WACHOVIA

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Equity Research

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Chinese Manufacturing In Orthopedics

A Boon To The Implant Firms But A Bane To Their Suppliers

Sector Rating: Orthopedics, Overweight

Company Name	Stock Rating	Price 08/21/08	FY EPS 2008E	FY EPS 2009E	FY P/E 2008	FY P/E 2009
Orthopedics						
Smith & Nephew plc (SNN)	1	$59.01	$2.94	$3.56	20.1x	16.6x
Stryker Corp. (SYK)	1	67.20	2.88	3.46	23.3x	19.4x
Symmetry Medical Inc. (SMA)	3 V	18.17	0.75	1.00	24.2x	18.2x
Wright Medical Group, Inc. (WMGI)	1	30.55	0.62	0.88	49.3x	34.7x
Zimmer Holdings, Inc. (ZMH)	2	73.61	4.08	4.58	18.0x	16.1x

Source: Company data and WCM, LLC estimates *NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful*
1= Outperform, 2 = Market Perform, 3 = Underperform, V = Volatile

- **Several Orthopedics Companies Are Setting Up Manufacturing Operations In China.** Biomet, DePuy, and Smith & Nephew (SNN) all currently have or are setting up production facilities in China. Biomet has been transferring production of its international instruments to China (including a new $15MM facility in Changzhou) over the past few years and has now begun to do so for its domestic instruments. JNJ opened a $100MM manufacturing complex in Suzhou on 4/22/08 where DePuy production has already started. And SNN is building an orthopedics plant in China where production is expected to begin in 2010.

- **Instruments Seem Best Suited To Chinese Manufacturing.** While the companies have not detailed exact plans for their Chinese plants, we suspect the plants may initially produce instruments for both Chinese and export markets and implants for Chinese markets. We see three reasons that the implant companies may move instrument production to China: (1) instruments are produced in low volumes through relatively labor-intensive processes which are better suited to low-cost regions like China than implant production which tends to be highly automated; (2) since instruments are not sold and are essentially worthless without the implant there is little risk of "knock-offs"; and (3) there is less legal and regulatory risk with instruments in the event that quality is compromised.

- **Cost Savings On Instruments Could Be Significant But Impact On Earnings May Be Delayed Since Instruments Are Capitalized.** Our research indicates that Chinese manufacturing costs are 20-40% less than U.S. or European manufacturing costs. On average, we estimate that the implant companies spend 5-6% of their sales on instrument purchases which are typically capitalized and depreciated over 3-6 years. Based on these numbers, sourcing instruments from China could result in a 100-250 bps margin improvement though this would take several years to be fully reflected in earnings since the instruments are depreciated over an extended period.

- **Chinese Production Is A Boon To Implant Firms But A Bane To Suppliers.** The implant firms are likely to benefit over the next 3-5 years if instrument (and possibly some implant) production is moved to China. Of our covered companies, SNN seems furthest along in moving to China and is likely to see the earliest benefit. We suspect, however, that the firms may limit Chinese production to their own plants to maintain a tight grip on quality control. This trend is likely to hurt suppliers such as SMA with established capacity mostly in the developed world.

Medical Technology/Devices

Michael Matson, CFA, Senior Analyst
(212) 214-8017 / michael.matson@wachovia.com
Vincent Ricci, Associate Analyst
(212) 214-8016 / vincent.ricci@wachovia.com

Please see page 6 for rating definitions, important disclosures and required analyst certifications.

Chinese Manufacturing: An Emerging Trend In Orthopedics

While many manufacturing industries including electronics, apparel, toys, and even in some cases pharmaceuticals have moved significant amounts of production to lower cost regions the medical device industry has largely kept its manufacturing in the U.S. and Europe. Within the orthopedics sub-sector of the medical device industry, we think that we are on the verge of increased production in low-cost regions, particularly China. Of the five largest orthopedics firms (Biomet, DePuy, Smith & Nephew, Stryker, and Zimmer), three (Biomet, DePuy, and Smith & Nephew) have recently publicly discussed plans to increase production at plants in China.

