

JOHNSON & JOHNSON - FINANCIAL PERFORMANCE EVALUATION

ASSESSMENT 1

MODULE TITLE: FINANCIAL MANAGEMENT LCMB7002

LECTURER: JIA MIAO

STUDENT NAME: NADEZHDA KITANOVA

STUDENT NUMBER: 1918675

1. JOHNSON & JOHNSON INC. - HISTORY, CORPORATE INFO, MARKET POSITION

Johnson & Johnson is a multinational corporation founded in 1886 in the USA. Alex Gorsky is the current CEO of Johnson & Johnson. He assumed this position on April 26, 2012. Gorsky started working for Johnson & Johnson in 1988 for Janssen Pharmaceutica as a sales representative. The company operates into three major segments: Pharmaceuticals, Medical Devices, and Consumer Products. In 2015, these segments contributed to the total revenue with 44.9%, 35.9%, and 19.2%, respectively. Among its well-known consumer products are the Tylenol medications, Johnson's Baby products, [Neutrogena](#) skin and beauty products, Acuvue contact lenses. It completed its IPO and became a public company in 1944. Currently their stock market price has remained stable, being \$150/ per share in the last 6 months. Nowadays, Johnson & Johnson is one of the largest corporations by total revenue in the USA, ranking among the top 50 according to Fortune magazine. The company's business success is due to its aggressive acquisition strategy, achieved economies of scale and global presence. The corporation includes 250 subsidiary companies with operations in 60 countries and products marketed in over 175 countries. It reported revenues of US\$82,059 million for the FY2019, marking an increase of 0.6% over FY2018. In FY2019, the company's operating margin was 21.1%, compared to an operating margin of 22.1% in FY2018. In FY2019, the company recorded a net margin of 18.4%, compared to a net margin of 18.8% in FY2018. The company reported revenues of US\$20,691 million for the first quarter ended March 2020, a decrease of 0.3% over the previous quarter, which is mainly due to the global stagnation caused by COVID-19 pandemic. Its biggest competitors are Bayer (€43.5b revenue FY2019), Procter & Gamble (\$71b FY, 2020) Pfizer (\$51.8b FY, 2019), Unilever (€52b FY2019), Novartis (\$47.4b FY, 2019), Abbot (\$31.9b FY, 2019). Currently the company is focusing on the development of a COVID-19 vaccine, receiving support funding from the US government. The company is involved in a series of litigation, resulting in billions of legal losses and product recalls. Multiple claims that Johnson & Johnson's baby powder causes ovarian cancer has cost the company billions of dollars with the most recent case as of December 19, when the company failed to reverse a jury verdict that awarded \$4.14 billion in punitive damages and \$550 million in compensatory damages for the company. Other acquisitions include foreign bribery, consumer fraud, illegal marketing. On the other side, the company is a leading player in the global health care supplies market with 6.7% share of the market's value and in the healthcare equipment sector - with 15% share of the market.

1. JOHNSON & JOHNSON - FINANCIAL PERFORMANCE ANALYSIS. CRITICAL REVIEW

A) BALANCE SHEET & INCOME STATEMENT (APPENDIX A)

In terms of financial success, Johnson and Johnson has stayed relatively constant over time. This can be seen by analyzing two key factors. The first factor is total assets, which from 2015 to 2019 has increased only by 0.2%. On the other side, total liabilities increased with approximately 0.4% between 2015 and 2019. Although the numbers in each specific section

vary, the balance sheet of Johnson & Johnson displays consistent liabilities and slight increase in assets over years. Although there was a consistent growth in assets, liabilities have a bigger percentage increase with the biggest jump from 2016 to 2017 due to tax increase and long-term debt increase. When analyzing the equity portion of the balance sheet, there are a couple of observations to be made. For one thing, retained earnings went up gradually, while stockholder's equity went down from 2015 to 2019. At the end of the whole balance sheet, it can be said that Johnson and Johnson is better off by 2020, but there is no significant growth.

