J&J: Secrets of Success

Johnson & Johnson doesn't seek the spotlight, but its extraordinary track record—and how it pulls that off—is a wonder to behold.

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PHOTOGRAPH BY DAVID YELLEN

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ARE YOU HAVING A TOUGH YEAR at your company? Sorry to hear it. If it makes you feel any better, they're also having a tough year at Johnson & Johnson. How tough? Well, it appears—though it's not certain—that sales may actually decline in 2009, and that hasn't happened in 76 years. Profits will probably decline too, which hasn't happened in 25 years. But don't worry about the dividend. The company will almost certainly manage to raise it this year, just as it has done annually for the past *46.* years.[Okay, that probably doesn't make you feel any better. Those facts show the extent of the damage at J&J during the economic collapse, and if it seems laughably mild, then you're beginning to see why this company is worth much more attention than it usually gets. J&J doesn't make a lot of noise. It doesn't seek media attention and rarely gets major headlines. Its advertising focuses on its famous brands—Band-Aids, Tylenol, Splenda—that don't include the J&J name. The company is easy to overlook, yet in these desperate times its extraordinary performance demands closer scrutiny than ever.

To see just how well J&J performs, first check its stats in the new Fortune 500. Last year—12 solid months of economic decline in the U.S.—the company's sales rose 4.3%, and it jumped six places in the 500 ranking, to No. 29. Though the 500'$ profits dropped 85% last year, J&J's profit increased 22%. That made J&J the sixth-most-profitable company in the Fortune 500 and the fifth most valuable, ahead of Procter & Gamble. Berkshire Hathaway, Chevron, IBM, General Electric, and many other famously great performers.

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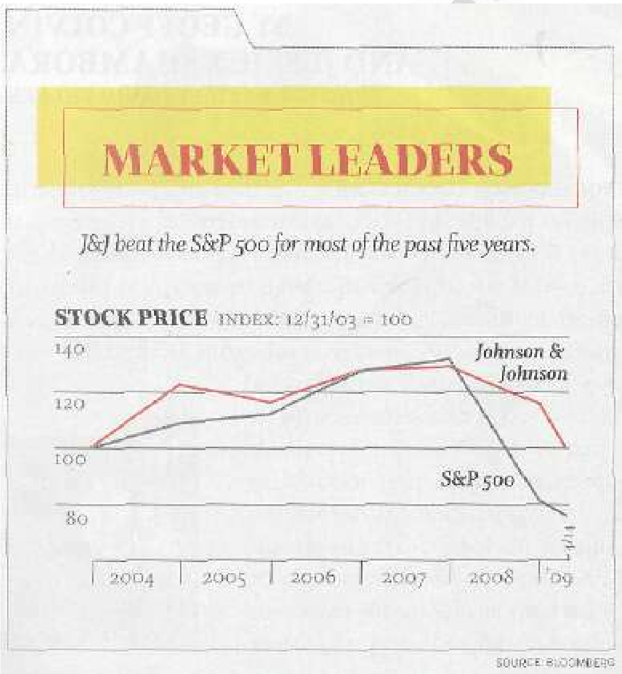
As remarkable as that record seems, you get a more impressive perspective by stepping back—way back. Not many companies can give you their loo-year compound annual growth rate, but J&J can. It's 10.5%, and that's not coming off some tiny startup's base revenues, since the company was already 23 years old a century ago. Nor is the company a typical lumbering giant that grew like a sprout in its early years and then leveled off; it actually grew faster in the recent 50 years than in the previous 50.

As for the measure that most people really care about: The stock has been a marvel. It beat the market easily last year, but again, the longer view is even more impressive, If you'd bought a single share when the company went public in 1944 at its IPO price of $37.50 and had reinvested the dividends, you'd now have a bit over $900,000, a stunning annual return of 17.1%, Even if you hadn't reinvested the dividends, that single share would now be 2,500 shares as a result of splits, and you'd be collecting dividends of $4,500 a year from that $37.50 investment. If only Grandpa had bought 100 shares.

