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INSTITUTIONAL RESEARCH

Healthcare & Biotechnology

UPDATE REPORT

NuVasive, Inc. (NUVA)

Strong New Product Flow Should Lead to Continued Rapid Revenue Growth-Raising Target Price to \$60 from \$49

BUY

July 29, 2008

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Current Price \$54.96 Old Target \$49.00 New Target \$60.00

Investment Highlights:

- We are raising our target price to \$60.00 from \$49.00 based on our belief that with the introduction of new products at the upcoming North American Spine Society (NASS) meeting in October, NuVasive continues to develop a product portfolio that completely addresses the minimally invasive spine surgery market.** Based on better than expected Q 2 results, including revenues of \$57.4 million (+61% Y/Y), and \$6.0 million better than expected, we believe the company can reach revenues of \$500 million by 2011.
- Excluding non-cash expense for SFAS 123R and amortization of acquired intangible assets, the company earned EPS of \$0.14. GAAP results were a loss of \$0.01 per share as compared to our estimate of a loss of \$0.05
- Large, Underserved Market:** We estimate the potential market opportunity for NUVA is approximately \$3.2 billion in the U.S. which is growing about 15-18% per year. The world-wide opportunity is at least 2x that of the U.S. NuVasive estimates that its market share is no more than 5% suggesting to us that there is more than ample market opportunity for the company to rapidly advance its revenues.
- Near-term Catalysts:** Strong sales of three recently **launched products (Formagraft, SpheRx II pedicle screw system, XLP(TM) Lateral Plate). **New spinal access and fusion products will be introduced at NASS. Clinical trial of its NeoDisc nucleus replacement product enrollment to be concluded by year end of August.****

Stock Data	
52-Week Range	\$26.79-\$55.89
Shares Outstanding (Mill)	35.6
Market Capitalization (\$Bill)	\$1.95
Average Daily Volume	526,923
Book Value/Share	\$5.12
Price/Book	10.7x
Cash / Securities (\$Mill)	\$209.0
Cash/Share	\$7.41
Insider Ownership	10.8%
Institutional Ownership	85.3%
Debt (\$Mill)	\$Nil
Dividend/Yield	-
Short Interest (\$Mill) / %	\$300 / 15.4%

Estimates (Dec)	2007A	2008E	2009E
Sales	\$154.3	\$239.2	\$320.4
GAAP EPS	(\$0.33)	(\$0.65)	\$0.36
Net Inc. (Loss) (\$Mill)	(\$11.3)	(\$22.9)	\$13.5

Management

Chairman & CEO	Alexis V. Lukianov
President	Keith C. Valentine
EVP & CFO	Kevin C. O'Boyle



Price target and ratings changes over the past 3 years:

Initiated November 29, 2006 – BUY – Price Target \$27.00.
Update February 21, 2007—BUY—Price Target \$30.00
Update August 16, 2007---BUY—Price Target \$36.00
Update October 30, 2007—BUY—Price Target \$49.00
Updated July 29, 2008—BUY—Price Target \$60.00

See last page for important disclosures and analyst certification.

INVESTMENT CONCLUSION & VALUATION

We are raising our price target on NuVasive Inc. to \$60.00 from \$49.00 and reiterating our Buy recommendation. Although we do not believe the 61% Y/Y and 12% sequential growth rates for revenues posted in the just reported Q 2008 are sustainable indefinitely (although similar results were achieved in Q1), we do believe that given the full compliment of products necessary to perform minimally invasive spine surgery, the proven track record of industry leading innovations, the huge potential market (\$3.2 billion growing at 15-18%) and NuVasive's very small market share (about 5%) that the **company can sustain revenue growth averaging 30-35% over the next five years.**

Such a growth rate would **put NuVasive's revenues at around \$540 million by 2011.** If we assume that the company is worth a **multiple of revenues** between that being afforded Biomet, which is being acquired by a private equity group, at **five times** and Kyphon being acquired by Medtronic at seven times revenue), then theoretically, NuVasive would have a value of \$3.25 billion. **Discounting that at 15% annually would generate a price target of \$60.00 our new share price objective.**

