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INSTITUTIONAL RESEARCH

Healthcare & Biotechnology

UPDATE REPORT

Orthofix International N.V. (OFIX)

**Q4 Outlook Remains Disappointing--
Company Could be Acquisition Candidate**

BUY

November 14, 2008

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Current Price \$12.99 Old Target \$30.00 New Target \$20.00

Investment Highlights:

- 1) We are reducing our Target Price to \$20 from \$30 but reiterating our BUY recommendation reflecting our belief that despite the diminution in the value of Blackstone, the company's spine surgery hardware business, the 80% plunge in Orthofix's stock from its \$61.66 high on December 21, 2007 makes it a compelling acquisition.
- 2) Although we recognize that other recent transactions in the orthopedic industry may have carried higher valuations, a transaction at \$20 per share, with the assumption of the \$288 million in debt the company took on to acquire Blackstone Medical, would value such a transaction at \$620 million or about 1.2X 2008 projected revenues. Reaching our target price would net investors in the stock more than a 60% return.
- 3) In the third quarter, OFIX took a \$237.7 million charge (\$13.90 per share) for the impairment of assets and inventory at Blackstone.
- 4) While we are the first to recognize that the orthopedic business can not sustain the level of growth it has enjoyed recently and that the spine business has negatively effected by a change in the sales model back to include independent reps, we question whether or not management can recognize enough sales growth from new products in 2009 to really jump-start the spine business again.

Stock Data

52-Week Range	\$8.65-61.66	
Shares Outstanding (Mill)	17.1	
Market Capitalization (\$Mill)	\$211.2	
Average Daily Volume	216,215	
Book Value/Share	\$12.27	
Price/Book	1.0x	
Cash / Securities (\$Mill)	\$10.3	
Cash/Share	\$0.67	
Insider Ownership	7.3%	
Institutional Ownership	93.6%	
Debt (\$Mill)	\$288.0	
Dividend/Yield	N.A.-	
Short Interest (\$Mill) / %	\$14.3/ 6.8%	

<u>Estimates (Dec)</u>	2007	2008E
Sales	\$490.3	\$520.0
EPS (GAAP)	\$0.64	(\$13.04)
Net Inc. (Loss) (\$Mill)	\$11.0	(\$223.0)

Management

President & CEO	Alan W. Milinazzo
CFO	Bob Vaters
Pres N. America/Blackstone	Bradley R. Mason



Initiated October 11, 2006 – BUY – Price Target \$57.00
Update January 4, 2007—BUY--Price Target \$60.00
Updated August 12, 2008—BUY-Price Target \$30.00
Updated November 14, 2008—BUY Price Target \$20.00

See last page for important disclosures and analyst certification.

- **Near Term Outlook Reduced Due to Blackstone Underperformance**
- **Lowering Target Price to \$20 from \$30**
- **Maintaining BUY as Company is Acquisition Candidate**

• **Based on a diminished valuation of Blackstone and continued uncertainty going into 2009 reflecting its major restructuring, we are lowering our Target Price to \$20 per share from \$30. We are reiterating our BUY recommendation because we believe the market's current valuation of Orthofix makes it a compelling acquisition despite the diminution of Blackstone's value.**

• In our opinion, the most troublesome number reported in the quarter was the 13% Y/Y decline and the 5.9% sequential decline in spinal implants and biologics (Blackstone). Assuming the biologics business continues to grow as management asserts, we can only assume that the implants' business is down even more than the numbers would imply and which further suggests that OFIX continues losing market share in spine implants, a disturbing trend to say the least.

• As troublesome, is the apparent acceptance on the part of Wall Street and the investment community of the company's dubious thesis that non-cash expenses do not matter, nor apparently do abrupt changes in management's approach to organizing and running the company. We find this rationalizing both maddening and dangerous. Management strongly posits that it has figured out the right strategy for managing the company, that most of the risks are now behind them and that many of the one-time cash expenses they have experienced will not be recurring. We have little confidence in these assertions and have taken this into account in our projections.

• **The most glaring example of this ineptitude is the Blackstone situation. In the third quarter, OFIX took a \$237.7 million charge (\$13.90 per share) for the impairment of assets and inventory at Blackstone.** Blackstone was acquired in August of 2006 for \$333 million in cash, or at a valuation of 3.8X annualized revenues at the time but 175X operating income. At the time it was billed as "the largest and fastest-growing privately-owned spinal implant & biologic company in the U.S., with profitable annual revenue growth of more than 25% in each of the last 3 years", but Blackstone has grown at only 8.1% annually for the past two years and is currently showing negative Y/Y and Q/Q sales growth. OFIX has lost one of the most promising products in Blackstone's product portfolio, Trinity, manufactured by Osiris Therapeutics (OSIR-NASDAQ-\$17.01-not rated), the only commercially produced stem cell based biological bone growth stimulation product on the market today, to NuVasive (NUVA-NASDAQ-\$40.16-rated Buy). **Although the company believes it can replace this product with a similar product for which it will pay an additional \$10 million to the Musculoskeletal Transplant Foundation (MTF), the product will not be available until mid-2009 and there is no guarantee of a product or that its intellectual property position will be adequate to fend off a challenge by NuVasive.**

