Medical Technology

GNYDM Takeaways - Steady as She Goes

Checks at GNYDM suggest U.S./European dental trends remain largely stable, with no real inflection into year-end (better or worse) vs. past couple quarters. With most dental stocks currently trading above five-year averages, we therefore don't see a table-pounding near-term idea, although HSIC and XRAY remain compelling 12-month ideas, in our view, given solid double-digit EPS growth potential, while SIRO remains our top dental idea given an expected ramp to mid-teens+ EPS growth over the next few quarters.

- **Dental checks stable.** We hosted booth tours at the Greater New York Dental Meeting yesterday, including stops at SIRO, XRAY, HSIC, PDCO, DHR, and ALGN. Consensus seems to be that North American dental trends remain stable for both consumables and equipment, while European demand also seems to be holding in well (flat/modest growth). More specifically:
  - **For NA consumables,** it sounds as if end-market growth remains approximately +1-2%, with HSIC (mix) and XRAY (product cycle) slightly above and PDCO more in line.
  - **For NA equipment,** year-end checks were also stable, as potential 4Q benefits of expiring Section 179 tax incentives and the planned January 1 implementation of the medical device tax (2.3% price increases expected across most equipment lines) are being somewhat offset by still-uncertain end markets and potential for personal income tax changes next year (dentists deferring purchases in order to shield 2013 income). Bottom line, with one month in the quarter left, it sounds as if mid-single-digit growth remains reasonable for C'4Q, but upside to this rate shouldn't be expected.
- **Company specifics.** Additional details over following pages, but key takeaways include:
  - **For HSIC,** solid execution continuing, including mid-single digit consumables growth in corporate accounts (~25% of NA dental consumables revenues), with HSIC sounding the most upbeat of any company we met with yesterday.
  - **For XRAY,** solid new product flow is helping offset still sluggish dental implant market (implant market still flattish ww, better U.S./worse Europe), with net being management still expects to grow ww revenue 100-200bp above market in 4Q (even against tough comps) and 2013.
  - **For SIRO,** Omnicam manufacturing remains modestly constrained but production schedules are on (if not slightly ahead of) schedule, suggesting revenue may only grow mid-single-digits next couple quarters but could quickly accelerate to low/mid-teens+ (with decent leverage) as full Omnicam availability scales in 2H-13.
  - **For PDCO,** few incrementals following last week's FQ2 report, but management continues to expect a solid ramp in CEREC Omnicam sales by FQ4-13.

Prices as of 11/26/12

Ticker	Price	Mkt Cap (mil)	Rating Current Prior	Target Current Prior
HSIC	$80.58	$7,220	O/A	$88
PDCO	$33.63	$3,511	N/A	$35
SIRO	$62.00	$3,496	O/H	$68
XRAY	$39.22	$5,644	O/A	$44

Sources: Bloomberg and Baird Data

Please refer to Appendix - Important Disclosures and Analyst Certification

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Prices as of 11/26/12	Market Cap (mil)	Rating	Target	F2012	F2013	F2014
COMPANY TICKER - PRICE		Current Prior	Current Prior	Current Prior	Current Prior	Current Prior
DENTSPLY International Inc. **XRAY - $39.22**	$5,644	O/A	44	2.21	2.45	2.68
Henry Schein, Inc. **HSIC - $80.58**	$7,220	O/A	88	4.37	4.84	5.35
Patterson Companies, Inc. **PDCO - $33.63**	$3,511	N/A	35	1.92	2.03	2.23
Sirona Dental Systems, Inc. **SIRO - $62.00**	$3,496	O/H	68	3.07	3.41	3.87

Details

We attended the GNYDM yesterday, where we conducted booth tours with six companies and spoke with a number of sources regarding the current state of the worldwide dental market and expectations heading into 2013. From these meetings, our sense is that dental trends remain largely stable across both consumables and equipment relative to what we've seen in both the U.S. and Europe over the past two quarters. Net, we continue to believe the ww dental market is currently growing ~3-4%, including 1-2% growth in NA dental consumables, 3-5% growth in NA dental equipment sales, flat to slight growth across both consumables and equipment in Europe, and mid-single digit growth in other worldwide markets.

