



Equity Research

October 30, 2008

Q4 2008 HME Sleep & Wound Care Survey

Sector Rating: Orthopedics, Overweight
Sector Rating: Respiratory, Market Weight

Company Name	Stock Rating	Price 10/30/08	FY EPS 2008E	FY EPS 2009E	FY P/E 2008	FY P/E 2009
Orthopedics Kinetic Concepts, Inc. (KCI)	1V	\$24.04	\$3.53	\$3.83	6.8x	6.3x
Respiratory ResMed Inc. (RMD)	1V	34.06	1.52 A	1.83	22.4x	18.6x

Source: Company data and WCM, LLC estimates NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful
1 = Outperform, 2 = Market Perform, 3 = Underperform, V = Volatile

- **Sleep Growth Looks Steady.** We partnered with *HME Business* magazine to conduct our 5th survey of home medical equipment dealers (HMEs). The survey included responses from 190 HMEs received 10/17/08-10/27/08. HMEs expect sleep revenue to grow by 10% (vs. 10% in Q2) in the next 12 months after growing at 8% (vs. 9% in Q2) in the last 12 months. This is about in line with our estimate of 10-12% growth in the U.S. market. Though expectations for growth declined in our earlier surveys, they have stabilized at 10% in our last two surveys.
- **HMEs Have Begun To Manage CPAP Costs Ahead Of Medicare's 9.5% Cut.** Although Medicare's competitive bidding program was delayed by 18 months, a 9.5% reimbursement cut begins on 1/1/09. A majority of HMEs (56%) have already begun to implement changes to lower CPAP costs. HMEs appear most likely to negotiate lower prices with existing suppliers and to move Medicare patients to lower cost CPAPs. And 81% of HMEs expect private insurers to cut reimbursement based on Medicare's cut; this represents potential downside to our RMD estimates.
- **Respirionics May Gain Some Share Though RMD Should Benefit From Its New Apria Contract.** RMD's S8 II was rated 5.7 on a scale from 1 (very poor) to 7 (very good) while Respirionics' M Series was rated 5.8. RMD's Swift LT was rated 5.8 while Respirionics' OptiLife was rated 5.2. Respirionics may gain share in both flow generators (43% expect to increase purchases, 18% to decrease) and masks (39% expect to increase purchases, 12% to decrease). This is somewhat better than RMD's flow generators (36% expect to increase purchases, 21% to decrease) and masks (36% expect to increase purchases, 16% to decrease). However, we continue to believe that RMD will gain market share within Apria (which makes up about 15% of the U.S. sleep market but was likely underrepresented in our survey).
- **So Far, Impact Of Credit Crunch And Economy Appears Minimal.** Most (57%) HMEs have reduced inventories to conserve cash though only a minority (20%) have seen more difficulty in borrowing money. On average, HMEs indicated that 15% of CPAP purchases are "out-of-pocket" and 12% have seen a major decline in "out-of-pocket" purchases in the past 3-6 months.
- **We Remain Positive On RMD Despite Mixed Survey Results.** On one hand, the sleep market appears stable with minimal economic exposure. On the other hand, Respirionics appears set to gain share outside of Apria and private insurers could follow Medicare's cuts. We continue to expect upside to RMD's EPS estimates from the Apria contract and favorable currency movements.

Medical Technology/Devices

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Please see page 11 for rating definitions, important disclosures and required analyst certifications.

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Survey Background

Wachovia partnered with the trade magazine *HME Business* to conduct our latest survey of home medical equipment (HME) providers. Among the ~4,000 HME professionals that we sent the survey to, 190 responded to one or more of the survey questions for a total participation rate of about 5%. None of the questions in this survey were mandatory, therefore response rates varied from question to question (we note the response rates for questions on each of the charts). Of the 190 respondents, 162 (or 85%) completed the entire survey. The surveys replies were received between 10/17/08 and 10/27/08.

Survey Says...

