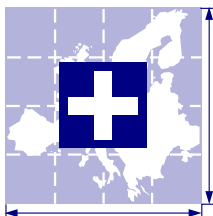


26 September 2005



# Dental Implant Update

*An Inelastic Market is Driving Prices Up***Medical Technology**

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## Highlights of This Issue

- The 14th annual meeting of the *European Association of Osseointegration* (EAO) kicked off on 22 September 2005 in Munich, Germany. This year's congress was disappointing with a weak clinical program compared to previous meetings as well as a low level of new product launches/updates. The most interesting development was the launch of Straumann's innovative new *SLActive* implant surface that demonstrates faster osseointegration (i.e. bone integration of the implant) as well as an update on the dental implant market.
- While we believe that **product branding** and **customer training/support** will continue to be key, we are starting to see the emergence of the **next round of meaningful product differentiation**, which could give some companies additional impetus over the next 3 years, through the introduction of new implant surfaces and improved esthetics.
- With respect to esthetics we believe **Nobel Biocare's competitive advantage will start to be eroded over the coming 24 months** driven by the introduction of customized ceramic abutments by other premium dental implant companies, in particular Straumann who in our view made a strategic error and is now catching-up through the agreement with Sirona; we expect Straumann to launch a ceramic abutment in 1H CY06E. In addition, we believe Nobel Biocare will need to pay a lot of attention not to fall behind the competition with respect to new dental implant surface treatments; in our view an introduction of a *TiUnite* covered BMP2 product in CY10E will not be soon enough to stem off the competitive threats. We are not convinced that the recent introduction of a micro groove (i.e. *Groovy*) onto its entire dental implant range is being regarded as **sufficiently innovative & revolutionary** by dentists/surgeons, partly because there is currently a lack of human clinical data surrounding this feature set.
- During the EAO we also took the opportunity to gauge the overall health of the dental implant market. **Europe** continues to be robust growing in the high-teens and showing little impact from an ongoing soft economic backdrop; Germany while improving slowly continues to be the most difficult market. Growth rates in the **U.S.** continue to be stronger than in Europe and appear to be somewhere in the low 20% range, driven by strong investment from overseas companies in this lower penetrated market.
- We retain our **positive stance** on the **dental implant sector** and retain our **Buy** rating on **Straumann** (B-1-7) and **Nobel Biocare** (C-2-7).

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## What Has Changed?

The 14th annual meeting of the *European Association of Osseointegration (EAO)* kicked off on 22 September 2005 in Munich, Germany. This year's congress was disappointing with a weak clinical program compared to previous meetings as well as a low level of new product launches/updates. The most interesting development was the launch of Straumann's innovative new *SLActive* implant surface that demonstrates faster osseointegration (i.e. bone integration of the implant) as well as a general update on the dental implant market.

## Dental Implants

### ■ Product Differentiation Re-Igniting

#### *The Previous 3 Years*

Following our attendance at the previous four EAOs, we highlighted that there was a clear trend towards product convergence, with all systems offering simplified implants for one or two-stage procedures as well as unique rough surface textures that improve healing times. As a result, we suggested that companies focusing on **product branding** (both on simplicity and ease of use) **customer training/support** as well as pushing into the generalist dentist segment are likely to better our 3 YR industry CAGR of 16-17%.

#### *The Next 3 Years*

While we believe that product branding and customer training/support will continue to be key, we are clearly seeing the emergence of the next round of **meaningful product differentiation**, which should give some companies additional impetus over the next 3 years. Specifically, the areas of differentiation include:

- **New implant surfaces** – that should accelerate post-operative healing time and allow the implant to be loaded more quickly; and
- **Improved esthetics** – that provide more realistic restorations of missing teeth.

On the topic of new **implant surfaces**, we are starting to see the next round of technological innovations, that are likely to reduce the period before an implant can be loaded and thus provide the patient with a final solution significantly earlier than the standard protocol of 3-6 months. During the EAO, Straumann launched the *SLActive* surface which shows greater hydrophilicity, promotes the initial healing reaction and generates higher implant stability. Specifically the clinical data suggests that at two weeks after the placement of the implant the bone-to-implant contact with *SLActive* was 60% higher than with SLA; this in our view significantly improves implant stability in the important treatment phase between week 2 and 4 and thus enhances treatment security and predictability for the clinician and patient. This makes Straumann the second company within 12-months to launch an improved implant surface. The first was