We review company-specific takeaways below, but from a high level came away from our meetings believing HSIC sounded the most upbeat of any of our meetings, as the company continues to execute well across its business units, including North American dental consumables where we sense a slight sequential improvement relative to softer July/August demand. While Hurricane Sandy sounds as if it could weigh on the company's NA dental consumables growth by ~50bp this quarter, we still wouldn't be surprised to see sequentially improved (by 50-100bp) organic growth for this segment after adjusting for both Sandy and the extra 4Q selling week in last year's 4Q, especially as demand from the company's corporate dental accounts continues to grow mid-single digits+. Importantly, we believe corporate dental accounts represent close to 25% of HSIC's overall consumables business in North America.

Outside of HSIC, XRAY management sounded fine, with management still expecting to grow 100-200bp above market even against more challenging upcoming comps as new products continue to do well and offset still sluggish dental implant end markets (management seemed to indicate no real change in 4Q from what was flat to slightly lower ww dental implant market-wide growth in 3Q). For SIRO and PDCO, Omnicam manufacturing constraints sound as if they'll likely hold near-term CEREC growth in check, but upgrades and strong pricing trends (ASPs for Omnicam holding at $129,900 for now) set the stage for meaningfully improved revenue growth and potentially better margin expansion opportunities once constraints begin to lift in February. For SIRO, we expect that to translate to mid-teens+ revenue and earnings growth beginning 2H-13 (second half of their fiscal year that began in October), while for PDCO we believe that means performance for at least the next couple quarters could remain pressured, with some improvement likely late in the company's FY'13 (FY'13 ends April 2013) but not before. But CEREC only accounting for ~5% of company-wide revenue, NA dental consumables growth still lagging that of HSIC (and at the low-end of market), and revenue/margin pressures expected to persist in Medical, we still see few reasons to try and call an inflection point for PDCO's company-wide fundamentals.

Net, we come away from our meetings believing dental end markets are fairly stable, with some companies positioned to do better in the near-term (mainly HSIC) and others better positioned for a couple quarters from now (namely SIRO). But with all of our dental stocks currently trading above five-year average levels (see below), it's also hard to find a table-pounding near-term idea in the group.

DENTAL COMP GROUP													
			Mkt Cap	- P/E -			- EV/S-	- EV/EBITDA -	- Cons. Growth Est. -		- NTM P-E-G -	- 5 - Year Average -	
Company	Ticker	Price	($mil)	CY'12E	CY'13E	NTM	TTM	TTM	Sales / 3-Yr	EPS / 3-Yr	3-Yr	NTM P/E	EV/TTM EBITDA
SCHEIN (HENRY) INC	HSIC	$80.58	$7,091	18.4	16.6	16.9	0.9	10.8	8%	11%	1.6	15.8	10.0
DENTSPLY INTERNATL INC	XRAY	$39.22	$5,566	17.7	15.9	16.1	2.6	15.8	11%	9%	1.8	16.8	12.6
PATTERSON COMPANIES INC	PDCO	$33.63	$3,711	16.9	15.3	15.7	1.1	9.9	4%	6%	2.6	14.8	9.6
SIRONA DENTAL SYSTEMS INC	SIRO	$62.00	$3,409	20.3	17.7	18.0	3.4	12.8	15%	14%	1.2	14.1	11.5
ALIGN TECHNOLOGY INC	ALGN	$26.99	$2,197	23.9	21.6	22.2	3.5	16.8	17%	16%	1.4	31.8	17.1
STRAUMANN HLDG	STMN	$116.53	$1,827	15.2	12.9	16.2	1.8	8.9	-1%	-7%	-2.2	20.7	15.2
NOBEL BIOCARE AG	NOBE	$8.26	$1,023	15.0	11.0	15.7	1.4	8.3	-1%	3%	6.1	18.5	11.8
YOUNG INNOVATIONS INC	YDNT	$36.23	$287	16.7	16.0	15.9	2.5	8.9	3%	7%	2.3	13.7	8.4
COLTENE HOLDING AG	CLTN	$29.50	$124	NM	NM	12.7	1.0	7.8	0%	2%	6.3	13.0	8.6
BIOLASE INC	BLTI	$1.88	$59	NM	NM	NM	1.1	NA	36%	NM	NM	NM	NM
Mean			**$2,529**	**18.0**	**15.9**	**16.6**	**1.9**	**11.1**	**9%**	**7%**	**2.3**	**17.7**	**11.6**
Median			**$2,012**	**17.3**	**16.0**	**16.1**	**1.6**	**9.9**	**6%**	**7%**	**1.8**	**15.8**	**11.5**
High			**$7,091**	**23.9**	**21.6**	**22.2**	**3.5**	**16.8**	**36%**	**16%**	**6.3**	**31.8**	**17.1**
Low			**$59**	**15.0**	**11.0**	**12.7**	**0.9**	**7.8**	**-1%**	**-7%**	**-2.2**	**13.0**	**8.4**

