



SONOSITE WITHIN THE SIGHTS OF SAMSUNG

11-4-2011



One of the more interesting M&A deals in the works was leaked almost a month ago by Bloomberg. In a story published at the beginning of November, Bloomberg writers Jeffrey McCracken and Cathy Chan tipped us off to the fact that Sonosite (Nasdaq: SONO) had hired JP Morgan to rep them in a possible sale of the company to Samsung. The stock was around \$31 at the time and immediately rocketed to the \$40 range where it has slowly winded itself higher over the past four weeks.

Sonosite is interesting because they are the market leader in the portable ultrasound market. Under chief exec Kevin Goodwin, Sonosite took the technology to miniaturize ultrasound from a niche experimental product line to a widely accepted portable platform rapidly gaining market share throughout the medical system.

Portable ultrasound is the fastest growing submarket within ultrasound, which in and of itself is a growing field. We have spoken to a number of physicians, and its very clear why. Over the past few years, using portable ultrasound has become the standard of care for a number of common hospital procedures. At one ER I spoke to, it is now standard of care every time PIC line is put into a patient. Another site used Sonosite to confirm the death of all bodies brought into the morgue. The number of one usage in an urban ER we spoke to is ruling out an ectopic pregnancy for patients presenting with vaginal bleeding – something that could take 3-4 hours waiting for an overworked radiology department to do the same thing.

Like many pieces of portable technology, once it gets introduced into an environment people discover new and more cost-effective ways to treat existing problems. Its no wonder that, even throughout the sluggish economic malaise infecting North America, Sonosite was able to rack up a 24% increase in its core home market.

Perhaps the most exciting long term growth trend facing Sonosite lies within emerging markets. Its clear to me that in countries such as China and Vietnam, more medical services will be provided in small clinical settings scattered throughout the populace than in large centrally designated ones, making a great opportunity for low-cost, high value added product lines such as Sonosite. The company has a good presence overseas, with dozens of distributors in virtually every major overseas market. Unlike the US, their brand presence and awareness is less of a strength. In recent quarters Sonosite has had difficulty in generating the same growth overseas that they have in the US. Therein, however, lies the long term opportunity for a strategic buyer.



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Samsung clearly fits the bill. With operating cash flow approaching US\$15 billion, Samsung earlier this year announced its long term investment strategy of building a large medical instrument and technology business. Taking a page from General Electric, Samsung's Lee Kun-hee sees the company's future in investing its impressive electronics and shipbuilding profits into higher-margin businesses. You can't find a larger target than medical devices.

Last year Samsung made its first major foray into ultrasound by acquiring a large minority stake in Medison, the world's sixth largest manufacturer. Samsung bought out most of the remainder this year and renamed the company Samsung Medison. While the purchase price was not completely disclosed, our estimates based upon various trade publications is that Samsung paid approx. 3x revenues, or nearly \$600m for this approx. \$200m business.

It's clear to all Samsung observers that this purchase was merely a platform upon which to build a multi-billion dollar medical device business. Jay Caplan wrote a good piece on this back in January. Since picking up Medison, Samsung has gobbled up a dental-equipment manufacturer and, just recently, a well regarded cardiac point-of-care testing solutions business.

Samsung has hired Morgan Stanley to identify additional candidates to acquire and according to press accounts has been spending a considerable amount of time kicking the tires at SonoSite. A first round of bidding turned up Samsung and a handful of other unannounced players. My guess is that Roper Industries, Inc. and possibly J&J were two of the interested parties.

I have had a few discussions with SonoSite distributors and my sense from them is that Samsung is the most logical buyer for SonoSite. Further, the feeling was that management of SonoSite is very predisposed to handing the ball off, so to speak, to the Koreans, which is important given the companies unyielding commitment to its' customer base. No one I spoke to felt that SonoSite would not want to sell themselves at this stage of the company's growth cycle.

Unlike many other medical device companies whose Boards of Directors maul their shareholders with ill timed and highly dilutive offerings, SonoSite seems to have done quite alright by its' owners. In July 2007 the company raised \$225 million in convertible debt struck at \$38.20 (the stock at the time traded between \$27 & \$32 per share).



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As part of the deal the company bought 2.5 million call options at the convert price, hedging 42% of the dilution. These call options were partially financed with the sale of 2.5 million long-dated warrants at \$46.965 (effectively creating a bullish call spread). When Sonosite's stock price declined, the Board authorized the repurchase of 1.4 million of those warrants at attractive prices, effectively lowering shareholder's future dilution (and increasing the upside) above \$47. Looking at these transactions, it's clear to me the Board did everything in its power to lower dilution and preserve value for its shareholders in the eventuality of the sale of the company, which lends more credence to the Bloomberg story of an ongoing sales process.

Healthy medical device companies have historically sold for between 2.5x & 5.0x sales. Sonosite's gross margins are in the mid to high 60s, a fairly healthy sign of its' market position. Overall growth has been excellent and in my conversations with customers its clear that those who buy from Sonosite will continue to do so at a healthy clip. I don't believe Samsung has any qualms with paying 3.0x multiple, especially since Sonosite has \$200m of working capital (cash + A/R + inventory) in its most recent 10-Q. I also think Samsung has the most to gain from picking up Sonosite's cross-license agreement with General Electric, the product of years of litigation that settled in 2009, an agreement which in my opinion was tilted heavily in Sonosite's favor.

Although an article yesterday in the Financial Times quoted an unnamed banker as saying that fair value is around \$50/share, my math gets me to between \$55 and \$60. I don't think the Board of Directors would have been buying back \$46.96 warrants if the game plan was to sell out at \$50 – and the history of high growth/high margin M&A for businesses such as Sonosite bears this out. At today's price of \$41.50 I think there is \$5-8 of downside if the sales process falls apart (a low likelihood in my mind) and \$8 – \$18 if Sonosite is sold. That's a bet I'm more than eager to take.

Disclosure : As of the publishing of this report, I am Long Sonosite (SONO) common stock.