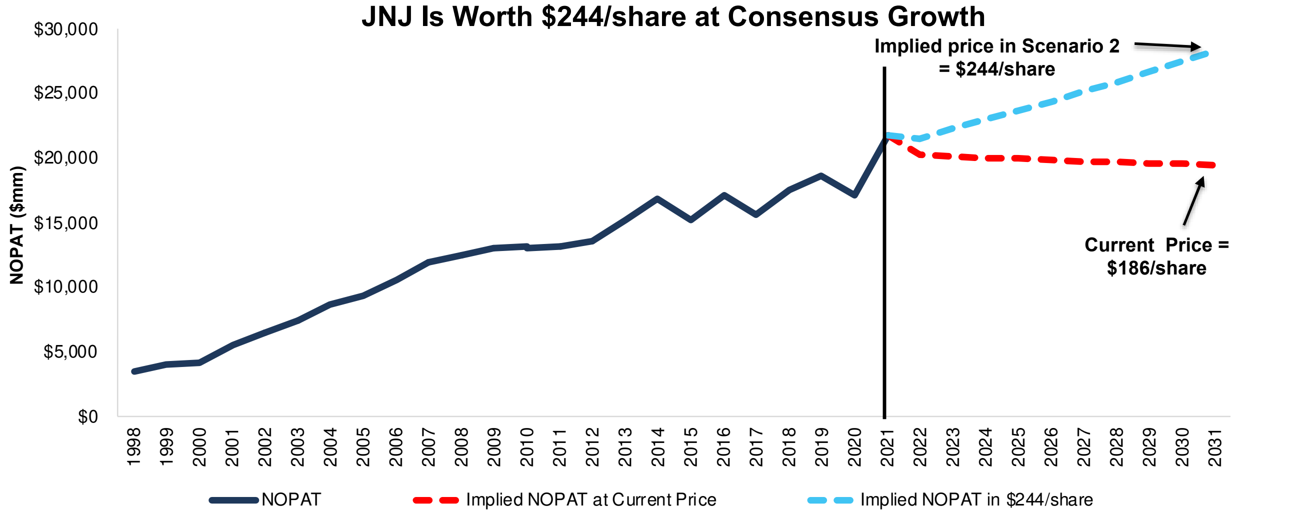
- NOPAT margin falls to 22.3% (three-year average) from 2022 – 2031, and
- revenue grows at a 3% CAGR from 2022 – 2031 (equal to consensus estimate CAGR from 2022 – 2024), then

the stock is worth $244/share today – a 32% upside to the current price. In this scenario, Johnson & Johnson's NOPAT grows just 3% compounded annually for the next decade. For reference, Johnson & Johnson grew NOPAT at a 5% CAGR from 2011 – 2021. Should Johnson & Johnson's NOPAT grow in line with historical growth rates, then the stock has even more upside.

Figure 5 compares Johnson & Johnson's historical NOPAT to its implied NOPAT in each of the above DCF scenarios.

[2] Derived from the Centers for Medicare & Medicaid Services (CMS) forecasted 2030 insured rate of 89.8% and the Census Bureau's 2030 population projection of 355 million.

Figure 5: Johnson & Johnson's Historical and Implied NOPAT: DCF Valuation Scenarios



Sources: New Constructs, LLC and company filings

This article originally published on [April 27, 2022](#).

Disclosure: David Trainer, Kyle Guske II, and Matt Shuler receive no compensation to write about any specific stock, style, or theme.

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It's Official: We Offer the Best Fundamental Data in the World

Many firms claim their research is superior, but none of them can prove it with independent studies from highly-respected institutions as we can. Three different papers from both the public and private sectors show:

1. Legacy fundamental datasets suffer from significant inaccuracies, omissions and biases.
2. Only our "novel database" enables investors to overcome these flaws and apply reliable fundamental data in their research.
3. Our proprietary measures of Core Earnings and Earnings Distortion materially improve stock picking and forecasting of profits.

Best Fundamental Data in the World

Forthcoming in The Journal of Financial Economics, a top peer-reviewed journal, Core Earnings: New Data & Evidence proves our Robo-Analyst technology overcomes material shortcomings in legacy firms' data collection processes to provide superior fundamental data, earnings models, and research. More details.

Key quotes from the paper:

- "[New Constructs'] *Total Adjustments* differs significantly from the items identified and excluded from Compustat's adjusted earnings measures. For example… 50% to 70% of the variation in *Total Adjustments* is not explained by *S&P Global's (SPGI) Adjustments* individually." – pp. 14, 1st para.
- "A final source of differences [between New Constructs' and S&P Global's data] is due to data collection oversights…we identified cases where Compustat did not collect information relating to firms' income that is useful in assessing core earnings." – pp. 16, 2nd para.

Superior Models

A top accounting firm features the superiority of our ROIC, NOPAT and Invested Capital research to Capital IQ & Bloomberg's in Getting ROIC Right. See the Appendix for direct comparison details.

Key quotes from the paper:

- "…an accurate calculation of ROIC requires more diligence than often occurs in some of the common, off-the-shelf ROIC calculations. Only by scouring the footnotes and the MD&A [as New Constructs does] can investors get an accurate calculation of ROIC." – pp. 8, 5th para.
- "The majority of the difference…comes from New Constructs' machine learning approach, which leverages technology to calculate ROIC by applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies." – pp. 4, 2nd para.

Superior Stock Ratings

Robo-Analysts' stock ratings outperform those from human analysts as shown in this paper from Indiana's Kelley School of Business. Bloomberg features the paper here.

Key quotes from the paper:

- "the portfolios formed following the buy recommendations of Robo-Analysts earn abnormal returns that are statistically and economically significant." – pp. 6, 3rd para.
- "Our results ultimately suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts." – pp. 20, 3rd para.

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