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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Johnson & Johnson (JNJ) EQ Review

Current EQ Rating*	Previous EQ Rating
4-	na

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

*For a more detailed explanation of the EQ Review Rating scale, please refer to the end of this report

We are initiating earnings quality coverage of JNJ with a 4- (Acceptable) rating.

While we do see some red flags and one time-benefits in JNJ's earnings, we are choosing to initially rate JNJ a 4- (Acceptable) due to its cash flow generation. As far back as the *Tylenol* tampering fiasco in the 80s, JNJ has experienced more than its fair share of missteps leading to conflicts with plaintiffs' attorneys. However, through it all, the company has managed to generate enormous amounts of cash that have enabled it to weather the storms. The dividend consumes about 50% of free cash flow. We do note that the buyback more than consumes the extra free cash flow at the current accelerated pace and the resulting 2%+ share reduction is a key supplement to EPS growth. However, with net debt to EBITDA less than 1x this is not a pressing issue.

A recent $4 billion litigation charge related to opioid litigation and a flood of negative headlines surrounding alleged carcinogenic baby powder are reminders of the likelihood of future payments related to lawsuits. Assessing the size and probability of future payments is beyond the scope of this review, but the $17 billion in cash on the balance sheet and the low debt level seem like solid preparation for foreseeable negative outcomes.

We note the following observations regarding the company's accounting:

- The allowance for doubtful accounts has been declining for several quarters, falling to 1.5% in the 9/19 quarter versus 2% a year ago. We estimate it would take about 2.2 cps in charges to bring the reserve back to last year's level.

- An obvious trend in the company's balance sheet is the disproportionate growth in allowance for rebates, returns, and promotions relative to sales. This is traceable to huge growth it the pharmaceutical segment allowance for rebates. These rebates represent incentives paid to pharmacy benefits managers to include the company's drugs on their formularies and are recorded as a reduction in sales. They are an integral and complex part of the overall pricing structure in the pharma industry. Therefore, we do not view the movement in these accounts as indicative of more conservative accounting, but rather a symptom of pricing concessions for some of its higher-priced drugs which the company has prominently discussed in recent quarters.

- JNJ's pension expense has been declining for the first nine months of 2019 with the decline adding almost 3 cps in the 9/19 quarter. This has largely been the result of lower recognition of actuarial losses likely driven by an increase in the discount rate used to calculate the PBO. In addition, we are puzzled by the decline in service cost given the presumably lower discount rate used in their calculation. The company has made no mention of a change to the benefit formula. Regardless, this seems unsustainable going forward in a low rate environment.

- Like most pharmaceutical companies, JNJ excludes the amortization of intangibles from its non-GAAP earnings figures. In our mind, this practice overstates the adjusted results as it fails to recognize that the company would have incurred research and development expenses if it had developed the acquired products itself. For perspective, the company's non-GAAP EPS figure of $2.12 in the 9/19 quarter had $0.38 worth of intangibles amortization added back to it representing a 22% boost.

- JNJ incurs regular restructuring payments with quarterly cash payments ranging from 1.5% to almost 5% of adjusted operating income. Our main concern regards the makeup of the charges as virtually all of the charges and cash payments for the first nine months of 2019 was labeled as "other" rather than severance or asset write-offs. The company describes the other category as including "project expense such as salaries for employees supporting the initiative and consulting expenses." Such a large portion of payments assigned to a category including employee time is always a concern as it requires management to estimate how much of its time was spent dealing with the restructuring versus day-to-day activity. This increases the chance of operating expenses being included in the charges and essentially written off in the non-GAAP adjustments.

- The company does not always exclude material gains from its non-GAAP adjustments. Case in point, JNJ realized a $2 billion gain from the divestiture of its ASP business in the 6/19 quarter. However, this amount was not adjusted out of the non-GAAP numbers. While the company included the gain in its outlook for Other (Income)/Expense for 2019 and called it out in the conference call, the failure to remove it led to a reported 23% increase in non-GAAP earnings. However, we estimate non-GAAP operating income actually declined by about 2% in that quarter. This makes the company's non-GAAP numbers unreliable as a gauge of true operational growth.

