Recommendation: BUY **Target Price until (12/31/2015) : $93**

1. Reasons for the Recommendation

The recommendation for Stryker Corporation is a buy. The company's future looks bright through acquisitions, international expansion, and product innovation.

Stryker Corporation's commitment to innovation and expansion earned the company positive growth in 2013. The company is dedicated to expanding their current product set, while devoting resources to international expansion. Also, they continue to increase research and development expenses to stay ahead in a very competitive industry. Keys to success in the next few years will be focused on an efficient healthcare system. Stryker sees the necessity of reducing costs to be more attractive to healthcare providers and customers.

Stryker's two acquisitions in 2013 were MAKO Surgical and Trauson Holding Company. MAKO Surgical brought an innovative robotic surgical product set to their reconstructive segment. The acquisition allowed the company to reach providers focused on robotic surgical procedures and equipment. Not only will MAKO's acquisition bring in more market share to Stryker's highest revenue segment, it also brings an additional benefit as a successful salesforce. The Trauson acquisition will contribute market share into the fast growing Chinese market. Stryker will continue to grow in the European market, as well as has sights to expand into the emerging market of India.

Stryker continues to innovate their products while maintaining a focus on reduced costs to customers. In March of 2014, the company completed the acquisition of Patient Safety Technology, which added the Safety-Sponge System to their product set. This system prevents retained foreign objects in the operating room while reducing overall costs for surgical procedures. With increased research and development costs, as well as innovative acquisitions, the company is positioned well for a successful 2014.

As Stryker gains more products sets such as robotic technology, they will obtain a higher market share in an ever growing "baby-boomer" segment. Analysts expect that the number of people over 65 will double by 2030. The trend is resulting in more hip, knee, and joint reconstruction. Stryker Corporation continues to make acquisitions supporting the trend for more reconstructive surgeries and equipment.

Despite many positive changes, Stryker Corporation will be affected by industry-wide risk factors as well as expensive product recalls and litigation. Passed in 2012, the Affordable Care Act has affected the medical industry as a whole. This act taxes the majority of products from medical device companies, and regulates how healthcare providers supply their medical devices with a goal to reduce cost. As healthcare reform continues into 2014, the extent of positive or negative effects is unknown. However, many argue the act will provide a larger pool of patients available for medical device procedures.

An additional challenge Stryker faces is a massive product recall in their hip product segment. The recall could cost the company billions of dollars in the next few years in litigation and settlements. The company has recorded initial estimates of costs involved in the recall yet future losses could be in the billions based on the outcomes of lawsuits. Overall, Stryker Corporation strategic acquisitions and innovations is projected to outweigh any of the negative results of government regulation and litigation.

2. Company Analysis

Stryker Corporation was established in 1946 and was originally founded by Dr. Homer H. Stryker. The company is a leader in medical technology, and continues to grow internationally. As of 2013, Stryker's revenues were $9.02 billion. The three business segments are Reconstructive, MedSurg, and Neurotechnology and Spine which make up 44%, 37%, and 17% of the revenues. The company sells their products internationally to healthcare facilities such as hospitals and doctors; however, nearly two-thirds of revenues come from the United States.

The main segment, Reconstructive, is related to surgery and recovery of patients in the hip and knee joint replacement field. With $4 billion in sales in 2013, the segment grew 4.8% from 2012. Implants are designed and developed by Stryker to make surgery and recovery process faster and easier in patients. This segment makes up nearly half of the revenue earned by Stryker.

The second largest segment of Stryker, Medsurg, brought $3.4 billion revenue in 2013, an increase of 2.9% from 2012. This segment includes the communication, navigation, and surgical equipment for various medical specialties. The third segment, Neurotechnology and Spine, brought in $1.7 billion in revenues in 2013, an increase of 2.1% from 2012. This segment focuses on neurosurgical and neurovascular devices. These devices are used to perform brain/skull surgeries, treat hemorrhagic strokes, as well as provide implants for spinal injuries.

