This Week From Barron's
Impacted Industry
By Vito J. Racanelli Published: February 15, 2005

THE MARKET HAS SMILED brightly on two European dental-implant makers, Nobel Biocare Holding and Straumann Holding, Nos. 1 and 2 in respective global market shares in this fast-growing industry. Their stocks' performances also have investors grinning — up over 140% since early 2003, outstripping both the broad market and health-care-equipment peers by a wide margin.

Nobel and Straumann dominate the market for prosthetic teeth with a better than 50% share of the global business, which is growing 15%-20% a year. They also are among the top three in the U.S., where implant surgery is rapidly gaining popularity and which bulls think will catapult their growth.

Dental implants are relatively new in the U.S. compared with the Continent, and both companies are ramping up overhead in such areas as sales representatives to take advantage. Tens of millions of Americans are missing at least one tooth, according to National Institute of Dental and Craniofacial Research. The American Dental Association says the average number of implants done by dentists is rising briskly as baby boomers age.

But shareholder smiles could turn to frowns in the not too distant future. While prospects for dental implants are bright, these stocks' valuations are quite rich, leaving them vulnerable to any disappointments. Moreover, Straumann and Nobel will soon be facing a formidable new competitor, a pioneer in the industry whose noncompete clause runs out in less than a year and who's set to jump back in the business — and sharply undercut their prices.

Thus far, however, their shares have been strong in part because money managers have sought refuge in the sector from other poorly acting health-care sectors, like pharmaceuticals. That's become a double-edged sword. Any disappoints could have those folks selling out just as quickly in search of more promising or less risky places for their money.

The most important potential threat, however, for the Swiss Straumann and Swedish-Swiss Nobel probably isn't even on many investors' radar screens. Few expect an acute intensification of competition with the return later this year of Gerald Niznick — a prosthodontist and entrepreneur who is considered by many as the godfather of American implant dentistry — once his noncompete clause with U.S.-based **Zimmer** (ZMH) expires. His prices for dental implants are expected to be one-third to one-half that of Straumann and Nobel, and, given Niznick's high regard in the industry, there's little doubt that many fellow dentists will opt for his cheaper alternative.

There are other nagging concerns. As the procedure spreads to the much more numerous and slower-to-adopt general dentist from specialists such as oral surgeons and periodontists, sales per company representative will likely decline because of planned sharp increases in sales staff. Operating margins at both companies — currently running at a lush 30% or so — could weaken if the new sales to generalists don't grow faster than the investment being poured in.

Past growth has come from dental surgeons who adapted to implants very quickly, says James Rasteh, a money manager at Jana Partners who has sold Straumann short. Penetration of the broad dentist population "will take a long time to do," he posits, probably much longer than the current high share prices discount.

In the U.S., unlike some European countries, implants aren't covered by insurance or government reimbursements to the same extent as other areas of health care. Consequently, the implant industry is more of a discretionary consumer business than many investors might believe. As such, because implants are generally more expensive than dentures and bridges, any slowdown in U.S. economic growth could cut into patient demand.

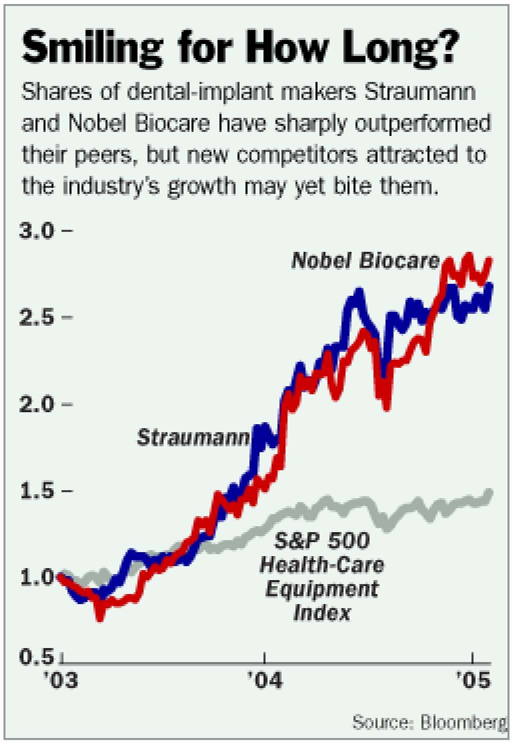
A dental implant is a titanium screw that is embedded into the jawbone and supports a prosthetic tooth or teeth, says Dr. Ken Parrish, a periodontist who performs implant surgery at the Advanced Implant and Periodontics Center in Louisville, Ky. It's indicated for almost anyone with missing teeth and is technically and aesthetically superior to more traditional dentures or bridges. An implant is more secure and natural looking, and it doesn't rely on support from adjoining teeth, he says.

