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# IDEXX Labs

# Neutral

August 1, 2007

IDXX - \$101

Market Cap: \$3.2 billion



## Company Description:

IDEXX Labs is the dominant provider of in-clinic diagnostic tests for pets and farm animals. Demand for the company's products grows steadily as people grow accustomed to paying premium prices for health care for their companion animals. A small but profitable division focuses on water testing. IDEXX is benefiting from a series of new product introductions, which are accelerating revenue and boosting earnings growth.

## Operating & Financial Highlights

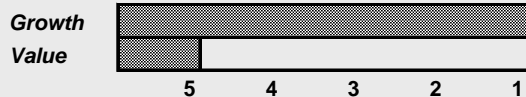
(\$ Millions, Adjusted for Certain Items)

|                   | 2007F  | 2008F  | 2009F  | 2010F  |
|-------------------|--------|--------|--------|--------|
| Sales             | 904    | 1,044  | 1,193  | 1,343  |
| Operating Income  | 152    | 185    | 220    | 257    |
| Diluted Shares    | 32     | 33     | 34     | 34     |
| EPS               | \$3.14 | \$3.75 | \$4.35 | \$5.05 |
| EPS (ex. 123R)    | \$3.41 | \$4.02 | \$4.62 | \$5.32 |
| P/E               | 32     | 27     | 23     | 20     |
| Operating Margins | 17%    | 18%    | 18%    | 19%    |
| Capital Employed  | 472    | 489    | 531    | 561    |
| Pretax ROCE       | 32%    | 38%    | 41%    | 46%    |
| Pretax ROTCE      | 32%    | 38%    | 41%    | 46%    |

## 2007 Estimated Quarterly Results

|                | Q1     | Q2     | Q3F    | Q4F    |
|----------------|--------|--------|--------|--------|
| Sales          | 211    | 237    | 222    | 234    |
| EPS            | \$0.65 | \$0.89 | \$0.77 | \$0.84 |
| EPS (ex. 123R) | \$0.72 | \$0.96 | \$0.84 | \$0.89 |

## GARP's Quintile Ranking System



IDXX scores in GARP's most attractive growth quintile and least attractive valuation quintile. See disclaimer for additional information.

## Summary Points

### Growth:

- Core products grow consistently at mid-single-digit rates as people spend more money on their pets' health care.
- New product introductions in diagnostics support accelerated revenue and earnings growth above the firm's historical trend.

### Quality:

- Leading provider of in-clinic diagnostic tests for pets and farm animals.
- High gross margins; modest capital employed is required.
- Clean balance sheet and strong cash flow generation.

### Control of Risk:

- The stock has doubled the past three years and is now trading at 20x our 2010 EPS forecast of \$5.05.

## Recent Developments

IDEXX had very strong quarter in 2Q07, with revenues up 24% (9% due to acquisitions, 2% to FX, and 12% organically). Within the Companion Animal Group segment, all major business categories returned organic growth in the teens. Instruments & Consumables (30% of company revenue) and Laboratory & Consulting Services (28% of company revenue) businesses turned in organic growth of 16%, compared to a healthy prior-year quarter. Organic growth in the Water Testing segment was 13%; only the Production Animal segment stayed in single digits (9%). Customers continue to accept the *VetLab Station* into their practices. With 800 units sold in the quarter, the installed base has risen to about 3,500. The *pro forma* gross margin of 52.7% was 90 basis points higher than last year's and is expected to end the year near the 52% mark. *Pro forma* EPS of 89¢ was up 22%, due mainly to higher revenue at steady margins, supplemented by modest share repurchases and a slightly lower tax rate for the quarter. The upcoming launches of three new instrument platforms—*Coag DX* (4Q07), *Catalyst DX* (1Q08), and *SNAPSHOT DX* (1Q08) remain on target. For 2007, management raised its revenue forecast to the \$900 million to \$905 million range, reflecting the brisk pace of instrument placement and continued strength in other major product lines. After *pro forma* adjustments, EPS are now expected fall within a range of \$3.11 to \$3.16, including 11¢ to 12¢ of dilution from recent acquisitions.

