Framework Investing ChartBook – Globus Medical (GMED)

Globus is no slouch, but hurdles exist before it can generate more value for its owners

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Three Things You Should Know About Globus Medical

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- **Without a large acquisition last year, revenues would have been flat.**

  Both of its product segments – Innovative Fusion and Disruptive Technology – saw steep fall-offs in revenues in 2016, even with the inclusion of $18 worth of revenues from Alphatec International. 2017 revenues will continue to be boosted by the acquisition, but the company will have to reenergize its product line-up to boost demand for its products if it is to create as much value for its owners as we have estimated it can.

- **Profitability last year was boosted last year by several factors, but don't expect this to last.**

  Our preferred measure of profitability, Owners' Cash Profits (OCP) showed a significant uptick in fiscal year 2016, but we believe this is an artifact of accounting conventions and is not sustainable long-term. We have estimated best- and worst-case profitability levels on the high side – close to those of much larger competitor Zimmer Biomet – but think that the firm will have to spend more on sales and marketing if it is to gain more of a foothold in this competitive business.

- **The firm is spending a lot on investments and its future is dependent on the success of this spending.**

  With Globus's sales growth starting to flag, the company must focus on developing and marketing differentiated, innovative, and uniquely efficacious spinal treatment products that will be recognized as outstanding in the industry.

  As for any small, young company, Globus's value will be determined by how great the demand is for its products and how quickly it can develop the scale required to get its products to market. Growth of cash flows several years down the line is key, and this growth cannot occur without the company making sound investments right now.

Valuation Summary

Globus Medical must reinvigorate its flagging top-line in a way that is not value destructive to its owners (i.e., it must be careful not to overspend on acquisitions and invest in value-creative development projects).

We believe that the firm can generate from $955 million to $1 billion in revenues in five years' time (compared to $564 million in 2016) and generate profits for its owners totaling from 15% to 20% of that. The firm is spending heavily on investments – as it should at this stage of its economic life – so we believe that it will be able to generate free cash flows to its owners of about $0.10 for each dollar of revenues it generates in five years.

As a young firm, Globus has the potential to grow very quickly in the medium-term and to have a medium-term period that extends for a relatively long time. We have set the medium-term period to 10 years and forecast a growth in cash flows of between 10% and 25% per year during this entire time. We consider this assumption to be aggressive.

We assume a long-term cash flow growth rate of 5% and use a discount rate of 12%, due to its market capitalization.

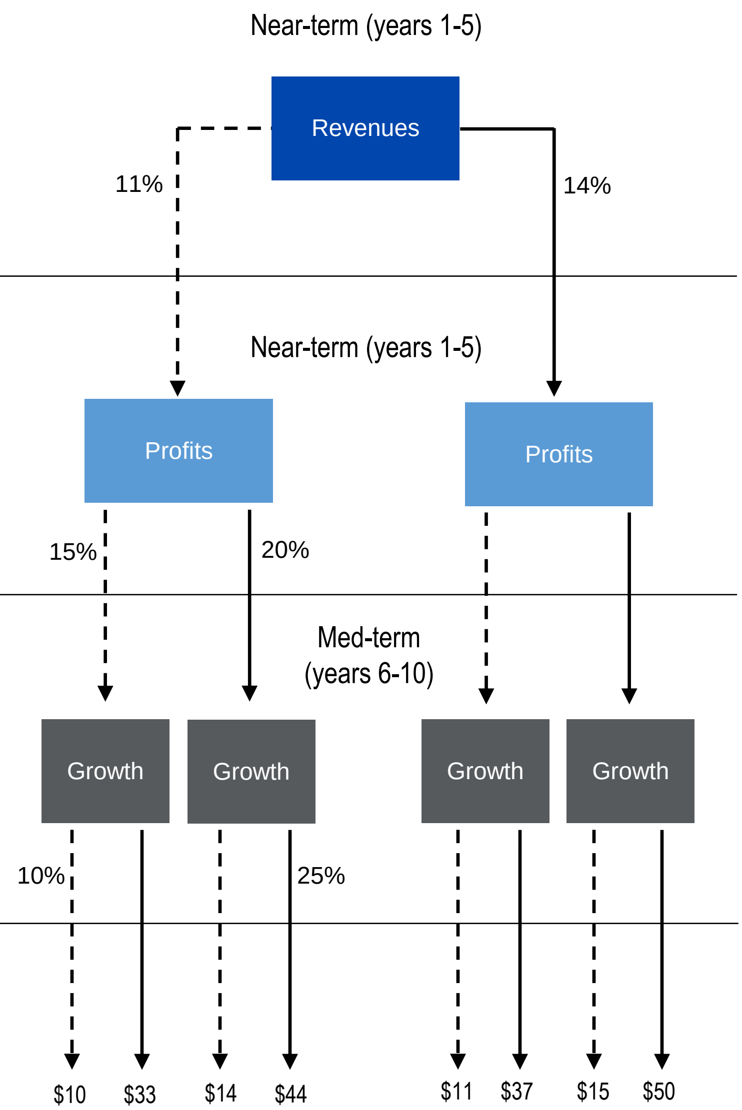
Valuation Waterfall

Revenue Growth
The best- and worst-case estimates listed here include eight more months of Alphatec International's revenues, followed by best-case growth of 11% per year and of 9% per year in the worst case. Globus's 2016 organic revenues grow at less than half the pace of our worst-case assumption, so our assumptions regarding future revenue growth rate are aggressive.

Profitability
The firm's profit margins have averaged around 17% since 2010. Larger competitor, Zimmer Biomet, generates similar margins, so we have chosen 15% and 20% as worst- and best-case forecasts, respectively. We have fairly high confidence in this driver's forecast.

