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Acquisition The Johnson and Johnson Way-the Case of Depuy Synthes

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Johnson and Johnson, the brand synonymous with protection and care, had for long been voted as globalmost trusted brand. The management of Johnson and Johnson decided for further expansion in healthcare domain and reviewed the brand Synthes Inc.performance to formulate upon its merger /acquisition strategy. Johnson and Johnson had to face uncertainties and challenges to make this acquisition successful.This case study outlines the acquisition and governance of Johnson & Johnson for its medical device division as it considered diversification of its products in the medical instruments domain, which encompasses many opportunities of disruptive innovations to market to new or underserved customers. Depuy Synthes the flagship healthcare company of J&J had a significant growth trend and is steady over the years and a number of initiatives taken in the recent years had started yielding results. Depuy Synthes strategy was communicated widely to shareholders and employees alike and changed little over time as it focused mainly on organic growth although Mergers and acquisitions is considered appropriate if the targets had great strategic fit, and if J&J could clearly add value to the target, and if the financials made sense from a shareholder point of view.

Keywords: Mergers, Acquisition, Portfolio Diversification, Uncertainty Identification.

Company Background

Johnson and Johnson origin can be traced as far back in 1886 by Robert Wood Johnson, James Wood Johnson and Edward Mead Johnson, when a healthcare company was established in State of New Jersey in 1887.From 1943 chairman Robert Wood Johnson wrote J&J Credo, outlining their responsibilities to doctors, nurses, patients, consumers, employees, and the community. During this period they continued overseas growth and began to broaden their efforts in pharmaceuticals and medical products. Their continued Product Growth and their Credo positioned Johnson & Johnson as Responsible Industry Leader. The Company's structure is based on the principle of decentralized management. The Executive Committee of Johnson & Johnson is the principal management group responsible for the strategic operations and allocation of the resources of the Company.

The Company's primary focus has been on products related to human health and well-being and is basically into activities of the Consumer, Pharmaceutical and Medical Devices and Diagnostics business segments In line with the principle of decentralized management, senior management groups at U.S. and international operating companies are each responsible for their own strategic plans, as well as the day-to-day operations of those companies, and each subsidiary within the business segments is, with some exceptions, managed by citizens of the country where it is located.

Their Medical Devices and Diagnostics segment includes a broad range of products used principally in the professional fields by physicians, nurses, hospitals, and clinics. These include products to treat cardiovascular disease; orthopedic and neurological products; blood glucose monitoring and insulin delivery products; general surgery, biosurgical, and energy products; professional diagnostic products; infection prevention products; and disposable contact lenses.

The Issue

Johnson & Johnson fast become synonymous with healthcare. Through mergers, acquisitions and the formation of new companies, they have become the world's largest and most broadly based health care company.

In line with this the issues faced by the company were following:

1. Why did Johnson & Johnson went to acquire Synthes.

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2. How did the company stave off uncertainties toacquisition?

3. Did the acquisitionreap profits for Johnson & Johnson?

Data

Orthopedic Implants Demand

A new global market report on 'Orthopedic Implants' was been released by Industry Experts. According to the report, the global market for orthopedic implants is projected to reach US$ 46.5 billion by 2017 from an estimated US$ 21.1 billion in 2007.The number of younger patients has also increased due to higher quality of life expectations. Patients with high levels of immobility and pain have no option but to go in for major joint replacement, which can induce a radical change in people's quality of life by relieving pain and restoring their physical independence, thus estimated a growth of demand by 8.9 percent annually through 2012 (Investors media, 2011, p. 22).

Market for Orthopedic Implant product segments analyzed in this study includes Joint Implants, Trauma Implants and Other orthopedic Implants. The global market orthopedic implants expected to touch US$ 30.5 billion in 2012.The study also analyzed the competitive environment of orthopedic implants key players and illustrates the market shares of major global players for the year 2010.