The analysis of the income statement involves comparing the different line items within a statement, as well as following trends. This analysis is used to understand the cost structure of a business and its ability to earn a profit. One of the most significant, and clear observations made from the income statement is that J&J has improved over time, where in 2015, they made 70.2 billion, 76 billion in 2017 and 82.11 billion in 2019 which shows a gradual growth. Contrary, net income which is an indicator for company's profitability has remained relatively stable, but with a trend to decrease. Ratio analysis is used by the accounting managers to identify the long term business ethics and sustainability of an organization by identifying the overall financial health (Al Nuaimi & Nobanee, 2019). This research focuses on the analysis of key accounting ratios to identify the financial performance of Johnson & Johnson in the period 2015-2019. The ratio and profitability of the organization provide a proper understanding of the whole company. Four major ratios are analyzed in this research such as liquidity, leverage, profitability and efficiency ratios. Liquidity ratio helps understanding the day to day activities of an organization that refers to how a firm manages its short term operations by utilizing its current assets and inventories. Efficiency ratios help in identifying the expected turnover of an organization over its assets and trade receivable (Karkowska, 2018).

A) FINANCIAL RATIOS ANALYSIS

Liquidity ratios of (Johnson & Johnson company)

Ratios/Year	2019	2018	2017	2016
Current Ratio	1.25	1.47	1.41	2.47
Quick Ratio	1.00	1.19	1.12	2.16
Cash Ratio	0.536	0.630	0.599	1.594

While observing the current ratio margin of Johnson & Johnson, it is found that the company faces a consecutive decline in that margin due to an increase in current liabilities. As can be observed from the table given above. The ratio has been seen to have declined over the years and in the current ratio it is quite clear how the liquidity for the company has been decreasing over the years and has reached the current position for the company. The current ratio margin of the company is around 1.25 in 2019 in comparison to 2.47 in 2016. Based on the performance, it ensures that the company requires to utilize its current assets to mitigate the current liabilities. As for the ratio in the company that has already been seen decreasing, the other ratios are also seen to have decreased as is prevalent in the table. The quick ratio margin of Johnson & Johnson is also decreased to 1.01 in 2019 from 2.16 in

2016. Cash ratio helps to identify how an organization utilizes its cash balance to pay off current or short term obligations (Li & Wang, 2017). In that context, the Cash ratio margin of Johnson & Johnson is also going down in four consecutive years such as 1.59, 0.59, 0.630, and 0.53 in 2016, 2017, 2018, and 2019, respectively. The Cash ratio shows the percentage of cash that the company has been possessing new implementation and better product quality. Also, from the table, it is quite evidently shown how much the ratio has been decreasing.

Leverage ratios of (Johnson & Johnson company)

Ratios/Year	2019	2018	2017	2016
Debt-equity ratio	0.47	0.51	0.57	0.39
Debt-capital ratio	0.32	0.34	0.37	0.28

Debt-equity ratio

The Debt to Equity Ratio is a leverage ratio that calculates the value of total debt and financial liabilities. The higher the ratio is, it means the company presents higher risk, because it finances its operations with debt. In this case, although it has increased from 2016, Johnson & Johnson's debt to equity ratio improved from 2017 to 2018 and from 2018 to 2019. The debt- equity ratio is a measure of a company's financial leverage. It's calculated by dividing a firm's total liabilities by total shareholders' equity.

Leverage describes a business's use of debt to finance business activities When debt is the primary way a company finances its business, it's a "highly leveraged" company. Johnson and Johnson is not considered highly leveraged because a good debt-equity ratio is around 1-1.5. This important financial metric indicates the stability of a company and its ability to raise capital.

Debt-capital ratio

This ratio is calculated as total debt divided by total debt plus shareholders' equity. This ratio gives better insights on the company financial situation rather than just looking at the total debt. The higher the ratio is, the riskier investment is the company. Johnson & Johnson's debt to capital ratio improved from 2017 to 2018 and from 2018 to 2019.

