

Zimmer Holdings, Inc (ZMH)

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- I am not a registered investment advisor and I do not offer any investment advise
- No parts of this talk are suggestions to invest, not invest, buy or sell any kind of securities or other financial instruments

Zimmer Holdings, Inc - business

- Orthopaedic reconstructive implants, dental implants, spinal implants, trauma products, and related surgical products
 - Americas 60%, Europe 25%, Asia Pacific 15% (58% of APAC sales is Japan)
 - Reconstructive 76% of sales (Knees 43%, Hips 29%, Extremities 4%)
 - Dental, trauma, spine, surgical and other - each about 6%
 - About 14% growth in APAC, flat elsewhere
- 2010 earnings announcement:
<http://finance.yahoo.com/news/Zimmer-Reports-Fourth-Quarter-prnews-735803756.html?x=0&.v=1>

Zimmer Holdings, Inc - business (cont'd)

- Competition:

- DePuy Orthopaedics, Inc. (a subsidiary of Johnson & Johnson), Stryker Corporation, Biomet, Inc., Smith & Nephew plc, Wright Medical Group, Inc., Synthes, Inc.
- In APAC also: Japan Medical Materials Corporation and Japan Medical Dynamic Marketing, Inc.
- In Europe market more fragmented and specialized. Also: Aesculap AG (a subsidiary of B. Braun), Waldemar LINK GmbH & Co., KG and Mathys AG.

Zimmer Holdings, Inc - Misc thoughts

- What can go wrong?
 - Medical reform: unclear impact
 - No growth in USA and Europe
- Opportunities:
 - APAC? This is also risky, since markets/prices/competition more unclear?

Strategic considerations

- Moat (*switching costs, habit, low cost*):
 - What are the moats? Brand?
 - What does it take to sustain the moats? Brand?
 - Bargaining power of suppliers/customers? Hospitals? Healthcare plans?
- Is it a low risk business? No.
- Is there high uncertainty? No.
- How capital intensive is the business? Not really
- Future growth - unknown
- Are the revenues and cash flows of the business sustainable or overstated / understated due to boom or bust conditions? Not clear

Management

- I don't usually do management analysis. Included for template completeness
- No dilution
- Can I trust management?
- Management shareholding (> 10%)
- Management incentives?
- Are the salaries too high?
- Is there heavy insider buying?
- Is there heavy insider selling?
- Do I like the management? (Operators, capital allocators, integrity)
- Profitable reinvestment
- What has management done with the cash?
- Where is Free Cash Flow invested? Share buybacks, dividends, reinvested, ROE & ROCE, incremental BV

Is it a good business? Cash flow

- Strong cash flow
 - 2010 600M earnings, 1200M operating cash flow, 800M FCF (FCF = OCF - capital expenditures)
 - Free Cash Flow/Share higher than dividends paid

Is business cheap? - Buffettology calculations

- ROE 15%
- Earnings in 10 years = $ROE * Equity * (1 + ROE)^9 = \$3B$
- Equity in 10 years = $Equity * (1 + ROE)^9 = \$20.5B$
- Market cap = $3B \times P/E (15) = \$46B$
- Rate of return = **-13%** after tax (calculations omitted)

- 9 year earnings growth: 18%. Assuming 18% earnings growth: 16% share price growth.
- **Not clear if the recent performance can be repeated for 10 years either in equity or earnings**

Is business cheap? DCF

- Discounted cash flow
 - Current earnings of ~750M (actually 600M after charge)
 - 10% growth for 5 years, leveling after that
 - 15% discount -> **\$7292M** current valuation (if you buy company at <\$7292M, you will get 15% return or higher)
 - 5% growth for 10 years, leveling after that
 - 15% discount -> **\$6717M** current valuation
 - **15% growth for 10 years**, leveling after that
 - 15% discount -> \$12500 current valuation
- Owner's yield = earnings / (market cap + debt - cash) = earnings/EV
 - $600M / (11600M + 1100M - 900M) = 5\%$
- What makes up the margin of safety? **Not enough margin of safety**
- Is there a sufficient margin of safety? **No**

Is business cheap? - Graham investment considerations

- N/A for ZMH - included for completeness
- 2 P/Book - not a net net
- Altman Z score (http://en.wikipedia.org/wiki/Altman_Z-score)