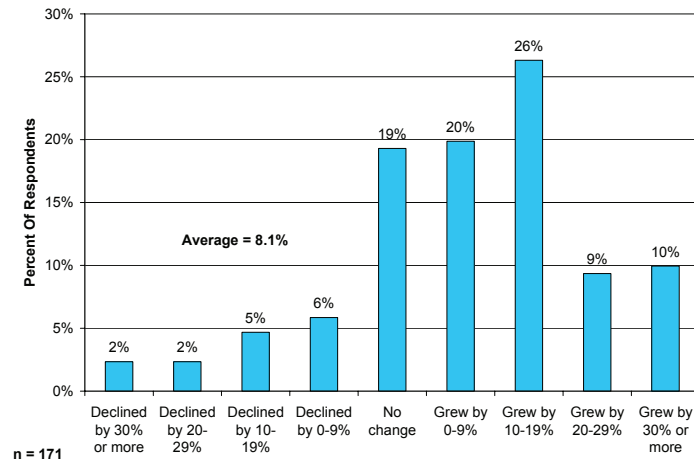
Sleep Therapy Questions

...HME Expectations For Sleep Revenue Growth Have Stabilized At 10%

On average, HMEs report 8.1% growth in the past 12 months and expect 9.7% growth in the next 12 months. The retrospective growth was down 80 bps from Q2 2008 survey while the forward outlook was stable at 9.7%. Of the respondents, 15% saw a decline in their sleep revenue in the past 12 months (vs. 11% in our prior survey) and only 7% expect a decline in the next 12 months (vs. 9% in our prior survey). These growth rates compare with our estimate of low-teens (10-12%) domestic growth.

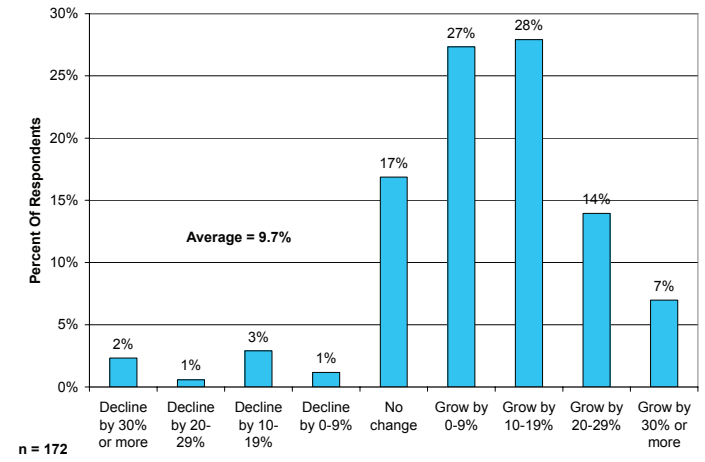
HME growth expectations declined in the first three surveys we conducted falling from 15% in our Q4 2006 survey to 10% in our Q2 2008 survey. Expectations in this survey matched our prior survey, however. This is consistent with our belief that the domestic sleep market has slowed due to greater penetration (which we estimate is around 35%), slower expansion at sleep labs ahead of home testing, and a slowing mix shift towards higher-end flow generators.

Figure 1: Sleep Revenue Growth Past 12 Months



Source: Wachovia Capital Markets, LLC Q4 2008 HME Survey

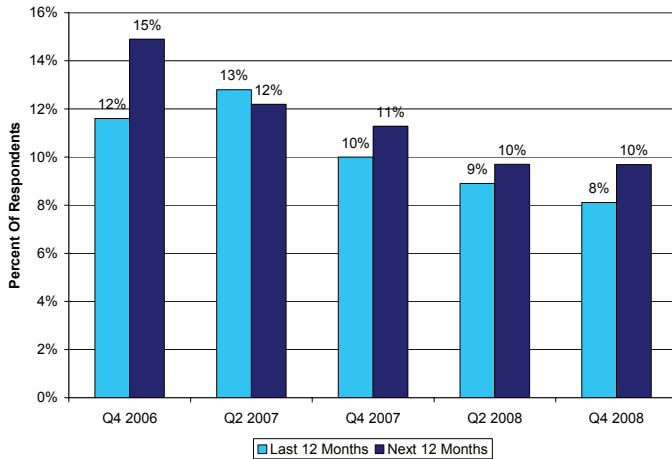
Figure 2: Sleep Revenue Growth Next 12 Months



Source: Wachovia Capital Markets, LLC Q4 2008 HME Survey

Q4 2008 HME Sleep & Wound Care Survey

Figure 3: Sleep Revenue Growth (Time Series)