The acquisition of MAKO Surgical Corp and Trauson Holdings Company Limited accounted for $1,679 and $751 million, respectively. From an investor standpoint, this could be both positive and negative. On the positive end, the acquisitions open up doors for Stryker that could lead to billions of dollars in potential revenue. For example, Trauson Holdings Company Limited has a key presence in the Chinese orthopedic market, and the acquisition could lead to greater market share in their emerging economy. However, the company also shows concerns with these acquisitions in their risk assessment section. The company sees a real risk of not being able to capitalize on their previous or future acquisitions. One reason for this fear is anticipating the resources necessary to integrate and introduce new product development activities from acquisitions. As the acquisitions were completed in 2013, these new integration and restructuring expenses will take place in 2014. The restructuring expenses decreased in 2013 to $48 million from $75 million in 2012. This can be concerning in 2014 as the company will have to allocate enough resources to integrate the companies acquired for over $2.5 billion.

A future risk to Stryker involves federal and state regulations of the healthcare system. The company acknowledges the unpredictability and volatility of the healthcare system with the recent approval of the Affordable Care Act (Obama Care). The act aims to ultimately reduce cost and improve the quality of the United States healthcare system. One such initiative that will directly affected Stryker is the creation of a 2.3% excise tax on Class I,II, and III medical devices that started in January of 2013. Since the beginning of the tax in 2013, the company reported the expense to be responsible for .9% of total sales. As the tax is based off of total sales and not profit, the expense had a significant effect on Stryker's net earnings by 81 million.

In 2012, Stryker voluntarily recalled their Rejuvenate and ABGH modular neck hip stem product. The recall resulted in lawsuits stemming from hip equipment causing erosion of joint tissue. The concern with these suits is that there is not a concrete number the company can put in their financials. The company has stressed the difficulty of predicting the total costs of revision surgeries, settlements, or third party insurance recoveries. The total cost range given in the 10-K is anywhere from $790 million to $1.235 billion. As of now, there are over 600 complaints filed for the estimated 20,000 implants that were recalled by Stryker. For 2013, the company recorded "$600 million representing the excess of the $790 minimum of the range over previously recorded reserves."[1] Depending on whether the company correctly estimated these numbers, the effect could greatly change cash flows and Stryker's financial position in general. A similar recall occurred with Johnson & Johnson regarding their implants. The settlement resulted in nearly $3 billion that the company had to pay out.[9] As these cases move forward, the outcomes of the settlements and litigation will directly influence the ability for Stryker to control one-time expenses.

The previously mentioned risks were a big part of the 22.5% decrease in net earnings in 2013. The firm also contributed CoGS inventories being "stepped up" to fair value due to the acquisitions. This fair value change was $28 million in additional cost. Overall, acquisitions, product recalls, and litigation costs were the largest components to the expenses. The decrease in net earnings did result in the lowest earnings per share since 2008. Although the above examples could produce billions in unwanted expenses, these should gradually decrease in the coming years and result in overall higher net earnings and EPS.

3. Industry Analysis

The medical device industry includes many competitive and highly innovative firms. As technology changes, firms are required to reevaluate their standing within the medical device community, as well as how their products affect society. Therefore, firms are constantly looking to acquire or merge with other firms within their sector. As of 2012, 80% of medical device companies had fewer than 50 employees.[7] Many of the larger companies use their size to acquire these smaller firms. However, with a new concept and financial support, any start up can get into the medical device field. This creates a low barrier as companies can use a single device innovation and make it attractive to larger corporations.

In 2012, the top 30 companies in the medical device sector generated over $240 billion in sales. These companies have large revenue streams dedicated to medical devices; however, they may not necessarily be the prime competitor to Stryker Corporation. Johnson & Johnson, GE Healthcare, and Siemens Healthcare produced $27.43, $18.29, and $17.54 billion in revenues in 2012, respectively.[7] These top three indirect competitors produced double or even triple revenues compared to Stryker Corporation. For this particular discussion, we will focus on direct competitors to Stryker's segments to evaluate the biggest impact to Stryker if they took market share from their segments.