• Additionally, the **transaction was financed with \$330 million of debt** the terms of which have been renegotiated because of violations of the debt covenants. At the end of September, **the company announced it had renegotiated its \$288.4 million in debt which will now carry an interest rate of LIBOR plus 450 basis points up from LIBOR plus 175 basis points.** The good news, there is no penalty for prepayment. Management was quick to point out that of the \$5.7 million expense incurred for renegotiating its debt, \$3.7 million is a non-cash write-off of previously capitalized debt placement and only \$2.0 million was real cash.

• **Two other unsettling issues exist with Blackstone. First, in early 2008, management announced its intention to convert its distributor network for Blackstone to a hybrid sales force including both independent distributors and direct sales reps. In August, OFIX promoted Brad Mason, a founder and the manager of its Breg division and President of North America to the additional role of President of Blackstone. Mason has decided to return to a distributor network while retaining some direct sales reps where appropriate. And finally, the company has announced a major restructuring and consolidation of Blackstone which will eventually result in its operations in New Jersey and Massachusetts being moved to Dallas, Texas. The cost of this reorganization and consolidation is estimated to be \$4.2 million, split**

\$900,000 in Q4 2009 and the remainder, \$3.3 million in 2009. The company expects to save \$2 million in 2010 and \$5 million annually beginning in 2011. Since this project involves building a new facility in Dallas, we doubt the costs are fully known or can be accurately forecasted.

- While Blackstone remains troubling there are **some positive aspects to Orthofix's current operations. Spinal stimulation increased 12% Y/Y in Q3 and management believes it continues to gain market share. Sports medicine grew 7%Y/Y but perhaps 10% on a real basis excluding the infusion pump sales from Q3 2007, a product the company sold in Q1 of this year. U.S. knee bracing grew 8% Y/Y and cold pain therapy was up 18%. Orthopedic sales continue to show upside surprise, increasing 29% Y/Y. Both internal and external fixation device sales were strong in international markets as well as long bone stimulation sales which grew 8% in the quarter. In total, 73% of Orthofix's revenue base has grown at 16% during the first nine months of 2008, unfortunately offset by declines in Blackstone.** Investors should keep in mind that management wanted to sell its legacy orthopedic business in Q1 which would have proven disastrous and did cost the company almost \$3.9 million pre-tax or about \$0.23 per share in the first nine months.
- **Fourth quarter guidance is now lower than previous consensus.** Management expects revenues to be between \$130 million and \$135 million in the final quarter, as compared to consensus of \$141 million and our estimate of \$142 million. Reported GAAP EPS are now expected to be \$0.28 to \$0.32 as compared to consensus at \$0.11 and our estimate of \$0.13. The differences lie generally in an improvement in the profitability of the orthopedic division and a \$0.09 tax benefit that will accrue in Q4.
- Management recently announced FDA approval of two new spine products. Firebird is a comprehensive system with a modular screw designed to provide surgeons with intra-operative flexibility during various thoracolumbar spine procedures, including the treatment of degenerative disc disease and deformity corrections. The Firebird system can also be used during a minimally invasive surgical approach in conjunction with instrumentation available in the company's ProView Minimal Access Portal System. The company expects to make the Firebird system widely available in the U.S. beginning during the first quarter of 2009. It also announced approval of PILLAR SA, which is a unique standalone inner body spacer and vertebral body replacement. Both were previewed at the North American Spine Society (NASS) meeting in October.
- So where does all this leave current shareholders and potential buyers both private and public? We do not know if things could get worse for Orthofix but **we would suggest that most of the more serious problems have probably already occurred and there are several positive initiatives underway including the reorganization of Blackstone under new management and hopefully stronger financial management under the new CFO. The major risk we see is the potential weakening of Orthofix's legacy orthopedic business which has been the major engine of its recent revenue growth.**
- **The stock closed at \$9.05 on October 27, 2008, a price the shares had not equaled since May 28, 1997, more than a decade. Since then the shares have recovered almost 40%. Despite the share's recovery, the market cap stands at only \$222 million or about 0.43X projected 2008 revenues. At a 50% premium to today's closing price, or about \$20 per share and the assumption of the debt of \$288 million, a strategic buy could acquire Orthofix for \$630 million or about 1.2X 2008 revenues, truly a bargain in our opinion despite whatever problems and challenges the company may face.**
- **As such, we are lowering our target price to \$20 from \$30 but maintaining our BUY recommendation based on our continued belief that Orthofix remains a very compelling takeover candidate.**

RISKS

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

- **Clinical Indications** – Orthofix continues to explore additional indications for use of its current technologies including bone growth stimulation. Its inability to discover and commercialize new applications could relegate bone growth stimulation to a low double digit revenue growth contributor. 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** – Orthofix 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 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** – Orthofix 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.