THE COMPANY

NuVasive is a leading, developer, manufacturer and marketer of minimally invasive surgical systems and products for performing delicate surgery on the human spine. NuVasive's already broad and still developing line of products comprises a platform called Maximum Access Surgery (MAS). This platform allows spine surgeons to perform a widening array of procedures that most importantly, reduces the risks of surgically associated trauma to the spinal nervous system. Additionally, NuVasive's products and proprietary procedures reduce surgical time, blood loss, hospital stays and recovery times. Spinal surgery is growing rapidly due to an aging population that wishes to remain physically active and advances in procedures, devices and implants to repair damage caused by both aging and trauma. Deformities and tumors are also a leading cause of spine disorders. As a leader in this newly developing technology, NuVasive has the ability to rapidly advance revenues and achieve profitability, thus affording investors an opportunity to participate in this nascent, yet quickly advancing technology.

The company's goal is to provide products that facilitate safe and reproducible outcomes from spinal surgery with minimal intervention. Primary among the company's goals is to reduce the risk of spinal surgery which frequently entails trauma to the nerves surrounding the spine. Although the company was incorporated in 1997, NuVasive has been a public company for slightly over two year having completed its IPO in May of 2004.

The company is a pioneer in minimally invasive spinal surgery but has taken a somewhat different approach in that it trains surgeons using its proprietary access products in combination with other familiar instrumentation, resulting in a more rapid adoption of its proprietary products.

The use of NuVasive's products and systems results in significant reductions in surgical time (50% in some cases), faster patient recovery (hours versus days) shorter hospitalization stays (2 or 3 days shorter) along with less blood loss and less trauma.

Recent Results

- ✓ **Management Raises 2008 Guidance Again**
- ✓ **NuVasive Exceeds Q2 Expectations**
- ✓ **Revenues up 61% to \$57.4 million Matching Q4 2007 Increase**
- ✓ **Non-GAAP EPS of \$0.06 Better Than Street Forecast**

- For the second consecutive quarter, management raised full year 2008 revenue guidance to \$238 to \$240 million from \$210 million to \$214 million. The new revenue guidance includes \$15 million from the acquisition of Osteocel Biologics from Osiris. The full year GAAP per share, excluding one time charges, should range from \$0.05 to \$0.07 as compared to a previous range of break-even to \$0.03. Non-GAAP EPS should be in a range of \$0.68 to \$0.70, up from the previous guidance of \$0.54 to \$0.57.
- NUVA reported revenues of \$57.4 million, an increase of 61% Y/Y and 12% sequentially as compared to our estimate of \$51.5 million and a street consensus of \$51.7 million. International revenues accounted for 3% of total revenues in the second quarter, similar to the first quarter.
- The GAAP loss for the quarter was \$0.01 per share. On a non-GAAP basis, the company reported net income of \$5.1 million or \$0.14 per share. The non-GAAP net income calculation in the second quarter of 2008 excludes stock-based compensation of \$5.1 million and amortization of intangible assets of \$467,000. Our estimate was for a GAAP loss of \$0.05 and non-GAAP EPS of \$0.14.
- The company attributed its remarkable sales growth to its previously announced strategy of expanding its sales territories in the U.S. from five to 11, which began in January. This has produced deeper penetration of the company's entire product line in existing accounts, also part of the strategy initiated at the beginning of this year. The sales headcount stood at 269 professionals at the end of the quarter. Management is also continuing to make additional training of its sales force in 2008 a top priority.
- Management believes this sales force restructuring was necessary to maintain its corporate culture of absolute responsiveness and achieve deeper penetration in existing accounts, both essential in order to reach \$500 million in revenues over the next several years (2012 if revenues grow at 25% compounded annually). Management believes that the market for minimally invasive spine surgery will be approximately \$4.2 billion in 2008 and is growing at 12% to 15% suggesting that NUVA is taking market share and will have an approximate market share of 5% this year.
- NuVasive also announced that it had closed on its acquisition of Osteocel Biologics for initial consideration of \$35 million in cash. The total maximum consideration being paid by NUVA to Osiris could be \$85 if all milestones are met. NUVA is anticipating revenues from Osteocel of \$15 million in 2008 and \$25 million in 2009 and believes it will be the basis of a \$100 million biologics business. Osteocel is the only viable bone matrix product on the market that provides the three beneficial properties similar to Autograft: osteoconduction, which provides a scaffold for bone growth; osteoinduction for bone formation stimulation; and osteogenesis for bone production.
- The company's gross margin was 82.2%, down from Q 4 2007 at 82.9% and down slightly from a year ago at 82.8%. Going forward, the gross margin should range between 80% and 81% due to the addition in the sales mix of Osteocel, which carries a gross margin of about 60%.
- NeoDisc, the company's woven elastomeric nucleus replacement device is now nearing completion of its patient enrollment at 500, slightly behind schedule. A PMA could be filled with two year data on approximately 480 patients sometime in 2010. Management believes an FDA approval is possible sometime in 2011.