Medium-Term Cash Flow Growth
It is not an exaggeration to say that Globus's value will be determined by how quickly it can generate cash flow growth during its medium-term period (which we assume will last for 10 years starting in 2022). Only 10% of the firm's value is generated by our assumptions for its short-term success. To generate value for its shareholders, its investments must generate significant increases in demand for its products. We believe the best-case assumption to be aggressive.

Fair Value Range
The dependence on medium-term growth is obvious here. Note that each of the values associated with solid lines (fast medium-term growth) are high and vice versa. The range extends from $10 per share to $50 per share and five of the eight valuation scenarios are lower than today's closing price. We are relatively uncertain about our valuation, so have not marked any scenarios as likely.



Methodology

Framework Investing analyses focus on three main valuation drivers: revenue growth, profitability, and medium-term cash flow growth. We estimate a best- and worst-case scenario for each of these drivers resulting in a total of $2^3 = 8$ fair value scenarios based on discounted cash flow methodology. Profitability is measured by Owners' Cash Profit (OCP) margin. We use a discount rate of 10% for large capitalization stocks.

A wide spread of lowest and highest fair values indicates a firm whose value is uncertain. Risk depends on the stock price's relationship to the valuation range.

Best-case scenarios are represented with a solid line; worst-case scenarios, with a dotted one.

Valuation Scenario Overview

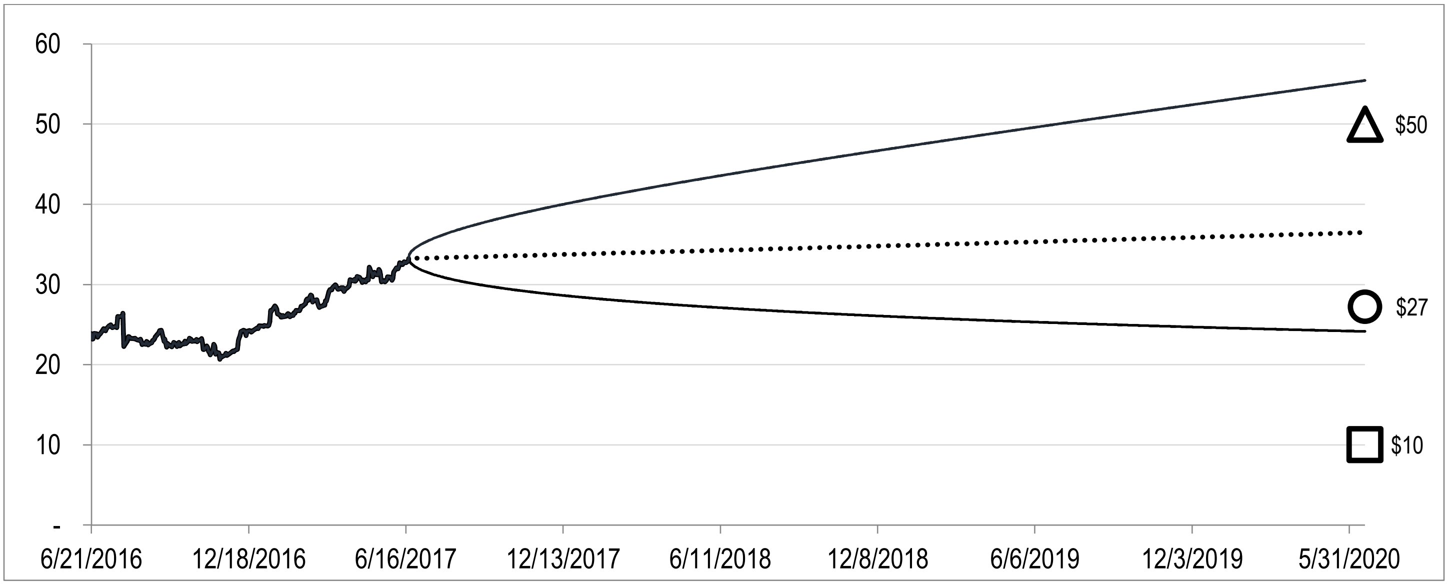


Figure 1. Source: YCharts, CBOE, FWI Analysis. Geometrical markers show FWI's best-case (triangle), worst-case (square), and equally-weighted average value (circle). Cone-shaped region indicates option market's projection of the company's future stock price.

	FWI Best Case	FWI Worst Case	Historical Median
Year 1-5 Average Revenue Growth	14%	11%	13% (5 & 10-year)
Year 1-5 Average Profitability	20%	15%	17% (5 & 10-year)
Year 6-20 Cash Flow Growth	25%	10%	21%

We have not recommended a stock or option position in this ChartBook due to the very large degree of valuation uncertainty to this company. However, on the basis of the figure above, we think the shares are likely relatively overvalued today.