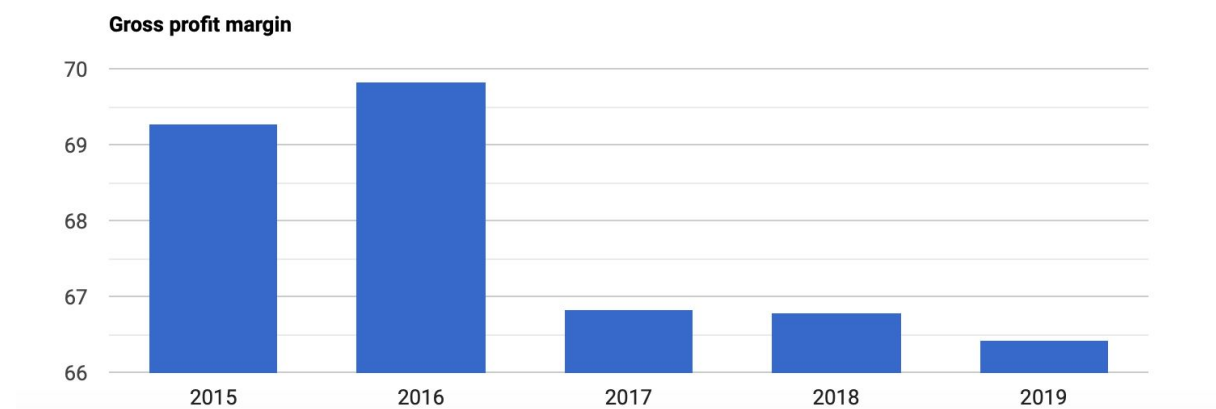
Profitability ratios of (Johnson & Johnson company)

Ratios/Year	2019	2018	2017	2016
Gross profit margin	66.42%	66.79%	66.84%	69.84%

Operating profit margin	24.15%	24.27%	24.07%	28.72%
Net profit margin	18.42%	18.75%	1.70%	23.01%

Gross profit margin

Profitability ratios measure the company's ability to generate profitable sales from its resources. Gross profit margin indicates the percentage of revenue available to cover operating and other expenditures. Johnson & Johnson gross profit margin has gone down since 2016. It is relatively low compared to its competitors with Pfizer with the highest gross profit margin for 2019, at 80.25%. A higher gross profit margin indicates that the business has more cash assets to cover liabilities. It may also result in higher ending profits for owners and shareholders.



Operating profit margin

Operating profit, or earnings before interest and taxes (EBIT), deducts operating expenses from gross profit. These expenses may include commissions, administrative expenses, and other general costs. A company's operating profit reveals how much revenue is left over after it covers both COGS and operating expenses. The operating profit margin shows the percentage of revenue which remains. After decreasing with 4% from 2016 in 2017, Johnson & Johnson's operating profit margin improved from 2017 to 2018 but then went down from 2018 to 2019.

Net profit margin

The net profit margin ratio reveals the percentage of profit the company keeps from its sales revenue after all expenses (operating and non-operating) are paid. A high net profit margin indicates a company that is operating successfully. Johnson & Johnson's net profit margin follows a decreasing trend from 2016.

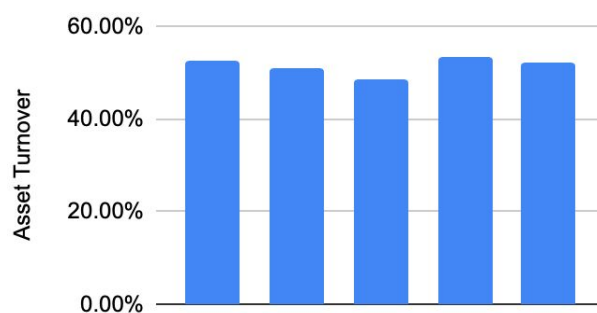
Profitability ratios can attract new investors. Reviewing a company's profitability ratios is a simple way to analyze whether a business is performing well. Johnson & Johnson should review their costs, how much their customers are willing to rebuy their products. The bad reputation from lawsuits and product recalls mentioned in the previous chapters reflect on the financial performance of the company. Return ratios are also profitability ratios, but while the margin ratios discussed so far measure the return on sales, return ratios measure the return on investments.

Return ratios of (Johnson & Johnson company)

Ratios/Year	2019	2018	2017	2016
Return on equity (ROE)	25.42%	25.60%	2.16%	23.49%
Return on assets (ROA)	9.59%	10.00%	0.83%	11.71%
Asset Turnover	52.62%	50.95%	48.62%	53.31%

Total Assets of Johnson & Johnson:

Asset Turnover



Total Assets Turnover refers to the ability of an organization to gain a high margin of revenue over its assets. It's the most broad used ratio to measure efficiency. Assets are an important part of any organization. It provides the organization with the amount that they need to run their business properly and their expenses for the company. Johnson & Johnson is a big company and is focused on providing the best products to the clients. The total assets turnover indicates the highest margin was in the year 2016, with a slight decrease in 2017 and 2018. In 2019, the company achieved 52.62% as assets turnover, which indicates the capability of the organization to spot operational flows and recover efficiency rates.

