Recommendation: BUY **Target Price until (12/31/2015): $99**

1. Reasons for the Recommendation

The recommendation for Stryker is a buy. The company is in good position to take advantage of industry trends and factors, is committed to strategic acquisitions and has made several important ones recently that should result in significant future returns, and a number of key competitive advantages that will allow them to remain relevant and profitable within the industry. Although there are apparent risks, the company is committed to minimizing them through constant innovation and growth.

Stryker has proven to remain committed to innovation recently by making a few large acquisitions in the last 2 years. The company feels that the current state of these purchases appears promising. Primarily, the acquisition of MAKO, a company that developed a robotic arm to assist with reconstructive surgeries, is in the implementation phase of coinciding with Stryker's products. The company believes that they will have the FDA's approval of using this technology for total knee replacements during the 2015 fiscal year, and states that trials have been going well. Stryker has had success with hospitals implementing the new technology as a result of offering a flexible financing plan. This could lead to an increase in the quantity of procedures due to an increase in patient confidence. Additionally, Stryker acquired Trauson as a means of increasing their presence in the Chinese market. The company has also attempted to expand its international role by opening an international headquarters in Amsterdam during the summer of 2014. Not only will this improve Stryker's local sales, it is resulting in large tax advantages by being under a 25% corporate income as opposed to the 40% rate applied in the United States. Innovation is a staple of the industry and is a must for all companies that want to remain competitive. The primary means of innovation comes through the funding of research and development. Stryker has proven to remain committed to funding R&D as much as possible, and states that this trend will continue, if not grow, in coming years.

Stryker's relationship with its surgeons figures to be a viable and sustainable competitive advantage. There is a unique relationship between a surgeon and their sales representative. A sales rep is in attendance for every procedure and is responsible for teaching them how to operate all necessary equipment and instruments required for the procedure. This is an invaluable service and Stryker's ability to effectively foster these relationships, is an intangible asset that, in tandem with the high costs of both time and money of switching vendors, creates vendor loyalty. As such, this loyalty, specifically in regards to their knee implant business, results in very steady market share. Stryker knee implant market share, has stayed steady at about 20% for the last decade. Another asset Stryker possesses is their persistence in and effectiveness at patent protection. The ability to develop and manufacture innovative products is the main driver of success in this industry. Therefore, protecting against patent infringement will allow Stryker benefit fully from new innovations and prevent competitors from capitalizing on their ideas. Case in point, Stryker recently won a lawsuit against Zimmer Holdings for infringement that not only protected their intellectual property, but entitled them to receive substantial damages.

Stryker is not one of the largest players in the medical device industry. Johnson & Johnson, MedTronic, and Abbott Laboratories represent competitors that are significantly larger than Stryker. Even Zimmer Holdings, one of their most direct competitors, is larger. This is however, of little consequence. The Medical Instrument and Supply Manufacturing industry is one characterized by a low level of concentration; meaning that despite the presence of several large businesses, it is small and medium businesses that collectively dominate the market. The four largest companies in the industry combine for less than 20% of market share. Stryker should be capable of overcoming their relative size through mergers and acquisitions of their own. Additionally, despite their size, Stryker has the highest return on invested capital, highest operating profit margins, the highest capital efficiency, and the best revenue growth since 2009 in comparison to their competitors.

Although there are many beneficial aspects and trends to the outlook of Stryker, there are definitely risks that must be addressed. First, the company runs the risk of developing a product that either fails after it has already been implemented, or takes advantage of intellectual property that is not their own. Both have occurred in the past, and have resulted in huge litigation charges, even if the liability ends up not being on the company. Another important risk that Stryker faces is the 2.9% excise tax imposed on the sale of all medical devices that began in January of 2013 as a result of the Affordable Care Act of 2010. However, it should be noted that these risks are industry-wide and will not necessarily impact Stryker's relative performance to its peers. Also, the company plans to recover the losses of the excise tax as a result of more abundant availability of health insurance to Americans and the aging of the baby-boomer generation. Next, there is obvious risk associated with major acquisitions, and they may not always work out. For example, the MAKO acquisition was done at an 87.5% premium. However, we are very confident that this acquisition's return will outweigh that risk.