Of course, nothing guarantees that this extremely rare record of standout performance will continue. The company faces major risks. Highly lucrative drugs are going off patent, and pinched consumers could switch from J&J's premium branded products to less expensive generics. Any maker of drugs and medical devices faces the danger of devastating lawsuits. Giant-scale national health-care reform, if it happens, could hurt the company. Citigroup analyst Matt Dodds says 2009 "will be J&J's most challenging year in a decade."

Yet investors don't seem much worried by any of that. The share price indicates that they figure J&J will most likely keep performing in line with its record. All of which makes you wonder what lessons other businesses can learn from this outfit. As always with extraordinary performance, the explanation isn't any one thing. Instead, it's a matter of remaining faithful to several imperatives simultaneously—in this case, five of them.

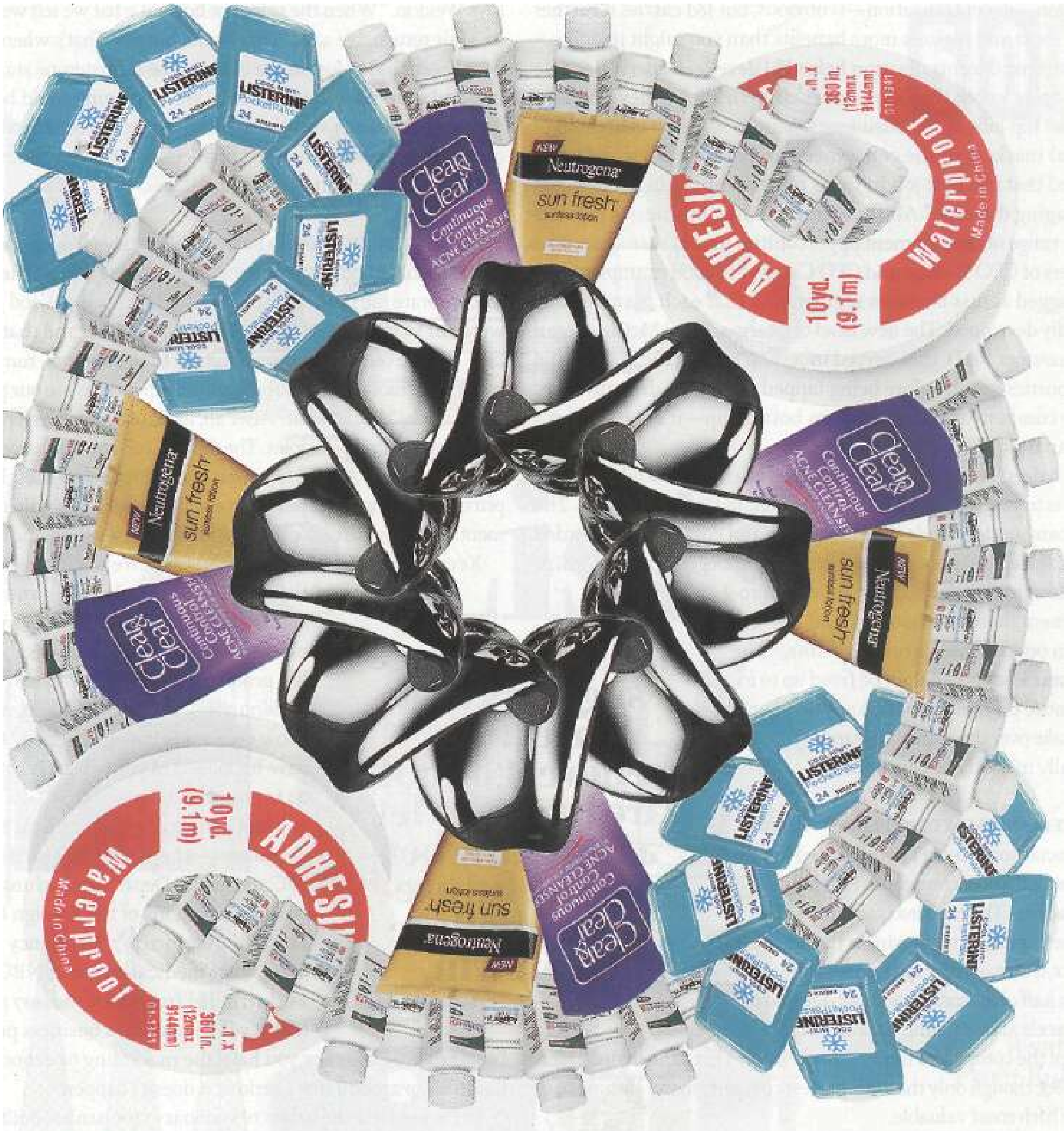


DIVERSIFY WITHIN A SINGLE INDUSTRY. "We're not really a conglomerate," says CFO Dominic Caruso, but J&J isn't really not one, and the balance it has struck turns out to be important. The company is organized into three major groups. Consumer products includes not just famed J&J items like Johnson's baby shanipoo and Tylenol but also Nicorette anti-smoking gum, Listerine mouthwash (both acquired when J&J bought Pfizer's consumer business in 2006), Neutrogena skin-care products, and dozens of other brands. The medical devices and diagnostics group supplies operating rooms and doctors' offices with a wide range of products including sutures, blood tests, endosurgery tools, and artificial joints like the high-tech knee in CEO Bill Weldon's right leg. The pharmaceuticals business sells prescription drugs that include Concerta for attention deficit disorder, Remicade for arthritis, Prezista for HIV/AIDS, and many others. Though the consumer business is best known, it's the smallest of the three.

All three groups are obviously in the health-care industry—that's why J&J isn't exactly a conglomerate—yet their furthest corners are clearly unrelated. The portfolio works because it captures benefits from both worlds. Its diversification reduces risk. This year the company expects that its strong devices and diagnostics business will help buffer against the expiration of two key patents in the pharma group—a loss of about £2.9 billion, reckons Citigroup's Dodds.

At the same time, J&J realizes benefits by staying within one broadly defined industry. For example, a meeting between engineers from the Devices group and scientists from the pharma group led to a groundbreaking discovery: The tiny metal stents used to open blocked arteries could be coated with a drug to prevent the artery from narrowing again. The resulting drug-eluting Cypher stent, though controversial, has brought more than $10 billion in sales since its 2002 launch.