Return on Equity of Johnson & Johnson:

The return on equity ratio is perhaps the most important of all the financial ratios to a publicly-held company's investors. It measures the return on the money the investors have put into the company. The Return on Equity (ROE) margin of the company is quite consistent in 2018 and 2019 with a margin of 25.60% and 25.42% and has an increasing trend. Returns are important for an organization. Whereas, the ROE margin of the business is around 2.16% in 2017 which decreases due to lesser net profit during this year.

Return on Assets of Johnson & Johnson:

Return on Assets (ROA) margin of the company also remains consistent in 2018 and 2019, which is around 9.6% and 10% in 2019 and 2018. Returns on assets provide the interest that they may receive as they are getting from having an asset to look into. Whereas, the ROA margin has deteriorated to 0.83% in 2017 that indicates Johnson & Johnson has failed to utilize its assets efficiently. Although the ROA recovered in the following years, it didn't reach values from previous years.

The liquidity ratio helps in understanding the liquidity position and its capacity to deal with current liabilities. The company needs to focus on improving its liquidity as liquidity ratios have been decreasing since 2016. The company should analyse its operating costs and aim to reduce them. It can relocate resources to further develop and promote its business which could increase profits. Johnson & Johnson is a multinational corporation with a large scale of operations, so it could invest in automatization of processes in order to reduce costs.

Although the total assets have increased over the years, total liabilities have increased proportionally, which negatively affects the liquidity ability of the company.

Leverage ratios show the proportion of debts compared to the company's equity/capital.

They represent the financial health of the company. The higher the ratio is, the higher the amount of debt is, which means that the company has less ability to pay its debts and would be perceived as a "risk company" from investors. Johnson & Johnson's situation has remained stable over the years, indicating that the company remains stable and safe investment.

Every company is most concerned with its profitability. One of the most frequently used tools of financial ratio analysis is profitability ratios. Profitability measures are important to managers and stakeholders. Management has to have a measure of profitability in order to choose the right business strategy. The company management has to show profitability to present and future shareholders. A more profitable company is naturally more attractive to investors. Gross profit margin has remained stable from 2017 till 2019, but it never recovered to 2016 levels. From 2016 to 2017 there is the biggest drop of 3%, which along with increasing liabilities, led to a very big drop in net profit margin, too. Operating expenses have remained stable after an increase from 2016 to 2017. Unusual expenses in 2017 have affected negatively the ROE & ROA, which are usually stable for Johnson & Johnson. The only stable profitability ratio is the Assets Turnover, which indicates that the company has a good ability to maintain high revenues over its assets. As ROE is one of the most important profitability ratios for investors, it could be further revealed what influences it. The DuPont model decomposes the different drivers of return on equity (ROE) which allows investors to focus on the key metrics of financial performance and identify strengths and weaknesses. The DuPont model is useful in determining whether and what financial adjustments need to be made.

There are three major financial metrics that drive return on equity (ROE): operating efficiency, asset use efficiency and financial leverage. Operating efficiency is represented by net income divided by total sales or revenue. Asset use efficiency is measured by the asset turnover ratio. Leverage is measured by the equity multiplier, dividing total assets by

shareholder's equity. ROE metric is calculated by dividing net income by shareholders' equity. The Dupont analysis is an expanded version of ROE, giving deeper insights into what drives changes in ROE.

	2019	2018	2017	2016
Operating efficiency	21.95%	22.99%	1.70%	18.77%
Asset use efficiency	52.62%	50.95%	48.62%	53.31%
Leverage	2.14	1.99	1.62	1.64
DuPont Analysis	24.75%	23.36%	1.34%	16.42%

It can be concluded from the DuPont analysis of Johnson & Johnson that ROE is very much influenced by operating efficiency and leverage metric. ROE fluctuates directly proportional to leverage, while asset use efficiency doesn't influence ROE of Johnson & Johnson. In order for Johnson & Johnson to increase their financial performance, the company should focus on maintaining good operating efficiency, keeping a balanced financial leverage and maintaining their high asset use efficiency.