Prices can vary widely around the country, but a dental-implant procedure runs roughly \$2,000-\$3,500, with much of that for the actual procedure. Of the total, the implant itself — sold to the dentist by Straumann, Nobel, Zimmer and others — usually runs \$400 to \$500. Meanwhile, traditional procedures cost less: Dentures could cost a patient about \$800 to \$1,800, and bridgework typically runs \$1,500-\$3,000.

Those mouthwatering 30% corporate operating margins for implants, however, are drawing increased efforts by the competition as well as by new entrants, hoping to encroach on the huge market share Straumann and Nobel Biocare hold. For example, **Biomet** (BMET), an orthopedic company, bought 3i, a dental implant company, in 1999, while Andreas Stutz, a former chief executive of Straumann, helped create a new entrant, Thommen Medical, in 2001. That year Centerpulse, now owned by Zimmer, bought Core-Vent from Niznick.

And investors would do well to pay close attention to Niznick, generally recognized for his pioneering work in the field and his numerous patents. He is a particularly serious industry rival, but one unknown to many investors.

Niznick, who received his first implant patent in 1982, has formed Paragon Implant Co. and will soon be heard from. He tells Barron's he's itching to get back into the business by selling implants over the Internet to dentists at prices one-third to one-half charged by big boys like Straumann and Nobel. His noncompete clause with Zimmer expires Jan. 8, 2006, and he already has a factory with 24-hour-a-day manufacturing capacity.



"We start shipping Jan. 8," he vows. Niznick is readying the factory to be able to produce 150,000 implants a year, along with drills and other equipment needed for the procedure. There are about 700,000 to one million implants sold each year, and he asserts that Paragon will eventually have the capacity to produce that amount by itself.

"Our competitors' expenses are mostly in sales forces and marketing," he adds. "All these companies can't compete on price." Paragon is planning to sell a broad product line, with implants specifically targeted to compete with products from Straumann, Nobel and Zimmer, among others. Dentists who have already invested in Straumann or Nobel training and equipment will be able to use Paragon implants, he says.

Should his competitors be worried? "If they aren't worried, they should be," he quips. "Dentists are afraid of buying cheaper, but they know me." His attitude might seem boastful, but he's seconded by other dentists we contacted.

Dennis Flanagan, a general dentist at the Groton Dental Group in Connecticut, for example, already knows of the intensifying competition for his business and of Paragon's cut-rate prices. "Dentists will be cautious at first....But Niznick has 20 years of experience and is selling online." As dentists adopt his products successfully, they will gain popularity, he predicts.

Gary Bauman, who practices at the Baltimore Center of Advanced Dentistry, says that, assuming the quality is the same, he would "absolutely" go for the lower-priced implant. "Dentists are always looking for increasing margins....Once it's not considered a specialty, prices will drop considerably."

Falling implant prices won't be good news for the Straumann and Nobel, which, as the only major pure plays in this sector, carry those premium valuations.

Shares of Strauman, listed on SWX Swiss Exchange in Zurich, trade at 35 times consensus analyst earnings estimates for 2005 of 7.97 francs a share. Nobel Biocare, listed in both Stockholm and Zurich, also trades in nosebleed territory, with its shares changing hands at 38 times consensus expectations of 38.35 krona a share. While both stocks might be expected to sport a nice premium to the broad market, they also are rewarded with a 50% higher price-earnings multiple than its medical-technology peers, even though long-term growth will likely turn out not much different. (See table below.)

"These stocks are very expensive compared to peers and to the market, and all the good news is priced in," contends Nicolas Mathys, a Zug, Switzerland-based portfolio manager at Zulauf Asset Management. Using a 10-year discounted-cash-flow analysis and assuming 12% annual growth, "which is being generous, that gets you to only 200 francs," far below current price of 280 francs for Straumann, says Mathys, who's short the stock.

Its share price anticipates 15% average annual earnings growth over the next 10 years, but very few companies can manage that, he adds. Straumann had a weak third quarter, so if it should disappoint again the stock will suffer, he avers.

With the new competition coming, those 30% margins are simply not sustainable, adds Jana's Rasteh. He notes that Straumann, for example, is raising its investment in the U.S. by about $50 million over the next four to five years, but the pace of adoption by dentists will slow as it spreads to the more numerous and nonspecialist general dentist. Consequently, "sales per rep will go down a lot and margins will get squeezed," he predicts. Rasteh thinks Straumann is worth 180 Swiss francs, or 25 times his estimated earnings per share.

Stockholm-based ABN Amro analyst Sten Gustafsson expects global implant growth to slow to 18% this year from 20% last year and to 16% in 2006. He has a Reduce rating on Nobel Biocare with a target price of 991 krona, about 32% below the current price of 1,455. ABN's target for Straumann is 225.

