Zimmer Holdings, Inc (ZMH)

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Disclaimers

• I am not a registered investment advisor and I do not offer any investment advice

• 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% or 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

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?

• >10 year history of profits

• ROE:
  • 2008: 15
  • 2009: 13
  • 2010: 10

• Margins
  • 2008: 21
  • 2009: 18
  • 2010: 14

• Not growing earnings: 3 year sales growth 3%, earnings growth -8%

• No dilution

• Strong balance sheet
  • Debt covered by cash/short term investments

• ROIC = Earnings / (Equity + Debt - Cash) = Earnings / (Assets - non-debt liabilities - Cash)
  • ~ = ROE
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? - Buffetology 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 x 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)