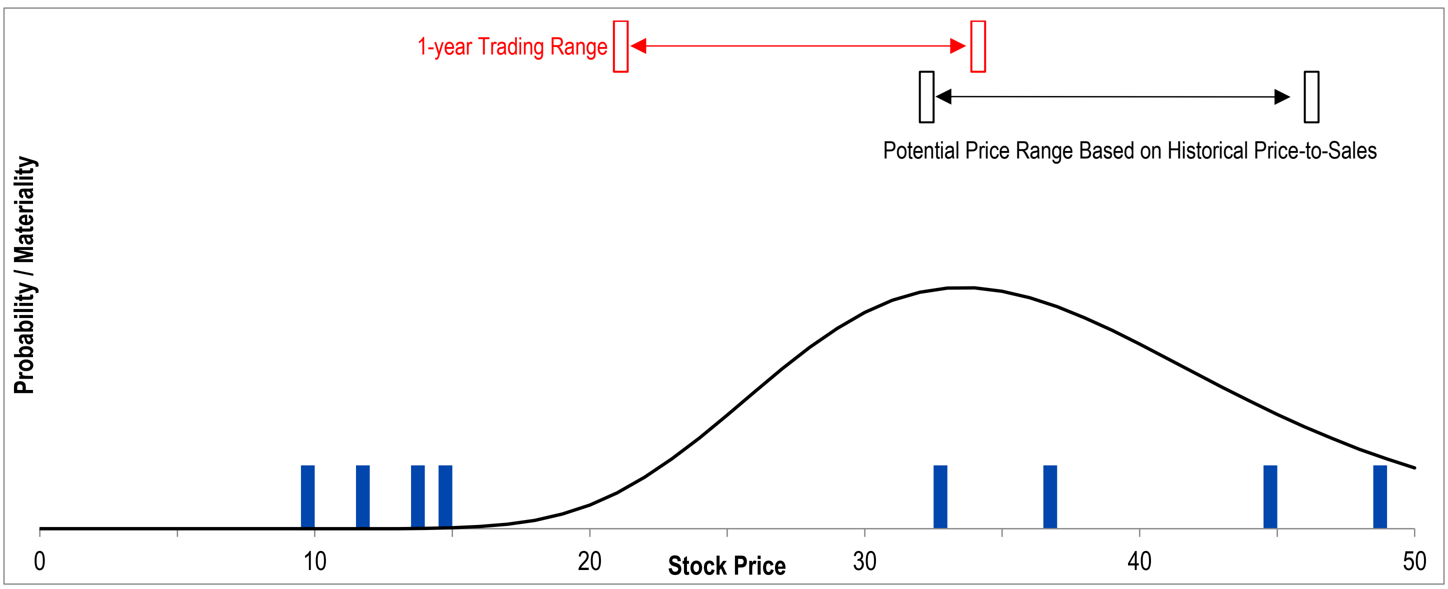


Figure 2. Source: CBOE, FWI Analysis

All four valuation scenarios in the teens (and below) are associated with slow medium-term cash flow growth. Given the tepid pace of growth in its Innovative Fusion segment and the flagging growth in its Disruptive Technology segment, we believe that without a truly ground-breaking product, slower growth scenarios are more likely for Globus. Please see the Revenue Growth commentary in the Valuation Drivers section below.

Valuation Drivers

Revenue Growth

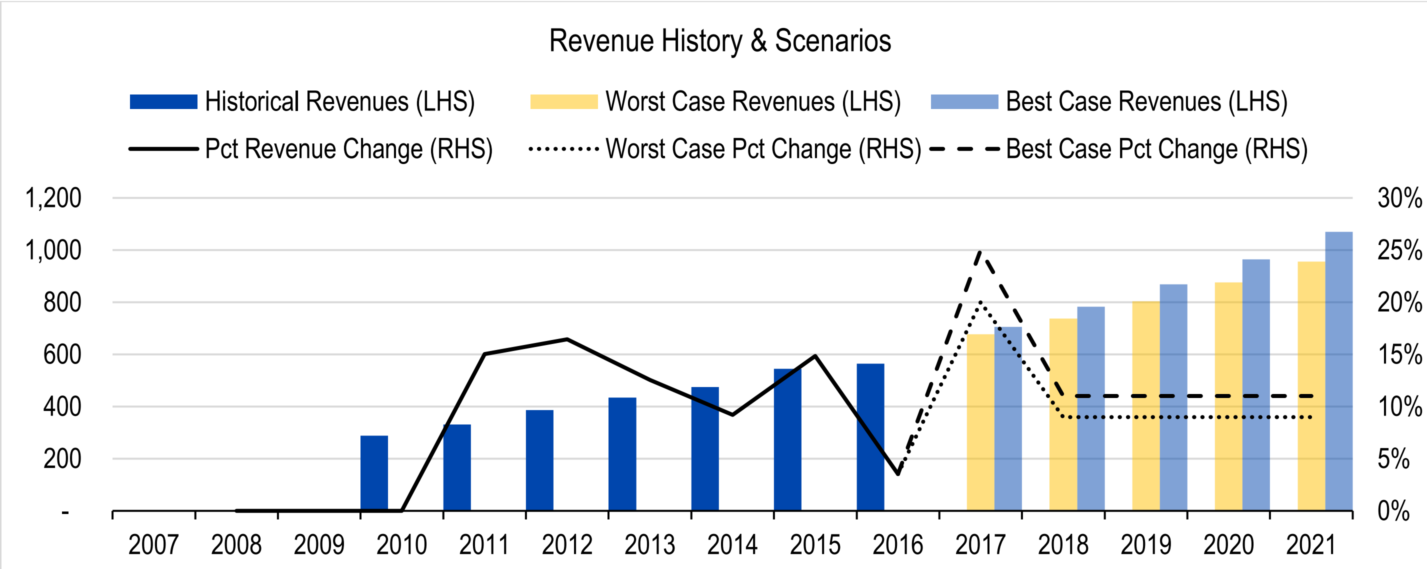


Figure 3. Source: Company Statements, Framework Investing Analysis

The bump in 2017 is influenced by the September 1, 2016 acquisition of Alphatec International, the international operations and distribution business of Alphatec Holdings (ATEC). As shown below, the revenue bump of this was just shy of $20 million for a four-month period. Our best- and worst-case estimate build in an increase in 2017 revenues of $60 million due to Alphatec and an increase in Globus Medical's legacy products.