The report reviews, analyses and projects the Orthopedic Implants market for global and the regional markets including United States, Europe, Asia-Pacific and Rest of World. The regional markets further analyzed for 10 independent countries across Europe Austria, France, Germany, Italy, Spain, the United Kingdom, Scandinavia, Eastern Europe and Rest of Europe; Asia-Pacific China, Japan, South Korea, Taiwan and Rest of Asia-Pacific.

Case Resolution: Acquisition of Depuy Synthes

The company market research and intelligence clearly demonstrated certain success factors in the merger:

1. J &J had to maintain double digit growth rate to meet the demands of their shareholders
2. The acquisition will create the most innovative, comprehensive orthopedics business in the world and enable it to better serve clinicians and patients especially in emerging markets.

How Johnson & Johnson got it Right - The Expansion Game

Consolidation of business entities is a world-wide phenomenon which Johnson & Johnson adapted as one of the tools in healthcare sector driven by the objective of leveraging the synergies arising out of the consequences of M&A process.Ensuring merger with its franchise of orthopedic and neurosurgery Dupuy Synthes which is a companies acquired by Johnson & Johnson in 1998, part of the Johnson & Johnson Medical Devices & Diagnostics group. DePuy develops and markets products under following brands:-Joint Reconstruction & Trauma - DePuy Orthopedics EMEA.,Spinal Care - DePuy Spine EMEA. ,Sports Medicine - DePuy Mitek EMEA.,Neuroscience Therapies - Codman EMEA.

Dupuy acquired Synthes which was a leading global medical device company, employing about 12,000 people whose mission was to improve patient care around the world(Company report 2012).Synthes has set the standard for treating fractures and are the world leader in traumatology; and rank among the top companies for spinal devices and have a leading position in the cranio-maxillofacialbusiness. Synthes an innovative pioneer in the field of biomaterialssuch as resorbable implants, bone graft substitutes and coated materials. Synthes also offers a wide range of power tools for surgical use, a business unit that was recently enhanced by a selection of high-speed devices with the acquisition of Anspach in 2010.

Johnson & Johnson realized that in order to get its acquisition right it has to encourage more effective management to make a better merged company.Prior to the merger, Synthes has been unable to grow despite previously buying, while J&J had to make long term investments into their product pipelines, Moreover J &J had to maintain double digit growth rate to meet the demands of their shareholders.

Johnson & Johnson believed that the acquisition will expand and strengthen its orthopedics business worldwide, which represents an important growth driver for it. Johnson & Johnson further believed that Synthes is widely respected for its innovative high-quality products, world-class research and development capabilities, commitment to education, high standards of service and extensive global footprint. It expected that the acquisition will create the most innovative, comprehensive

orthopedics business in the world and enable it to better serve clinicians and patients worldwide.

Johnson & Johnson for years had been transforming more and more into a medical device company. In 2001, the medical device and diagnostics (MD&D) unit was 34% of revenues, with operating margins (OM) of 18%, and playing second chair to pharmaceuticals at 46% of revenues with OM of 33%. But fast forward to 2010, and MD&D had become the largest percentage of revenue at 40% compared to pharmaceuticals 36%, and the OM of MD&D had improved to over 33%. MD&D has been a key growth driver for the company for the past decade. Operating margins took a hit in 2011, as charges were taken to exit the cardio-stent business, but the unit was still J&J largest source of revenues. So there was not a great deal of surprise that JNJ would look to the medical device area for a large acquisition.

From Mergers to Acquisitions: The Synthes board of directors considered the required regulatory approvals for the merger and the prospects (Investors media 2011, p. 17) and anticipated timing of obtaining such approvals. The Synthes board of directors also considered that Johnson & Johnson had agreed to use reasonable best efforts to obtain necessary antitrust approvals (including the divestiture of assets pursuant to the merger agreement), and that Johnson & Johnson had agreed to pay a termination fee to Synthes of $650 million if the merger is not completed solely for antitrust reasons.

