Credit Opinion: Stryker Corporation

Stryker Corporation

Kalamazoo, Michigan, United States

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	A3

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Key Indicators

Stryker Corporation
Fiscal Years Ending December 31[1]

	LTM 9/30/06	2005	2004	2003
Revenues (Millions)	**5,221**	**4,872**	**4,262**	**3,625**
Cash Flow From Operations / Debt	**177.5%**	**128.7%**	**136.4%**	**97.7%**
Free Cash Flow / Debt	**120.1%**	**83.5%**	**87.9%**	**64.7%**
EBIT Margin	**23.9%**	**20.8%**	**19.6%**	**18.6%**
Debt / Capitalization	**13.0%**	**20.0%**	**16.8%**	**23.4%**
ROA (NPATBUI / Average Assets)	**15.4%**	**13.0%**	**12.4%**	**12.3%**

[1] Standard adjustments in accordance with "Rating Methodology: Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations, Part I (February 2006)."

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Company Profile

Stryker Corporation (Stryker) manufactures a broad range of medical devices primarily used in the orthopedic and medical surgical markets. Although Stryker is best known for its orthopedic products, it also has a material presence in certain endoscopic, surgical instrumentation and bed product lines. Stryker is global in scale with international revenues accounting for approximately one-third of total revenues based on revenues for the twelve months ended September 30, 2006.

Rating Rationale

Stryker's rating is evaluated in accordance with Moody's Global Medical Products and Device Industry Methodology published in August 2006. The key rating drivers for medical products and device companies include: (1) size, scale, and diversification; (2) product portfolio and profitability; (3) financial strength; and (4) financial policies, including reliance on acquisitions, stock buybacks, and dividends.

Stryker's actual A3 issuer rating is currently two notches below the "A1" implied rating under Moody's Global Medical Products and Device Methodology, based on September 30, 2006 financial information. The company has a solid credit profile highlighted by very strong free cash flow generation, minimal debt levels, and healthy cash and investment balances, partially offset by a relatively high degree of exposure to the highly competitive orthopedics market - highlighted by price constraints and a slowdown in hip implant sales during fiscal 2005 - and potential litigation stemming from a US Department of Justice (DOJ) investigation. Moody's notes that the "A1" methodology-implied rating is influenced by extraordinarily low debt levels that result in very strong financial strength and policy ratios. In Moody's opinion, although the company has demonstrated very conservative financial policies, the "gap" between the actual and methodology-implied ratings reflects the potential for acquisitions in a highly competitive and consolidating marketplace.

The company's A3 issuer rating reflects the following factors (in order of importance):

Financial Policies

Stryker is a relatively conservative company when it comes to financial policies, scoring at "Aaa" for all the sub-factors that are used to measure this factor. The company has not exercised a share repurchase since 1996, pays a relatively small dividend, and has not engaged in any large debt-financed acquisitions since the $1.65 billion acquisition of Howmedica from Pfizer in December 1998. This is a key distinction relative to other investment grade companies of its size.

The company has made relatively small to moderate-sized, bolt-on acquisitions during the last few years. The most recent acquisition was a private company called Sightline Technologies, which develops flexible endoscopes and was acquired for about $50 million in cash. Moody's anticipates that the company will continue to make moderate sized acquisitions going forward.

The company's "Reliance on acquisitions, share buybacks, and dividends" ratio comes to approximately 5%, which maps to a "Aaa" rating. Moody's anticipates that the company will continue to invest in their business, but at the same time, should maintain a prudent posture toward shareholder initiatives.

At September 30, 2006, Debt to Capitalization and Debt to EBITDA were 13% and 0.4x, respectively, which also map to "Aaa" ratings. The company has almost no debt and continues to maintain a conservative balances sheet while focusing on organic growth. However, because these ratios benefit from minimal debt, the addition of even a moderate amount could cause material declines in both of these sub-factors. Moody's understands that if Stryker were to engage in a large acquisition financed with debt, Moody's does not anticipate that Debt to Capitalization would rise beyond 35-45%. Current Debt to Capitalization levels are about 13% due to adjustments for leases and pension liabilities.

Financial Strength

Stryker has consistently generated strong, increasing cash flows. Coupled with conservative financial policies, the company's cash flow from operations to debt (CFO/TD) and free cash flow to debt (FCF/TD) were 129% and 84% during fiscal year 2005. During the twelve months ended September 30, 2006, CFO/TD and FCF/TD were 178% and 120%, respectively. Stable cash flow generation, in combination with a limited amount of debt, enable both metrics to consistently score at "Aaa" in the methodology.

During the twelve months ended September 30, 2006, capital expenditures as a percentage of cash flow from operations was 28%, which represents an approximate decline of 350 basis points from fiscal year 2005. The reduced capital expenditures contributed to improved free cash flow for the period.

Because of low levels of debt, interest coverage, as measured by EBIT/Interest expense, is very strong at approximately 31 times, which maps to a "Aaa" rating for this sub-factor.

Size, Scale & Diversification

Stryker is a moderately-sized company, with just over $5.2 billion in revenues for the twelve months ended September 30, 2006, which scores at the low to mid range of the "A" category. Stryker is larger in size compared to other pure-play orthopedic companies and offers more products outside of orthopedics.

Overall revenue growth has declined to the low double-digit range (10% growth for the twelve months ended September 30, 2006 compared to the same period in the prior year). This represents the lowest level of sales growth since fiscal 2000 with the most recent years ranging from 14% in 2005 to 20% in 2003. In addition to lost market share in its hip franchise, price increases have been weaker than in years past, coming in at about 1.5% in fiscal 2005 and about 0.3% in fiscal 2006 compared to 3% in fiscal 2002.