Allowance for Doubtful Accounts Declining

Despite the increase in accounts receivable, the allowance for doubtful accounts has actually been declining both year-over-year and sequentially. This has led to a noteworthy decline in the allowance percentage as seen below:

	9/29/2019	6/30/2019	3/31/2019	12/30/2018
Gross Receivables	$15,028	$14,904	$14,359	$14,346
Allowance for Doubtful Accounts	$227	$251	$244	$248
% of Gross Receivables	1.5%	1.7%	1.7%	1.7%

	9/30/2018	7/01/2018	4/01/2018	12/31/2017
Gross Receivables	$14,329	$14,380	$14,447	$13,781
Allowance for Doubtful Accounts	$281	$269	$281	$291
% of Gross Receivables	2.0%	1.9%	1.9%	2.1%

We estimate that just the sequential decline in the allowance percentage added a penny per share to earnings in the quarter. When viewed over the longer-term, it would take about 2.2 cps in charges to bring the allowance back to the 2% level.

Rebates Are Increasing Relative to Sales

JNJ makes provisions for rebates, sales incentives, trade promotions, coupons, returns and discounts which are accounted for as a reduction to sales and recorded in the "Accrued Rebates, Returns, and Promotions" account on the balance sheet. The following table shows the balance of the account as a percentage of trailing 12-month sales for the last eight quarters:

	9/29/2019	6/30/2019	3/31/2019	12/30/2018
Sales	$20,729	$20,562	$20,021	$20,394
Accrued Rebates, Returns and Promotions	$10,977	$10,433	$9,523	$9,380
% of T12 Sales	13.4%	12.8%	11.7%	11.5%

	9/30/2018	7/01/2018	4/01/2018	12/31/2017
Sales	$20,348	$20,830	$20,009	$20,195
Accrued Rebates, Returns and Promotions	$8,684	$8,717	$7,956	$7,210
% of T12 Sales	10.7%	10.8%	10.1%	9.4%

The table shows a sharp increase in the allowance relative to sales. While the company does not disclose the quarterly development of the allowances, it does provide detail by segment in its 10-K. The ending balances of the respective accruals for each segment are shown below:

	2018	2017	2016
Consumer Segment			
Rebates	$271	$186	$136
Returns	$57	$68	$65
Promotions	$497	$481	$358
Pharmaceutical Segment			
Rebates	$7,510	$4,862	$3,420
Returns	$436	$362	$334
Promotions	$13	$35	$0
Medical Device Segment			
Rebates	$1,218	$1,620	$1,500
Returns	$114	$152	$127
Promotions	$42	$83	$32

We can see that by far the largest component of the "Accrued Rebates, Returns, and Promotions" account is comprised of Pharmaceutical segment rebate provisions followed by Medical Device segment rebate provisions. Also, the source of the increase in the account is traceable to the increase in rebate provisions from the pharmaceutical segment which has more than doubled in the last two years. This is not surprising given that rebates are a major component of the complex pricing mechanism in the pharmaceutical industry. These payments essentially represent amounts paid to pharmacy benefits managers (PBMs) based on sales of the company's drugs which incentivize the PBM to include the company's drugs on the PBM's formularies (approved list of drugs). An increase in these rebates essentially represents a price cut that results in lower realized net revenue. JNJ has made multiple references to higher rebates, (particularly related to some of its higher-priced drugs) negatively impacting sales growth in recent quarters.

The same mechanism holds true with Medical Device rebates. Medical device rebates have not received much focus and frankly, we are not certain of the reason for the decline in the associated rebate provision. This is an area to focus on when the 2019 10-K comes out.

With consumer companies, we view significant changes in provision for rebates and promotions relative to sales as a concern as contract terms are generally not subject to rapid change so movements can indicate a company is becoming more aggressive in its estimates of how much it will eventually have to pay to customers. However, in the medical industry, this is more closely related to pricing action so we are less inclined to view the increase in pharmaceutical rebates provisions as more conservative accounting and more inclined to see it as the byproduct of pricing pressure in that product area.

Pension Expense Declining

JNJ has enjoyed a decline in pension and postretirement benefits expense for the last three quarters. In the 9/19 quarter, we estimate the decline in pension costs added almost 3 cps to earnings growth. While this is a relatively small amount of total earnings, it did represent well over a quarter of the reported growth in non-GAAP EPS in the period.