Source: FactSet, Robert W. Baird & Co. Estimates

Ultimately, SIRO remains our top 12-month dental idea given expectations for a solid 2H-13 acceleration in both top- and bottom-line growth, especially as CEREC Omnicam availability scales (should provide both revenue and margin tailwinds in 2H-13) and one to two additional new products launch in the early part of next year (likely ahead of IDS in March 2013). In our opinion, this should mitigate the risk that any type of mid-cycle multiple compression begins to hit shares by the middle of next year, argues that shares should instead be able to carry a mid- to upper-teens multiple even into the back half of next year and early in FY'14, and suggests shares could move into the low $70s over the next 6-12 months.

Additional company-specific details from our meetings yesterday are provided below:

XRAY ($39.22 - Outperform, $44 Price Target)

At XRAY, we met with Senior Vice President and Chief Financial Officer Bill Jellison and Vice President of Investor Relations Derek Leckow. Highlights from our conversations include:

- **Still expecting above-market growth in 4Q against tough comps.** Despite coming up against y/y organic growth comps this quarter of 7.6% for the U.S. and 3.8% ww (both excluding ortho/Japan-related losses in last year's 4Q), management still expects to grow revenue 100-200bp above market, implying U.S. growth (ex ortho) of ~2-4% and ww growth (ex ortho/Japan) of ~3-4% by our math. To put that in perspective, we currently project +1% U.S. and +2.5% ww (both ex ortho/Japan) organic growth this quarter, suggesting modest upside potential vs. our current 4Q-12 model. Assuming recaptured ortho sales (see below) then add another 100-200bp to company-wide growth in 4Q, we then believe company-wide cc growth of 4-6% might be possible this quarter, above the +3.5% growth we currently project.
- **Ortho recapture continues.** Management also continues to see good success recapturing orthodontics business lost following last year's earthquake/tsunami in Japan. To date, the company has recaptured more business in its first few months back on the European (since June) and U.S. (since August) markets, with our math suggesting upwards of 40% of sales lost last year have been recaptured thus far. Given this initially solid recapture rate, however, and as competitors (especially in the higher-margin self-ligating segment of ortho) try to maintain share picked up from XRAY last year through a variety of ways including more aggressive pricing, incremental gains next year could be harder to come by. Even so, management still expects ortho revenue in general to grow nicely above company-wide rates next year. To that end, we remain comfortable modeling 45% y/y growth in XRAY's ww ortho revenue in 4Q-12 and 9% growth for 2013 (to $145 million vs. ~$200 million pre-Japan earthquake/tsunami).
- **Astra Tech integration continues to progress nicely.** While dental implant market growth is some 300-500bp below what management envisioned when they acquired Astra Tech last year, integration efforts continue to progress nicely, urology trends (~45% of the acquired Astra business) are holding

in better than expected, and cost synergies have delivered to -- if not a bit above -- initial expectations. While management isn't providing additional specifics regarding 2013 potential cost synergies or EPS accretion from this deal, it sounds as if accretion next year is still expected to be nicely above 2012 and that Astra cost synergies could still (conservatively) add 20-40bp to company-wide OM% next year, providing a potential 100-300bp (by our math) to EPS growth next year.