Zimmer Holdings, Inc. focuses on hip and knee specialties similar to the reconstruction segment of Stryker, which includes: shoulders, elbows, feet, ankles, and spines. The company produced $4.47 billion in revenues in 2012, and is producing growing sales. As of January 30th, 2014, Zimmer reported 4th quarter earnings which included a 5.1% rise in sales to $1.24 billion. The net sales for 2013 came out to $4.62 billion, and provided an optimistic outlook for 2014. Zimmer expects between 3% and 5% revenue growth in 2014[11.] Zimmer recently acquired Biomet, another hip and knee implant company, for $13.4 billion, which could make them a stronger company against Stryker. However, Stryker and Zimmer's recent patent suits have ruled in favor of Stryker which could affect future market share.

In the MedSurg segment, the company competes directly with Medtronic. Medtronic is the fourth largest medical device company, and employs over 46,000 people worldwide. In 2013, the company brought in revenues of $16.6 billion. Their core technologies include electrical stimulation, implantable structural devices, powered energy instruments, and surgical navigation and imaging. These technologies are comparable to the MedSurg segment for Stryker Corporation. The size and reputation of Medtronic makes them the primary competitor to Stryker. Medtronic has a larger presence outside the United States with 45% of their sales coming from international customers. On top of that, the company recently released its 4th quarter results with a 5% growth over the previous year, and a predicted 4% revenue growth in 2014.[6] Medtronic continues to ride their declining revenue segment, cardiac rhythm management, and expectations are that this will continue to keep their revenue growth low in the next year.

The final segment, Neurotechnology and Spine, has direct competition with Covidien. This company is ranked 7th in the top 30 medical device firms, and brought in $9.85 billion in revenues in 2012. As a provider of medical devices and medical supplies, the company was able to increase their revenues in 2013 to $10.2 billion.[7] The company produces devices in specialties such as soft tissue repair, airway and ventilation, vascular, and endomechanical. Covidien is larger than Stryker in sales, so their size and reputation is also a key factor in their ability to compete in the medical device industry.

The medical device industry has undergone some major changes in regulation which has forced firms to re-evaluate their business models, as well as product innovation. One such provision of the Affordable Care Act will be cuts planned for private Medicare options. These cuts include federal funding that will go directly to healthcare facilities to pay portions of medical bills. Medicare Advantage, a private Medicare plan, predicts a 2% decrease in payouts in 2015[10]. This will be on top of current cuts and reductions already taking effect resulting in $150 billion for payouts to medical providers. Nearly 60% of all medical device sales are to hospitals, so as these facilities cut costs; they will have to pass this along to medical device manufacturers. Stryker and other companies will experience these ramifications through pricing pressure and lower sales of expensive devices. As a cost-cutting mindset is established across the industry, one can argue this will result in hospitals buying the cheapest devices possible. Not only could this result in lower quality product from manufacturers, medical device firms will have to continually adapt to pricing pressure from hospitals. These changes will force companies to redesign their business models to focus on cost-cutting measures.

Appendix: Inputs into valuation using multiples

	2008	2009	2010	2011	2012	2013	2014F	2015F
Stock Price	59.98	41.82	52.03	54.73	53.67	68.08	84.84	93.54
Diluted EPS	2.78	2.77	3.19	3.45	3.39	2.63	3.28	3.61
Sales	6718.20	6723.10	7320.00	8307.00	8657.00	9021.00	9472.05	9945.65
P/E	28.73	28.83	25.04	23.15	23.56	30.37	25.89	25.89
P/S	3.69	2.48	2.84	2.57	2.37	2.88	3.42	3.59

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