To evaluate the sustainability of this tailwind, we must look at the components of pension cost and what is driving each one. The following table shows the component of pension cost for the company's retirement and other benefit plans:

	9/29/2019	6/30/2019	3/31/2019	12/30/2018
Service Cost	$343	$346	$344	$425
Interest Cost	$319	$320	$321	$284
Expected Return on Plan Assets	-$580	-$582	-$585	-$550
Amortization of Prior Service Costs/(Credits)	-$6	-$7	-$7	-$7
Recognized Actuarial Losses	$177	$179	$176	$242
Settlement Losses	-$4	$8	-$1	$3
Total Pension/Postemployment Benefit Expense	$249	$264	$248	$397

	9/30/2018	7/01/2018	4/01/2018	12/31/2017
Service Cost	$374	$377	$376	$370
Interest Cost	$284	$287	$289	$274
Expected Return on Plan Assets	-$551	-$556	-$562	-$514
Amortization of Prior Service Costs/(Credits)	-$6	-$8	-$7	-$7
Recognized Actuarial Losses	$244	$244	$245	$188
Settlement Losses	$0	$0	-$2	$16
Total Pension/Postemployment Benefit Expense	$345	$344	$339	$327

The detail reveals that the decline is due to a combination of lower recognized actuarial loss followed by an increase in the expected return on plan assets and a decline in service cost.

To examine the forces behind the move in pension expense, we must examine the funded status of the plan and the assumptions used in the calculation of pension costs. This information is only available annually. The following table shows the funded status for the company's retirement plans and its other benefit plans:

	12/30/2018	12/31/2017	01/01/2017
Retirement Plans			
Benefit Obligation	$31,670	$33,221	$28,116
Fair Value of Plan Assets	$26,818	$28,404	$23,633
Retirement Plans Funded/(Unfunded) Status	-$4,852	-$4,817	-$4,483
Other Benefit Plans			
Benefit Obligation	$4,480	$4,582	$4,605
Fair Value of Plan Assets	$180	$281	$75
Other Benefit Plans Funded/(Unfunded) Status	-$4,300	-$4,301	-$4,530
Total			
Total Benefit Obligation	$36,150	$37,803	$32,721
Total Fair Value of Plan Assets	$26,998	$28,685	$23,708
Funded Status	-$9,152	-$9,118	-$9,013

The key assumptions used in the calculation of both the benefit obligation and the periodic pension expense are shown in the following table:

	12/30/2018	12/31/2017	01/01/2017
Benefit Obligations Assumptions			
Retirement Plans			
Discount Rate	3.76%	3.30%	3.78%
Rate of Compensation Increase	3.97%	3.99%	4.02%
Other Benefit Plans			
Discount Rate	4.40%	3.78%	4.42%
Rate of Compensation Increase	4.29%	4.30%	4.29%
Net Benefit Cost Assumptions			
Retirement Plans			
Service Cost Discount Rate	3.20%	3.59%	3.98%
Interest Cost Discount Rate	3.60%	3.98%	4.42%
Rate of Increase in Compensation Levels	3.98%	4.01%	4.02%
Expected Long-Term Rate of Return on Plan Assets	8.46%	8.43%	8.55%
Other Benefit Plans			
Service Cost Discount Rate	3.85%	4.63%	4.77%
Interest Cost Discount Rate	3.62%	3.94%	4.10%
Rate of Increase in Compensation Levels	4.29%	4.31%	4.32%

Key points to take away:

- Plan obligations fell in 2018 due to actuarial gains, the bulk of which is most likely due to the increase in the discount rate used to calculate the PBO.

- However, the company also experienced a negative return on plan assets which drove down the value of assets and resulted in the overall funded status remaining flat with 2017.

- The discount rate used to calculate service cost declined which has an upward impact on service cost as the present value of future benefits earned from current service are discounted at a lower rate. The company did, in fact, experience an almost 20% increase in service cost in 2018. We have seen no mention of the company changing its formula for future benefits so we are somewhat puzzled by the decline in service costs seen in the first nine months of the year and do not view that as sustainable in a lower rate environment absent changes to the pension formula.