Stryker's potential could be limited by the highly specialized nature of its products and innovations. They might be entirely too specialized. This prevents Stryker products from having any notable cross-applications. They do not create any synergistic relationships between their business operations in different segments. This is in contrast to such companies as Medtronic, who has a history of technologies that have applications in a number of different business segments and fields of research. This characteristic of Stryker products will act as a limit to returns on their research and development investments.

II. Company Analysis

Founded in 1946 by Homer Stryker, Stryker Corporation is a leading company in the medical device manufacturing industry. Stryker researches, develops, and markets a wide range of medical devices. These devices are then sold to doctors and hospitals to be used on patients. The company operates domestically and internationally, with about one third of its sales being from over 100 international markets. Stryker is structured into three business segments called Reconstructive, MedSurg, and Neurotechnology and Spine. During the company's 2013 fiscal year (January 1, 2013 - December 31, 2013), Stryker reported $9.021 billion of revenue with 44%, 37%, and 18% coming from the segments respectively. In that same time, the company reported $1.006 billion of net income.

The Reconstructive segment contributes devices that are used in surgeries replacing and/or repairing patients' knees, hips, and other trauma. Sales for this segment are distributed relatively evenly across the three. Sales continue to grow for this segment.

The next largest segment, MedSurg, consists of three smaller subsegments: Instruments, Endoscopy, and Medical. Instruments consists of general equipment required for surgery and patient navigation systems. Endoscopy provides instruments that allow surgeons to see inside of patients where they otherwise would not be able to see, as well as communications systems. Medical provides devices for patient handling and emergency medical equipment. Again, sales for this segment are relatively equal and have increased over each of the prior 2 years.

Finally, Neurotechnology and Spine is broken down into just that, and sales are evenly distributed. Neurotechnology is products that assist doctors in surgery through the use of blood vessels as well as traditional brain and skull procedures. The company also manufactures implants for the correction of spinal injuries.

Positively, Stryker has made quite a few large acquisitions in the last couple of years in an attempt to become more diverse and expand its international presence. MAKO and Trauson were both large acquisitions made in 2013, totaling over $2 billion. These expenses were a large part of why the company had over a 20% decrease in net income from 2012. With that being said, the acquisitions present a large opportunity for potential revenues in the future. MAKO developed a technology that assists surgeons through the use of a robotic arm. This makes surgeries more precise and more consistent. This should increase sales and profits for the Reconstructive segment. Trauson is the leading manufacturer of orthopedic implants in China. This acquisition should increase sales, and percentage of sales that are international.

Over the past 2 years, (Oct. 31, 2012- Oct. 31, 2014) Stryker has significantly outperformed the S&P 500 (SPY) according to the adjusted close prices from Yahoo Finance. Stryker has a return of 71.83%, while the S&P has only a 48.63% return. This a strong quality for a company to possess in order to show investors a reason to not simply invest in the benchmark.

While these acquisitions are promising, the company is faced with a few risks that could be detrimental to its success, but could also be overcome. First, Stryker relies heavily on research and development in order to expand and remain competitive. Research and development can only be funded once all operating expenses have been covered and is usually consistent with the trend of the economy as a whole. Therefore, if the economy is down, or takes a plunge as it did from 2007 to 2009, Stryker's growth potential moves in the same direction. Next, the company runs a high risk of being sued as a result of faulty devices implanted into patients. Even if the company is not liable, they will still incur legal costs, negatively affecting net income. Finally, Stryker is subject to government regulation around the world. This risk ranges from government reforms such as that seen in the United States in 2010, placing an excise tax on all sales, with the opportunity of increased quantity of units sold, to regulations on bribery as Stryker sales reps often develop long lasting and personal relationships with surgeons they sell to.