- **Still expect to pass medical device tax through to dentists.** At this point, management still expects to pass the 2.3% medtech tax through to dentists next year, assuming dental isn't carved out completely from being subject to the tax (still a small potential that dental could be excluded from the tax, although our industry contacts admittedly sounded more skeptical about such an outcome yesterday than they did a couple months ago). Even if management couldn't pass the tax through, it would likely only impact EPS growth next year by 150-200bp per our math (35% of ww revenue subject to 2.3% tax), although the likelihood of even this level of impact seems low to us at this point.

HSIC ($80.58 - Outperform, $88 Price Target)

At HSIC, we met with Executive Vice President and CFO Steven Paladino, VP and Corporate Treasurer Ferdinand Jahnel, and Vice President and General Manager of Henry Schein Dental, Dave Steck during our booth tours. Last night, we then hosted an investor dinner with Mr. Paladino and HSIC CEO Stanley Bergman. Highlights from our HSIC meetings include:

- **Dental consumables tone modestly improved.** Our sense is that after adjusting for the extra selling week HSIC enjoyed in last year's 4Q, the company's N.A. dental consumables trends have improved on a sequential basis relative to 2Q and 3Q for several reasons, including modestly improved demand from corporate accounts (while corporate dental practices only account for ~8-10% of the NA dental market, these markets are currently growing mid- to upper-single digits and HSIC is the biggest player in these markets, with PDCO having little to no presence in these markets) and still solid response to the company's ongoing efforts with DPAT (2,000+ DPAT expected to in 2012 and 2013, with the average office going through this process growing their consumables sales through HSIC 20%+ annually in their first year).
- **Core margin expansion still expected in 2013.** While management continues to believe it can deliver 30-50bp of annual OM% expansion longer-term, it sounds as if 2013 is setting to come in at the low end or even a bit below this range given still pressured end markets and modest margin contraction currently being seen in Europe (due in large part to flattish European growth in recent quarters that is expected to continue into 2013). Even with these generally sluggish end markets and European margin pressures, management still expects 10-30bp of core (ex acquisition) OM% improvement in 2013, which is in line to above the 10-15bp of OM% expansion we model for next year after adjusting out a modest (10-15bp) expected 2013 headwind from the 2Q-12 acquisition of AUV Veterinary Services and the late 2012 acquisition of C&M Vetlink.
- **Emerging markets remain key priority.** Management continues to believe emerging markets remain a key intermediate- to longer-term growth opportunity, especially in the BRIC countries, where China remains the biggest opportunity. Specifically, management noted that while the Chinese dental market is currently valued at ~$1 billion and is growing 20%+ annually, HSIC's share of this market is very small (no more than ~1-2%, or an annual revenue run rate of ~$10-20 million). Importantly, in China and a number of other emerging markets, HSIC believes it's important the company ultimately pursues exclusive distribution agreements with a variety of manufacturers so as to offer not only a differentiated product line up vs. other distributors, but to also more effectively compete against lower-end/more commoditized product manufacturers in the region(s).

SIRO ($62.00 - Outperform, $68 Price Target)

At SIRO, we met with Vice President of Investor Relations Joshua Zable. Highlights from our conversation include:

- **FY'13 back-end loaded.** It continues to sound as if SIRO's top-line growth could moderate over the next 1-2 quarters as Omnicam manufacturing capacity ramps and European dentists draw down purchases ahead of IDS in March. However, it also sounds as if growth can likely accelerate well into the double-digits (potentially mid-teens+) in the back half of FY'13, especially as Omnicam constraints lift, a potential Omnicam upgrade cycle begins (see our dental survey results HERE that suggest solid upgrade demand for Omnicam in the U.S. later this year), and at least two new products launch early next year, including a potential treatment center that directly incorporates a CEREC wand and the "super top secret" project for which management has accrued in excess of $40 million in IPR&D over the past 18 months.