Biomet has had a production facility in China for at least the past several years and has begun producing instruments for international markets there. On Biomet's FQ4 2008 conference call, management noted that it expects to begin manufacturing instruments for the U.S. market in China as well. CEO Jeff Binder noted on the 7/10/08 call:

> *"In terms of moving instrumentation to China, we had been in the process of moving many of our instruments for outside the United States to China over the past couple of years and now have begun to do so for our U.S. based instrumentation. I won't tell you that all of our instrumentation is going to China. But a significant percentage of it is being transferred to China for a significant cost savings."*

DePuy discussed its plans for Chinese manufacturing at its Medical Devices & Diagnostics investor day this past June. Johnson & Johnson, DePuy's parent company, opened a $100 million complex in Suzhou, China on 4/22/08. Production of DePuy products is already underway at this facility. DePuy Chairman Mike Mahoney made the following comment during the investor day on 6/5/08:

> *"In China this year we've just begun manufacturing at our new Suzhou plant. This facility is going to manufacture select joint, trauma, spine and sports medicine products so we can meet the increased global demand and complement our global manufacturing footprint."*

And Smith & Nephew also discussed China briefly on its Q2 2008 earnings call. Smith & Nephew is building plants in China for both its wound care and orthopedics businesses. The orthopedics facility is expected to begin production in 2010. CEO David Illingworth made the following comments on Smith & Nephew's China strategy on the Q2 call:

> *"On China, we actually have two facilities that we're building in China. One is going to be for our orthopedic business. And the other that I referred to was the groundbreaking for our advanced wound care business. We've already announced the closure of our Largo, Florida plant and we're transferring all of that manufacturing—substantially all of that manufacturing, over to China. We're also taking some other manufacturing in different parts of the world for wound care as well and moving it to that facility as well.*
>
> *It's going to serve two purposes for us. It really is a two-pronged strategy that may not seem to be totally related. One is a lower cost manufacturing base. And that's clear. That's easy to calculate. And we'll have some gauze-based products and foam-based products and different types of things that we're going to be manufacturing at that facility.*
>
> *The other thing is that if you're going to establish a lower cost manufacturing base, why not do it in the country that everybody believes is going to have a tremendous impact and tremendous potential in two years, three years, five years, 10 years; pick the timeframe?*
>
> *So our feeling was, strategically, why not go to the lower cost manufacturing in a country that would give us a critical mass and a base of operations so that we could get real people on the ground, start developing relationships with customers and government officials and all the other things, so that we could exploit the Chinese market when it became commercially available to us. And that's just as transparent as I could be on our strategy for that."*

We note that Stryker, Zimmer, and Wright Medical have not disclosed plans for Asian manufacturing.

Instruments Are Likely To Be First Products Exported From China. While only Biomet has offered details on what it expects to produce at its Chinese operations, we suspect that initially, the implant companies will produce instruments (to meet global demand) and implants (to meet local demand). We do not expect the orthopedics companies to begin producing U.S. and European implants in China in the next few years. While China offers tremendous cost savings potential there are several drawbacks to manufacturing in China. Given these inherent trade-offs, we think that instruments are much better suited for Chinese production than implants.

There are three reasons that we think that instruments are better suited for production in China: (1) instruments are produced in low volumes through relatively labor-intensive processes which are better suited to low-cost regions like China than implant production which tends to be highly automated; (2) since instruments are not sold and are essentially worthless without the implant there is little risk of "knock-offs"; and (3) there is less legal and regulatory risk with instruments in the event that quality is compromised.

Cost Savings From Chinese Production Could Be Significant. Our research indicates that Chinese manufacturing costs are 20-40% less than U.S. or European manufacturing costs. On average, we estimate that the implant companies spend 5-6% of their sales on instrument purchases which are typically capitalized and depreciated over 3-6 years. Based on these numbers, sourcing instruments from China could result in a 100-250 bps margin improvement though this would take several years to be fully reflected in earnings since the instruments are depreciated over an extended period. If instrument production was completely moved to China at a 30% cost savings and the U.S./European produced instruments were no longer being depreciated, we think that the implant firms could see a $0.10-0.22 boost to EPS (see table below). This is somewhat of an academic exercise, however, since it would take several years for this to happen. For a more realistic view of the impact of Chinese manufacturing see our model on page 5 of this note. Savings could be much more significant if implants were produced in China as well, but we think that liability concerns may limit the export of implants produced in China.