## Recommendation Rationale

IDEXX Labs is the dominant provider of in-clinic diagnostic tests for pets and farm animals. IDEXX has the leading brand name in diagnostics, and demands exclusivity from all the third-party vet clinic distributors that wish to carry its products. This contributes to the greater than 50% market share that the company enjoys in almost all its major product categories. The firm's core business has consistently grown at around a 6% annual rate, in line with increases in the dog and cat population over the past decade. Recently, management has begun introducing new products that are accelerating sales growth into the double digits. First, IDEXX has developed *LaserCyte*, an advanced benchtop hematology system that provides vets with sophisticated test results at their clinics. We estimate instrument and consumable sales associated with this system will produce over \$70 million of annual sales by 2009. IDEXX is also developing a next-generation chemistry system called *Catalyst DX*, which is to be released in January 2008. We note that this system should be an even larger growth driver than *LaserCyte*, because IDEXX's current chemistry system accounts for the majority of its installed base and consumables. *Catalyst DX* is designed for ease of use and rapid turnaround; it is able to process a 'stat' chemistry test in 8 minutes, and can run samples from three different animals within 15 minutes. We believe that upgrades from the current installed base will be brisk. However, management's track record for keeping to a launch schedule and ironing out performance bugs in the beta-test phase is less than perfect. IDEXX's new veterinary pharmaceutical products have run into stiff competition from established brands, and the adoption of *HerdChek*, a new BSE ("mad cow" disease) diagnostic, has been slow. This latter product could still make headway in Europe against the lead test product, produced by competitor Bio-Rad Laboratories. Should the USDA change its policies and permit more widespread testing of cattle, a large market would quickly open. However, even when meaningful contributions from these "wild cards" are factored in, the stock is trading at 20x our 2010 EPS estimate, excluding net cash per share. We maintain our Neutral rating on IDXX due to valuation, despite the company's strong fundamentals.

## Operations

IDEXX enjoys high gross margins and employs little capital. In 2006, the company produced \$120 million of operating profit from a base of only \$320 million of capital, which generated a pre-tax return of 40%. IDEXX operates three business segments. The Companion Animal Group (CAG) includes all of IDEXX's diagnostic products and services for pets, mainly dogs and cats. In 2006, the CAG accounted for 82% of IDEXX's sales and roughly three-quarters of operating profits. Nearly 30% of CAG sales come from consumables used by IDEXX's line of in-clinic chemistry and hematology instruments. Growth has picked up due to the introduction of the advanced hematology instrument *LaserCyte*, which is modeled on the sophisticated flow cytometers used in hospitals to characterize blood disorders and immune status. We estimate that *LaserCyte* generated about \$30 million of sales in 2006. The new *Catalyst DX* chemistry platform is scheduled to launch in January 2008. It should be a larger stimulus to earnings, as a chemistry analyzer in a busy clinic will use many times more consumables than will a hematology machine. Another 20% of CAG sales came from test kits—handheld, disposable devices that vets use to check for such conditions as heartworm and Lyme disease. These products are very profitable, and sales typically grow in the high single-digits annually. IDEXX runs a number of reference labs, which contribute another 30% of segment sales, and are used when vets need to perform complex or 'esoteric' tests, such as for animals that are severely ill or are about to go into surgery.

IDEXX's second business segment, Water Testing, chipped in 8% of total revenues in 2006 while contributing 20% of operating profit. Most Water Testing products are disposable culture tests and immunochemical tests that identify and quantitate potentially hazardous microorganisms. The best-known of these are fecal coliform (e. coli associated with human waste), *Cryptosporidium*, and *Giardia*. Sales have been growing in the low double-digits, as IDEXX's product has been gaining market share from older, more labor-intensive testing methods.

The company's Production Animal Group (formerly called the Food and Environmental Division), was 10% of sales and about 8% of operating profit in 2006. The focus of this sector is the marketing of diagnostic tests to farmers for testing dairy cows and other livestock. Most of these products are mature. However, we note that *HerdChek*, IDEXX's diagnostic test for Bovine Spongiform Encephalopathy (BSE or mad cow disease), has the potential to grow into a large opportunity. *HerdChek* is one of the few BSE tests that has been approved by the USDA, but at present, only federal and state laboratories may test for BSE. Paradoxically, the USDA and cattle ranchers are concerned that widespread testing and labeling of beef as "shown free of BSE" would *decrease* consumer confidence in the safety of the meat supply as a whole. The European Union, where testing is already in general use, approved *HerdChek* in 2005. Although the test has technical characteristics that are superior to competitors, adoption has been slow. We believe that the test did not meet all of the RFP conditions in certain key countries. *HerdChek* generated \$11 million in sales worldwide in 2006; 2007 sales are projected as \$15 million.