- **Omnicam pricing holding in at list.** Even though Omnicam isn't yet widely available, management seems to believe pricing for the new Omnicam system is likely to hold at, or very near, the product's current $129,900 list price for at least the next 6-12 months. We continue to believe that even if Omnicam doesn't drive accelerated end user demand for CEREC over the next year (which both PDCO and SIRO management seem to believe it will; we remain a bit more skeptical), higher ASPs for Omnicam alone (vs. an ASP over the past year+ for CEREC Bluecam of ~$109,900), these highers ASPs should be enough to drive double-digit CEREC revenue growth for both PDCO and SIRO, while an eventual Omnicam upgrade program will likely provide an additional 300-500bp+ of growth for SIRO later in FY'13. By our math, these two factors alone -- even in the absence of accelerated new system user demand -- should be enough to drive double-digit to low/mid-teens growth in CAD/CAM revenue for SIRO in FY'13 (we currently model +14% ww cc CAD/CAM growth for SIRO in FY'13).
- **Pricing not yet a competitive CEREC threat.** HSIC and 3M sources continue to voice their belief that 3M's recently launched True Definition chair-side scanner (and the combined True Definition scanner/E4D milling unit) represents a new dynamic in pricing and could put pressure on CEREC demand near-term. Our analysis, however, continues to suggest that True Definition pricing isn't nearly as competitive as it might appear on first glance after also taking monthly data fees and/or monthly milling fees into account (see our ADA note HERE), leading us to believe that so far, pricing dynamics in chair-side CAD/CAM have not changed dramatically. In turn, we don't yet see significant risk that SIRO (or distribution partner PDCO in North America) has to lower either Bluecam or Omnicam pricing from their current $99,900 or $129,900 levels, respectively, near term, thus mitigating significant margin risk to SIRO near term.

PDCO ($33.63 - Neutral, $35 Price Target)

At PDCO, we met with Vice President of Sales for Patterson Dental, Dave Misiak. Highlights from our conversation include:

- **C’4Q update.** With PDCO having reported FQ2 results last Tuesday (quarter-end October), there was understandably limited incremental color on C’4Q trends beyond what was stated on last weeks call.
- **With regards to dental equipment,** it sounds as if management expects modestly improved year-end demand, but against a tough 22% y/y growth comp from last year's FQ3 and as Omnicam availability remains limited, a meaningful improvement off last quarter's -3.3% seems unlikely. More importantly, it sounds as if year-end potential growth drivers (January 1 implementation of medical device tax and expiration of heightened Section 179 levels) are largely being offset by potential headwinds related to ongoing fiscal cliff discussions (sentiment headwind) and potential that personal income tax rates could move higher next year (giving dentists reason to put off equipment purchases this year and shield that income from higher tax rates next year), meaning an upside surprise for equipment due to the former is unlikely.
- **For consumables,** PDCO remains focused almost exclusively on the private dental practitioner and not corporate dental offices, meaning that even as the company modestly gains share in this segment of the market (private offices), its North American consumables rates will likely remain suppressed as private practitioners seem to be ceding share to corporate dental offices, with private practice revenues flattish vs. mid- to upper-single digit growth for corporate dental office revenues at present.
- **Hurricane Sandy update.** While management expects to have a better estimate of Hurricane Sandy’s impact on its consumables business in coming weeks, Mr. Misiak didn't disagree with our

estimate that domestic dental consumables market growth could face a ~50bp headwind from Sandy in the current quarter. However, the company has put in some fairly aggressive promotions to help support those offices impacted by Sandy (dentists must prove their practice is/was in a region impacted by Sandy to qualify), including: (1) Freezing payments and accruing no financing charges for six months for existing equipment accounts, (2) offering a 3.9% financing rate for five years and no payments for three months for new equipment accounts, and (3) charging 0% interest and requiring no payment for 90 days for consumables sales to accounts that typically do $30,000 or more in business a year with PDCO. As we alluded to above, these promotions are relatively similar to what HSIC is currently offering.