AstraTech (a subsidiary of AstraZeneca) which launched its new *OsseoSpeed™* surface (contains fluoride to improve bone formation) at the EAO in September 2004. According to the company, tests have shown that this new surface can safely reduce post-operative healing times by up to 50%, allowing the prosthetic to be fitted to the implant more quickly (for more information refer to 'Other EAO Tid-bits' below). While other companies like Biomet (3i), Dentsply, Nobel Biocare and Zimmer appear to be working on new surfaces, we see it as unlikely that their new surfaces will hit the market within the next 18-24 months. As a result, we believe the new enhanced surface initiatives by **Astra Tech and Straumann are likely to give these companies a useful differentiating factor over the intermediate term.**

On the topic of **esthetics**, we continue to see stronger product differentiation between the dental implant manufacturers. Specifically, we believe that Nobel Biocare and Dentsply are intelligently trying to leverage off their unique esthetic franchises, with a view of selling a tooth replacement 'solution' (i.e. dental implant, abutment and prosthetic), rather than just a dental implant. In our view, Nobel Biocare is making a particular strong push towards the 'solution' approach, using its powerful and unique *Procera* technology; as a reminder during the EAO 2004 the company added some further components to its esthetic range, by not only launching the new *Procera Forte* scanner (which for the first time allowed for the production of a single unit bridge), but also extend its complete esthetic range to competitors' dental implant systems, including Straumann, 3i and Zimmer. To date this has not only allowed Nobel Biocare to get some of the competitors' abutment business but also convert a number of accounts to also use its dental implant system, which has helped boost constant currency sales growth to a very strong 25.7% in 1H FY05. With arguably the strongest esthetic product offering on the market (i.e. customized ceramic abutments and prosthetics), we believe Nobel Biocare will continue to leverage this technology to win additional competitive accounts.

However, over the next 24 months we believe Nobel Biocare's **competitive advantage will start to be eroded** driven by the introduction of customized ceramic abutments by other premium dental implant companies, in particular Straumann who in our view made a strategic error and is now catching-up through the agreement with Sirona; we expect Straumann to launch a ceramic abutment in 1H CY06E. In addition, we believe Nobel Biocare will need to pay a lot of attention not to fall behind the competition with respect to new dental implant surface treatments; in our view an introduction of a *TiUnite* covered BMP2 product in CY10E will not be soon enough to stem off the competitive threats. We are not convinced that the recent introduction of a micro groove (i.e. *Groovy*) onto its entire dental implant range is being regarded as sufficiently innovative and revolutionary by dentists/surgeons, partly because there is currently a lack of human clinical data surrounding this feature set.

Interestingly, our field checks with dentists/surgeons at the EAO suggest that *Groovy* is seen more of a “Mickey Mouse” feature used by the company to justify a price premium rather than supported by good clinical evidence. As a result, we do not believe that *Groovy* will have sufficient amount of shelf-life to make it useful differentiating factor for Nobel Biocare. While many of the recent product introductions such as *NobelGuide* and *Rondo* have been very well received, we feel Nobel Biocare’s *Groovy* introduction has done little for the company’s strong reputation.

#### ***Small Manufacturers Less Aggressive On Price***

Unlike our observations at the 2004 EAO congress in Paris, we are of the strong opinion that smaller dental implant manufacturers have become less aggressive on price, with the exception of *Camlog*. We get the impression that the smaller manufacturers have started to realize that the **dental implant market is much more ‘inelastic’** than they had expected and that the demand for their products **can not** be greatly influenced using a ‘deep discounting’ strategy. As a matter of fact most companies we have spoken to at the EAO have indicated that they have raised prices, which is a very different picture to what we experienced last year. As a reminder, at the EAO in 2004 we saw a number of companies like *M.I.S. Implant Technologies*, *BioHorizons* and *Anthogyr* starting to offer dental implants for 50% less at ~EUR100 compared to the average selling price of the premium companies at ~EUR200. Interestingly, recently *M.I.S. Implant Technologies* raised its price for its new dental implant ‘Seven’ by ~10%.