While we are building an increase for Globus's legacy business into our model, it looks as though substantively all of Globus's revenue growth in 2016 came from the Alphatec acquisition. See the excerpts from Globus's 2016 annual report here:

> *Internationally, the increase in sales of $17.2 million [in 2016] was primarily due to incremental sales from the Alphatec International acquisition. On a constant currency basis, our international sales grew $18.8 million, or by 40.4%, due to expansion into new international territories.*
>
> 2016 10-K, p. 56

> *Net sales contributed by Alphatec International from the acquisition date through December 31, 2016 were $18.6 million while earnings were break-even*
>
> 2016 10-K, p. 88

2015 Revenues came in at $545 million and 2016 were $564, suggesting that if Alphatec's $19 million worth of revenues had not been acquired, Globus's legacy revenues would have fallen by around $10 million. International sales increased by $17 million in 2016 over 2015, and considering the information in the quotes above, all this growth must be associated with the Alphatec acquisition.

Globus has two segments, Innovative Fusion and Disruptive Technology. The former is a more mature business, with sales typically in the mid-single digit percentage range (see figure on next page).

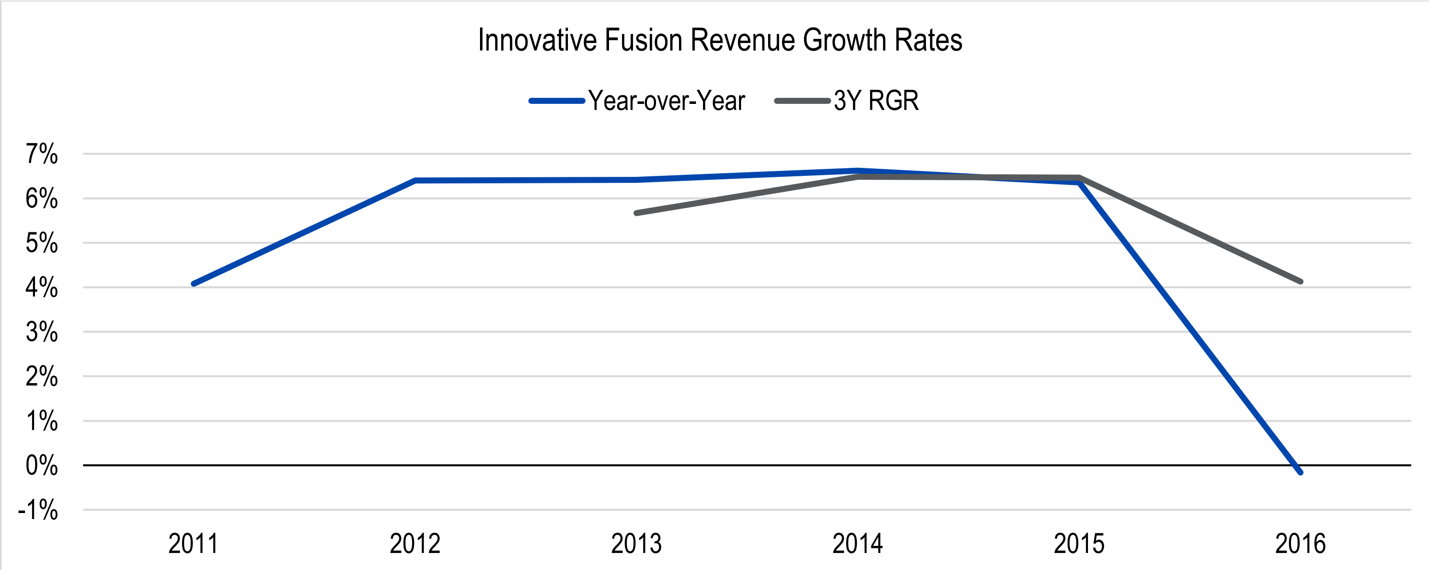


Figure 4. Source: Company Statements, Framework Investing Analysis

The severe drop-off in Innovative Fusion in 2016 is shocking, because according to page 7 of the annual report:

> *Our Innovative Fusion products also include the Alphatec products we began distributing following the Alphatec International Transaction.*

In other words, even with the inclusion of Alphatec's line, revenues in the Innovative Fusion business still contracted in 2016.

Disruptive Technology includes a portfolio and pipeline of "expandable cages, MIS, motion preservation, and regenerative biologics technologies" (2016 10-K, p. 7). It's revenue growth has been consistently much higher than Innovative Fusion, but in 2016, also slipped into the high-single digit percentage change range.

