

CASE 31

JOHNSON & JOHNSON*

On January 20, 2015, Johnson & Johnson CEO Alex Gorsky proudly announced that his firm had sales of \$74.3 billion during the previous year, representing an increase of 4.2 percent over 2013. Most of this growth came from the firm's pharmaceutical division, which Gorsky pointed out was clearly generating the largest revenues and was the fastest-growing such division in the drug industry in the United States. The results of this division compensated the relatively modest increases in revenue from the firm's medical devices and consumer health divisions, both of which were recovering from lawsuits and recalls.

Several years earlier, Johnson & Johnson (J&J) had settled with an estimated 8,000 patients over problems with its flawed all-metal artificial hip. The device had a design flaw that caused it to shed large quantities of metallic debris after implantation. It was finally recalled by the firm in 2010, after Johnson & Johnson had covered up the problems for almost five years after they began to surface. The settlement cost the firm as much as \$3 billion to compensate patients who had to have the artificial hip replaced. The problems with this device would classify it as one of the largest medical failures in recent history.

The problems with the medical devices unit were compounded by serious issues that arose with the consumer products unit, leading it to recall many of its products—including the biggest children's drug recall of all time—that were potentially contaminated with dark particles. The Food and Drug Administration also slapped a plant at one of its business units, McNeil Consumer Healthcare, with a scalding inspection report, causing the company to close down the factory to bring it up to federal standards. The publicity that arose from these problems tarnished the name of one of the nation's most trusted firms.

Much of the blame for Johnson & Johnson's stumbles fell on William C. Weldon, who stepped down as CEO in April 2012 after presiding over one of the most tumultuous decades in the firm's history (see Exhibits 1 and 2). Critics said the company's once-vaunted attention to quality had slipped under his watch. Weldon, who had started out as a sales representative at the firm, was believed to have been obsessed with meeting tough performance targets, even by cutting costs that might affect quality. Erik Gordon, who teaches business at the University of Michigan, elaborated on this philosophy: "We will make our numbers for the analysts, period."¹

Weldon was replaced by Alex Gorsky, who had headed the medical devices and diagnostics unit. Like his predecessor, Gorsky had worked his way up by meeting tough performance targets as a sales representative, and his appointment as CEO continued the firm's 126-year tradition of hiring leaders from within. "The future of Johnson & Johnson is in very capable hands," said Weldon.² However, the decision to hire another insider raised concerns that the firm was not very serious about changing the corporate culture that had created so many of its recent problems. "As somebody steeped in J.&J. culture, I would be very surprised to see big changes," said Les Funtleyder, a portfolio manager at a firm that owned J&J stock.³

EXHIBIT 1

Income Statement (\$ millions)

	Year Ending December				
	2010	2011	2012	2013	2014
Revenue	61,587	65,030	67,224	71,312	74,331
Gross profit	42,795	44,670	45,566	48,970	51,585
Operating income	16,527	16,153	15,869	18,377	20,959
Income before taxes	16,947	12,361	13,775	15,471	20,563
Net income	13,334	9,672	10,853	13,831	16,323

Source: Johnson & Johnson.

EXHIBIT 2

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Balance Sheet (\$ millions)

	Year Ending December				
	2010	2011	2012	2013	2014
Total current assets	47,307	54,316	46,116	56,407	59,311
Total assets	102,908	113,644	121,347	132,683	131,119
Total current liabilities	23,072	22,811	24,262	25,675	25,085
Total liabilities	46,329	56,564	56,521	58,630	61,367
Total stockholders' equity	56,579	57,080	64,826	74,053	69,752

Source: Johnson & Johnson.

Cultivating Entrepreneurship

Johnson & Johnson relied heavily upon acquisitions to enter into and expand into a wide range of businesses that fell broadly under the category of health care. It purchased more than 70 different firms over the past decade. Among Johnson & Johnson's recent moves was the \$20 billion purchase of Synthes, a leading player in trauma surgery. In November 2014, J&J completed its \$1.75 billion acquisition of Alios BioPharma, which produced therapeutics for viral infections.

As it grew, Johnson & Johnson developed into an astonishingly complex enterprise, made up of over 250 different subsidiaries that were divided among three different divisions. The most widely known of these was the division that made consumer products such as Johnson & Johnson baby care products, Band-Aid adhesive strips, and Visine eyedrops. The division grew substantially after J&J acquired the consumer health unit of Pfizer in 2006 for \$16.6 billion, the biggest acquisition in its 120-year history. The acquisition allowed J&J to add well-known products to its lineup, such as Listerine mouthwash and Benadryl cough syrup.