In 2006 we may also see Jerry Niznick, former owner of Paragon, re-enter the market with a new dental implant system that is likely to be sold predominantly through the Internet. Whether he can enter the market will depend on the decision of the arbitration panel, which we understand will have to rule by early December 2005 as to whether he has breached his non-compete clause with Zimmer. Should the arbitration panel rule in favor of Zimmer, Niznick’s non-compete clause could be extended until late 2006/early 2007. As we highlighted in previous research, we suspect the price may be less than US\$100 per implant, which may still equate to a healthy 15-20% EBIT margin due to the lower cost structure. However, in light of the current inelastic demand of dental implants, we believe a deep price discounting strategy is unlikely to work; furthermore low prices are often associated with inferior quality and thus dentists/surgeons may actually be turned off using a medical device that will remain in a patient for the rest of their life. As a result we continue to believe that Niznick is unlikely to pose a material risk to our forecast for Nobel Biocare and Straumann. We would be a little more concerned, should Niznick’s strategy focus on marketing his new implant system as the second

generation of his previously developed ‘Screw-Vent’ system (now owned by Zimmer Dental) that incorporates many of his innovative features at a price that is not quite as aggressive. We feel such a strategy would be particularly effective in the U.S. market.

#### ***Consolidation – Expect More Moving Forward***

With dental implants representing one of the fastest growing areas in dentistry and EBIT margins at +30% for the industry leaders, it is not surprising that large dental companies are making acquisitions, to get a slice of the action. Some of the more recent transactions include Henry Schein, which on 6 July 2004 entered into the dental implant market through a strategic partnership with Camlog Holding AG. Under the agreement, Henry Schein holds a majority equity position in the company and will focus on building the market position of the Camlog product line in the U.S. In addition on 23 August 2004 *Sybron Dental* made an offer for Canadian dental implant manufacturer, *Innova Corporation*, for CAD57m. With 2003 sales of CAD20.3m, the valuation equated to 1-year trailing sales multiple of 2.8x. On 8 June 2005 *Sybron Dental* made a further acquisition by purchasing German based *Oraltronic*, which in 2004 had annual revenues of US\$10m. While the aforementioned transactions are relatively small, we are convinced that we will see more material acquisition over the coming 12-24 months, driven by large medical device companies looking for new long-term growth opportunities.

#### **■ Summary**

Based on our observations at the EAO we believe we are starting to see two key trends:

1. **Product Differentiation** - a new round of production differentiation from the industry leaders, in the areas of new implant surfaces for faster bone healing and improved esthetics for a more natural look. Currently leading this race are Straumann with *SLActive*, Astra with *OsseoSpeed™* and to a lesser degree Nobel Biocare with *Groovy*. We feel such innovations provide dental implant companies with the ability to put through very material price increases; and
2. **Price Discounting** – while smaller dental implant companies continue to use price as a means of attracting customers, our field checks at the EAO suggest that this has started to change over the past 12-months, with some actually raising prices. We believe this driven by the fact that many manufacturers have realized that the demand for dental implants is relatively inelastic. As a result we would be surprised if we see any material pricing pressure for dental implants over the coming 24 months.

## Dental Implant Market

During the EAO meeting we also took the opportunity to gauge the overall health of the dental implant market through field checks with dental implant manufacturers as well as physicians.

### ■ Europe

The European market continues to reflect differing growth rates amongst countries. The continent's biggest market of **Germany** appears to have improved materially from the poor growth rates (i.e. ~5%) in Q1 CY05 to ~10% in Q3 CY05, driven partly by reduced confusion amongst the *Krankenkassen* (i.e. insurance companies) in how to process tooth replacement applications following the introduction of a new dental reimbursement system on 1 January 2005. However, growth rates continue to linger the overall European market driven by a German consumer, who following the uncertainties surrounding the recent Federal elections, remains cautious. The **French** market continues to be fairly stable with growth rates of ~15%. The demand in **Iberia** continues to be very strong suggesting market growth rates of around 16-18%. The **Italian** market appears to have become slightly more competitive as a result of the large number of 'copy-cat' companies that are using price discounting as means of attractive customers. Nevertheless, this does not appear to have had a major impact on the larger companies such as Nobel Biocare and Straumann that offer premium products (typically with large amounts of clinical data) and excellent customer support and training. With such a large number of competitors it is difficult to assess the overall market growth rates; however based on comments from the larger manufacturers it appears the Italian market continues to grow comfortably in the mid to high double digits. The **United Kingdom** continues to show very strong demand for dental implant procedures, with growth rates sighted between 20-40%; this is not at all surprising given that dental implant penetration remains to be one of the lowest in Europe.

Overall, the European market continues to be robust, showing little impact from an ongoing soft economic backdrop. In addition, there appears to be no pressure on pricing, for the larger dental implant manufacturers.