- **Omnicam update.** Similar to the tone on last week's call, management remains upbeat regarding the prospects for Omnicam over the next few quarters, even if system availability remains somewhat constrained through early next year (capacity constraints expected to lift around February 2013). Once these manufacturing constraints lift, however, management believes a large majority of CEREC new system sales will skew towards Omnicam (Mr. Misiak noted his own expectations are 80-90% of CEREC sales skewing towards Omnicam and 10-20% to Bluecam, although he was quick to point out this was his personal view and not official company guidance), while ASPs for Omnicam sound as if they should remain at $129,900 for at least the next 6-12 months.

Price Target Justification and Risks

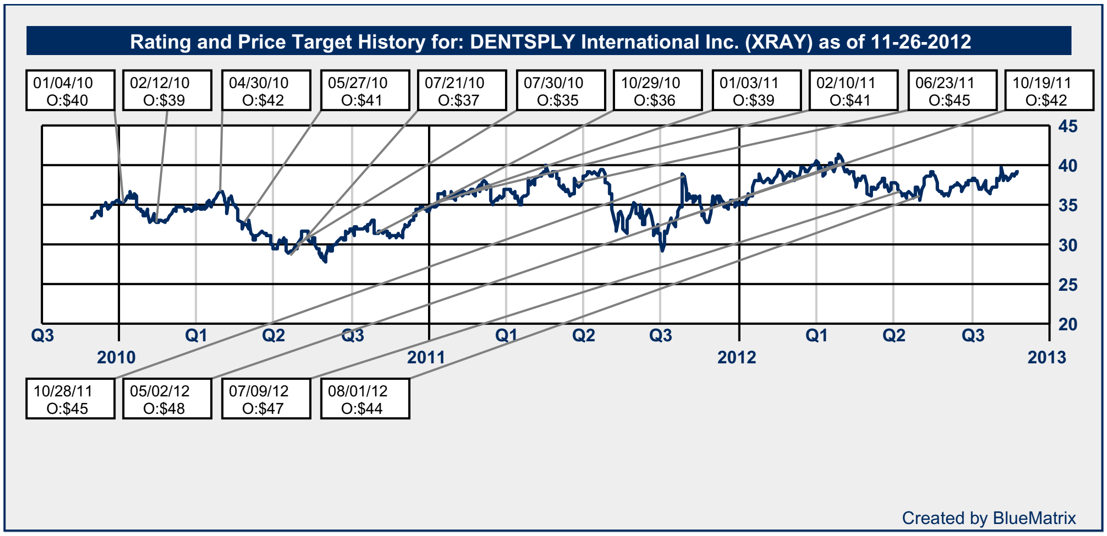
XRAY: We rate shares of XRAY Outperform with a $44 price target. Our $44 price target represents a forward year NTM EPS multiple of ~16.7x, just below the company's five-year average multiple of 17x. While we believe this could prove conservative in light of our double-digit (and potentially low teens) EPS growth outlook for 2013, we also believe current end market uncertainty warrants a bit of near-term conservatism on our part. Risks include a slower-than-expected dental market recovery in the U.S. or incremental slowing of dental demand in Europe or other markets, risks around orthodontic market share recovery, acquisition and integration related risks, as well as sensitivity to dealer purchasing patterns.