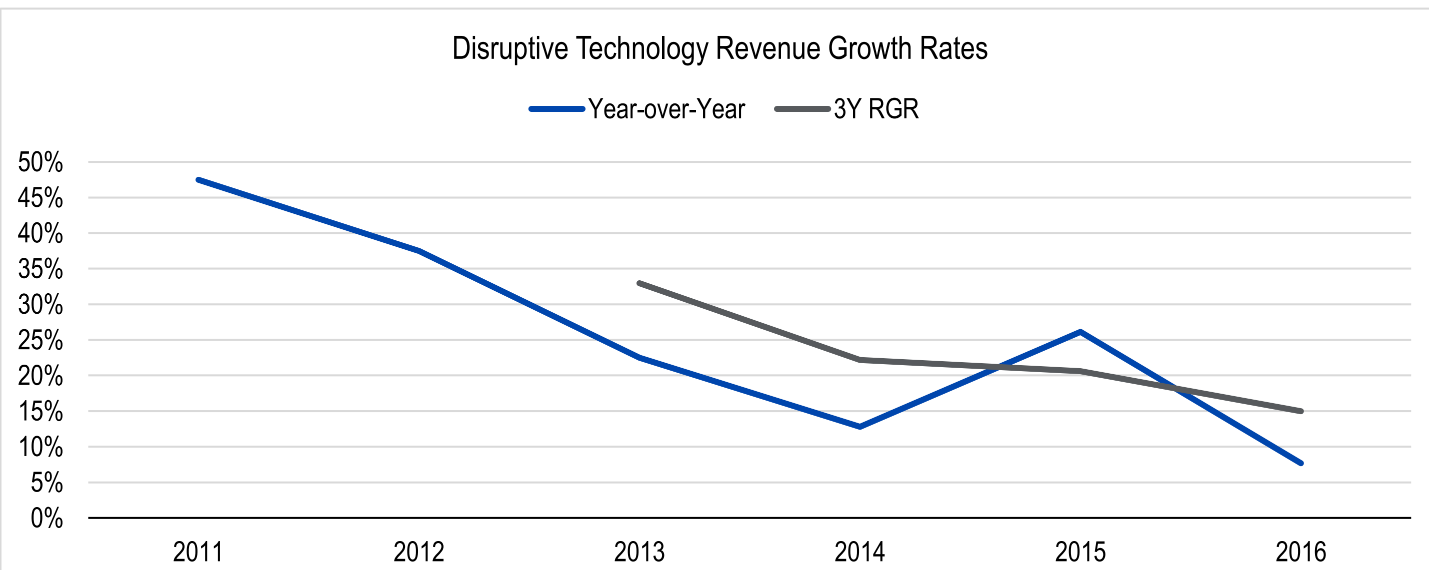


Figure 5. Source: Company Statements, Framework Investing Analysis

We do not have the background in this field necessary to judge whether Globus's spinal devices are more efficacious or otherwise desirable than those by Medtronic or DePuy Synthes, so it is difficult to make revenue projections on anything other than historical trends. What we understand about the industry is that relationship with healthcare providers tend to be fairly sticky, so large upticks in revenues are relatively rare once a certain threshold has been reached. We wonder if Globus is starting to reach that threshold now.

Profitability

Note that we assess profitability using our favored measure – Owners' Cash Profits (OCP) – a measure similar to Buffett's concept of "Shareholder Earnings."

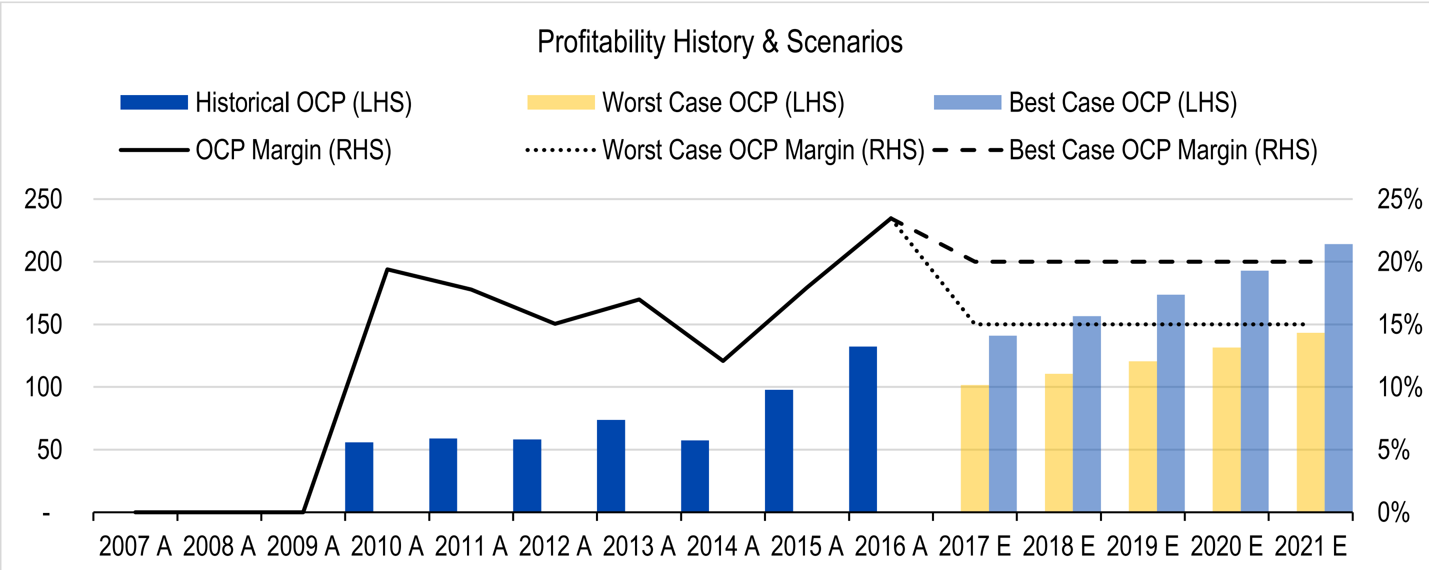


Figure 6. Source: Company Statements, FWI Analysis

The large jump in profitability in 2016 is partially an artifact of how we calculate Owners' Cash Profits, which is based on cash flows and can be slightly more volatile in any single year. The biggest drivers of the OCP increase in 2016 were write-downs in obsolete inventories, impairment of intangible assets, a release of restricted cash, and an increase in income taxes payable, combined with a much smaller build of inventories.

We believe that these factors counted for the entirety of the $34 million jump in OCP last year and offset the drop in 2014. We do not consider these factors to be durable sources of wealth for the company's shareholders.

Investment Level

[Expansionary Cash Flow](#) is FWI's measure of investment spending net of asset sales and divestments.