### ■ United States

Growth rates in the U.S. continues to be stronger than in Europe and appear to be somewhere in the low 20% range with no signs at this stage that the hurricane season in southern part of the country is having a material affect on the demand for dental implant procedures. We believe the strong market growth rate in the U.S. is driven by the heavy investment in this lower penetrated market by companies like 3i, Nobel Biocare, Straumann and Astra Tech. The pricing environment remains stable, with dental implants continuing to sell at a slight premium to many of the European markets.

## Other EAO Tit-bits

### ■ 3i (Biomet)

Biomet's 3i dental implant business, which is the third largest dental implant franchise with an estimated market share of ~17% introduced *Certain PREVAIL*, which is designed to potentially enhance crestal bone and improve the long-term esthetic outcome.

### ■ Astra Tech

#### *Fluoride Modified Implant Surface*

Since the launch of Astra Tech's *OsseoSpeed*, which is a biologically-based bone trigger that has been approved both by the FDA and CE, the company has been able to virtually convert its entire customer base to this premium priced (6-10%) implant surface. As a reminder the Astra Tech implant is dipped into a hydrofluoric acid that chemically modifies the surface structure and deposits fluoride ions; this then helps to exploit the power of fluoride to encourage the growth of more bone more rapidly. Pre-clinical trials have been run and show promising results, suggesting that the Astra Tech implant produces more bone more quickly in the crucial healing period immediately after installation.

#### *Sales Force Expansion*

We believe Astra Tech is investing heavily in sales force expansion, particularly in the U.S. where we estimate the number of reps to have grown from ~30 at the beginning of 2004 to ~65 at the beginning of 2005 and should approach ~80 by year end.

#### *Growth Rates*

As a result of favorable market conditions and strong invest in its sales force, we believe Astra Tech's dental implant business is currently growing worldwide at ~40% in constant currency. With this growth rate not too different from the previous 3 years we believe this company has about 7-8% market share or US\$90-100m in sales.

### ■ Dentsply (Friadent)

It appears that Dentsply has introduced the *Ankylos* dental implant surface onto its *FRIALIT* dental implant system called *FRIADENT plus*. The surface macroroughness is achieved by grit-blasting the endosseous section of the implant after which the implant goes through a unique thermal etching process. At this stage we are unclear as to why that decision was made; however it should be noted that there were rumors circulating within the industry that the old *FRIALIT* system showed some early implant failures in the U.S.

### ■ Nobel Biocare

With new product launches at its World Congress in *Las Vegas* in June 2005, it was not surprising the company did not launch any new products at the EAO. Instead, the EAO



was the first European congress where it showed its new dental implant products including *Groovy*, *Nobel Guide* and *Shorty*. Given the strong product roll-out we hope that Nobel Biocare will give its customers some time before it rolls out any new products in order to allow them to digest the new systems/features. Our field checks with dentists/dental surgeons suggest that additional products over the coming 12-24 months could confuse its existing as well as new customers.

## ■ Straumann

### *New Implant Surface – SLActive*

At the EAO Straumann launched its new *SLActive* dental implant. Based on our field checks it appears that the company has priced *SLActive* at a 30-40% premium (depending on geography) to its older *SLA* implant and well above our estimate of 10%. It appears STMN is convinced that the human clinical data shows a sufficiently large patient benefit with respect to osseointegration (i.e. the speed of bone in-growth into the implant) that the premium is warranted. Interestingly Nobel Biocare's *Groovy* implant (contains a microgroove for increased stability), which was recently launched at its World Congress in Las Vegas was only given a 10% price premium (or ~15% if you also include the healing cap). We understand that the *SLActive* is available immediately in Europe and Asia while the North American launch is expected in Q1 CY06. Based on our model we have assumed that Straumann will be able to convert 20% of its existing customer base from *SLA* to *SLActive* in the first 12-months (i.e. by CY06E).

Our existing CY06E constant currency sales growth forecast of 19% assumes that *SLActive* will add 2% points. While we are not changing our forecast at this stage, the significantly higher price premium announced at the EAO has the potential to add 4-5% points (i.e. adjusted for abutments), which would increase our CY06E sales growth rate to 21-22%. Assuming no material increase in the gross margin (which may be conservative given that the higher price of *SLActive* should more than offset the higher production costs) this could increase our CY06E EPS by at least 3-4%. In addition we feel that Straumann has finally decided to become a little more aggressive on sales and marketing.