Within Our Universe, Move To China Most Likely To Help Smith & Nephew (SNN), Most Likely To Hurt Symmetry Medical (SMA). Within our coverage universe, SNN is the furthest along and should begin Chinese production in 2010. None of the other orthopedic implant firms that we cover (Stryker, Wright Medical, and Zimmer) have publicly disclosed plans for production in China. In contrast, as a supplier to the orthopedic firms, Symmetry Medical is at risk from this emerging trend, in our view. Of Symmetry's 21 total production facilities all but one in Penang, Malaysia are in the U.S. or Europe. And on a square footage basis, >95% of Symmetry's capacity is in the developed world. The "big five" orthopedics firms make up a significant portion of Symmetry's sales (its top 10 customers accounted for 69% of its sales in the most recent quarter). In particular, DePuy which has just opened a plant in China is Symmetry's largest customer and accounted for 33% of its sales in the most recent quarter.

Instrument Accounting Approaches

Company	Instrument Accounting
Smith & Nephew (SNN)	Depreciated over useful lives
Stryker (SYK)	Straight line depreciation over 3 years, recorded in SG&A
Wright Medical (WMGI)	Straight line depreciation over 6 years, recorded in SG&A
Zimmer (ZMH)	Straight line depreciation over 5 years, recorded in SG&A

Source: Company reports

Potential EPS Impact Of Chinese Instrument Manufacturing

Assumes:

- 100% of instrument production in China
- U.S./European instruments fully depreciated
- Implant firms spend 5.3% of sales annually on new instruments

China Cost Savings	20%	30%	40%
Company	Annual EPS Impact	Annual EPS Impact	Annual EPS Impact
Smith & Nephew (SNN)	$0.10	$0.15	$0.19
Stryker (SYK)	$0.09	$0.14	$0.18
Wright Medical (WMGI)	$0.07	$0.10	$0.14
Zimmer (ZMH)	$0.15	$0.22	$0.30

Source: Wachovia Capital Markets, LLC estimates

Sensitivity Analysis

China Cost Savings	20%			
Year	2009E	2010E	2011E	2012E
% In China	25%	50%	75%	100%
Smith & Nephew (SNN)	$0.00	$0.02	$0.04	$0.07
Stryker (SYK)	$0.00	$0.02	$0.04	$0.06
Wright Medical (WMGI)	$0.00	$0.01	$0.01	$0.03
Zimmer (ZMH)	$0.00	$0.02	$0.04	$0.07

China Cost Savings	30%			
Year	2009E	2010E	2011E	2012E
% In China	25%	50%	75%	100%
Smith & Nephew (SNN)	$0.01	$0.03	$0.06	$0.10
Stryker (SYK)	$0.01	$0.02	$0.06	$0.10
Wright Medical (WMGI)	$0.00	$0.01	$0.02	$0.04
Zimmer (ZMH)	$0.01	$0.02	$0.06	$0.10

China Cost Savings	40%			
Year	2009E	2010E	2011E	2012E
% In China	25%	50%	75%	100%
Smith & Nephew (SNN)	$0.01	$0.04	$0.08	$0.14
Stryker (SYK)	$0.01	$0.03	$0.07	$0.13
Wright Medical (WMGI)	$0.00	$0.01	$0.03	$0.05
Zimmer (ZMH)	$0.01	$0.03	$0.07	$0.14