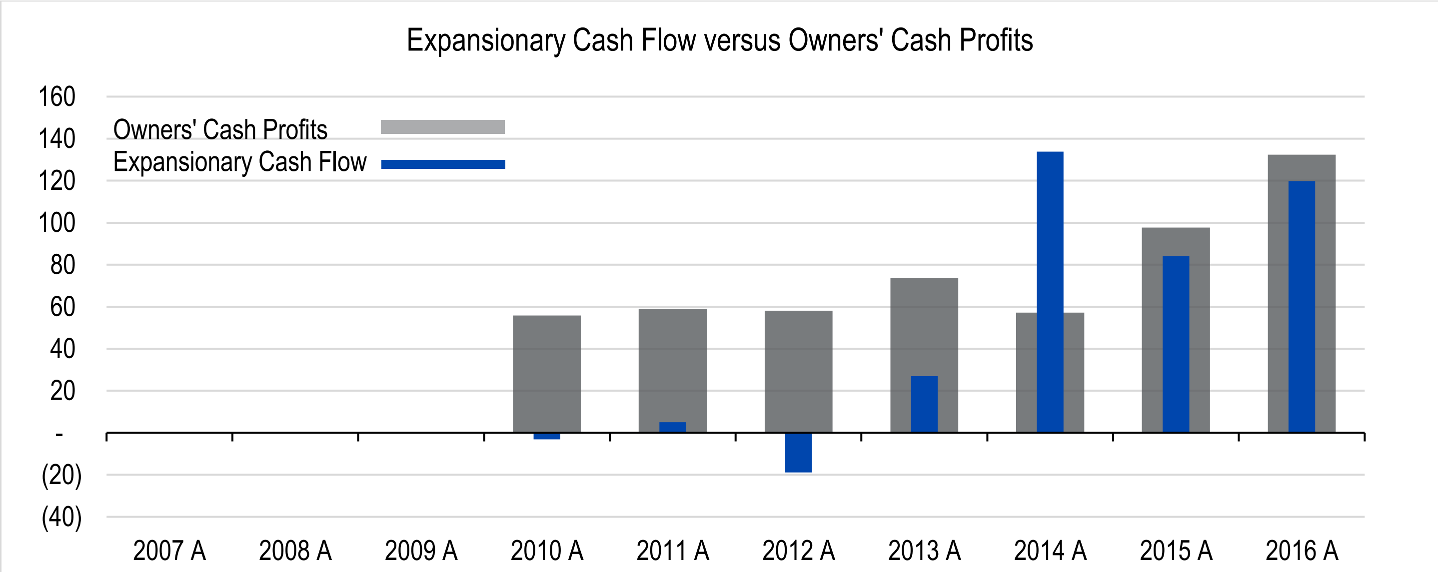


Figure 7. Source: Company Statements, FWI Analysis

Over the last three years, the firm has spent heavily on investment projects. We have modeled an average of 100% of profits spent on investment projects in the next two years, followed by two years of 70% investments as a percentage of profits, ending with a ratio of 50% in year five.

For a young firm like Globus, this assumption is very difficult to forecast accurately. However, even pulling the investment level of years 1-4 of our forecast period to a flat 70% and finishing with 50% in year five adds only one dollar to our best-case valuation and to the weighted average valuation scenario.

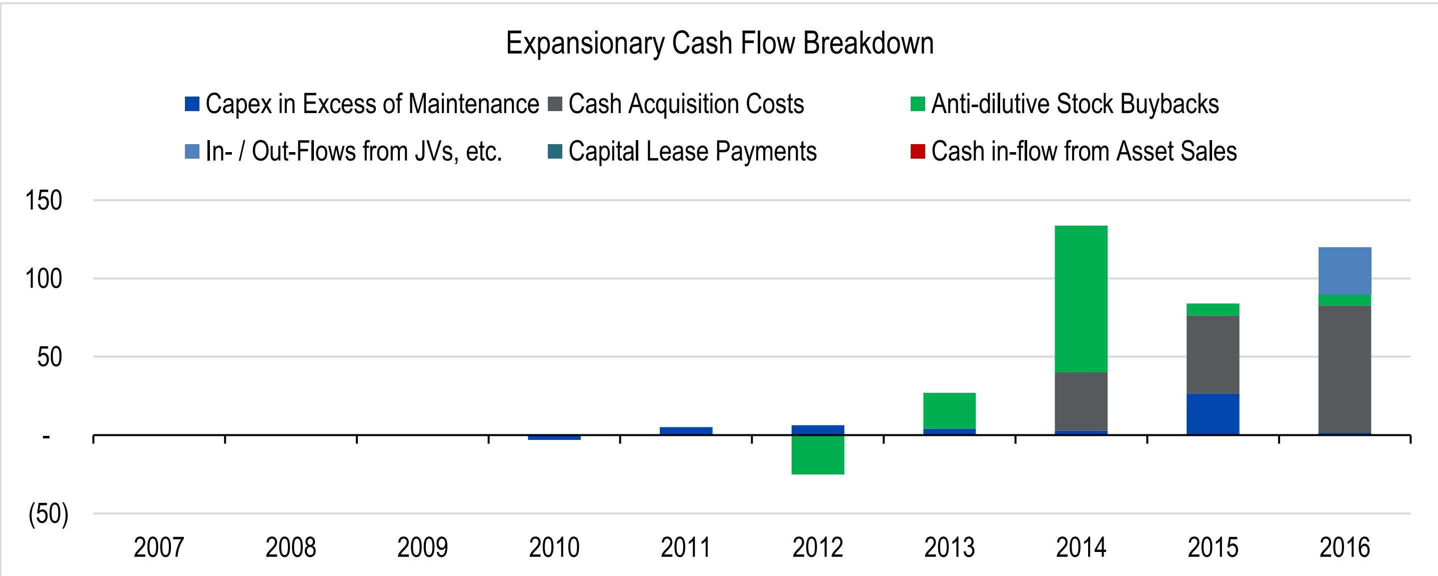


Figure 8. Source: Company Statements, FWI Analysis.