But Johnson & Johnson reaped far more sales and profits from its other two divisions. Its pharmaceuticals division sold several blockbuster drugs, such as anemia drug Procrit and schizophrenia drug Risperdal. A new drug, named Zytiga, prescribed to treat prostate cancer, was selling well. The medical devices division was responsible for best-selling products such as DePuy orthopedic joint replacements and Cypher coronary stents. These two divisions generated operating profit margins of around 30 percent, almost double those generated by the consumer business.

To a large extent, however, Johnson & Johnson's success across its three divisions and many different businesses hinged on its unique structure and culture. Most of its far-flung subsidiaries were acquired because of the potential demonstrated by some promising new products in their pipelines. Each of these units was therefore granted near-total autonomy to develop and expand upon its best-selling products (see Exhibit 3). That independence fostered an entrepreneurial attitude that kept J&J intensely competitive as others around it faltered. The relative autonomy that was accorded to the business units also provided the firm with the ability to respond swiftly to emerging opportunities.

Johnson & Johnson was actually quite proud of the considerable freedom that it gave to its different subsidiaries to develop and execute their own strategies. Besides developing their strategies, these units were also allowed to work with their own resources. Many of them even had their own finance and human resources departments. While this degree of decentralization had led to relatively high overhead costs, none of the executives who ran J&J, Weldon included, had ever thought that this was too high a price to pay. "J&J is a huge company, but you didn't feel like you were in a big company," recalled a scientist who used to work

Pushing for More Collaboration

The entrepreneurial culture that Johnson & Johnson developed over the years clearly allowed the firm to show a consistent level of high performance. Indeed, Johnson & Johnson had top-notch products in each of the areas in which it operated. It had been spending heavily on research and development for many years, taking its position among the world's top spenders (see Exhibit 4). In 2014, it spent about 12 percent of its sales on about 9,000 scientists working in research laboratories around the world. This allowed each of the three divisions to continually introduce promising new products.

In spite of the benefits that Johnson & Johnson derived from giving its various enterprises considerable autonomy, there were growing concerns that these units could no longer be allowed to operate in near isolation. Shortly after Weldon had taken charge of the firm, he realized that J&J was in a strong position to exploit new opportunities by drawing on the diverse skills of its various subsidiaries across the three divisions. In particular, he was aware that his firm might be able to derive more benefits from the combination of its knowledge in drugs, devices, and diagnostics, since few companies were able to match its reach and strength in these basic areas.

EXHIBIT 3

Segment Information (\$ millions)

Johnson & Johnson was made up of over 250 different companies, many of which it had acquired over the years. These individual companies were assigned to three different divisions.

Segments of Business and Geographic Areas				
Sales to Customers				
Dollars in Millions	2014	2013	2012	
Consumer —				
United States	\$ 5,096	5,162	5,046	
International	9,400	9,535	9,401	
Total	14,496	14,697	14,447	
Pharmaceutical —				
United States	17,432	13,948	12,421	
International	14,881	14,177	12,930	
Total	32,313	28,125	25,351	
Medical Devices —				
United States	12,254	12,800	12,363	
International	15,268	15,690	15,063	
Total	27,522	28,490	27,426	
Worldwide total	\$74,331	71,312	67,224	
Segment Pretax Profit				
Percent of Segment Sales				
(Dollars in Millions)	2014	2013	2014	2013
Consumer	\$ 1,941	1,973	13.4%	13.4
Pharmaceutical	11,696	9,178	36.2	32.6
Medical Devices	7,953	5,261	28.9	18.5
Total	21,590	16,412	29.0	23.0
Less: Expenses not allocated to segments	1,027	941		
Earnings before provision for taxes on income	\$20,563	15,471	27.7%	21.7

Source: Johnson & Johnson.

This led Weldon to find ways to make J&J's fiercely independent units work together. In his own words: "There is a convergence that will allow us to do things we haven't done before."⁵ Through pushing the various far-flung units of the firm to pool their resources, Weldon believed that the firm could become one of the few that was actually able to attain that often-promised, rarely delivered idea of synergy. To pursue this, he created a corporate office that would get business units to work together on promising new opportunities. "It's a recognition that there's a way to treat disease that's not in silos," Weldon stated, referring to the need for collaboration between J&J's largely independent businesses.⁶

For the most part, however, Weldon confined himself to taking steps to foster better communication and more frequent collaboration among Johnson & Johnson's disparate operations. He was convinced that such a push for communication and coordination would allow the firm to develop the synergy that he was seeking. But Weldon was also aware that any effort to get the different business units to collaborate must not quash the entrepreneurial spirit that had spearheaded most of the growth of the firm to date. Jerry Cacciotti, managing director of consulting firm Strategic Decisions Group, emphasized that cultivating those alliances "would be challenging in any organization, but particularly in an organization that has been so successful because of its decentralized culture."⁷

EXHIBIT 4

Research Expenditures (\$ millions)

Year	Expenditure
2014	\$8,494
2013	8,183
2012	7,665
2011	7,548
2010	6,864
2009	6,986
2008	7,577
2007	7,680
2006	7,125
2005	6,462

Source: Johnson & Johnson.