- During 2007, NuVasive launched its SpheRX II pedicle screw, a new XLP lateral plate and the acquired Formagraft. NuVasive also introduced five new products at the North American Spine Society's annual meeting in October 2007 including the XLIF Thoracic approach which relies on the MaXcess® Thoracic retractor system that facilitates minimally disruptive lateral access to the thoracic spine in the same manner as an XLIF procedure. In conjunction with the XLIF Thoracic, NuVasive also introduced the CoRoent XLT and CoRoent Revision PEEK implants designed specifically for thoracic applications. The Company also launched the SpheRx DBR II system, a minimally disruptive pedicle screw system utilizing the Company's unique "dual ball rod" technology. In addition, as part of a strategy to expand its cervical offering and supplement the Gradient Plus cervical plate, NuVasive introduced the Helix anterior cervical plate and the Helix MiniPlate, both designed to offer flexible and elegant solutions for cervical fusion. These new product offerings provide the base for the very strong sales growth the company is currently experiencing and are examples of NuVasive's desire and success in becoming a fully integrated minimally invasive spine surgery company and further demonstrate its ability to leverage its highly trained and specialized sales force.
- During the annual meeting of the North American Spine Society, or NASS, being held in Toronto in October of this year, the company will introduce the next-generation of its NeuroVision product line known as NeuroVision M5. NeuroVision M5 offers complete monitoring coverage for the entire spinal cord along with the simplicity of M5 guidance. The next-generation NeuroVision leverages NuVasive's five years of system experience in more than 70,000 cases of surgeon-directed neuro-monitoring and will create even greater separation between it and its competitors.
- The company will complete the move into its new campus styled headquarters in August and has completed its MIS upgrade.
- In 2008, NuVasive will introduce approximately 10 new products and endeavor to double its cervical revenues which represented less than 10% of its total revenues in 2007. As we have stated, management raised 2008 revenues in a range of \$ 238 million to \$240 million, an increase of approximately \$27 million with Osteocel contributing about \$15 million and international contributing 3% of the total. Full year gross margin should range between 81% and 82% as compared to 82.3% in 2007. The GAAP per share loss, including the \$0.12 charge associated with the acquisition of the royalty buyout should be between \$0.09 and \$0.12 and non-GAAP EPS, excluding stock based compensation and amortization of acquire intangible assets, should be on the order of \$0.54 to \$0.57, a few cents lower than previous guidance, but of little consequence in our opinion.
- Third quarter revenues should be about \$62 million including \$5 million from Osteocel or flat with the second quarter without Osteocel. This would still representing a 60% Y/Y increase. The GAAP loss per share should be about \$0.02 with non-GAAP EPS a positive \$0.17.