Source: Wachovia Capital Markets, LLC estimates

Potential Cost Savings Impact From Move To Chinese Instrument Production

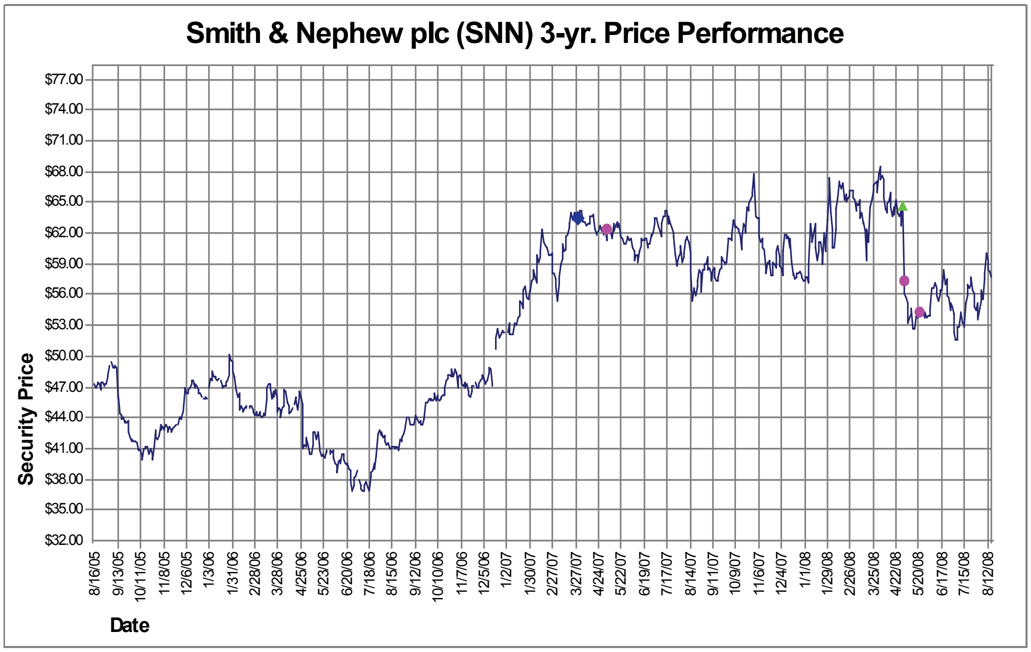
	2006A	Mar-07	Jun-07	Sep-07	Dec-07	2007A	Mar-08	Jun-08	Sep-08	Dec-08	2008E	2009E	2010E	2011E	2012E
Revenue	Annual	Q107A	Q207A	Q307A	Q407A	Annual	Q108A	Q208A	Q308E	Q408E	Annual	Annual	Annual	Annual	Annual
Smith & Nephew	2,779	744	813	845	967	3,369	911	1,000	944	1,081	3,936	4,323	4,693	5,116	5,576
Stryker	5,147	1,426	1,464	1,453	1,658	6,001	1,634	1,713	1,657	1,876	6,880	7,727	8,648	9,513	10,464
Wright Medical	339	94	98	91	103	387	116	118	111	125	470	527	583	635	692
Zimmer	3,495	950	971	903	1,074	3,898	1,059	1,080	983	1,130	4,251	4,571	4,881	5,271	5,693
Instrument Expenditures															
Smith & Nephew	66.5	18.7	20.5	22.1	25.9	87.1	25.3	26.6	24.2	28.1	104.2	114.3	123.9	135.0	147.2
Stryker	198.1	51.3	50.1	40.5	43.0	184.9	53.2	49.3	51.1	57.8	214.3	237.0	262.8	289.1	318.0
Wright Medical	18.0	6.7	6.7	6.7	6.7	26.6	4.8	5.0	4.6	5.2	19.7	22.2	24.6	26.8	29.2
Zimmer	126.2	34.5	38.4	33.3	32.3	138.5	57.5	62.0	48.6	56.0	210.3	226.7	241.8	261.1	282.0
Estimated Depreciation Expense															
Smith & Nephew							18.7	19.6	20.4	21.5	80.2	95.9	110.2	120.5	131.2
Stryker							47.6	47.1	47.7	49.5	192.0	201.9	225.0	252.9	279.5
Wright Medical												18.0	20.2	22.2	24.1
Zimmer							34.9	36.8	37.5	38.9	148.2	166.0	182.6	208.3	236.0
Depreciation As % Of Revenue															
Smith & Nephew							2.0%	2.0%	2.2%	2.0%	2.0%	2.2%	2.3%	2.4%	2.4%
Stryker							2.9%	2.8%	2.9%	2.6%	2.8%	2.6%	2.6%	2.7%	2.7%
Wright Medical												3.4%	3.5%	3.5%	3.5%
Zimmer							3.3%	3.4%	3.8%	3.4%	3.5%	3.6%	3.7%	4.0%	4.1%
Percent Of Instrument Expenditure In China	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	25%	50%	75%	100%
Instrument Expenditures With Chinese Production															
Smith & Nephew	66.5	18.7	20.5	22.1	25.9	87.1	25.3	26.6	24.2	28.1	104.2	105.7	105.3	104.6	103.0
Stryker	198.1	51.3	50.1	40.5	43.0	184.9	53.2	49.3	51.1	57.8	214.3	219.2	223.4	224.0	222.6
Wright Medical	18.0	6.7	6.7	6.7	6.7	26.6	4.8	5.0	4.6	5.2	19.7	20.5	20.9	20.8	20.5
Zimmer	126.2	34.5	38.4	33.3	32.3	138.5	57.5	62.0	48.6	56.0	210.3	209.7	205.5	202.4	197.4
Estimated Depreciation Expense With Chinese Production															
Smith & Nephew												94.1	103.5	105.2	104.7
Stryker												198.3	211.0	220.5	222.9
Wright Medical												17.9	19.5	20.7	21.3
Zimmer												163.9	174.7	190.3	203.0
EPS Impact Of Cost Savings From China															
Smith & Nephew												$0.01	$0.03	$0.06	$0.10
Stryker												$0.01	$0.02	$0.06	$0.10
Wright Medical												$0.00	$0.01	$0.02	$0.04
Zimmer												$0.01	$0.02	$0.06	$0.10
% Of EPS															
Smith & Nephew												0.2%	0.6%		
Stryker												0.2%	0.6%		
Wright Medical												0.3%	0.9%		
Zimmer												0.1%	0.5%		

