BEHIND
THE NUMBERS
Quality of Earnings Analysis

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Johnson & Johnson (JNJ) Earnings Quality Update 1/21 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We maintain our earnings quality rating on JNJ of 4- (Acceptable)

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

JNJ's 12/20 quarterly non-GAAP EPS of $1.86 was 3 cps ahead of the consensus. Not surprisingly, the company's consumer business has seen increased sales of certain products such as analgesics, fever remedies, and mouthwash a result of COVID. However, this has been somewhat offset by declines in others categories such as cold and flu treatments resulting from the non-existent flu season. Likewise, medical products have been hurt by delays in elective procedures which should reverse over the next year as the pandemic wanes. The company's guidance towards $9.50 per share in non-GAAP earnings in 2021 does not include the impact of the release of its COVID vaccine.

Overall, we do not have any large concerns regarding the company's earnings quality. We identified approximately 5.5 cps in non-operating EPS headwinds in the quarter. Our biggest point of concern remains the adding back of expenses to non-GAAP earnings that could be considered operational.

What is stronger?

- JNJ was guiding towards $850 million of adjusted net other income for 2020 prior to the fourth quarter. The figure came in at $720 million. The implied shortfall in the fourth quarter would have cost the company 4 cps in earnings in the 12/20 quarter.

- The adjusted tax rate in the 12/20 quarter increased by 70 bps year-over-year which cost the company almost 1.4 cps in earnings growth in the quarter.

What is weaker?

- JNJ adds back restructuring changes to non-GAAP earnings. As we have observed with JNJ before, its charges are not as large relative to earnings as some “serial restructurers” we follow. However, what stands out with JNJ is the large percentage of its restructuring charges that are allocated to the “other” category which includes the salaries of employees involved with the actions and consulting charges. We see these types of charges as having the largest chance of including costs that should be viewed as part of the company’s ongoing business activities. Of the $446 million in charges taken in 2020, $405 million were labeled as “other”.

- JNJ added back $2.9 billion in pre-tax litigation charges in the 12/20 associated with the quarter bringing the 12-month total to more than $5.1 billion. Most of this is related to the company’s talc litigation. While the talc issue may be a one-time event, litigation is a typical occurrence for JNJ going back to the *Tylenol* problem decades ago. For reference, pre-tax litigation charges were $5 billion in 2019, $1.9 billion in 2018, and $1.3 billion in 2017. At what point should a large part of these charges be viewed as operational?

What to watch

- Consumer segment accrued consumer rebates, returns, and promotions fell by 1.3 days of Consumer sales due to a decline in accrued promotion costs. This is not overly alarming given the increased demand for OTC analgesics/fever remedies and mouthwash which likely reduced the need for promotional activity.

- Medical Device segment accrued rebates, returns, and promotions increased by $187 million (16%) on a decline in Medical Device sales. This drove the allowance up more than 4 days of device sales. This should not be unexpected given that the company was

likely extending more aggressive rebates to customers in an attempt to drive sales in a weak demand environment.

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 Concern)- 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 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 upcoming quarters. 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.

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