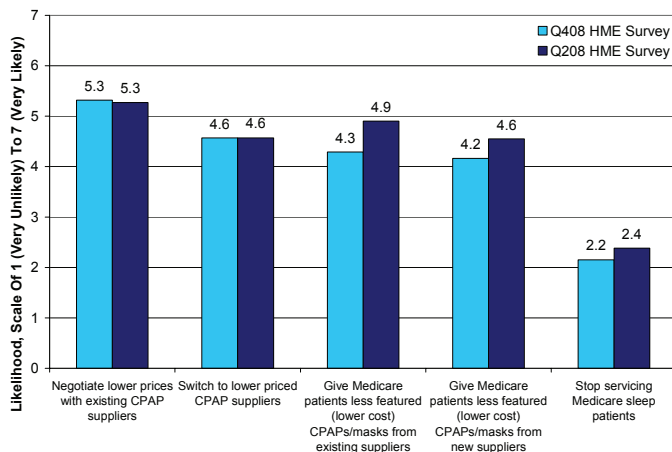
Source: Wachovia Capital Markets, LLC Q4 2008 HME Survey

... HMEs Are Already Taking Steps To Rein In CPAP Costs Ahead Of Medicare's 9.5% Reimbursement Cut (1/1/09)

We suspected that the slowdown in the domestic sleep market may have been due in part to HMEs preparing to deal with competitive bidding and the subsequent 9.5% reimbursement cut. We asked questions to determine how the HMEs intended to deal with these pressures and whether or not they had begun to take any steps in this direction. Based on our questions, the HMEs appear more likely to stick with their existing suppliers but to negotiate lower prices and move Medicare patients to lower-end devices. The HMEs look somewhat less likely to move to lower priced suppliers or to move patients to lower-end devices from new suppliers. And the HMEs appear very unlikely to stop servicing Medicare patients.

Many HMEs (57% of respondents) indicated that they have already begun to implement some of these strategies. We think that this may be driving a mix shift away from higher-end units which might be a factor in the domestic sleep market slowdown. Given that competitive bidding will be rolled out over the next few years, we think that the domestic market may remain under pressure for some time.

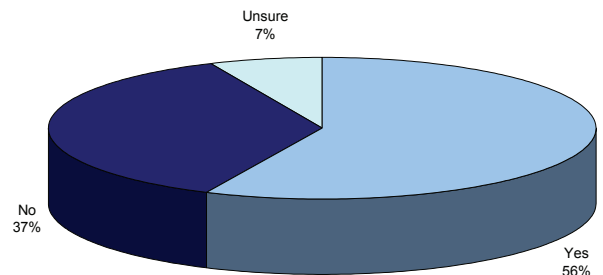
Figure 4: Given Declining Medicare Reimbursement, How Likely Is Your Firm To Do The Following (Time Series):



n = 166

Source: Wachovia Capital Markets, LLC Q4 2008 HME Survey

Figure 5: Has Your Firm Begun To Implement Any Of These Changes Yet?



n = 167

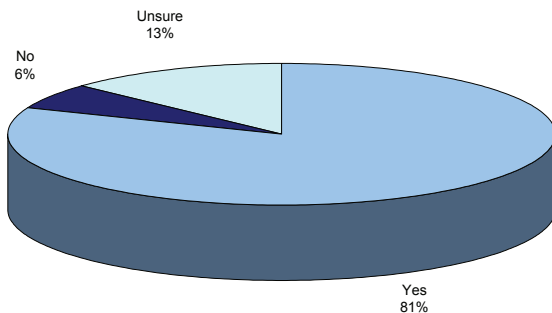
Source: Wachovia Capital Markets, LLC Q4 2008 HME Survey

...There Is A Risk That Medicare’s Cut Spills Over To Private Insurers

Prior to our Q2 2008 survey, we had been operating under the assumption that the declines in Medicare CPAP reimbursement that result from competitive bidding will not be followed by private insurers. At that time, 89% of respondents felt that private pay insurers could follow Medicare’s lead in lowering reimbursement.