Source: Wachovia Capital Markets, LLC estimates and company reports

Key Assumptions:

- 30% cost savings on instruments produced in China
- Implant firms spend 5.3% of revenue on instruments H2 2008-2012
- Depreciation as shown in table on page 4 (we assume SNN depreciates instruments over 3 years)
- Revenue growth in 2011-2012 as follows: SNN, 9%; SYK, 10%; WMGI, 9%; and ZMH, 8%

Required Disclosures

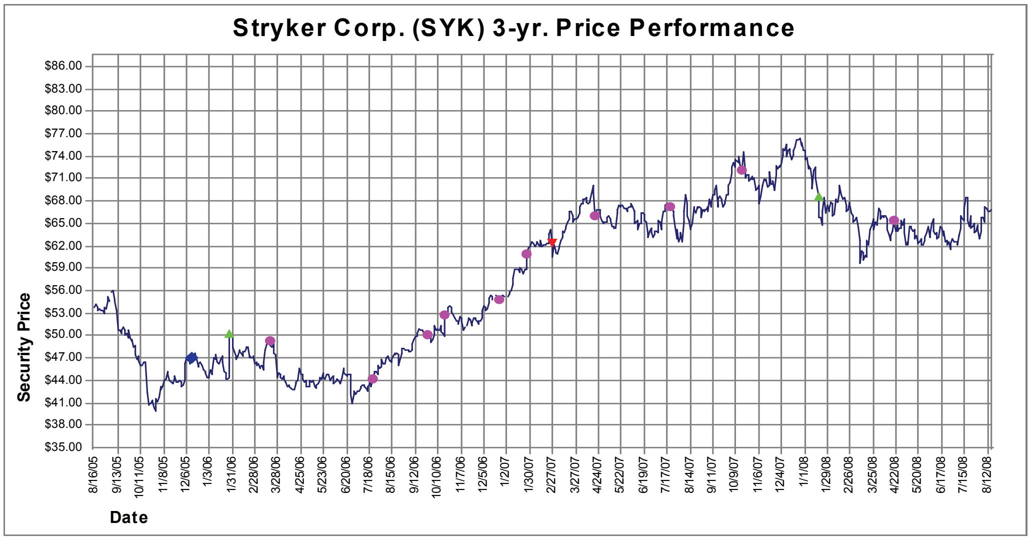


	Date	Publication Price ($)	Rating Code	Val. Rng. Low	Val. Rng. High	Close Price ($)
	3/29/2007		Matson			
◆	3/29/2007	63.22	2	62.00	68.00	63.40
●	5/4/2007	61.34	2	60.00	66.00	62.30
▲●	4/30/2008	62.71	1	75.00	83.00	64.73
●	5/1/2008	57.40	1	73.00	80.00	57.40
●	5/21/2008	54.23	1	70.00	76.00	54.23