III. Industry Analysis

Stryker operates primarily within the Medical Instrument and Supply Manufacturing industry. The industry is characterized by the development, manufacture, and sale of medical and surgical equipment.

The industry has been largely resistant to the effects of economic downturn. Industry revenues have experienced consistent growth for nearly a decade and are expected to grow another 5.1% in 2014 to $96.4 billion. Beyond that, revenues are expected to grow at an average annual rate of 2.5% from 2014 to 2019.

Several important industry trends and factors spell optimism for the industry. Firstly, key demographic trends will likely increase demand for medical products and services. The number of adults age 65 or older should see an increase as the result of aging baby boomers. Older adults are more likely to need medical attention and devices such as joint replacement surgeries. The same can be said for the obese. Growing obesity rates should provide another boost to demand. Secondly, healthcare reform has made health insurance more affordable and widely available. As more previously uninsured adults become insured, they will have a greater ability to pay for health care services, increasing overall demand within the industry. Lastly, industry consolidation should positively affect profit margins. The number of companies operating in the industry is expected to decrease at an average annual rate of 1.4% over the next five years. Consolidation allows companies to spread fixed costs across larger product portfolios and across different markets. It also provides key advantages such as greater economies of scale, valuable strategic relationships, wider knowledge base, access to more patents and innovations, greater pricing and negotiating power and larger research and development budgets.

Although there are a number of competitors in all business segments that Stryker operates in, the overall level of competition within the industry is just medium. Significant barriers to entry and key competitive advantages allow established players to maintain market share and remain profitable. Firms within the industry also experience little from external sources. This is a result of the high level of specialization and expertise required to manufacture and sell medical devices and technologies. The most significant external competition is the result of advances in biotechnology, which offers other, often more effective and long lasting options.

Significant levels of government regulation acts as one of the major barriers to entry. It is difficult for new companies to cope with the amount of legislation regulating the specification and manufacturing of medical devices, as well as the intense testing required to gain approval. It is also very difficult for new firms to compete with established firms with large portfolios of patented products. In order to break into the industry, they would have to spend large amounts of capital in order to produce and market a new, innovative product that can compete. Even after doing so, the risk of product liability and patent infringement claims are of ongoing concern and could represent very high costs. Additionally, the manufacture of medical devices and supplies has such significant capital requirements that it acts as a deterrent to new potential competitors.

An overall contraction of profits within the industry are expected. This is due mostly to the 2.3% excise tax imposed by the Affordable Care Act on all medical device sales as well as more price erosion than in the past. This is largely offset, however, by the diverse product portfolios of most of the industry players as well as high profit margins on high-tech products. Profit margins will also benefit from industry consolidation- currently a prevalent trend within the industry.

Investment in Research and Development (R&D) will be a key driver of the success of companies in the industry. The industry is highly reliant on product innovation, substantial investment in R&D is a necessity for companies to remain competitive. Although a necessary expenditure, investment in R&D rarely results in immediate returns.

Appendix: Inputs into valuation using multiples

	2006 A	2007 A	2008 A	2009 A	2010 A	2011 A	2012 A	2013 A	2014 F	2015 F
Stock Price	55.11	66.97	42.24	51.92	57.56	55.43	62.65	77.60	94.00	99.00
Diluted EPS	1.89	2.44	2.78	2.77	3.19	3.45	3.39	2.63	3.19	3.35
Sales	5,406,000,000	6,001,000,000	6,718,000,000	6,723,000,000	7,320,000,000	8,307,000,000	8,657,000,000	9,021,000,000	9,319,000,000	9,645,000,000
Sales per share (diluted)	13.15	14.39	16.23	16.85	18.30	21.30	22.60	23.62	24.39	25.24
P/E	29.16	27.45	15.19	18.74	18.04	16.07	18.48	29.51	29.49	29.55
P/S	4.19	4.65	2.60	3.08	3.15	2.60	2.77	3.29	3.85	3.92

* *Analyst's own calculations. Source of basic data: company's 10-K; Yahoo! Finance*

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