## ■ Z Systems

Based on our field checks it appears that German based *Z Systems* is one of the first companies to sell a ceramic based dental implant system. This one-piece system was launched mid 2004 with ~2,500 dental implant sold to date. So far the company has only seen four fractures and has started to see strong demand in Germany, where the demand for metal free restorations is particularly topical. We understand the company intends to start its clinical trials for FDA approval in Q4 CY05 or Q1 CY06. The

implant price ranges between EUR492 and EUR638 and equates to healthy price premium of traditional titanium based dental implant and abutment systems that are typically sold for EUR300-350.

## Conclusion

Based on the various product updates by Straumann, Astra Tech and Nobel Biocare over the past 12-months, we are starting to see the next round of **technological innovations** following a period of 4-5 years of product convergence, where all systems started to offer simple implants for one or two-stage procedures as well as rough surface textures that improve healing times. While we believe that **product branding** and **customer training/support** will continue to be important, it is companies that can combine this with the next of meaningful innovation, including new implant surfaces that should further accelerate post-operative healing and improved esthetics that provide more realistic restorations of missing teeth, that will be able to beat our 3 year industry CAGR of 16-17%.

Beyond that we are seeing the **introduction of biologics** to shorten healing times as well as improving implant success rates in patients with poor bone. As a result, we expect **product differentiation to increase over the medium to long-term**. With biologics typically requiring substantial amounts of investment, we suspect it will be the larger dental implant companies such as Nobel Biocare, Straumann and 3i that will end up trumps, driving the smaller implant companies out of the market.

## Recommendations

We remain positive on the dental implant market and are forecasting the industry to show local currency sales growth for CY05E & CY06E of ~19% & ~17% in local currencies, driven by both volume and price. Over the intermediate term to long term we believe the worldwide dental implant market is likely to post +15% growth annually as improved technology reduces procedure cost and additional training for dentists increases usage patterns. Overall, this should drive implant penetration rates to much higher levels in Europe and U.S., which we currently estimate at ~19% & ~15%. Indeed, with:

- **Dental implant manufacturers** becoming **financially stronger** permitting more investment in training, education and marketing;
- The **penetration rate** of surgeons and dentists who are performing dental implant procedures **approaching critical mass** (we estimate it currently stands at 20-25%), potentially forcing the remaining clinicians to quickly adopt the 'new technology' to **remain competitive**; and
- More **patient awareness** of the **superior clinical benefits** of dental implants over the traditional barbaric method of crown & bridges for tooth replacement.

we believe the dental implant market has the potential to grow significantly quicker than +15% over the intermediate term, which would provide tremendous upside to our earnings forecast for the dental implant manufacturers, including Nobel Biocare and Straumann.

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## Price Objective Basis and Risk

### ■ Nobel Biocare (NBCHF; CHF300; C-1-7)

We retain our **Buy** recommendation and 12-month price objective of CHF335, which for conservative reasons is below our DCF valuation of CHF350 per share using as WACC of 7.7% and a terminal growth rate of 3%. **Risks** to our valuation are a slowing dental implant market driven by a weaker economy in conjunction with the lack of reimbursement for dental implant procedures, inability to maintain high-teens sales growth as well as foreign exchange.

### ■ Straumann (SAUHF; CHF324; B-1-7)

We retain our **Buy** recommendation and our 12-month price objective of CHF342 per share, which is in line with our DCF valuation using a WACC of 7.8% and a terminal growth rate of 3%. Risks to our valuation are a slowing dental implant market driven by a weaker economy in conjunction with the lack of reimbursement for dental implant procedures, delays in product launches as well as foreign exchange.

We continue to believe that Straumann's share will perform better than Nobel Biocare over the coming 12-months.