EXHIBIT 5

Significant Innovations

Antiseptic Surgery (1888)

Three brothers start up a firm based on antiseptics designed for modern surgical practices.

Band-Aids (1921)

Debuts the first commercial bandages that can be applied at home without oversight by a professional.

No More Tears (1954)

Introduces a soap-free shampoo that was gentle enough to clean babies' hair without irritating their eyes.

Acuvue Contact Lenses (1987)

Offers the first-ever disposable lenses that can be worn for up to a week and then thrown away.

Sirturo (2012)

Gets approval to launch a much-needed treatment for drug-resistant tuberculosis, the first new medication to fight this disease in more than 40 years.

Even the company's fabled consumer brands started to show growth as a result of increased collaboration between the consumer products and pharmaceutical divisions. The firm's new liquid Band-Aid was based on a material used in a wound-closing product sold by one of J&J's hospital-supply businesses. And J&J used its prescription antifungal treatment, Nizoral, to develop a dandruff shampoo. In fact, products that were developed in large part out of such cross-fertilization allowed the firm's consumer business to experience considerable internal growth.

Confronting Quality Issues

Even as Johnson & Johnson was trying to get more involved with the efforts of its business units, it ran into quality control problems with several over-the-counter drugs made by McNeil Consumer Healthcare. Since 2008, FDA inspectors had found significant violations of manufacturing standards at two McNeil plants, leading to the temporary closure of one of them. These problems had forced the firm to make several recalls of some of its best-selling products. Weldon did admit that problems had surfaced, but he insisted that they were confined to McNeil. He responded to them in an interview: "This is one of the most difficult situations I've ever had to personally deal with. It hits at the core of who J&J is. Our first responsibility is to the people who use our products. We've let them down."⁸

Quality problems had arisen before, but they were usually fixed on a regular basis. Analysts suggested that the problems at McNeil might have exacerbated in 2006 when J&J decided to combine McNeil with the newly acquired consumer health care unit from Pfizer. Johnson & Johnson believed that it could achieve \$500 million to \$600 million in annual savings by merging the two units. After the merger, McNeil was transferred from the heavily regulated pharmaceutical division to the marketing-driven consumer products division, headed by Colleen Goggins. Because the consumer executives lacked pharmaceutical experience, they began to demand several changes at McNeil that led to a reduced emphasis on quality control.

Weldon realized the significance of the threat faced by Johnson & Johnson as a result of its problems with quality. He was especially concerned about the FDA's allegation that the firm had initially tried to hide the problems that it found with Motrin in 2009, hiring a contractor to quietly go from store to store buying all of the packets on the shelves. McNeil's conduct surrounding the recalls led to an inquiry by both the House Committee on Oversight and Investigations and the FDA's Office of Criminal Investigations.

Various changes were subsequently made at McNeil to resolve these quality issues. Goggins was pushed out of her post as senior executive in charge of all consumer businesses. Weldon allocated more than \$100 million to upgrade McNeil's plants and equipment, appoint new manufacturing executives, and hire a third-party consulting firm to improve procedures and systems. Bonnie Jacobs, a McNeil spokeswoman, wrote in a recent email: "We will invest the necessary resources and make whatever changes are needed to do so, and we will take the time to do it right."⁹

The problems at McNeil, coupled with growing problems with J&J's artificial hips and contact lenses, also led Johnson & Johnson to make changes to its corporate oversight of its supply chain and manufacturing. In August 2010, the firm appointed Ajit Shetty, a longtime executive, to oversee a new system of companywide quality control that involved a single framework for quality across all of the operating units and a new reporting system. The need for these changes was highlighted by Erik Gordon, a professor at the Ross School of Business at the University of Michigan: "Nothing is more valuable to Johnson & Johnson than the brand bond of trust with consumers."¹⁰

Passing the Baton

In April 2012, Johnson & Johnson appointed Gorsky to lead the health care conglomerate out of the difficulties that it had faced over the previous few years. He had been with the firm since 1988, holding positions in its pharmaceutical businesses across Europe, Africa, and the Middle East before leaving for a few years to work in Novartis. Shortly after his return to Johnson & Johnson in 2008, he took over its medical device and diagnostic group. Because of his extensive background with the firm, and with the division that was being investigated about its faulty hip replacements, Gorsky might have been regarded as the ideal person to take over the job.