EU Commission examined the competitive effects of the proposed acquisition in various affected markets and concluded that there were no competitive concerns for spine, shoulder replacement and cranio-maxillofacial devices as well as for surgical power tools. However, the investigation showed that for trauma devices the transaction would significantly impede effective competition in a number of markets in different Member States(Marisa Gonzalez Iglesias, Antoine Colombani,2012).

These concerns were based on very high combined market shares of the merging entities in these markets, the rather mature character of the products, In order to remove the significant impediment of effective competition resulting from the proposed transaction, Johnson & Johnson submitted commitments to the Commission, consisting of the divestiture of its entire trauma business in the EEA (European Economic Area). This divestment removes the overlap in the area of trauma devices and thus the competition concerns.

The European Commission cleared under the EU Merger Regulation proposed acquisition of Synthes Inc. by Johnson & Johnson, both US companies active in the area of orthopaedic medical devices. The Commission's investigation confirmed that, subject to the divestment of Johnson & Johnson's trauma business, the merged entity would continue to face competition from a number of other strong competitors and that customers would still have sufficient alternative suppliers in all of the markets concerned. Thus to ensure that competition will remain strong in these markets, for the ultimate benefit of patients and social security systems , the deal should shift from merger to acquisition

Also the Synthes board of directors considered the expected tax treatment of the merger to Synthes stockholders, including the fact that the merger is not structured as reorganization for United States federal income tax purposes that generally would allow Synthes stockholders not to recognize gain from the receipt of the stock portion of the merger consideration.

The Acquisition of Johnson & Johnson of Synthes Inc for $19.7 billion in total consideration in cash and stock. Each shareholder of Synthes will receive CHF55.65 in cash and 1.7170 shares of Johnson & Johnson. Based on the latest annual report, Synthes reported sales of $3.9 billion. This translates to a net profit of $966 million. The acquisition puts the valuation of Synthes at 20 times earnings. This is higher than other medical device stocks trading in the market. For example, Medtronics (MDT) trades at 12 times earnings and Boston Scientific (BSX) is valued at 17 times earnings.

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Based on this year's earnings forecasts, this puts the purchase at 11.2 times of operating income. Based on the latest data, acquisitions of medical devices companies are paid a median of 11.5 times operating profit. This seems reasonable as acquisitions require a premium purchase. Also Johnson & Johnson only paid 37% premium over the current market valuations. For a good company such as Synthes, a valuation of around 30-40 times earnings is not impossible.

This will give the company a majority share in the trauma market. Synthes has already cornered 50% of the market for screws, plates, bone grafts and other products to treat skeletal injuries. This is also a unique opportunity as the company possesses strong operating margins of 35% and already has scale. The effect will be to boost and complement Johnson & Johnson's orthopedics business. Since the start of 2010, JNJ has had more than 50 drug and devices recalls. The recalls have cost the company around $900 million in annual sales, which resulted in sales decline and pressures to find new revenue drivers and earnings growth. The purchase also gives J&J a device company with an operating margin of 35 percent, the highest among medical-products makers with stock values of more than $5 billion.

Results : Mounting Profits

Johnson & Johnson delivered solid results in 2012, reflecting continued sales momentum in many parts of their business driven by their focus on delivering meaningful innovation in health care to patients and customers. The results included strong growth of key products, successful new product launches, and the addition of Synthes to their family of companies. (Business segment 2012, p. 14)

With $27.4 billion in worldwide sales in 2012, in Medical Devices and Diagnostics (MD&D) business is the largest medical technology business in the world. Operational growth was 8.7 percent. Sales included the impact of the recently completed acquisition of Synthes, Inc., which contributed 7.9 percent to worldwide MD&D segment operational sales growth, net of the divestiture of the DePuy trauma business.

Primary contributors to operational growth were sales from the recently completed acquisition of Synthes, Inc. in the Orthopedics business; a number of products in the Specialty Surgery business.