B) EVALUATING PROJECTS BY USING INVESTMENT APPRAISAL TECHNIQUES

The first part of this chapter would evaluate two projects by using widely used financial techniques, while the second part would critically evaluate the advantages and disadvantages of these techniques. Capital investment appraisal provides information for long-term financial decisions. They are useful as they help to evaluate a project prior to implementation and actually see which project would be worthwhile. The most common techniques which are going to be discussed further in this chapter are PBP (payback period), ARR(accounting rate of return), discounted cash flow techniques.

Payback period (PBP)

The first step in the evaluation of the two projects, would be to calculate the Payback Period - or the amount of time it takes to recover the cost of an investment. Payback period indicates the time needed for an investment to reach a break-even point. Logically, shorter paybacks make an investment more attractive. Payback Period is a simple concept, used in day-to-day life as well. It is not complex enough though to give an accurate evaluation as it doesn't consider the time value of money, and it ignores cash flows after the investment is paid.

Evaluating the 2 projects below, if PBP is determining, it could be stated that project A is better, as the PBP is shorter. As mentioned above, this technique doesn't take into consideration the cash flows after, which are higher in the case of Project B. Although the initial investment is higher in project B and therefore the PBP period is longer, in the end project B would generate more cash than project A. Another flow in the PBP method is the lack of risk evaluation, which can influence a project positively or negatively. If it is supposed that project A is conducted in London and project B is conducted in Manchester, there would be further factors which should be considered when evaluating the two projects.

Year	Project A (£m)	Project B (£m)
0	-30	-50
1	0	15
2	15	15
3	20	15
4	10	27
Total cash flows:	15	22
PBP	2 years 6 months	3 years 2 months

Accounting Rate of Return (ARR)

Accounting rate of return, also known as Return on capital employed, is a financial ratio indicating the return of income generated from a capital investment. The ratio does not take into account the concept of time value of money. The ARR is a percentage return. When comparing investments, the higher the ARR, the more attractive the investment.

The key advantage of ARR is that it is easy to compute. The main disadvantage of ARR is that it disregards the time value of money or risks for long term investments. The ARR is built on evaluation of profits and it can give misleading information when evaluating investments of different sizes.

Year	Project A (£m)	Project B (£m)
0	-30	-50
1	0	15
2	15	15
3	20	15
4	10	27
Total profit	15	22
Average acc. profit/y	3.75	5.5
ARR (initial investment)	0.125	0.110

After calculating the return of investment of the two projects, it's noticeable that while by the PBP criteria, project A was a significantly better option, in terms of ROI, project A appears to be slightly better. This difference comes mainly from the fact that ARR takes into account the whole project, unlike PBP, which can be determining if the cash flows after the PBP are significantly different than it is in the case of the above 2 projects.

Net Present Value (NPV)

Net Present Value is known to be the best appraisal method as it takes into consideration the time value of money and evaluates the project as a whole. (NPV) represents the difference between the present value of cash inflows and the present value of cash outflows over a period of time. A positive net present value indicates that the projected earnings exceeds, where the values are equalled by the discounted value of money concept. It is assumed that an investment with a positive NPV will be profitable, and an investment with a negative NPV will result in a loss. An important drawback of using the NPV method is that it makes assumptions about future events, which are influenced by other non-financial factors. In terms of the two projects below, project B has a higher net present value, which indicates that project B is a better investment decision.

Year	Project A (£m)	Present value A	Project B (£m)	Present value B
0	-30	-30	-50	-50
1	0	0.00	15	13.42
2	15	12.00	15	12.00
3	20	14.31	15	10.73
4	10	6.40	27	17.28
NPV		2.71		3.43

Cost of capital: 11.8%

Evaluating the results of the capital investment appraisal of project A & B, a controversy between the 3 techniques could be noticed. While PBP and ARR indicated that project A is a better investment decision, NPV shows the opposite. As both projects deliver positive values and the difference between the results it's not very significant, other factors as the current economic environment and risk evaluation should be taken into consideration. Although it could be stated that NPV is the indicator with the biggest weight as it gives the most accurate picture and considers the time-value of money, in an unstable economic environment it ignores factors such as stability, risk, inflation, legal changes. In the highlights of the present COVID-19 pandemic, which is forecasted to result in higher rates of inflation because of the huge cash injections in the economy from the government side. Having in mind as well factors as lockdown measures, it is credible that projects with shorter payback periods could be more attractive than projects with higher profits, just because shorter PBP indicates less risk and time-value of money could be disrupted by inflation, economic crisis and political instability. In conclusion, capital investment appraisal methods like NPV, PBP and ARR are very useful as it provides a simple way of measuring and rating projects, but

relying only on them, could be a major drawback as all results should be critically evaluated by taking into consideration non-financial factors. In the dynamic economic environment of the 21st century, risk evaluation should be an inevitable part of the financial evaluation of investments.