Like Rasteh, Gustafsson believes there is a constraining factor: Implant growth will ease as the procedure spreads to the general practitioner, a more conservative lot. And with the two already dominating global market share, he finds it hard to see how they will sustain the growth discounted in the stock price or substantially exceed the industry's growth. Market shares have been fairly stable for the past five years, and "both will grow more or less in line with them," he says.

"It's an attractive market, but if you want to invest money you have to look at the valuations. A P/E above 30 is not very common in Europe medical technology," he says. Indeed, the medical-equipment group's recent history is instructive. Other med-tech stocks, like orthopedics shares, were trading at those levels last spring and then came crashing down after growth disappointments. Gustafsson points out that **Smith & Nephew** (SNN), the U.K. manufacturer of artificial hips and knees, for example, was trading at a P/E above 30, but when profit growth softened suddenly in the second quarter, investors bailed out. At one point the stock had dropped 25%, and it now sports a P/E of less than 25 times.

For the highflying dental-implant companies, the "risk is on the downside," the analyst adds. Any nasty surprise, even a small one, can hurt. He recalls that last year Nobel Biocare missed expectations in the first quarter and the shares quickly fell over 10%. Like fund manager Mathys, he's skeptical about a share price that discounts 15% growth for 10 years. "I don't know too many industries that do that. They will need many years of higher growth with sustained margins."

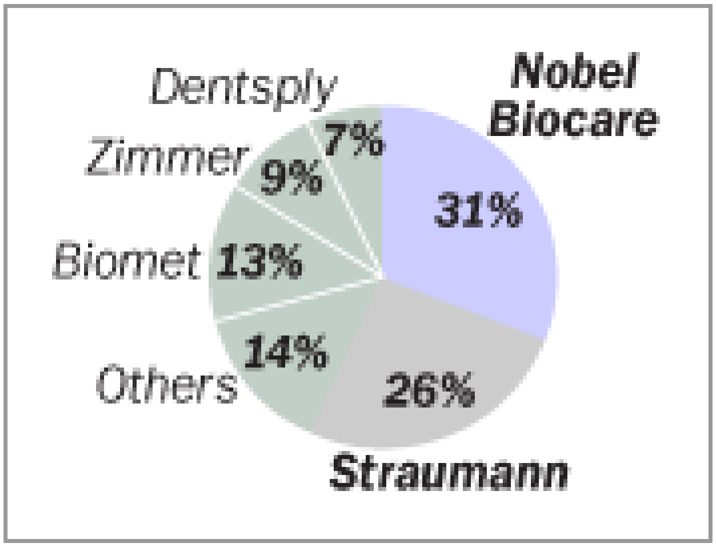
The CEOs of both companies pooh-pooh the skeptics. Nobel's Heliane Canepa says the factors driving the implant industry remain strong and she expects 20% U.S. annual growth for the next five years. In 2005, Nobel will improve on 2004's 22% sales growth and its 30.4% operating margin, she predicts. The 2004 figures, released last Thursday, pushed up Nobel's shares 12% in one day.

Canepa also denies that price is the most important factor in customer buying decisions. Dentists are conservative and want the clinical evidence, customer service and training that a company the size of Nobel Biocare offers, she adds.

Straumann CEO Gilbert Achermann says the industry will grow at "15%-plus and that Straumann will outperform the market." He will give more specific guidance on Feb. 17, when the company reports fourth-quarter results.

There is "significant pricing power in the industry. People will pay for superior service," Achermann adds. "Dr. Niznick is a formidable doctor and businessman, but only a narrow customer segment will be attracted to his business model." Still, the CEO concedes the stock price is vulnerable to a marginal miss, adding, "it's not our job to judge the multiple."

Indeed, last week's frothy reaction to Nobel's results suggests some nitrous oxide is affecting trading. In 12-18 months, valuations could be a lot less giddy.



Shares of Straumann and Nobel Biocare, which account for more than half of global dental-implant sales in 2003 (see pie chart), are richly valued, but new rivals will lower implant prices within a year, and that could dent these shares.

Company	Recent Price	Primary Exchange	Mkt Value (bil)	Earnings Per Share 2004	Earnings Per Share 2005E	Price/ Earnings 2004	Price/ Earnings 2005E
Straumann*	CHF280.00	SWX Switzerland Exch	$3.60	CHF6.49E	CHF7.97	43.1	35.1
Nobel Biocare**	SEK1455.00	Stockholm Stock Exch	$5.28	SEK33.94	SEK38.35	42.9	37.9
Index							
DJ Stoxx	263.13			€13.52	€15.81	19.5	16.6
S&P Health-Care Equip IDX	537.26			$16.30	$22.99	33.0	23.4

E=Estimate
* CHF = Swiss francs
** SEK = Swedish krona
Sources: Bloomberg; Lehman Brothers