- The company's expected return on plan assets of 8.46% was essentially flat in 2018. We note that while this is a relatively high assumed rate of return, the company's plans are roughly 70% invested in equity investments which makes it a little more reasonable. The increase in the expected return on plan assets the company has enjoyed so far in 2019 is likely due to rising asset balances driven by the market rebound.

- The largest component of the decline in pension expense in the first three quarters of 2019 is a lower amortization of actuarial losses which is likely being driven by the higher discount rate used in calculating the PBO. We would expect this to wane and even reverse in future quarters as the discount rate used in the calculation ultimately declines.

Restructuring Charges

In 2016, the company announced a restructuring program for its Medical Device segment to "strengthen its go-to-market model, accelerate the pace of innovation, further prioritize key platforms and geographies, and streamline operations while maintaining high-quality standards." Total charges under this plan amounted to $2.5 billion and it was substantially completed by the end of 2018.

In 2018, the company announced its Global Supply Chain initiative to "focus resources and increase investments in the critical capabilities, technologies, and solutions necessary to manufacture and supply its product portfolio, enhance agility and drive growth." The company anticipates spending approximately $1.9 billion to $2.3 billion for the plan which will run through 2022.

Over the last three years, cash restructuring payments have ranged from 1.5% to almost 5% of adjusted operating income. While this is not as egregious as some never-ending restructuring plans we see at some companies in terms of size, what catches our eye about the plan is the large percentage of the charge that is allocated to the "other" category. For the first nine months of 2019, the company took charges of $360 million and made cash payments of $316 million. Of those amounts, $279 million of the charges and $302 million of the payments were allocated to the "other" category with only $81 million of the charges assigned to asset-write-offs and only $14 million in cash payments assigned to severance. The footnotes explain that other "include project expenses such as salaries for employees supporting the initiative and consulting expenses." We are always concerned when we see large amounts of cash payments assigned to categories including employee expenses as management is essentially guessing as to how much of its time is being spent on the restructuring versus performing its regular duties. This increases the likelihood that expenses that should be viewed as operating are being included in the restructuring charges and getting added back to adjusted operating results.

Excluding Intangible Amortization

Like most pharmaceutical companies, JNJ excludes the amortization of intangibles from its non-GAAP earnings figures. In our mind, this practice overstates the adjusted results as it fails to recognize that the company would have incurred research and development expenses if it had developed the acquired products itself. For perspective, the company's non-GAAP EPS figure of $2.12 in the 9/19 quarter had $0.38 worth of intangibles amortization added back to it, representing a 22% boost.

Keep an Eye on Other Income/(Expense) vs. Non-GAAP

JNJ's "Other (Income)/Expense" line item on its income statement is a catch-all which regularly includes very material amounts. The company describes the account as follows:

> *"Other (income) expense, net is the account where the Company records gains and losses related to the sale and write-down of certain investments in equity securities held by Johnson & Johnson Innovation - JJDC, Inc. (JJDC), unrealized gains and losses on investments, gains and losses on divestitures, certain transactional currency gains and losses, acquisition-related costs, litigation accruals and settlements, as well as royalty income."*

The 9/19 quarter Other (Income)/Expense was an expense of $4.2 billion comprised mostly of a $4 billion settlement related to opioid litigation. Restructuring charges, litigation expenses, and unrealized gains/losses on securities are common constituents in the account. Most of these amounts are adjusted out of the company's non-GAAP earnings figures. However, occasionally material components don't wind up in the adjustments. For example, in the 6/19 quarter, the company recognized a $2 billion gain from the divestiture of its ASP business. However, this was not adjusted out of non-GAAP earnings, resulting in a reported increase of 23% for non-GAAP EPS in the 6/19 quarter on a 1.6% increase in non-GAAP sales. We estimate non-GAAP operating income actually declined by about 2% in the quarter. The company does give guidance for Other (Income)/Expense for the full year and highlighted the gain in the conference call. Still, we find it strange that the company did not elect to remove it from its non-GAAP earnings and the failure to do so seems to defeat the purpose of preparing the figure in the first place.

Explanation of EQ Rating Scale

6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor “red flag”, but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
3- "Minor Concern"	Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.
2- "Weak"	Indicates the company’s recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.
1- "Strong Concerns"	Indicates that the company’s recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

In addition to the numerical rating, the EQ Review Rating may also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into the next quarter. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

Disclosure

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