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APPENDIX 1: BALANCE SHEET AND INCOME STATEMENT, JNJ, 2015-2019

BALANCE SHEET					
Assets					
Fiscal year is January-December. All values USD millions.	2015	2016	2017	2018	2019
Cash & Short Term Investments	38.38B	41.91B	18.3B	19.69B	19.29B
Cash Only	13.73B	18.97B	17.82B	18.11B	17.31B
Short-Term Investments	24.64B	22.94B	472M	1.58B	1.98B
Total Accounts Receivable	10.73B	11.7B	13.49B	14.1B	14.48B
Other Current Assets	3.05B	3.28B	2.54B	3.65B	2.49B
Total Current Assets	60.21B	65.03B	43.09B	46.03B	45.27B
	2,015.00	2,016.00	2,017.00	2,018.00	2,019.00
Total Assets	133.41	141.21	157.30	152.95	157.73
Liabilities & Shareholders' Equity					
	2015	2016	2017	2018	2019
ST Debt & Current Portion LT Debt	7B	4.68B	3.91B	2.8B	1.47B
Short Term Debt	4.9B	2.98B	2.41B	160M	371M
Current Portion of Long Term Debt	2.1B	1.7B	1.5B	2.64B	1.1B
Accounts Payable	6.67B	6.92B	7.31B	7.54B	8.54B
Income Tax Payable	750M	971.00	1.85B	818M	2.27B
Other Current Liabilities	13.33B	13.71	17.47B	20.08B	23.68B
Dividends Payable	-	-	-	-	-
Accrued Payroll	2.47B	2.68B	2.95B	3.1B	3.35B
Miscellaneous Current Liabilities	10.85B	11.04B	14.51B	16.98B	20.33B
Total Current Liabilities	27.75B	26.29B	30.54B	31.23B	35.96B
Long-Term Debt	12.86B	22.44B	30.68B	27.68B	27.21B
Total Liabilities	62.26	70.79	97.14	93.20	98.26
Total Equity	71.15	70.42B	60.16B	59.75B	59.47B
Liabilities & Shareholders' Equity	133.41	141.21B	157.3B	152.95B	157.73B

INCOME STATEMENT					
Fiscal year is January-December. All values USD millions.	2015	2016	2017	2018	2019
Sales/Revenue	70.20	71.94	76.48	81.53	82.11
Cost of Goods Sold (COGS) incl. D&A	21.58B	21.64B	25.19B	27.19B	27.14B
COGS excluding D&A	17.83B	17.88B	19.55B	20.26B	20.13B
Depreciation & Amortization Expense	3.75B	3.75B	5.64B	6.93B	7.01B
Depreciation	2.55B	2.55B	2.64B	2.53B	2.51B
Amortization of Intangibles	1.2B	1.2B	3B	4.4B	4.5B
Gross Income	48.62B	50.3B	51.29B	54.35B	54.98B
	2015	2016	2017	2018	2019
SG&A Expense	30.26B	28.95B	31.95B	33.1B	33.43B
Research & Development	9.05B	9.01B	10.43B	10.56B	11.25B
Other SG&A	21.2B	19.95B	21.52B	22.54B	22.18B
Other Operating Expense	-	-	-	-	-
Unusual Expense	1.67B	1.59B	3.31B	4.14B	6.01B
EBIT after Unusual Expense	16.7B	19.76B	(3.31B)	17.12B	15.54B
Non Operating Income/Expense	2.92B	438M	2.28B	1.47B	2.2B
Non-Operating Interest Income	128M	368M	385M	611M	357M
Equity in Affiliates (Pretax)	-	-	-	-	-
Interest Expense	552M	763M	1.02B	1.19B	769M
Net Income	15.41	16.54	1.30	15.30	15.12