When he took over, DePuy, the firm's orthopedic unit, was already running into trouble with its newest artificial hip. The firm finally recalled the artificial hip, amid growing concerns about its failure among those who had received the implant. Until then, however, executives from the firm had repeatedly insisted that the device was safe. Andrew Ekdahl, the current president of DePuy, recently reiterated that position. "This was purely a business decision," he said.¹¹ In the trial in Los Angeles Superior Court regarding the defective hip

replacement, however, Michael A. Kelly, the lawyer making the case against Johnson & Johnson, suggested that company executives might have concealed information out of concern for firm profits.

In spite of all these issues, Johnson & Johnson did not attempt to clarify what information Gorsky might have had about the problems associated with the artificial hip. Under the circumstances, his promotion to lead the firm surprised Dr. Robert Hauser, a cardiologist and an advocate for improved safety of medical devices. "He's been overseeing one of the major J&J quality issues and the board of J&J sees fit to name him the new C.E.O.," he questioned.¹² These issues raised concerns about the ability of the firm to effectively deal with the quality concerns and to take steps to prevent them from recurring in the future.

Gorsky's first job as Johnson & Johnson's chief executive was, in fact, to reassure shareholders that the firm would move quickly to overcome its problems with manufacturing defects, product recalls, and lawsuits. "We've got to adapt faster than ever before, be more agile than ever before," he stated at the firm's annual meeting after taking over.¹³ He acknowledged that some of the problems could partly be attributed to the firm's attempt to continue to meet Wall Street's increasingly short-term demands. Gorsky announced that moving forward, J&J was committed to managing for the long term, actively soliciting feedback from all quarters and adhering to the mission that made customers the first priority.

Gorsky's biggest challenge, however, came from a proposal that Johnson & Johnson might be better off if it was broken into smaller companies, perhaps along the lines of its different divisions. There were growing concerns about the ability of the conglomerate to provide sufficient supervision to all of its worldwide subsidiaries. Gorsky dismissed the proposal, claiming that J&J drew substantial benefits from the diversified nature of its businesses. He did concede, however, that the firm would have to be more selective, careful, and decisive about the products that it would pursue.

Is There a Cure Ahead?

Under Gorsky, Johnson & Johnson began to divest some of its lower-growth businesses and reduce annual costs by \$1 billion. In 2014, the firm sold off its blood-testing unit, called Ortho-Clinical Diagnostics, for \$4.15 billion to the private equity firm Carlyle Group. It was actively seeking a buyer for Cordis, which made medical devices such as stents and catheters. Johnson & Johnson, which had helped to develop the roughly \$5 billion global market for cardiac stents, announced that it was shifting its focus to other medical technologies that showed more potential for growth.

To repair the damage to its reputation from the many recalls across two of its divisions, Johnson & Johnson recently announced that it would remove a host of potentially harmful chemicals, like formaldehyde, from its line of consumer products by the end of 2015. It was the first major consumer products company to make such a widespread commitment. "We've never really seen a major personal care product company take the kind of move that they are taking with this," said Kenneth A. Cook, president of the Environmental Working Group.¹⁴

As he tried to plot a course for the future of Johnson & Johnson, Gorsky realized that he had to deal with a variety of issues. He was aware that much of the firm's success to date resulted from the relative autonomy that it granted to each of its businesses. At the same time, he realized that he had to provide more direction for the businesses to collaborate with each other in order to pursue emerging opportunities. He also understood that it was critical for J&J to develop sufficient controls that could minimize future problems with quality control.

In overall terms, it was clear that the health care giant had to rethink the process by which it managed its diversified portfolio of companies in order to ensure that it could keep growing without creating issues that could pose further threats to its reputation. "This is a company that was purer than Caesar's wife, this was the gold standard, and all of a sudden it just seems like things are breaking down," said William Trombetta, a professor of pharmaceutical marketing at Saint Joseph's University in Philadelphia.¹⁵

* Case prepared by Jamal Shamsie, Michigan State University, with the assistance of Professor Alan B. Eisner, Pace University. Material has been drawn from published sources to be used for purposes of class discussion. Copyright © 2015 Jamal Shamsie and Alan B. Eisner.

ENDNOTES

1. Katie Thomas. J.&J.'s next chief is steeped in sales culture. *New York Times*, February 24, 2012, p. B6.