We continue to be impressed with the strength NuVasive is exhibiting at the top line and its further ability to bring innovative products to market in a timely manner and in significant quantities. Some of the company's operating leverage, which we believed would become more apparent in 2008 will be delayed now until 2009 because of the one-time costs associated with moving the company's HQ, the buyout of the SpheRx royalty and upgrading the company's management information systems in anticipation of continue rapid revenue growth. However, we believe that investors should view these as positive initiatives. We are raising our target price to \$60 from \$49 based on the increased revenue outlook, and a more solid belief that the company will achieve revenues in excess of \$500 million by 2011 when it should be able to reach GAAP margins of around 20%. As such, investors should continue to BUY the stock.

RISKS

We believe a BUY position with NuVasive involves the following risks:

- *Clinical Indications* – NuVasive continues to explore additional indications for use of its current technologies including bone growth stimulation. Failure to discover and commercialize new applications could relegate bone growth stimulation to a low double digit revenue growth contributor. While Blackstone has a competitive product line with many innovative devices, the spinal surgery market is highly competitive and the requirement for innovation and new clinical indications is enormous. A set-back or delay in such an initiative would negatively impact the company.
- *Regulatory* – NuVasive relies on its products receiving approval from the Food and Drug Administration. The company currently has several products under development that must go through the approval process prior to commercial availability. Any delay or rejection will negatively impact the company.
- *Reimbursement* – As with many medical devices, the adoption of the company's products will depend not only on clinical science, but adequate reimbursement from government and private insurers.
- *Competition* – The orthopedic device industry is highly competitive, from both private and public companies.
- *Sector Rotation* – NuVasive is a medical device company and is often held in a portfolio with other device companies. A material event affecting one company many times affects the entire group.

NuVasive, Inc.
INCOME STATEMENT, 2006E-2007E
(\$ millions, except per-share data)

Year ends December 31	2006A					2007A				
	1Q	2Q	3Q	4Q	2006	1Q	2Q	3Q	4Q	2007
Net Sales	\$ 19.7	\$ 22.7	\$ 25.2	\$ 30.5	\$ 98.1	\$ 33.2	\$ 35.6	\$ 38.5	\$ 46.9	\$ 154.3
Costs and Expenses:										
Cost of products sold	3.9	5.1	4.9	5.2	19.0	5.7	6.7	6.9	8.0	27.4
Gross Profit	\$ 15.8	\$ 17.6	\$ 20.3	\$ 25.3	79.0	\$ 27.5	\$ 28.9	\$ 31.6	\$ 38.9	126.9
R & D	3.9	4.2	5.5	4.2	17.7	5.7	5.9	6.2	6.7	24.6
S, G & A	21.1	23.3	25.7	25.3	95.4	28.0	28.0	29.0	34.6	119.6
In Process R&D	-	-	-	-	-	-	-	-	-	-
Milestone Expense	-	10.5	9.6	-	20.1	-	-	-	-	-
Restructuring charge										
Total Operating Expenses	25.0	37.9	40.8	29.5	133.3	33.8	34.0	35.2	41.2	144.2
Operating Income	\$ (9.2)	\$ (20.3)	\$ (20.5)	\$ (4.2)	(54.2)	\$ (6.3)	\$ (5.0)	\$ (3.6)	\$ (2.3)	(17.3)
Other expenses net (Inc.)	(1.1)	(1.8)	(1.9)	(1.5)	(6.3)	(1.9)	(1.6)	(1.3)	(1.1)	(5.9)
Earnings before income taxes	\$ (8.1)	\$ (18.5)	\$ (18.7)	\$ (2.7)	(47.9)	\$ (4.4)	\$ (3.4)	\$ (2.3)	\$ (1.2)	(11.3)
Provision for income taxes	-	-	-	-	-	-	-	-	-	-
Net earnings	\$ (8.1)	\$ (18.5)	\$ (18.7)	\$ (2.7)	(47.9)	\$ (4.4)	\$ (3.4)	\$ (2.3)	\$ (1.2)	(11.3)
Weighted avg. shares outst. (diluted)	29.6	33.1	33.3	33.9	32.5	34.3	34.7	34.9	35.2	34.8
EPS reported (FD incl. FAS123R)	\$ (0.27)	\$ (0.56)	\$ (0.56)	\$ (0.08)	(1.47)	\$ (0.13)	\$ (0.10)	\$ (0.07)	\$ (0.03)	(0.33)
EPS operating (FD w/o FAS123R)	\$ (0.14)	\$ (0.11)	\$ (0.16)	\$ 0.02	(0.39)	\$ (0.03)	\$ 0.01	\$ 0.04	\$ 0.08	0.10
RATIOS:										
(as a percentage of total revenues)										
Gross Margin	80.3%	77.6%	80.5%	83.1%	80.6%	82.8%	81.2%	82.0%	82.9%	82.3%
R & D	19.7%	18.4%	21.6%	13.9%	18.1%	17.3%	16.6%	16.2%	14.2%	15.9%
S, G & A	107.4%	102.4%	102.2%	82.9%	97.3%	84.4%	78.7%	75.1%	73.7%	77.5%
In Process R&D	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Restructuring charge	0.0%	0.0%	0.0%	0.0%	20.5%	0.0%	0.0%	0.0%	0.0%	0.0%
Other expenses net (Inc.)	-5.6%	-8.1%	-7.4%	-5.0%	-6.4%	-5.6%	-4.6%	-3.4%	-2.4%	-3.8%
Tax Rate	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Operating Margin	-46.8%	-89.4%	-81.4%	-13.8%	-34.8%	-18.9%	-14.2%	-9.3%	-5.0%	-11.2%
Pretax Margin	-41.2%	-81.3%	-74.0%	-8.8%	-48.9%	-13.3%	-9.6%	-5.9%	-2.6%	-7.3%
Net Margin	-41.2%	-81.3%	-74.0%	-8.8%	-48.9%	-13.3%	-9.6%	-5.9%	-2.6%	-7.3%