The CPAP industry has stated that private insurance pays significantly less than Medicare and that competitive bidding dynamics already exist. Medicare only makes up 20% of the payer mix for CPAP therapy with most of the rest made up by private insurance. With the reimbursement cuts limited to Medicare, only about 10% of ResMed’s revenue is exposed. However, if there is spill over to private insurers, up to another 40% of ResMed’s revenue would potentially be exposed. We asked a question in our surveys to attempt to test this assumption. In our latest survey, 81% of respondents indicated that they expect private insurers to lower their reimbursement as a result of Medicare’s cuts under competitive bidding. These results appear to indicate that there is potential for at least some private insurers to cut reimbursement leading to greater exposure for ResMed. In the worst case scenario with all private insurers following Medicare’s cut on 1/1/09 (which is admittedly unlikely), we estimate that ResMed’s EPS could be reduced by around \$0.20 in calendar 2009 (see our 6/24/08 note titled *Competitive Bidding Delay Analysis*).

Figure 6: Do You Believe That Private Insurers Will Use CMS's 9.5% Cut To Lower Their CPAP Reimbursement?



n = 169

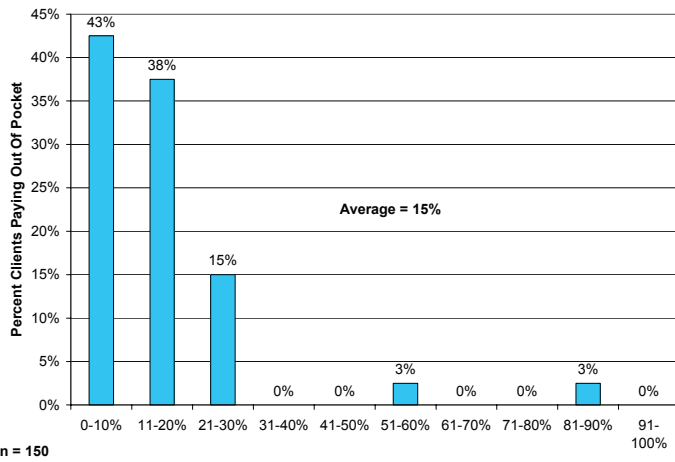
Source: Wachovia Capital Markets, LLC Q4 2008 HME Survey

...There Is Also A Risk That Prolonged Pressure On The Consumer Could Impact “Out-Of-Pocket” Expenditures On CPAP, But So Far The Effect Is Minimal

Prior to our current survey, we had quantified the “at risk” consumer discretionary portion of CPAP expenditure to be approximately 5-10%. We asked questions on this survey to test this hypothesis and further attempt to quantify any impact on this revenue stream due to economic pressures on consumers. Based on the responses to our survey, approximately 15% of CPAP purchases from HMEs could be classified as “out-of-pocket.” However, the HMEs indicate that at least so far, little impact has been seen on out-of-pocket expenditures on CPAP.

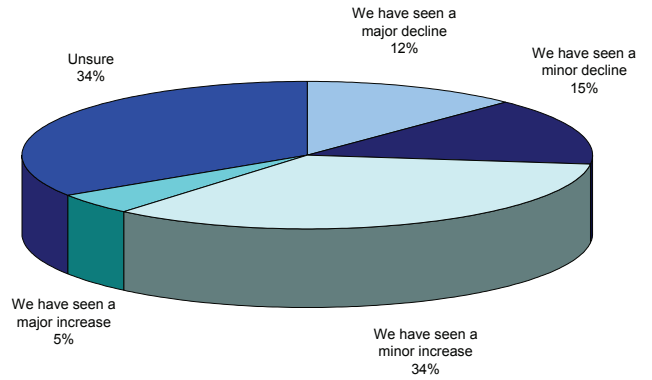
Q4 2008 HME Sleep & Wound Care Survey

Figure 7: What Portion Of Your Firm's CPAP Supply Sales Are "Out-Of-Pocket" (Not Covered By Insurance)?