Source: Wachovia Capital Markets, LLC estimates and Reuters data

Symbol Key
- ▼ Rating Downgrade
- ▲ Rating Upgrade
- ● Valuation Range Change
- ◆ Initiation, Resumption, Drop or Suspend
- ■ Analyst Change
- □ Split Adjustment

Rating Code Key
- 1 Outperform/Buy
- 2 Market Perform/Hold
- 3 Underperform/Sell
- SR Suspended
- NR Not Rated
- NE No Estimate



	Date	Publication Price ($)	Rating Code	Val. Rng. Low	Val. Rng. High	Close Price ($)
	12/12/2005		Matson			
◆	12/12/2005	NA	2	46.00	52.00	46.95
▲ ●	1/27/2006	NA	1	50.00	54.00	50.33
●	3/17/2006	NA	1	54.00	57.00	49.24
●	7/21/2006	NA	1	49.00	54.00	44.13
●	9/27/2006	NA	1	55.00	60.00	50.03
●	10/18/2006	NA	1	58.00	62.00	52.73
●	12/22/2006	NA	1	60.00	65.00	54.83
●	1/26/2007	NA	1	66.00	72.00	60.81
▼ ●	2/26/2007	NA	2	64.00	70.00	62.30
●	4/19/2007	NA	2	66.00	72.00	66.01
●	7/20/2007	NA	2	68.00	74.00	67.16
●	10/17/2007	72.19	2	72.00	76.00	72.19
▲ ●	1/17/2008	69.75	1	83.00	86.00	68.62
●	4/18/2008	63.95	1	80.00	84.00	65.30

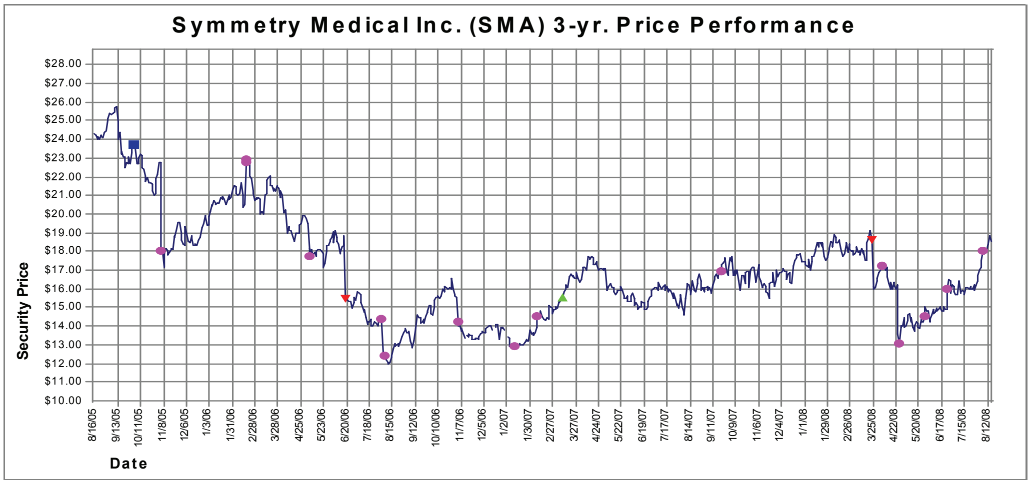
Source: Wachovia Capital Markets, LLC estimates and Reuters data

Symbol Key

▼	Rating Downgrade	◆	Initiation, Resumption, Drop or Suspend
▲	Rating Upgrade	■	Analyst Change
●	Valuation Range Change	❒	Split Adjustment