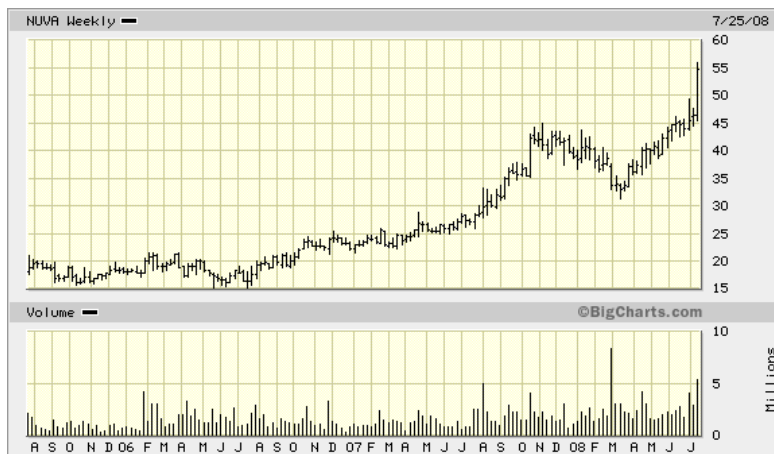
Source: Company and Dawson James Securities estimates

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NuVasive, Inc.
INCOME STATEMENT, 2008E
(\$ millions, except per-share data)

