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**Reason for Report:**  
Company Update

Related Companies:	Share Price:
JNJ	57.12
MDT	36.22
NUVA	31.60
TSON	2.28
ZMH	52.97

## Medical Technology & Hospital Supplies

### IMAST Adds Color to Clouded Spine Debate

#### CONCLUSION:

Our take-aways from this year's IMAST meeting are not surprisingly less about new widgets and techniques and more about tone and trends in the spine market. Given the results and commentary from JNJ and SYK earlier in the week and the sell-off in ortho and spine stocks, we spent our time digging into questions around pricing, volume trends and reimbursement with attendees and exhibitors. In a nutshell, we came away from the meeting with our bullish view on spine intact, and we remain buyers of Overweight NUVA, and we continue to recommend TSON for investors with a longer horizon. Our key take-aways are as follows:

- **Faster-growing innovators not tripped up by pricing and volume challenges:** Most manufacturers see consistent pricing pressure over the past several quarters, some agreeing with JNJ's and SYK's "mid-single digit" comments and some citing pressure in the low single digits. Similarly, there is little disagreement that there has been some modest slowing of unit volume growth, in the range of 100-200 bps, driven mostly by the economy. But we note that faster growing innovators like NuVasive, Globus Medical and to some degree K2 Medical stand out in that they do not expect these pressures to hamper their growth, share gains, innovation or new product penetration.
- **Reimbursement and payor pressure picking up for vertebroplasty, more stable in core fusion:** We found broad agreement that last year's New England Journal of Medicine paper on vertebroplasty has fueled an increase in payor scrutiny, focusing on severity of fractures and questioning the use of vertebroplasty in every VCF (vertebral compression fracture). In addition, attendees and manufacturers have had to deal with relatively comprehensive pre-certification requirements for almost every spine procedure they perform for the past two years now. However, pushback around core fusion procedures is more limited and focused on back-pain-no-leg-pain patients without evidence of instability. Again, as with pricing and easing volumes, we note that faster-growing players just don't seem to see it as much, and to the extent that they see it anecdotally and on the margins, they don't appear to view it as a factor that will materially impact their growth.
- **"Tale of Two Spine Markets"? How can this be?** It's difficult for us to explain the disparity between the performance and commentary from faster-growing innovators and larger slower-growing legacy players, yet, there it is. Having looked at this from a number of angles and discussed and debated this issue with a number of industry and company contacts, we offer a few points that play at least a partial role: 1) Greater exposure of innovators to the higher-growth, premium-priced MIS segment, 2) Greater number of new products per year drives more mix, helping offset pricing pressure, 3) No exposure among faster growing innovators to VCF's, 4) Greater portion of sales from new accounts and share gains (i.e. all pricing at new accounts is effectively flat by virtue of being new).
- **What's New?** We attended the annual International Meeting on Advanced Spine Techniques in Toronto this week. We met with a number of clinicians and manufacturers and have included selected company-specific notes on page 2.

#### RISKS

(1) Greater than expected pressure from European budget cuts and pricing pressure across all geographies, (2) Regulatory and reimbursement-related risks, and (3) Unexpected slowdown in key markets or delays of key products.

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**Additional details and take-aways:****NuVasive (NUVA, Overweight, \$51 PT)**

At the conference the company was highlighting its expanding portfolio of minimally invasive techniques, including the Lateral Corpectomy, MAS TLIF, ILIF, Degenerative Deformity using MaXcess and lateral access and of course XLIF. Management continues to focus on its core strengths of delivering suites of innovative, well-designed implants and instruments coordinated around advanced surgical techniques to deliver a repeatable result. We saw a busy booth and no apparent indication that the company is losing momentum in the market.

**Medtronic (MDT, Overweight, \$50 PT)**

Medtronic's market leading spine franchise has suffered over the past 18-24 months, driven by share losses, a dearth of meaningful new products and the bumpy integration of Kyphon. In line with the company's comments at its analyst meeting in June, the company appears to be finally righting the ship and getting underway again, with an improving flow of new products expected later this year. The company has been regaining traction in the VCF market, despite the rising reimbursement challenges more heavily focused on the vertebroplasty side of that market, driven in part by enhancements to the KyphX instrument system and stabilizing the turnover that had disrupted that franchise. Stay tuned.

**JNJ/DePuy Spine (JNJ, Neutral, \$63 PT)**

The company featured its well-established core products around complex spine and adult deformity, which is a core strength of DePuy and an important theme for the IMAST meeting (organized by the Scoliosis Research Society). The company also featured its lateral access surgery system and the Confidence Cement System for the treatment of vertebral compression fractures. Management's comments on its Q2 earnings call indicated that pricing pressure and slowing volumes, driven in part by rising reimbursement pressure were contributing factors to the company's weak spine performance (down 1% CC). We believe the company's exposure to VCF trends, albeit small, were a contributing factor, and see competitive share losses as a significant factor as well, given growth among smaller, faster-growing spine players in the 30-40% range over the past several quarters.

**Zimmer (ZMH, Neutral, \$66 PT)**

The company had a modest presence at the conference, but was highlighting an interesting deformity-oriented product called the Universal Clamp, that came over to Zimmer via the Abbott Spine acquisition. The product offers an attractive alternative to wires and we think could be appealing to the scoliosis surgeon base attending the conference. That said, recent performance of Zimmer Spine (down 9% in Q1, CC) indicates that the franchise will likely need to increase the flow of new and enhanced products to help reinvigorate growth.

**TranS1 (TSON, Overweight, \$5 PT)**

Although there was no senior management available when we visited the booth, the company appears to be hanging in there and potentially stabilizing its surgeon base and revenue trends. Our call on the stock remains that it will either start growing again or become strategically interesting to a larger player in the spine market, both of which would take the stock significantly higher, in our view.