The very large uptick in investment spending in 2014 was due to a conversion of Class B common stock to Class A and to the exercise of 1.2 million stock options; the amount shown above ($94 million) calculates the cash value of those dilution events based on the average price of the stock during that year.

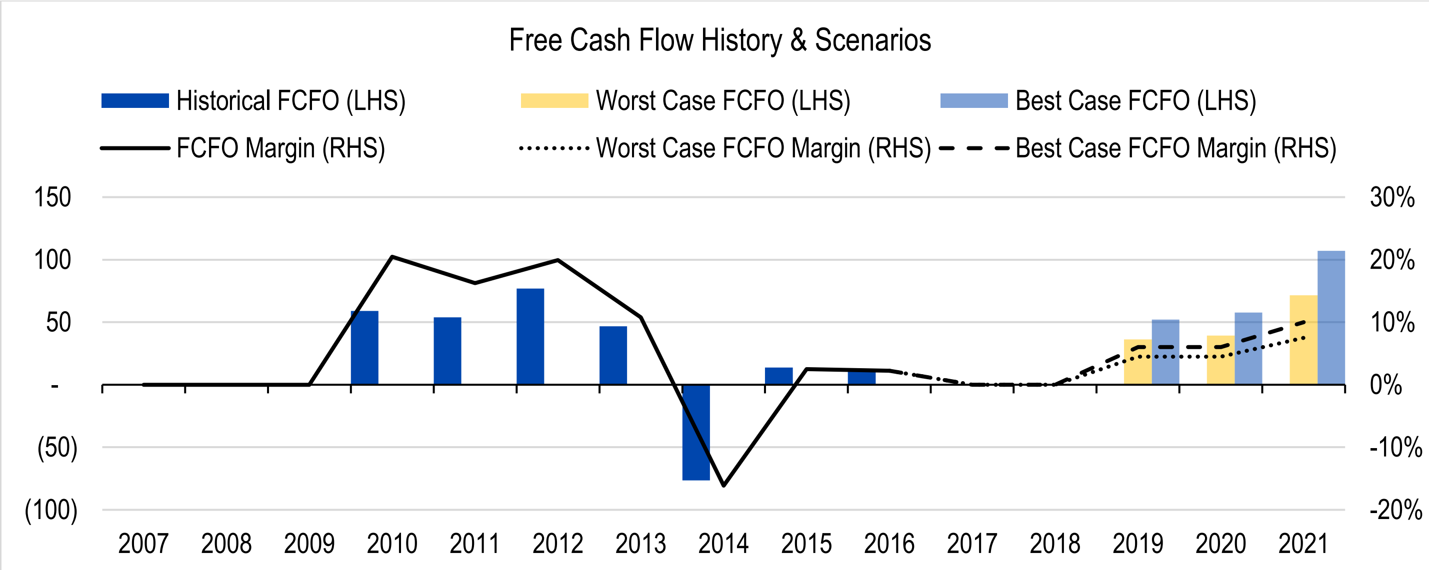


Figure 9. Source: Company Statements, FWI Analysis

Assumptions regarding profitability and investment spending allow us to calculate the measure on which we base the value of the firm: Free Cash Flow to Owners (FCFO). In the fifth year of our Explicit Forecast period, we project the company will generate between $0.075 and $0.10 worth of FCFO for every dollar of revenue generated.

Our best-case assumption generates aggregate FCFO over the Explicit Period of $217 million and our worst-case assumption, one of $147 million. In contrast, the aggregate FCFO in the seven years between 2010 and 2016 was $186 million.

Investment Efficacy

Corporate investments lead to profit growth. FWI measures profit growth versus the standard yardstick of nominal GDP growth to assess the efficacy of the company's past investments.