## Competition

IDEXX has dominant market share in nearly all of its major product segments. The company has the leading brand name in the small animal diagnostics industry, and it demands exclusivity from each of its third-party distributors, which collectively account for a large majority of the market. We estimate that IDEXX controls about 80% of the in-clinic instrument system sector, and about 70% of the market for handheld test kits. Other players include Heska, Abaxis, and Synbiotics. However, IDEXX does not have the leading market share in veterinary reference labs, where it competes with VCA Antec. The reference lab market is regional in nature, and IDEXX is the dominant provider in those areas where it has locations, such as Northern California and Texas. In the BSE diagnostic market, the company goes head-to-head with Bio-Rad Labs, which controls about 60% of sales. We feel that IDEXX may make inroads gain share against Bio-Rad and other competing solutions, for *HerdChek* eliminates several time-consuming sample preparation steps and it is at least twice as sensitive in detecting the causative agent in brain lysates.

## Market

As people in North America and the rest of the developed world delay marriage and put off having kids, companion animals have become increasingly popular. About 63% of American households—71 million--include at least one pet, a figure that has grown 11% in five years. We estimate that there are over 140 million dogs and cats in the US, and this number has increased steadily at an annual rate of about 5% since 1994. Additionally, spending on pets has outpaced the increase in their population. In the U.S., 2007 spending on pets is estimated at \$41 billion, a figure that may rise to \$52 billion by 2009. While large portions are devoted to food, grooming products, and toys, increasing amounts are being spent on health care. Veterinary care measured about \$10 billion; we believe that diagnostics accounted for close to 10% of that total. In our opinion, diagnostics will continue to rise at a high single-digit rate. In the BSE diagnostic market, we note that about 15 million cattle are tested worldwide. However, pricing pressures have pushed this market's size below \$100 million in recent years. The areas where BSE is of greatest concern are food-conscious Europe and Japan, where testing of beef cows at slaughter is required. Concern over the British experience and the negative publicity that ensued each time a sporadic case was detected in the U.S. or Canada led to a modest program of random testing in 2004, the first systematic attempt to look beyond "downer" cows. During the government's FY05 and FY06, some 350,000 cows a year were tested. With only two cases discovered by the program, the USDA declared that the problem was minor, and announced that it would scale back the program to a total of 40,000 cows per year. Cattlemen are unhappy that they are unable to tap export markets with "certified BSE-free" American beef. However, we doubt that the USDA will budge, in the absence of a fresh outbreak, or other new grounds for concern.

## Risks

IDEXX enjoys high profitability, has dominant market share in its main product areas, generates substantial cash, and has a clean balance sheet. Many of the risks associated with IDEXX are company-specific. The firm has encountered problems with getting timely approval for new animal drugs from the FDA. The new products slated for rollout in late 2007 and 2008 could falter. Some investors expressed skepticism about the willingness of veterinarians to pay for IDEXX's *LaserCyte* hematology platform as it costs three times as much as the conventional systems it supplants. While these fears have subsided as *LaserCyte* has continued to penetrate its market, analogous worries may arise about the January 2008 launch of the *Catalyst DX* chemistry platform. We believe that the premium being awarded to IDEXX shares has factored in a material contribution from this product line. Thus, if significant delays, sluggish sales, or lower-than-expected margins become associated with the *Catalyst DX* launch, a notable drop in share price would be a likely result.

## IDEXX Labs

Fiscal Year Dec 31

## Operating &amp; Financial Highlights

(\$ Millions, Adjusted for Certain Items)