Rating Code Key

1	Outperform/Buy	SR	Suspended
2	Market Perform/Hold	NR	Not Rated
3	Underperform/Sell	NE	No Estimate



	Date	Publication Price ($)	Rating Code	Val. Rng. Low	Val. Rng. High	Close Price ($)
	8/16/2005		Huber			
	8/16/2005	NA	1	29.00	31.00	24.29
■	10/3/2005		Matson			
●	11/4/2005	NA	1	21.00	23.00	18.00
●	2/16/2006	NA	1	23.00	25.00	22.77
●	2/17/2006	NA	1	25.00	27.00	22.90
●	5/5/2006	NA	1	20.00	22.00	17.73
▼ ●	6/19/2006	NA	2	17.00	19.00	15.47
●	8/2/2006	NA	2	13.00	16.00	14.38
●	8/4/2006	NA	2	12.00	15.00	12.41
●	11/2/2006	NA	2	13.00	16.00	14.21
●	1/11/2007	NA	2	12.00	15.00	12.91
●	2/8/2007	NA	2	13.00	16.00	14.55
▲ ●	3/12/2007	15.51	1	19.00	21.00	15.51
●	9/20/2007	16.95	1	21.00	23.00	16.95
▼ ●	3/24/2008	19.15	2	19.00	21.00	18.61
●	4/4/2008	17.38	2	17.00	19.00	17.24
●	4/25/2008	12.98	2	12.00	14.00	13.05
●	5/27/2008	14.53	2	13.00	15.00	14.53
●	6/24/2008	16.02	2	15.00	17.00	15.96
●	8/6/2008	18.08	2	16.00	18.00	18.03

Source: Wachovia Capital Markets, LLC estimates and Reuters data

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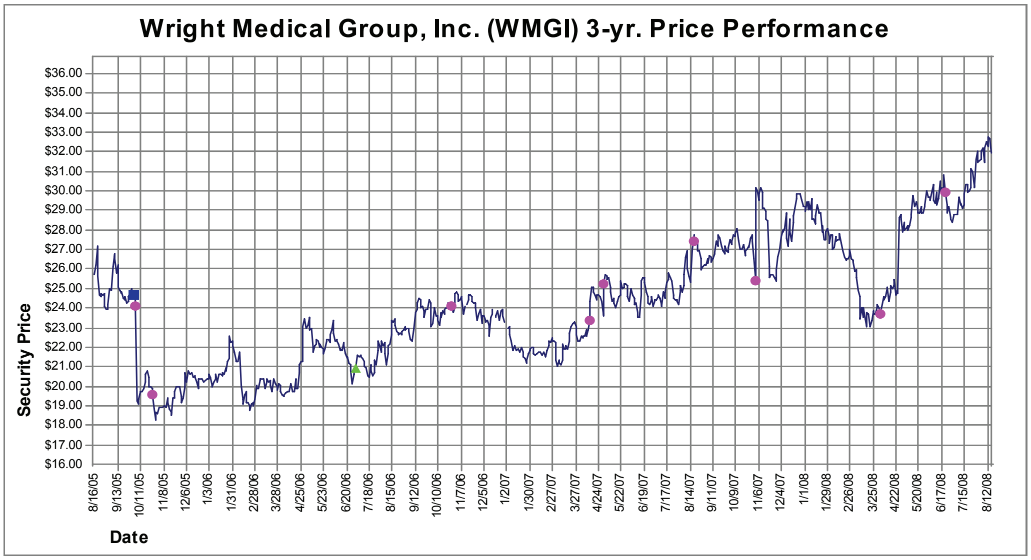

	Date	Publication Price ($)	Rating Code	Val. Rng. Low	Val. Rng. High	Close Price ($)
	8/16/2005		Huber			
	8/16/2005	NA	2	25.00	28.00	25.75
■	10/3/2005		Matson			
●	10/5/2005	NA	2	22.00	24.00	24.13
●	10/26/2005	NA	2	21.00	23.00	19.54
▲ ●	6/30/2006	NA	1	24.00	26.00	20.93
●	10/26/2006	NA	1	26.00	28.00	24.06
●	4/12/2007	NA	1	27.00	30.00	23.33
●	5/1/2007	NA	1	28.00	30.00	25.20
●	8/20/2007	NA	1	31.00	33.00	27.38
●	11/1/2007	25.41	1	33.00	36.00	25.41
●	4/2/2008	23.70	1	31.00	34.00	23.70
●	6/20/2008	30.84	1	35.00	38.00	29.90