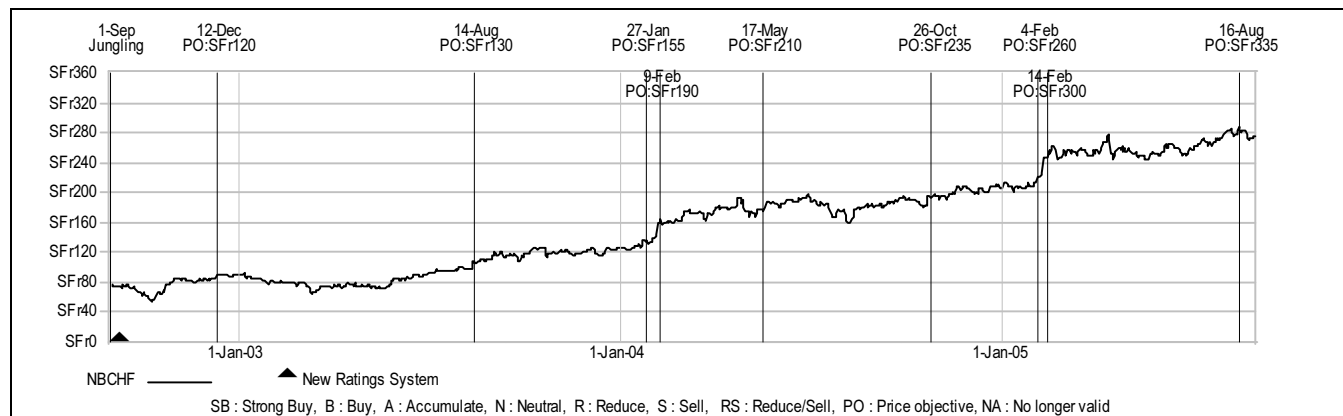
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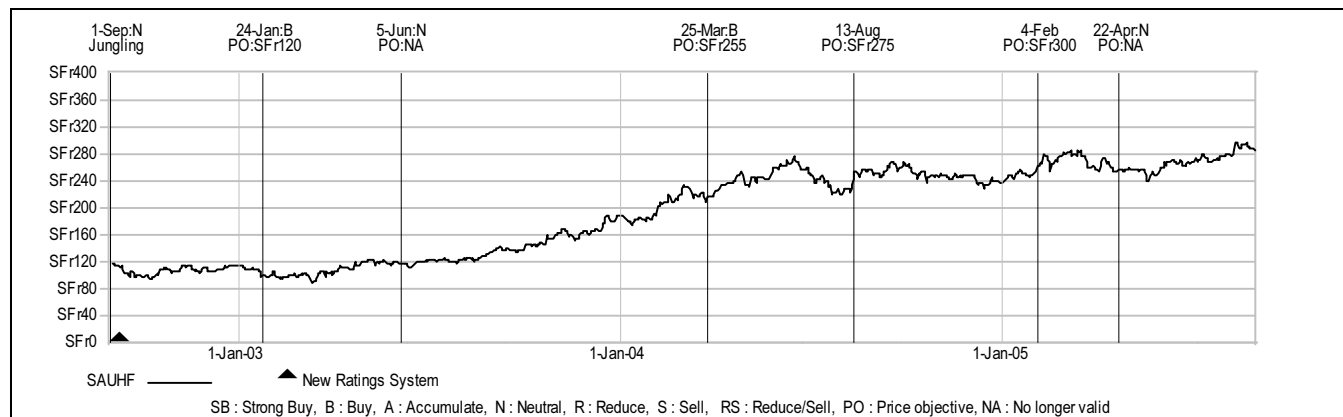
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From 8 Dec. 2001 to 6 Sep. 2002, the Investment Opinion System included: Strong Buy, Buy, Neutral, and Reduce/Sell. On 6 Sep. 2002, Strong Buy and Buy ratings became Buy, and Reduce/Sell became Sell. Any exceptions to these rating revisions are reflected in the chart. All price objectives for Neutral and Sell rated securities established before 6 Sep. 2002 were eliminated as of that date. The current Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark Grey shading indicates the security is restricted with the opinion suspended. Light Grey shading indicates the security is under review with the opinion withdrawn. Chart current as of August 31, 2005.

### SAUHF Price Chart



From 8 Dec. 2001 to 6 Sep. 2002, the Investment Opinion System included: Strong Buy, Buy, Neutral, and Reduce/Sell. On 6 Sep. 2002, Strong Buy and Buy ratings became Buy, and Reduce/Sell became Sell. Any exceptions to these rating revisions are reflected in the chart. All price objectives for Neutral and Sell rated securities established before 6 Sep. 2002 were eliminated as of that date. The current Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark Grey shading indicates the security is restricted with the opinion suspended. Light Grey shading indicates the security is under review with the opinion withdrawn. Chart current as of August 31, 2005.

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Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	90	44.12%	Buy	30	33.33%
Neutral	102	50.00%	Neutral	24	23.53%
Sell	12	5.88%	Sell	2	16.67%

**Investment Rating Distribution: Global Group (as of 30 June 2005)**

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1089	40.91%	Buy	359	32.97%
Neutral	1378	51.77%	Neutral	404	29.32%
Sell	195	7.33%	Sell	36	18.46%

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