With the mission to continue to invest for long-term sustainable growth and completed the largest acquisition with Synthes. In June, DePuy and Synthes joined to form the world's largest, most comprehensive orthopaedicsand neurologics organization. A total solutions business, DePuy Synthes offers an unparalleled breadth and depth of products, services and programs in the areas of joint reconstruction, trauma, spine, sports medicine, neurological, craniomaxillofacial, power tools and biomaterials, and has the opportunity to contribute in greater ways to meet the needs of today's dynamic health care environment.

Conclusion

The performance of J&J Inc has been steady in its industry by its addition of Synthes Inc in their healthcare portfoliowhich gives ita strong growth in emerging marketsWith a total shareholder return of 11%,the Orthopedics franchise achieved sales of $7.8 billion in 2012, a 34.3% increase over the prior year ,the company relies strictly on its credo for execution of its diversification strategy which is enabled by the company culture. The diversity in people and experiencesallows new ideas to surface and be vigorously debated. The company takes a disciplined approach to decision-making, eliminating politics and focusing on speed, action and mitigates uncertainties for its acquisition ventures.

EXHIBIT I

A note to J&J Major Medical Devices Orthopedics franchise achieved sales

The Orthopedics franchise achieved sales of $7.8 billion in 2012, a 34.3% increase over the prior year. Growth was primarily due to sales of newly acquired products from Synthes, Inc., and sales of joint reconstruction and Mitek sports medicine products. Sales were impacted by the divestitures of the surgical instruments business of Codman & Shurtleff,Inc., in the fiscal fourth quarter of 2011, and the divestiture of certain rights and assets related to the DePuy trauma business. The positive impact on the Orthopedics franchise total sales growth and operational growth due to the newlyacquired products from Synthes, Inc. net of the related trauma business divestiture was 34.7%.

(Dollars in Millions)	2012	2011	2010	Percentage change '12 vs. '11	Percentage change '11 vs. '10
Orthopedics	$7799	5809	5585	34.3	4

Source: Johnson & Johnson 2012 Annual Report

EXHIBIT II

A note to Medical Devices and Diagnostics Segment of J&J

In 2012, Medical Devices and Diagnostics segment pre-tax profit as a percent to sales was 26.2% versus 20.4% in 2011. The Medical Devices and Diagnostics segment pre-tax profit was favorably impacted by profits from Synthes sales, lower expenses of $1.4 billion for litigation, including product liability,

and the DePuy ASR™ Hip program and $0.1 billion for research and development primarily due to the discontinuation of its clinical development program for the NEVO™ Sirolimus-Eluting Coronary Stent. This was partially offset by an increase in integration costs and amortization of the inventory step-up of $0.8 billion associated with the acquisition of Synthes, Inc. and $0.1 billion attributed to the write-down of intangible assets. In addition, 2012 included higher gains on divestitures versus the prior year due to the divestitures of the Therakos business and RhoGAM®. Additionally, 2011 included a $0.7 billion restructuring charge related to the discontinuation of the clinical development program for the

NEVO™ Sirolimus-Eluting Coronary Stent. In 2011, Medical Devices and Diagnostics segment pre-tax profit decreased36.4% from 2010. The primary drivers of the decline in the pre-tax profit margin in the Medical Devices and Diagnostics segment were litigation expenses, including product liability, costs associated with the DePuy ASR™ Hip program restructuring expense, costs incurred related to the acquisition of Synthes, Inc., and increased investment spending.

Source: Johnson & Johnson 2012 Annual Report

EXHIBIT 3

Geographic information

Revenues, which are based on the location of the customer, and property, plant and equipment, net in the United

States and other countries, for the years ended December 31, 2011 and 2010, respectively of Synthes Inc, are as follows:

Revenues	2011 in 1,000 US$	2010 in 1,000 US$
United States	2,140,396	2,083,897
Rest of the world	1,833,362	1,60,3055
Totals	3,973,758	3,686,952

Source: Synthes Annual report 2011

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Teaching Note

"ACQUISITION THE JOHNSON AND JOHNSON WAY-THE CASE OF DEPUY SYNTHES"

Statement of Relevance

This case study outlines the strategic mergers, acquisitions and the formation of new companies by Johnson and Johnson, which made them the world's largest and most broadly based health care company.