Source: Wachovia Capital Markets, LLC estimates and Reuters data

Symbol Key

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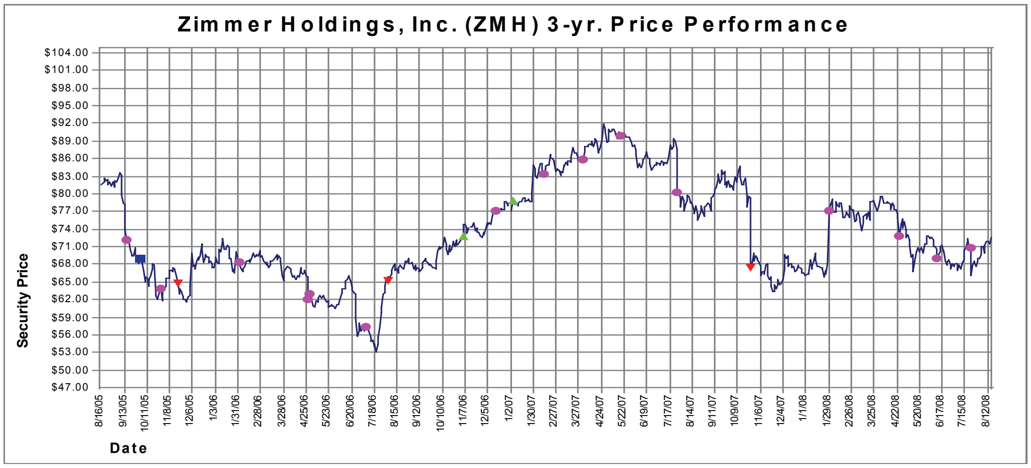

	Date	Publication Price ($)	Rating Code	Val. Rng. Low	Val. Rng. High	Close Price ($)
	8/16/2005		Huber			
	8/16/2005	NA	1	94.00	98.00	81.51
●	9/15/2005	NA	1	87.00	91.00	72.19
■	10/3/2005		Matson			
●	10/27/2005	NA	1	72.00	77.00	63.77
▼ ●	11/17/2005	NA	2	64.00	70.00	64.70
●	2/1/2006	NA	2	68.00	73.00	68.29
●	4/27/2006	NA	2	64.00	68.00	62.10
●	4/28/2006	NA	2	62.00	66.00	62.90
●	7/6/2006	NA	2	56.00	64.00	57.32
▼ ●	8/3/2006	NA	3	55.00	59.00	65.08
▲ ●	11/3/2006	NA	2	70.00	77.00	72.82
●	12/14/2006	NA	2	72.00	80.00	76.99
▲ ●	1/4/2007	NA	1	88.00	97.00	78.82
●	2/12/2007	NA	1	93.00	103.00	83.25
●	4/2/2007	NA	1	98.00	108.00	85.70
●	5/17/2007	NA	1	102.00	112.00	89.90
●	7/26/2007	NA	1	104.00	108.00	80.28
▼ ●	10/25/2007	68.57	2	68.00	73.00	67.39
●	1/29/2008	77.03	2	73.00	77.00	77.03
●	4/24/2008	72.90	2	73.00	78.00	72.87
●	6/11/2008	70.61	2	70.00	77.00	69.06
●	7/22/2008	70.88	2	65.00	70.00	70.88

Source: Wachovia Capital Markets, LLC estimates and Reuters data

Symbol Key
- ▼ Rating Downgrade
- ▲ Rating Upgrade
- ● Valuation Range Change
- ◆ Initiation, Resumption, Drop or Suspend
- ■ Analyst Change
- □ Split Adjustment

Rating Code Key
- 1 Outperform/Buy
- 2 Market Perform/Hold
- 3 Underperform/Sell
- SR Suspended
- NR Not Rated
- NE No Estimate

Additional Information Available Upon Request

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2 = Market Perform: The stock appears appropriately valued, and we believe the stock's total return will be in line with the market over the next 12 months. HOLD

3 = Underperform: The stock appears overvalued, and we believe the stock's total return will be below the market over the next 12 months. SELL

SECTOR RATING

O = Overweight: Industry expected to outperform the relevant broad market benchmark over the next 12 months.

M = Market Weight: Industry expected to perform in-line with the relevant broad market benchmark over the next 12 months.

U = Underweight: Industry expected to underperform the relevant broad market benchmark over the next 12 months.

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V = A stock is defined as volatile if the stock price has fluctuated by +/-20% or greater in at least 8 of the past 24 months or if the analyst expects significant volatility. All IPO stocks are automatically rated volatile within the first 24 months of trading.

As of: August 22, 2008

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