FOCUS ON THE FUTURE. Managers everywhere complain that investors are obsessed with the short term and will punish any



J&J'S WORLD *Diverse products from across all its businesses (including artificial knees, center) help keep customers healthy.*

company that even thinks of sacrificing today for tomorrow. J&J's experience suggests otherwise—that investors are happy to let a company bet on the future if they believe it can win. Citigroup's Dodds says R&D spending within the pharmaceutical business, though down slightly from recent years, is "still the highest number in Big Pharma."

Even before products reach the development pipeline, an internal think tank—the Corporate Office of Science and Technology (COSAT)—is looking way ahead, seeking the next big idea. "They're going across the landscape looking at this really early stuff, trying to identify the opportunities out there," explains Weldon. "It may be a decade before they bring value."

J&J is also extremely conservative. Robert Wood Johnson, the visionary CEO who took the company public, insisted that "reserves must be created" and "adverse times must be provided for." That's why J&J borrows little and won't even go near endangering its triple-A credit rating. Says Leerink-Swan analyst Rick Wise: "They're thinking 10 or 20 years out. They have the financial flexibility and staying power so that even when they make a mistake short-term, they have the ability to hang in there."

LET THE EXPERTS RUN THE BUSINESS. Because J&J is SO big, with 250 operating companies in 57 countries, running the whole thing from New Brunswick, N.J., would clearly be futile. The solution—decentralization—is obvious, but J&J carries it further than most and realizes more benefits than you might imagine.

Extreme decentralization helps J&J develop leaders. Because managers know they can run their own show, they try hard for the top jobs at J&J businesses. Jesse Wu, group chairman of global markets in the consumer group, says, "It's widely perceived that the best job in J&J is to be an operating company's managing director." All those freestanding businesses create a wide range of development opportunities for J&J managers. The careers of CEO Weldon and CFO Caruso are good examples; they zigzagged across business segments so that each man became broadly developed. The new head of pharma, Sheri McCoy, began in consumer R&D, then served in several roles in the devices and diagnostics group before being tapped to run the drug division. "The company is managed from bottom up—it's Darwinian," says analyst Wise.