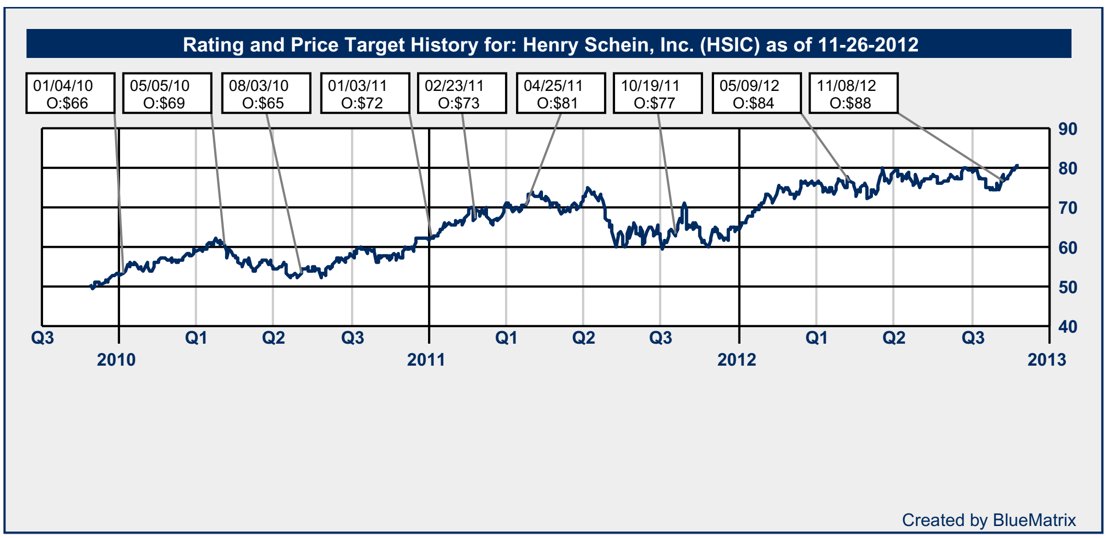
HSIC: We rate shares of HSIC Outperform with an $88 price target. Our $88 price target represents a ~17x multiple off our forward-year NTM EPS projections, essentially in line with HSIC's 10-year average NTM EPS multiple of 17.2x. We believe this multiple is justified by fairly stable end markets (sluggish but stable), HSIC s ongoing ability to grow above market and capture share across its dental, vet and medical businesses, and what we believe is a shareholder friendly capital deployment strategy in which free cash flow is expected to be allocated evenly between acquisitions (most of which are accretive within one year) and share repurchases over coming years. Risks include a slower-than-expected dental market recovery in the U.S. or incremental slowing of dental demand in Europe or other markets, acquisition and integration related risks, as well as uncertainty in flu vaccine dynamics that impacts HSIC in each H2.

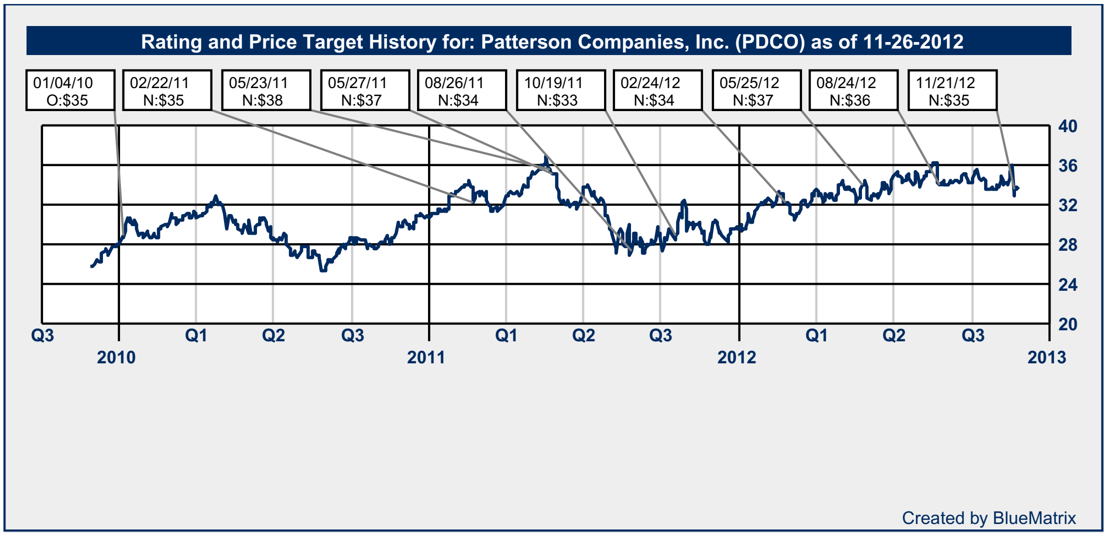
SIRO: We rate shares of SIRO Outperform with a $68 price target. Our $68 price target represents ~13x our 2013 EBITDA projection, and while this multiple is above the company's 5-year average of ~11.5x EV/EBITDA, we believe a higher multiple is justified as SIRO's multiple has historically expanded ahead of IDS and in the early stages of new product cycles. On a P/E basis, our price target reflects a multiple of 17.5x applied to our forward year NTM EPS projection, and while this represents a slight premium to the 17x multiples we're currently using to value our other Outperform-rated dental names in HSIC and XRAY, we believe such a premium can be justified by the slightly faster (low- to mid-teens) we expect from SIRO relative to these other names. Risks include intense competition in the $4.5+ billion dental equipment market, slower-than-expected dental market recovery in the U.S. or incremental slowing of dental demand in Europe or other markets, and variability in order trends since the majority of SIRO's sales are capital equipment products.