With limited ability to increase prices, estimated overall at 1.5% and less than 1% during fiscal 2005 and 2006, respectively, volume growth is critical to top-line growth. Over the past one to two years, Stryker has lost some market share in its hip implant business, with sales growth in the 2% range versus market growth in the 7% range. (To be noted, this growth rate has seen improvement in recent quarters.) This slowdown was attributable to a less productive sales-force as well as a more mature product line. Stryker is focused on getting its hip implant business back up to speed. In order to accomplish this, Stryker is looking to accelerate revenue growth by initiating modest sales force expansion in both the US and abroad. The company has added more associate-type sales representatives, whose primary focus will be to assist full line representatives in covering their territories while developing into full line representatives themselves. In addition, future revenue growth will also depend highly on innovation, which could spur the development of new products while building on existing product lines. Although we believe that reconstructive products remain physician preference items and orthopedic physicians tend to be fairly loyal to certain manufacturers, the recent loss of market share in hips highlights the ability for competitors to take share if there are competitive weaknesses.

Recently, Biomet, one of the major US based competitors in the reconstruction product area, announced that it was being purchased by a consortium of equity firms, including Goldman and TPG. Moody's believes that this could heighten competition as private equity firms seek to improve market positioning and operating performance of Biomet.

Stryker has three main product lines - Orthopedic Implants, MedSurg Equipment, and Physical Therapy Services - which accounted for 58%, 37%, and 5% of revenues during the twelve months ended September 30, 2006, respectively. Stryker's reporting segments are moderately diversified; with three segments, which score a "Baa" for this sub-factor. Stryker's Physical Therapy Services line accounts for only 5% of revenues on an LTM basis, which just qualifies it as a customer segment under the methodology. We believe that, with only 3 reporting segments, Stryker is not as well-diversified as other "A" rated companies in this sector. In measuring concentration risk, the company's largest segment - Orthopedic Implants - accounts for roughly 58% of revenues for the twelve months ended September 30, 2006, scoring a "Ba" for this sub-factor.

In the reconstructive area (hips, knees) Stryker is one of the top three players in a fairly crowded field of six major players (Zimmer, J&J, Biomet, Synthes and Smith & Nephew). However, in spine and trauma, Stryker faces significantly larger competitors such as Medtronic and Synthes. In the med/surg business, Stryker is one of the leading players in the US market for operating room equipment (#1 player), endoscopy digital imaging products (#2 behind Olympus) and hospital bed products (#2 behind Hillenbrand) according to data provided by the company.

Product Portfolio and Profitability

The company competes in industries that are characterized by medium-term lifecycles associated with its products and a moderate need to invest in technology to remain competitive. This is evidenced by its moderate and increasing levels of R&D as a percentage of revenue, which measured 6% during the twelve months ended September 30, 2006, and subsequently scores at a "Baa" rating. Moody's expects R&D spend to continue to increase, but remain consistent at 6% of sales.

During the same period, EBIT margins were a healthy 24%, largely driven by the high margin orthopedics business. Although EBIT margins currently map to an "A" rating, they are approaching the 25% threshold that would raise its score to "Aa" for this sub-factor. Moody's looks for margin expansion to stem from greater operating efficiencies and new product introductions, partially offset by higher costs related to sales force expansion.

ROA (NPATBUI/Average Assets) has improved annually since 2003, and is 15% for the twelve months ended September 30, 2006, scoring an "A" rating. Improvements in ROA are the result of increased earnings, which have outpaced asset expansion.

Litigation

In June 2006, Stryker, along with other orthopedic implant manufacturers, received a subpoena from the DOJ's Antitrust Division requesting documents from 2001 to the present regarding possible violations of criminal law related to its sales practices. While Moody's believes that it is too early to estimate potential damages (if any) related to this matter, we believe that the case represents a potential risk for the company.

Rating Outlook

The stable outlook recognizes that Stryker maintains very strong financial strength and financial policy credit metrics, which currently benefit from very low levels of debt and conservative financial policies. The stable outlook assumes that even if the company were to pursue debt financed acquisitions (that fall within the aforementioned debt to capitalization range) its methodology-implied rating would not likely fall below "Baa2" immediately following the transaction.

What Could Change the Rating - Up

Stryker's rating could be upgraded if the company continues to adhere to very conservative financial policies, cash flow levels do not deteriorate, and the company's hip implant business shows sustainable recovery. Better clarity on the scope of outstanding DOJ litigation would also help support upward rating movement. An upgrade could occur if debt financed acquisitions or shareholder initiatives are likely to result in a methodology-implied rating that is no lower than "Baa1" immediately following a transaction.

What Could Change the Rating - Down

The rating could come under pressure if the company pursues large, debt-financed shareholder initiatives or is subject to large litigation payments, which are likely to cause the methodology-implied rating to fall below "Baa2" immediately after these transactions.

Rating Factors

Stryker Corporation

Medical Products & Device Industry	Aaa	Aa	A	Baa	Ba	B	Caa
Factor 1: Size, Scale and Diversification							
a) Revenue			$5.2B				
b) Diversity by Customer Sales Segment				3			
c) Concentration by Top Customer Segment					58%		
Factor 2: Product Portfolio and Profitability							
a) R&D % of Sales				6%			
b) EBIT Margin			24%				
c) ROA (NPATBUI / Avg. Assets)			15%				
Factor 3: Financial Strength							
a) CFO / Debt	178%						
b) FCF / Debt	120%						
c) EBIT / Interest Expense	31.2x						
Factor 4: Financial Policies							
a) Reliance on Acquisitions, Share Buybacks, and Dividends	5%						
b) Debt / Book Capitalization	13%						
c) Debt / EBITDA	0.4x						
Rating:							
a) Indicated Rating from Methodology			A1				
b) Actual Rating			A3				