J&J Healthcare division is considering the development of products in the medical devices domain, whichencompasses many opportunities of breakthroughs or disruptive innovations to market to new or underserved customers. While these disruptive innovations face uncertainties and challenges (capabilities and capacities that may be beyond J &J current skill set, a more intimate knowledge of potential new customers, which may not be the focal point of the current sales/marketing initiatives), they can also, if successful, generate more profits. Since they do not compete with current J &J products, theycan also attract new customers and generate new sales.

Perspectives Presented by the Case

This case gives readers the opportunity to think about strategy in an uncertain environment. The case illustrates the challenges associated with acquisition. It highlights the importance of thinking about mergers and acquisitions structure uncertainties. It also explores marketing issueswhich type of customers to target for an project. Finally, it is an avenue for students to think about diversification and risk mitigation.

This means the case will work well as a learning tool for strategy implementation whereMergers and acquisitions is inherent, as an application to lectures on corporate level planning and its challenges.

Important discussion points and lessons emphasized by the case include:

1. Mergers and acquisitions are characterized by uncertainties, such as market and technical uncertainties.
2. Corporate level planning for diversification may not respond to every customer's needs thus customer segmentation is often necessary.
3. The success of the acquired project is in line with the principle Organization philosophy.

Target Market

The case has been tested and is effective as part of executive education courses. Students/participants are challenged to think strategic management and corporatelevel and business level planning.They are also motivated to think about risk mitigation. The case will be particularly useful for those who alreadyunderstand the need for growth and diversification, This case could also be used in Business Policy and Strategic Management class for Master'sdegree, MBA, and/or doctorate students.

Teaching Strategy

Teaching this case begins by asking students/participants to individually read and thinkabout the case prior to class. A 15-minute introduction to the case by the instructor may be usefulbefore beginning discussion. The introduction should explain Johnson and Johnson vision and mission statement and their corporate planning structure. The goal of the case is not to find the right portfolio diversification for J&J, rather to understand the challenges inherent in acquisition projects.

Alternatively, the instructor can elicit the same information from the class by askingquestions such as:

1. Why did Johnson & Johnson went to acquire Synthes.
2. How did the company stave off the new challenge from merger to acquisition.
3. Did the acquisition reap profits for Johnson & Johnson.

Once the introduction is complete, breaking the class into teams of three to five studentsmay be useful. The

teams should discuss and summarize their answers to each of the key questions presented in the case study and choose one representative to present a summary of the team's answers to the class. The facilitator should work to move the discussion past a listing of challenges for mergers and acquisitions.

Analytical Framework

Uncertainty identification

The first step to determine uncertainties (McGrath and MacMillan,2000). In analyzing the case and finding solutions to the challenges faced while acquisitions and to have students/participants determine the sources of uncertainties by asking the following question:

What are the dimensions of risk/uncertainties associated with acquisitions inthe healthcare domain?

For the dimensions of uncertainties, the tools that are useful in assessing the uncertainties in this case is Risk scorecarding/heat mapping. The approach is to present a mental model that frames assessment of uncertainty from both a potential and an exposure perspective. Scorecarding, a process for taking qualitative discussions about strategic uncertainty and turning these discussions into quantitative rankings, and heat mapping, a process of taking the rankings from scorecarding utilizing both colors/symbols and generic strategies to communicate the impact of the uncertainty on the business, are assessment tools which operationalize the mental model promote and generate discussion around key areas of uncertainty through a systematic framework that directs the firm in selecting an appropriate uncertainty management strategy.Table 1 can be used to guide the students/participants in their group discussion orcompletion of the assignment. It can also be used as a "solution" presented by the instructor tothe entire classroom for the wrap-up of the discussion or assignment.