Source: Wachovia Capital Markets, LLC Q4 2008 HME Survey

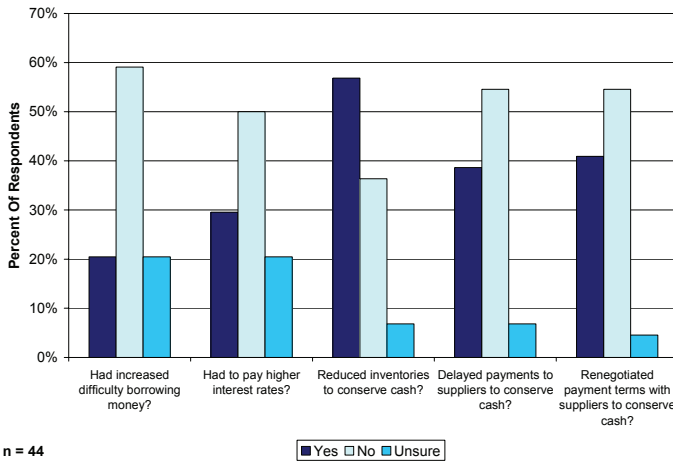
Figure 8: Has Your Firm Seen A Change In "Out-Of-Pocket" Purchases Of CPAP Supplies In The Past 3-6 Months?



Source: Wachovia Capital Markets, LLC Q4 2008 HME Survey

Finally we asked questions intended to quantify the impact of the credit crisis on the HMEs themselves (and not just their customers) since the HMEs are the direct customers to ResMed and other CPAP manufacturers. By and large the impact on the HMEs has been minimal with the only significant trend being a decrease in inventories by the HMEs to conserve cash. The HMEs themselves have not significantly seen borrowing costs rise or had difficulty raising capital.

Figure 9: Given The Recent Credit Market Turmoil, Has Your Firm:

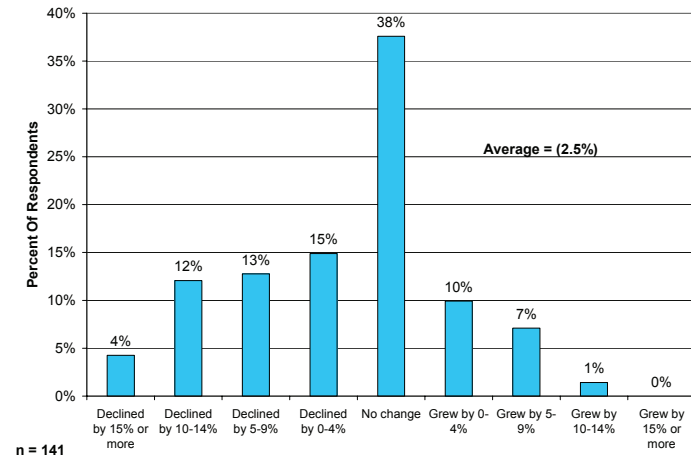


Source: Wachovia Capital Markets, LLC Q4 2008 HME Survey

...Price Declines On Flow Generators And Masks Are Stable

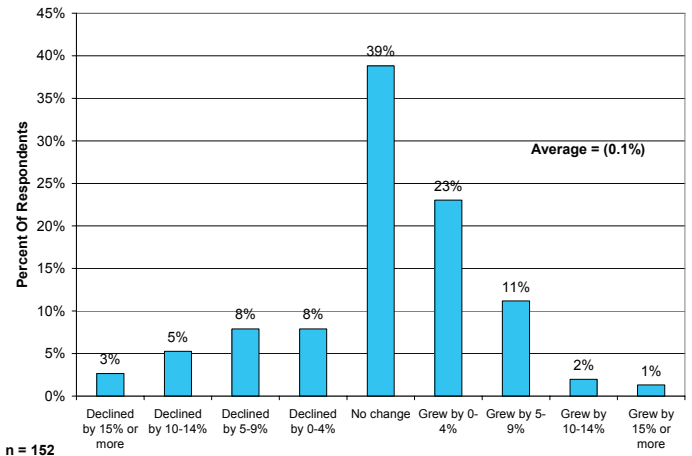
HMEs report that the average prices that they pay for flow generators and masks declined by averages of 2.5% and 0.1%, respectively, over the past 12 months. These are essentially in line with the price declines seen in our prior survey (2.5% for flow generators and 0.3% for masks) indicating that average selling prices (ASPs) have continued to decline at a consistent rate in flow generators but remained flat in masks. The manufacturers cite 5-15% annual price declines, however. How do we explain this differential? We think that the manufacturers refer to pure pricing while the HMEs refer to average selling prices which account for the effect of mix shifts as well as pricing. While these mix shifts continue to be positive, we think that reimbursement pressures have slowed the mix shift and may continue to do so for the next few years.