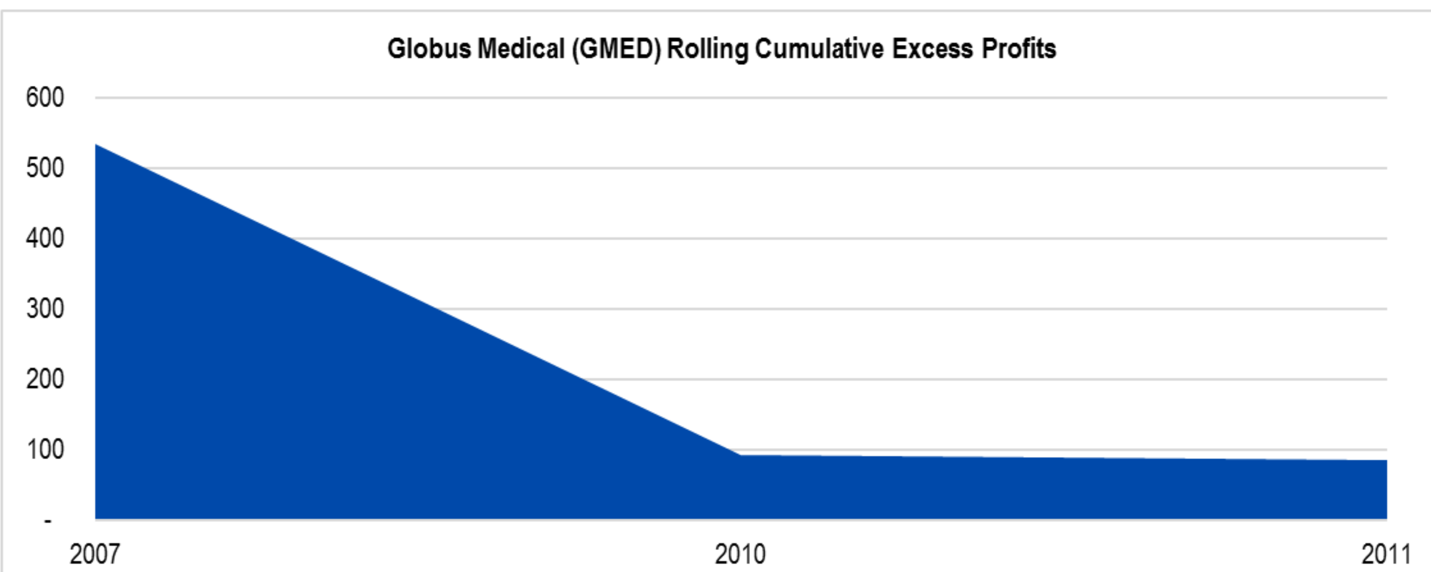


Figure 10. Source: Company Statements, FWI Analysis

The graph which we call the Rolling Cumulative Excess Profits view (explained fully in this post) shows the increase in profit growth outperformance as time goes on.

Globus has a short operational history, so this graph is not terribly helpful. We believe Globus's business will continue to be successful to the extent that the investments it has made in developing new products generates a significant increase in revenues. So far, we do not see this in the data, but we are willing to give Globus the benefit of the doubt and build in a 10-year medium-term growth period that sees cash flows increasing by 25% per year in the best case and 10% per year in the worst.

Valuation

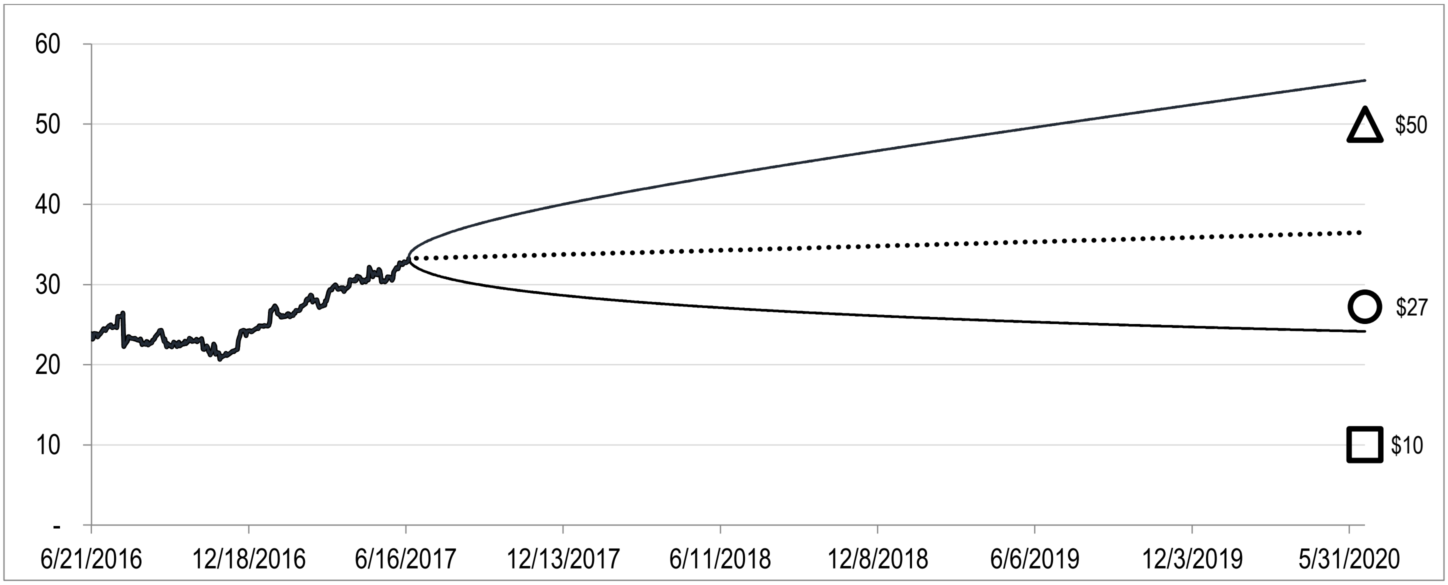


Figure 11. Source: Company Statements, FWI Analysis

The operational assumptions combine to create the valuation range shown above: $50 per share in the best-case and $10 per share in the worst-case.

In contrast, the option market forecasts a future stock price of roughly $55 per share on the upside and roughly $25 per share on the downside.

Our best-case valuation is in line with the option market price projection, but our worst-case valuation is significantly lower than the level the option market prices in as likely. There is an enormous amount of valuation uncertainty related to this company, but those wishing to make a speculative investment on the downside should consider purchasing Out-of-the-Money (OTM) put options.

The one factor that this valuation analysis leaves out is the possibility that Globus management might be building a product pipeline in the hope that the firm will be acquired by a larger maker such as Medtronic or Johnson & Johnson. If this is the case, the problem becomes not one of "valuation" but of figuring out the likely price that a large buyer is likely willing to pay. This is a much more transitory analysis and depends on market multiples, the results of similar transactions, and general market mood.

In either case, we believe that Globus's number one concern should be producing innovative, patent-protected products that will serve an unmet need in the treatment of spinal conditions.