**Alphatec (ATEC, not covered)**

The company was featuring its GLIF (Guided Lumbar Interbody Fusion) system, Illico percutaneous pedicle screw system and Aging Spine products at the conference. The company has built some very solid momentum over the past several quarters, and is one or two product approvals away from kicking its growth up a couple of notches. Products awaiting approval include the company's Osseoscrew expandable pedicle screw for use in osteoporotic bone, and Solace, the company's novel stand-alone interbody implant which uses a unique rotating blade mechanism for attaching to the upper and lower endplates of the adjacent vertebrae.

**Globus Medical (privately held)**

The company continues to roll a steady stream of new products, including its own system of instruments and implants support lateral access spine surgery, standalone anchor-cages and its alternative to Dynesys, Transition. Although the company does not disclose business trends per se, we suspect that Globus is growing at a rate closer to NuVasive than the larger, slower-growth players in the space.

**K2 Medical (privately held)**

We spoke with representatives at the booth less about new products and more about the tone of the business, which remains healthy. In terms of background, K2M has come at the market from the deformity side, and then shifting into a broader group of products over time. Again, similar to Globus, the company does not share details regarding its performance, but they appear less impacted by pricing and volume pressures cited by JNJ and SYK.

**Biomet Spine (privately held)**

Despite the company's below market growth in F4Q (up 1% CC for spine), we continue to see improvements in this division in terms of new talent and resources and new product flow. The company still has gaps to fill and more work to do in rebuilding momentum, but we like the progress we're seeing and are optimistic that management will be successful in getting this business back on its feet and

running at or above market growth rates, potentially over the next four quarters.

**Lanx (privately held)**

The company continues to promote its Aspen Spinous Process Fixation System. Although smaller than Globus and NuVasive, we see Lanx as similar in its ability to rapidly design and launch innovative new products.

**Ratings, Price Targets and Risks:**

**NuVasive (NUVA, \$31.60):** We rate NUVA at Overweight with a price target of \$51 based on 3.75x EV/sales 2011E. Risks: (1) Increased competition and litigation from other manufacturers; (2) Delays in product launches; and (3) Pricing pressure, regulatory and reimbursement risk.

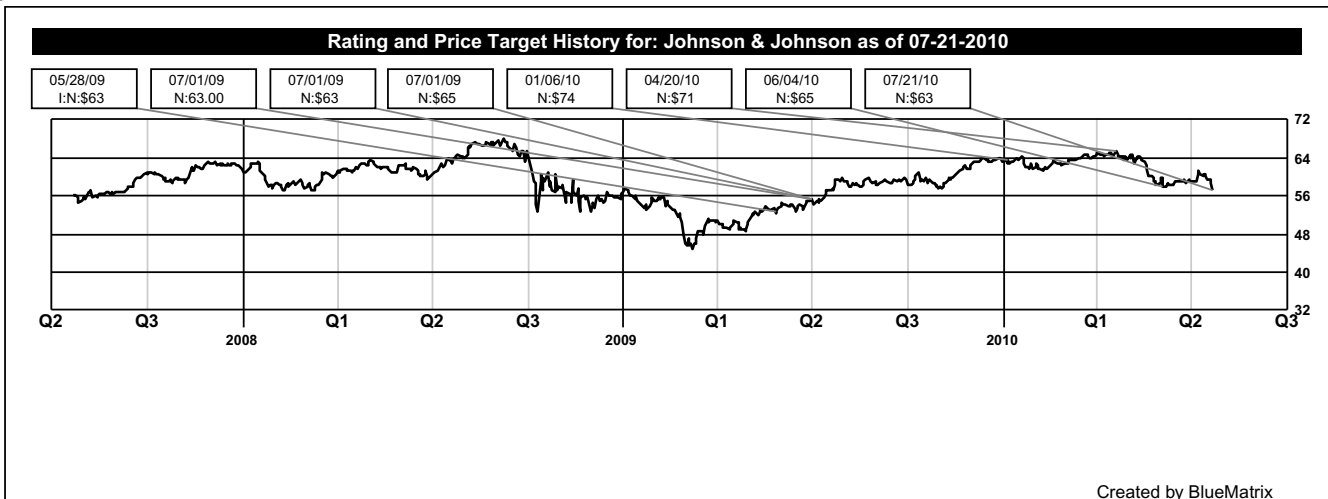
**Medtronic (MDT, \$36.22):** We rate MDT at Overweight with a price target of \$50 based on ~13x C'11 EPS est. of \$3.81. Risks: (1) unexpected slowdown in key markets (2) regulatory delays of key products.

**Johnson & Johnson (JNJ, \$57.12):** We rate JNJ at Neutral with a price target of \$63 based on 12.8x 2011E EPS of \$4.93. Risks: (1) Greater than expected pressure from European budget cuts and macro trends (2) Expansion of McNeil recall and other litigation, regulatory and reimbursement-related risks.

**Zimmer (ZMH, \$52.97):** We rate ZMH at Neutral with a price target of \$66 based on 14.5x 2011E EPS of \$4.57. Risks: 1) Significant drop in market volumes; 2) Greater-than-expected market share loss; and 3) Pricing pressure.

**TranS1 (TSON, \$2.28):** We rate TSON at Overweight with a price target of \$5 based on 2.0x EV/2011E Sales. Risks: (1) Further misses or disappointments could damage management's credibility and cause investors to question the viability of AxiaLIF, (2) Additional turnover in the company's sales force (3) An unexpected increase in adverse events or clinical problems related to the company's devices and surgical approach.

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