In a deep recession, the temptation at any decentralized company is to yank control back to the center. J&J is resisting that. The company understands the efficiencies and cost savings afforded by its scale, and over the past decade has begun to standardize processes in staff and support areas like procurement, human resources, and IT—but not in operations. Caruso explains, "The business leaders can then be freed up to focus more on the business, and the people that take over these areas of standardization actually make those best in class."

J&J's experience suggests that investors, believe it or not are happy to let a company bet on the future if they believe it can win.

STAY FINANCIALLY DISCIPLINED-ALWAYS. Financial success isn't complicated in theory, but plenty of companies find it difficult in practice. The big idea is to earn a return on the capital in the business that exceeds the total cost of the capital; over time, only about half of all companies manage to do it. J&J excels at it, earning a spread that beats 82% of the companies in the Russell 3000. That's the main reason why J&J, though only the 29th-biggest company in the *Fortune* 500, is the fifth most valuable.

The outstanding recent example of J&Js financial discipline is a roller-coaster deal with Guidant, a maker of pacemakers, clefibrillators, and other cardiovascular devices. J&J agreed to buy Guidant, but then reports of problems with its products reduced the company's value, and J&J negotiated a lower price. The deal was on track to close when a new bidder, Boston Scientific, suddenly made a higher offer. A bidding war ensued, and after 13 months of working on the deal J&J eventually withdrew, saying it could not justify raising its bid further. As a result, Boston Scientific bought Guidant for around $27 billion—a mountain of capital on which it was impossible to earn a sufficient return from the business. *Fortune*s Shawn Tully called the deal one of the worst ever, and to this day Boston Scientific stock has never risen higher than its price on the day in 2005 that it announced its bid for Guidant.

"This is where the financial discipline of J&J is so important," says Weldon. "When the price got beyond what we felt would give us a fair return, we said, 'Thank you, but no.' That's where a lot of people get kind of lost in the clouds. The testosterone starts flowing, and everybody wants to win. Well, winning could be losing. The biggest winner was the loser." That would be J&J, which not only saw a competitor hobbled financially but also collected a $705 million breakup fee from Guidant.

HAVE A PURPOSE BEYOND PROFITS. Even people who don't know much about J&J do know about its Credo, the formal statement of its corporate purpose. It's a document that Robert Wood Johnson wrote in 1943 before the company went public, and that begins, "We believe our first responsibility is to the doctors, nurses, and patients, to mothers and fathers and all others who use our products and services." But *so* what? After all, loads of companies have noble-sounding guiding principles. The difference? The company actually follows its rules. As Weldon often says, "Some of the best business principles ever written were Enron's. It's just an extraordinary document." The key isn't adopting the principles, it's believing them.

Keeping the Credo alive takes work. Weldon travels around the world with J&J's HR boss and general counsel, talking with employees who are moving into leadership positions about real-life problems and how the Credo applies. Weldon says, "It's an open dialogue about 'How could this have happened? Could it have happened in your area? What do you do to ensure it doesn't?'"

The Credo still guides critical business decisions, as when J&J turned itself in to the SEC and Justice Department on unspecified possible violations of the Foreign Corrupt Practices Act in 2007. Dr. Nancy Snyderman, chief medical editor at NBC News, worked at J&J from 2003 to 2007 and says that if you're making a business proposal, "regardless of whether you have the marketing or economics, it has to wrap around that Credo or it doesn't happen."

In his book on the habits of visionary companies, *Built to Last,* Jim Collins relates how former CEO Ralph Larsen saw the values outlined by the Credo: "We have them because they define what we stand for, and we would hold them even if they became a competitive disadvantage in certain situations." Of course the Zen-like conundrum is that taking such a stand makes the values into a tremendous competitive advantage.

What's frustrating about J&J's imperatives for success is that you probably could have thought them up yourself. The secret turns out to be not the rules but rather the company's extraordinary insistence on following them all the time.

That's hard, of course. But instead of being discouraged by that fact, think of it as good news: The secret to performing like one of the world's most successful businesses is merely a matter of doing several identifiable things that happen to be difficult. That's demanding, yes—but it isn't a secret at all. a

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