The Orthopaedic Bandwagon

. . . .

There is little argument of the financial success experienced from companies participating within the orthopaedic space. Over the years their stock has been an investor magnet, given high margins, seemingly cyclical insulation and favorable demographics. However, when speaking with analysts and those of financial interests, it appears their attention is riveted on issues expressed on quarterly calls, disassociated from underlying industry trends. Therefore I would propose that if you are contemplating "entering the game" you may want to look at some of the causal effects for these quarterly reports.

The Top 7 companies (J&J, Medtronic, Stryker, Zimmer, S&N and Synthes) represent ~70% of the total orthopaedic market with the Top 5 in Joint Reconstruction representing 87% of its largest market segment. Historically, companies in "Recon" have traded off individual share points like they were baseball cards, and with the recent exception of resurfacing technology, rarely does a company present breakthrough innovation that can entice a large share block. I would suggest that this level of consolidation is partly the result of the difficulty in developing new metals & plastics that can substantiate the differentiation needed to maintain existing margins. New entrants and top tiered companies alike have been forced to focus on new market approaches in segments spanning; trauma, spine, extremities, sports medicine *(a more palatable handle for Arthroscopy),* clinical therapies *(bone stimulation, joint fluid, etc)* and orthobiologics. This focus starts to take root as medicine moves "upstream" through diagnostic advances, resulting in therapeutic and less invasive surgical options.

Under this backdrop, let us then formulate our direction from *three* specific markers underlying this industry . . . . cellular healing . . . . . government intervention . . . . and capable management. *First* . . . . the obvious impact from improvements to the quality of care has lead to a dramatic platform shift from open surgery, the current hallmark of both spinal fusion and total joint reconstruction. With attention to less invasive procedures, new products and techniques are being introduced to satisfy both surgeon and patient needs for smaller incisions and faster recoveries. This is being supported by earlier event diagnoses and computer aided surgical systems . . . . . all contributing to the merging of joint reconstructive *(open)* and arthroscopic *(minimal invasive)* specialties. Additionally, advancements in biologic healing, which either entice or replace cellular growth and lead to natural restoration, are gaining investment attention from many companies filling out their portfolio for the long haul.

Secondly . . . . the Top 5 companies in recon have been under DOJ subpoenas, with recent fee settlements and transparency of financial physician relationships. Most believe this is the "beginning rather than the end" of these investigations and not just restricted to the big boys. In July the spine division of Orthofix *(Blackstone Medical)* was served a subpoena by the Dept of Health and Human Services regarding similar physician payment concerns. Although the strong cash position of these companies would temper indictment concerns . . . . . make no mistake that each company is or has implemented operational modification to their go-to market business process. On another front, more scrutiny is needed on the impact from the financial disparity among orthopaedic stakeholders. The numbers suggest annual revenue growth in the high single digits being enjoyed by suppliers, while hospitals continue to struggle with yearly increases of 1% - 4%, and the surgeons experiencing yearly reductions, continued in 2007 with a -5%. Additionally Congress is sending conflicting messages to the industry on whether it wants to support a competitive health care environment via the encouragement of physician owned specialty hospitals. *Finally* . . . . in an industry noted for its dependence on relationships, it is interesting to note that four of these top 6 recon companies had turnover of their top leadership during the past year, and three of these companies are now being directed by executives from outside the orthopaedic environment. As one might imagine, there has been residual losses from employees adjusting to new management styles, and contributing to movement in front line relational influences.

Consider the impact of this activity . . . (1) in an industry poised for transition . . . (2) under multiple government scrutiny . . . . . . (3) looking for stability in its leadership . . . . . . and parallel with the surgeons diminishing influence *(either externally directed or by their own accord)* . . . . then you may agree that there exists a strong recipe for major changes in the near future. Now it is a matter of determining which of these companies will control that change, and which ones will try to ride it out.