Year ends December 31	2008E					2009E				
	1Q	2QA	3Q	4Q	2008	1Q	2Q	3Q	4Q	2009
Net Sales	\$ 51.2	\$ 57.4	\$ 62.0	\$ 68.6	\$ 239.2	\$ 70.2	\$ 79.9	\$ 82.1	\$ 88.2	\$ 320.4
Costs and Expenses:										
Cost of products sold	9.1	9.6	12.1	13.2	43.9	14.0	16.0	16.4	17.6	64.1
Gross Profit	\$ 42.1	\$ 47.8	\$ 49.9	\$ 55.4	195.2	\$ 56.2	\$ 63.9	\$ 65.7	\$ 70.6	256.3
R & D	7.0	6.4	6.8	6.9	27.1	7.7	8.0	8.6	8.8	33.2
S, G & A	39.3	42.1	44.0	48.0	173.4	47.7	52.7	54.2	56.5	211.1
In-Process R&D	4.2	-	15.0	-	19.2	-	-	-	-	-
Total Operating Expenses	50.4	48.5	65.8	54.9	219.7	55.5	60.7	62.8	65.3	244.3
Operating Income	\$ (8.4)	\$ (0.7)	\$ (15.9)	\$ 0.5	(24.4)	\$ 0.7	\$ 3.2	\$ 2.9	\$ 5.3	12.1
Other expenses net (Inc.)	(0.7)	(0.2)	(0.3)	(0.3)	(1.5)	(0.3)	(0.3)	(0.4)	(0.4)	(1.4)
Earnings before income taxes	\$ (7.6)	\$ (0.5)	\$ (15.6)	\$ 0.8	(22.9)	\$ 1.0	\$ 3.5	\$ 3.3	\$ 5.7	13.5
Provision for income taxes	-	-	-	-	-	-	-	-	-	-
Net earnings	\$ (7.6)	\$ (0.5)	\$ (15.6)	\$ 0.8	(22.9)	\$ 1.0	\$ 3.5	\$ 3.3	\$ 5.7	13.5
Weighted Avg. shares outst. (diluted)	35.4	35.6	35.8	38.1	36.2	38.1	38.1	38.1	38.1	38.1
GAAP EPS (FD incl. FAS123R)	\$ (0.22)	\$ (0.01)	\$ (0.44)	\$ 0.02	\$ (0.65)	\$ 0.03	\$ 0.09	\$ 0.09	\$ 0.15	\$ 0.36
GAAP EPS Excl. One-Time Charges	\$ (0.10)	\$ (0.01)	\$ (0.02)	\$ 0.19	\$ 0.06	\$ 0.03	\$ 0.09	\$ 0.09	\$ 0.15	\$ 0.36
Non-GAAP EPS (FD w/o FAS123R)	\$ 0.06	\$ 0.14	\$ 0.17	\$ 0.33	\$ 0.70	\$ 0.19	\$ 0.25	\$ 0.25	\$ 0.31	\$ 1.00
RATIOS:										
(as a percentage of total revenues)										
Gross Margin	82.2%	83.3%	80.5%	80.8%	81.6%	80.0%	80.0%	80.0%	80.0%	80.0%
R & D	13.6%	11.2%	11.0%	10.0%	11.3%	11.0%	10.0%	10.5%	10.0%	10.3%
S, G & A	76.8%	73.3%	71.0%	70.0%	72.5%	68.0%	66.0%	66.0%	64.0%	65.9%
In Process R&D	8.2%		24.2%							
Restructuring charge										
Other expenses net (Inc.)	-1.4%	-0.3%	-0.5%	-0.4%	-0.6%	-0.4%	-0.4%	-0.5%	-0.5%	-0.4%
Tax Rate	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Operating Margin	-16.4%	-1.2%	-25.7%	0.8%	-2.2%	1.0%	4.0%	3.5%	6.0%	3.8%
Pretax Margin	-15.0%	-0.9%	-25.2%	1.2%	-9.6%	1.4%	4.4%	4.0%	6.5%	4.2%
Net Margin	-15.0%	-0.9%	-25.2%	1.2%	-9.6%	1.4%	4.4%	4.0%	6.5%	4.2%

Source: Company and Dawson James Securities estimates

DISCLOSURES


Initiated November 29, 2006 – BUY – Price Target \$27.00
 Update February 21, 2007—BUY—Price Target \$30.00
 Update August 15, 2007-BUY-Price Target \$36.00
 Update October 30, 2007—BUY—Price Target \$49.00
 Update July 29, 2008—BUY—Price Target \$60.00

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Ratings Distribution	Company Coverage		Investment Banking	
	# of Companies	% of Total	# of Companies	% of Totals
Speculative Buy	8	33%	4	50%
Strong Buy	3	13%	1	33%
Buy	10	42%	0	0%
Neutral	3	13%	2	67%
Sell	0	0%	0	0%
Sell Short	0	0%	0	0%
Under Review	0	0%	0	0%
Restricted	0	0%	0	0%
Total	24	100%	7	29%

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