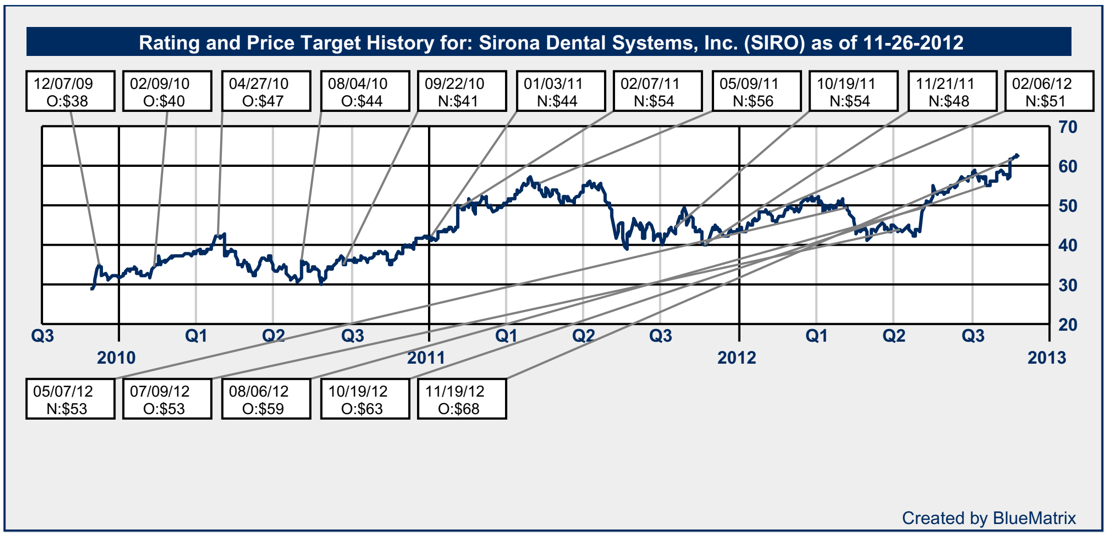
PDCO: We rate shares of PDCO Neutral with a $35 price target. Our $35 price target represents a 15x multiple to our forward-year NTM EPS projection of $2.33, which is in line with the company's five-year average NTM EPS multiple of ~14.8x and is two points below the 17x multiple we use to value closest peer HSIC, with the lower multiple warranted in our view by greater uncertainty caused by greater uncertainty in PDCO's margin trajectory and still uncertain rehab/medical end-market demand. Until we gain greater conviction on the margin front or unless shares fall to the low $30s ($30-$32) near term, we believe 12-month risk/reward remains fairly well balanced and therefore are maintaining our Neutral rating today. Risks to PDCO include a slower-than-expected dental market recovery in the U.S. or incremental slowing of dental demand in Europe or other markets, limited acquisition opportunities, an uncertain margin outlook, and the possibility that PDCO's EBIT growth over coming quarters trends in the low to mid-single digit range, in line to only slightly above-core market growth.

Appendix - Important Disclosures and Analyst Certification









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