ORTHOFIX INTERNATIONAL NV
 WORLDWIDE REVENUES BY SEGMENT
 (\$ millions)

REVENUE	2007A					2008E				
	1Q	2Q	3Q	4Q	Year	1Q	2Q	3QA	4Q	Year
Spinal Stimulation/other	\$ 30.0	\$ 31.3	\$ 31.7	\$ 34.4	\$ 127.4	\$ 33.9	\$ 35.4	\$ 35.5	\$ 38.5	\$ 143.4
Spinal Devices-Blackstone	26.1	30.1	29.6	30.0	115.8	28.6	27.3	25.8	25.5	107.1
Total Spine	\$ 56.1	\$ 61.4	\$ 61.3	\$ 64.4	\$ 243.2	\$ 62.5	\$ 62.7	\$ 61.3	\$ 64.0	\$ 250.5
Orthopedic	\$ 27.6	\$ 28.0	\$ 26.3	\$ 30.0	\$ 111.9	\$ 29.8	\$ 33.3	\$ 33.8	\$ 33.0	\$ 129.9
Sports Medicine	\$ 21.2	\$ 21.3	\$ 22.1	\$ 22.8	\$ 87.4	23.3	23.2	23.7	24.2	94.4
Total Orthopedic	\$ 104.9	\$ 110.7	\$ 109.7	\$ 117.2	\$ 442.5	\$ 115.6	\$ 119.2	\$ 118.8	\$ 121.2	\$ 474.8
Vascular	4.9	5.6	4.7	4.6	19.8	5.3	3.7	4.3	4.6	17.9
Total Non-Orthopedic	7.2	7.0	6.7	7.0	27.9	7.1	7.1	6.2	7.0	27.3
Total	\$ 117.0	\$ 123.3	\$ 121.1	\$ 128.8	\$ 490.2	\$ 128.0	\$ 130.0	\$ 129.3	\$ 132.8	\$ 520.0
PERCENT CHANGE Y/Y										
Spinal Stimulation/other	7.6%	5.7%	9.0%	14.0%	9.0%	13.0%	13.1%	12.0%	12.0%	12.5%
Spinal Devices-Blackstone				30.0%		9.5%	(9.3%)	(13.0%)	(15.0%)	-7.5%
Total Spine	101.3%	107.3%	109.3%	10.5%	67.7%	11.4%	2.1%	-0.1%	-0.6%	3.0%
Orthopedic	20.5%	12.9%	12.3%	21.5%	16.8%	8.0%	18.9%	28.5%	10.0%	16.1%
Sports Medicine	10.4%	10.4%	13.5%	8.0%	10.5%	10.0%	8.9%	7.2%	6.0%	8.0%
Total Orthopedic	49.9%	50.2%	52.0%	12.6%	38.3%	10.2%	7.7%	8.3%	3.4%	7.3%
Vascular	-9.3%	14.3%	-8.0%	-20.0%	-6.5%	8.0%	-33.9%	-8.5%	0.0%	-9.6%
Total Non-Orthopedic	23.9%	14.8%	10.0%	12.0%	15.0%	-2.0%	1.4%	-7.7%	0.0%	-2.0%
Total	44.1%	45.6%	45.2%	10.9%	34.2%	9.4%	5.4%	6.8%	3.1%	6.1%

Source: Company and Dawson James Securities, Inc. estimates

ORTHOFIX INTERNATIONAL NV
 Fiscal year ends December 31
 QUARTERLY EARNINGS MODEL, 2007A-2008E
 (\$ millions, except per share)