|                                     | 2003          | 2004          | 2005          | 2006           | 2007F          | 2008F          | 2009F          | 2010F          |
|-------------------------------------|---------------|---------------|---------------|----------------|----------------|----------------|----------------|----------------|
| Revenue                             | 476.0         | 549.2         | 638.1         | 739.1          | 904.0          | 1,044.0        | 1,193.0        | 1,343.0        |
| Operating Income                    | 86.2          | 108.0         | 115.4         | 128.0          | 152.0          | 185.0          | 220.0          | 257.0          |
| Net Income                          | 60.4          | 75.1          | 78.3          | 88.0           | 101.0          | 123.0          | 146.0          | 171.0          |
| Avg Shares Outstanding- Diluted     | 35.9          | 35.8          | 34.1          | 33.0           | 32.2           | 33.0           | 33.5           | 34.0           |
| <b>EPS - Diluted</b>                | <b>\$1.68</b> | <b>\$2.10</b> | <b>\$2.30</b> | <b>\$2.67</b>  | <b>\$3.14</b>  | <b>\$3.75</b>  | <b>\$4.35</b>  | <b>\$5.05</b>  |
| <b>Diluted EPS Without FAS 123R</b> |               |               |               | <b>\$ 2.94</b> | <b>\$ 3.41</b> | <b>\$ 4.02</b> | <b>\$ 4.62</b> | <b>\$ 5.32</b> |
| <i>Capital Employed</i>             |               |               |               |                |                |                |                |                |
| Property Plant & Equipment          | 45.2          | 62.6          | 65.7          | 99.6           | 114.6          | 136.6          | 166.6          | 196.6          |
| Operating Working Capital           | 49.6          | 64.5          | 60.6          | 81.9           | 137.0          | 134.0          | 148.0          | 148.0          |
| Other / Intangibles                 | 98.3          | 134.6         | 110.5         | 138.8          | 220.0          | 218.0          | 216.0          | 216.0          |
| <b>total</b>                        | <b>193.1</b>  | <b>261.7</b>  | <b>236.8</b>  | <b>320.3</b>   | <b>471.6</b>   | <b>488.6</b>   | <b>530.6</b>   | <b>560.6</b>   |
| <i>Financing</i>                    |               |               |               |                |                |                |                |                |
| Debt                                | 0.5           | 1.3           | 0.6           | 7.1            | 81.5           | 46.5           | 21.5           | 21.5           |
| Shareholders Equity                 | 413.3         | 397.7         | 369.0         | 409.9          | 460.9          | 533.9          | 629.9          | 750.9          |
| (Less: Cash)                        | (220.7)       | (137.3)       | (132.8)       | (96.7)         | (70.8)         | (91.8)         | (120.8)        | (211.8)        |
| <b>total</b>                        | <b>193.1</b>  | <b>261.7</b>  | <b>236.8</b>  | <b>320.3</b>   | <b>471.6</b>   | <b>488.6</b>   | <b>530.6</b>   | <b>560.6</b>   |
| <i>Ratios (%)</i>                   |               |               |               |                |                |                |                |                |
| Operating Margin                    | 18.1%         | 19.7%         | 18.1%         | 17.3%          | 16.8%          | 17.7%          | 18.4%          | 19.1%          |
| Return on Capital Employed          | 44.6%         | 41.3%         | 48.7%         | 40.0%          | 32.2%          | 37.9%          | 41.5%          | 45.8%          |
| Return on Tangible Capital          | 65.7%         | 41.3%         | 48.7%         | 40.0%          | 32.2%          | 37.9%          | 41.5%          | 45.8%          |
| Shareholders Equity / Capital       | 214.0%        | 152.0%        | 155.8%        | 128.0%         | 97.7%          | 109.3%         | 118.7%         | 133.9%         |
| <i>Valuation</i>                    |               |               |               |                |                |                |                |                |
| Price Earnings Multiple             |               |               | <b>44.0</b>   | <b>37.8</b>    | <b>32.2</b>    | <b>26.9</b>    | <b>23.2</b>    | <b>20.0</b>    |
| <i>Segment Estimates</i>            |               |               |               |                |                |                |                |                |
| Revenue                             |               |               |               |                |                |                |                |                |
| Companion Animal Group              | 384.4         | 448.7         | 520.8         | 606.3          | 740.0          | 860.0          | 980.0          | 1,100.0        |
| Water Segment                       | 46.9          | 53.1          | 56.8          | 58.5           | 66.0           | 74.0           | 83.0           | 93.0           |
| Production Animal Segment           | 28.6          | 31.7          | 44.9          | 58.9           | 75.0           | 90.0           | 110.0          | 130.0          |
| Other                               | 16.1          | 15.7          | 15.6          | 15.4           | 23.0           | 20.0           | 20.0           | 20.0           |
| Misc./Corporate                     | 0.0           | 0.0           | 0.0           | (0.0)          | 0.0            | 0.0            | 0.0            | 0.0            |
| <b>total</b>                        | <b>476.0</b>  | <b>549.2</b>  | <b>638.1</b>  | <b>739.1</b>   | <b>904.0</b>   | <b>1,044.0</b> | <b>1,193.0</b> | <b>1,343.0</b> |

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Alastair Mackay

**Price Chart and Recommendation History as of August 1, 2007**

