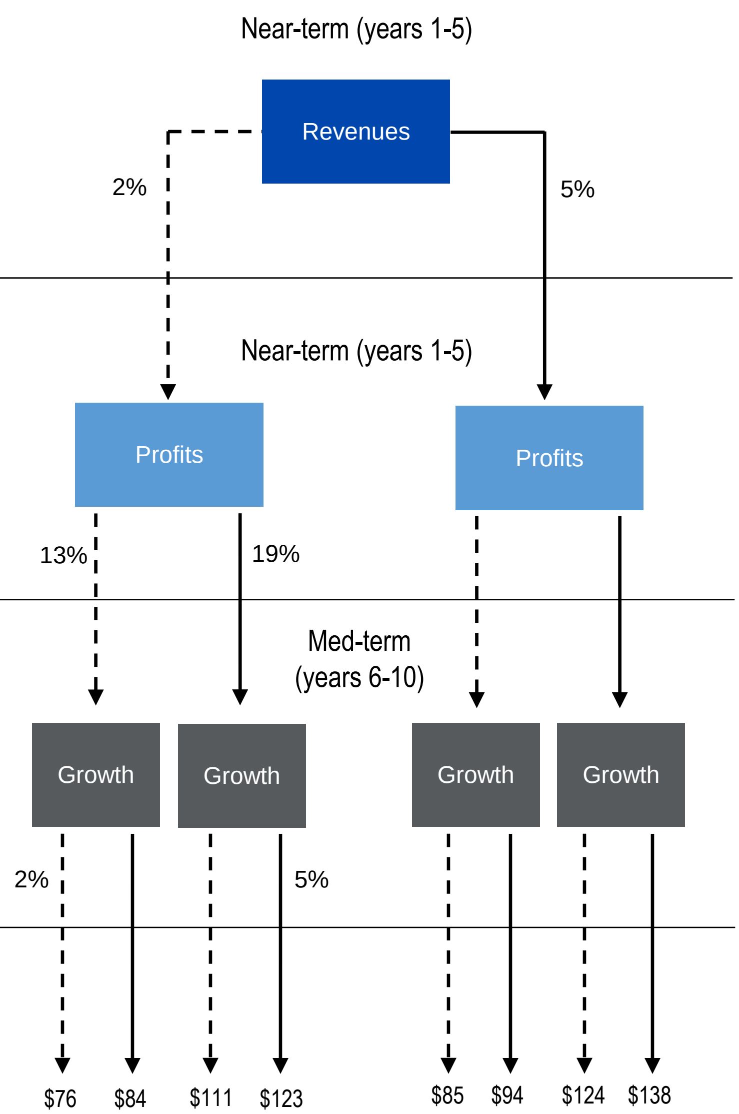
Valuation Waterfall



Revenue Growth
This is a market that is slow to change and is largely based on demographics. The quickest historical growth is around 5% per year over a five-year period. Recently, growth has been much more tepid – in the 0%-3% range. Considering the political issues surrounding healthcare in the US market, we think the worst-case scenario is likely better.

Profitability
Best-case scenario assumes a quick rebound to the best historical average (19% OCP margin) levels after the Biomet acquisition is digested. Worst-case scenario assumes that 10-year trend toward lower profitability is irreversible and project 13% average OCP margin. We think the high-profitability case is relatively more likely considering industry consolidation.

Medium-Term Cash Flow Growth
Historical investment efficacy has been low, but we think that industry consolidation and demographic tailwinds are likely to allow Zimmer's medium-term growth to improve. The biggest uncertainty is Medicare's future status. Our best-case assumption of 5% growth looks very quick compared to growth over the past 10 years. Worst-case scenario (2%) is closer to historical growth rates.

Fair Value Range
Our fair value range extends from $76 to $138 / share with an equally-weighted average value of $104 / share. Following the worst-case Revenue + best-case Profit path, we get a range between $111 and $123 – quite close to where the shares are now trading. This valuation has some uncertainty centered around the "normalized" level of capital expenditures required to maintain and expand the firm's profits.

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.