Fiscal year ends December 31	Mar-07	Jun-07	Sep-07	Dec-07	2007A	Mar-08	Jun-08	Sep-08	Dec-08	2008E
	Q1	Q2	Q3	Q4		Q1	Q2	Q3A	Q4	
Total revenue	\$ 117.0	\$ 123.3	\$ 121.1	\$ 128.8	\$ 490.2	\$ 128.0	\$ 130.0	\$ 129.3	\$ 132.8	\$ 520.1
Product costs	30.8	33.0	30.7	34.5	129.0	34.2	35.0	48.0	42.9	160.2
Gross profit	86.2	90.3	90.4	94.3	361.2	93.7	95.0	81.3	89.9	360.0
OPERATING EXPENSES										
S&M	44.6	47.3	47.1	48.0	187.0	50.2	53.2	50.2	50.5	204.1
G&A	15.9	16.8	16.9	23.3	72.9	22.2	18.8	19.3	19.3	79.6
R&D	6.3	6.0	6.0	6.0	24.3	6.4	6.6	6.4	6.0	25.4
Amortization	4.5	4.6	4.7	4.4	18.2	5.0	4.8	5.3	5.3	20.4
Gain on Sale of Assets						(1.6)				
Impairment of Intangible Assets				21.0				289.5		
Strategic Initiative/Office Consolidation										-
Total operating expenses	71.3	74.7	74.7	102.7	323.4	82.2	83.4	370.7	81.1	617.5
Operating Income	14.9	15.6	15.8	(8.3)	38.0	11.6	11.6	(289.5)	8.8	(257.5)
Interest Expense (Inc.)	5.7	5.9	5.7	6.5	23.7	5.4	4.1	4.2	4.0	17.7
Other Income (Loss)	(0.6)	0.3	0.5	0.1		0.5	0.6	(9.6)		
EBT	8.7	10.1	10.6	(14.7)	14.7	6.7	8.1	(303.3)	4.8	(283.7)
Income tax provision	2.4	2.9	2.6	(4.1)	3.8	3.1	2.3	(66.1)	0.0	(60.7)
Minority interest										
Net income	\$6.3	\$7.2	\$8.0	(\$10.5)	10.9	\$3.6	\$5.8	(\$237.2)	\$4.8	(223.0)
Weighted ave. shares (diluted)	16.93	16.82	16.89	16.91	16.89	17.26	17.12	17.10	17.10	17.15
GAAP EPS	\$0.37	\$0.43	\$0.48	(\$0.62)	\$0.66	\$0.21	\$0.34	(\$13.87)	\$0.28	(\$13.04)
EPS Reported (FD) excl. SFAS 123R & Non-cash Breg & Blackstone Amortization						0.46	0.62	(13.61)	0.35	(\$12.18)
EPS excl. non-cash amort.+ SFAS 123R+ cost of strategic initiatives+office consolidation+ asset impairment & inventory adj.	\$0.68	\$0.72	\$0.79	\$0.45	\$2.64	\$0.66	\$0.67	\$0.61	\$0.49	\$2.43
RATIOS: AS A PERCENTAGE OF TOTAL REVENUE										
Gross margins	73.7%	73.2%	74.6%	73.2%	73.7%	73.3%	73.0%	62.9%	67.7%	69.2%
S&M	38.1%	38.4%	38.8%	37.3%	38.1%	39.2%	40.9%	38.8%	38.0%	39.2%
G&A	13.6%	13.6%	14.0%	18.1%	14.9%	17.3%	14.4%	14.9%	14.5%	15.3%
R&D	5.4%	4.9%	4.9%	4.6%	5.0%	5.0%	5.1%	5.0%	4.5%	4.9%
Amortization	3.8%	3.7%	3.9%	3.5%	3.7%	3.9%	3.7%	4.1%	4.0%	3.9%
Tax Rate	27.8%	28.6%	24.6%	28.2%	25.6%	46.1%	27.9%	21.8%	0.0%	21.4%
Operating margin	12.7%	12.7%	13.0%	(6.5)%	7.7%	9.1%	8.9%	(223.8)%	6.6%	(49.5)%
Pretax margin	7.4%	8.2%	8.8%	(11.4)%	3.0%	5.2%	6.2%	(234.5)%	3.6%	(54.5)%
Net margin	5.4%	5.8%	6.6%	(8.2)%	2.2%	2.8%	4.5%	(183.4)%	3.6%	(42.9)%

NM = Not meaningful.

Source: Company and Dawson James Securities, Inc. estimates

DISCLOSURES



Initiated October 11, 2006 – BUY – Price Target \$57.00
 Update January 4, 2007—BUY—Price Target \$60.00
 Update August 12, 2008—BUY—Price Target \$30.00
 Update November 14, 2008—BUY—Price Target \$20.00

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	Company Coverage		Investment Banking	
Ratings Distribution	# of Companies	% of Total	# of Companies	% of Totals
Speculative Buy	6	26%	3	50%
Strong Buy	3	13%	1	33%
Buy	10	43%	0	0%
Neutral	3	13%	2	67%
Sell	1	4%	0	0%
Sell Short	0	0%	0	0%
Under Review	0	0%	0	0%
Restricted	0	0%	0	0%
Total	23	100%	6	26%

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