Table 1. Dimensions of Uncertainty

Categories of Acquisition Uncertainty	Sources of Acquisition Uncertainty
Business/Operational	
Operations and Business Practices	Contractual uncertainty, internal processes and controls, management transitions
People and Human Resources	Recruiting, training, retention, organizational culture
Strategic Positioning and Flexibility	Mergers and acquisitions, joint ventures, resource allocation and planning organizational agility, information access
Market Conditions	
Market Prices and Terms of Trade	Contract terms, market outlets, market access
Competitors and Competition	Antitrust, industrial espionage
Customer Relationships	Poor market timing, inadequate customer support
Reputation and Image	Corporate image, brand image, reputation of key employees, community relationships
Technology	Complexity, obsolescence, workforce skill sets, adoption rate, diffusion rate
Business Relationships	With Business Partners and Distributors
Policy and Regulation	Enforcement of intellectual property rights, change in leadership, Government trade negotiations,

Table 2. Examples of potentials and exposures for uncertainties in acquisitions

Categories of uncertainties	Potential	Exposure
Business/Operational	Superior operational efficiency, Superior workforce	Business interruption, Loss of Key employees
Market Conditions	Strong Brand, Strong product bundling	Pricing pressure, loss of market share, consolidation of customer industry
Technology	Speed of innovation, enhanced capacity	Slow commercialization of new products in healthcare domain
Business Relations	Strong supply chain network	Delay in product procurement
Policy and regulations	Patent protection, Speed of approval	Change in government guidelines for IPR

Strategic Uncertainty Scorecards for Exposure

Categories of uncertainties Likelihood	Potential	
Business/Operational	1 2 3 4 5	1 2 3 4 5
Market Conditions	1 2 3 4 5	1 2 3 4 5
Technology	1 2 3 4 5	1 2 3 4 5
Business Relationships	1 2 3 4 5	1 2 3 4 5
Policy & Regulation	1 2 3 4 5	1 2 3 4 5

Strategic Uncertainty Scorecards for Potential

Categories of uncertainties Likelihood	Potential	
Business/Operational	1 2 3 4 5	1 2 3 4 5
Market Conditions	1 2 3 4 5	1 2 3 4 5
Technology	1 2 3 4 5	1 2 3 4 5
Business Relationships	1 2 3 4 5	1 2 3 4 5
Policy & Regulation	1 2 3 4 5	1 2 3 4 5

Risk and uncertainties can be assessed on three dimensions: potential, exposure, and the likelihood of each. "Potential" is the opportunity that the firm can capture if it takes the risk. If the outcomes of the risk are favorable, the benefits may be a new market, more loyal customers, etc. "Exposure" represents the downside loss if the outcomes of the risk are unfavorable. This may be represented by losses in sales because of lost customers, a tarnished image, as well as financial losses. "Likelihood" is the probability of seeing the potential of the exposure event happening. Examples of potentials and exposures for strategic uncertainties are presented in Table 2.

Students can be given an assignment asking them to give scores for the potential and exposure uncertainity while acquisition.The instructor can ask the students to work in team or individually. If they work in team, students should be encouraged to start the assignment by individually listing the uncertainties and scoring them. Each individual answers and scores should then be discussed with the team or in the classroom.

A set of suggested answers is presented below:

In the case, there are two main uncertaintiesmarket uncertainty and technical uncertainty. Market uncertainty refers to the lack of knowledge at the market and demand level and major sources of uncertainty for J&J acquisition are:

(1) who are the targeted customers,

(2) how will competitors react, and

(3) how will the members of supply chain react.

The realization of these uncertainties will affect the demand and the associated cost of delivering service for J&J while approving the acquisition deal.Technical uncertainty in J&J is about whether or not the technology can be developed to the level of quality the company is committing to give to its customers.To further determine the market uncertainty, one needsto determine the types of customers J&J targets. Students/participants may approach the concept of market uncertainty through the growth Ansoff's product/market growth matrix and provide their approach towards successful acquisitions.

Reference

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