Figure 10: By What % Has The Average Price You Pay For A Flow Generator Changed In Past 12 Months?



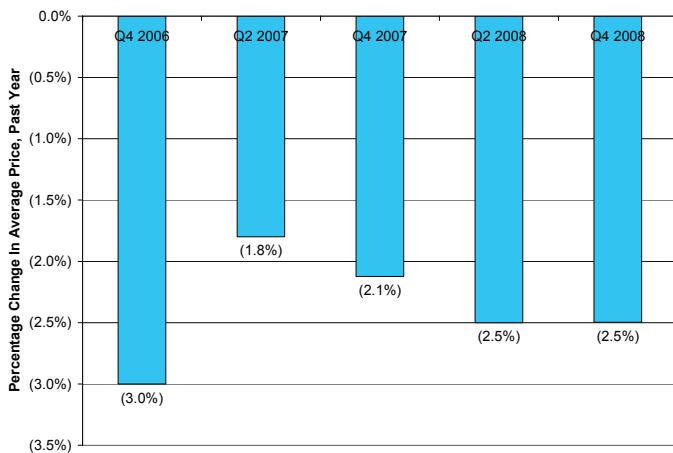
Source: Wachovia Capital Markets, LLC Q4 2008 HME Survey

Figure 11: By What % Has The Average Price You Pay For A Mask Changed In Past 12 Months?



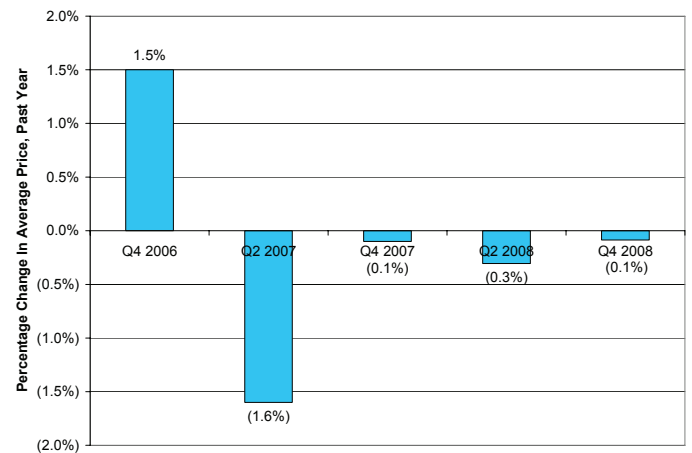
Source: Wachovia Capital Markets, LLC Q4 2008 HME Survey

Figure 12: Change In Average Flow Generator Prices (Time Series)



Source: Wachovia Capital Markets, LLC Q4 2008 HME Survey

Figure 13: Change In Average Mask Prices (Time Series)

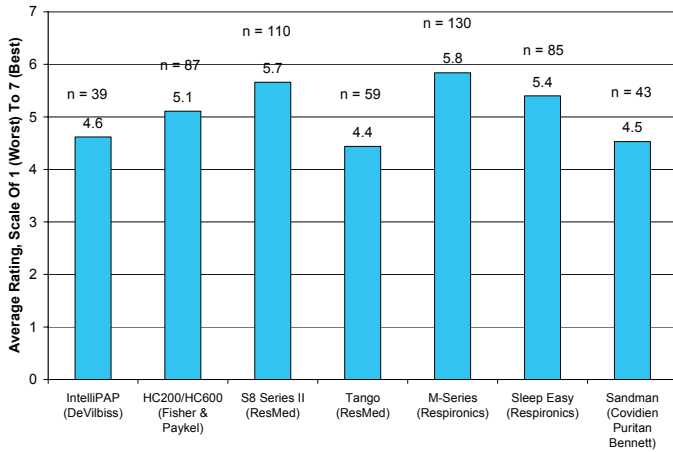


Source: Wachovia Capital Markets, LLC Q4 2008 HME Survey

...Respironics' Flow Generators Were Rated Highest And Respironics Looks Likely To Gain Some Flow Generator Market Share

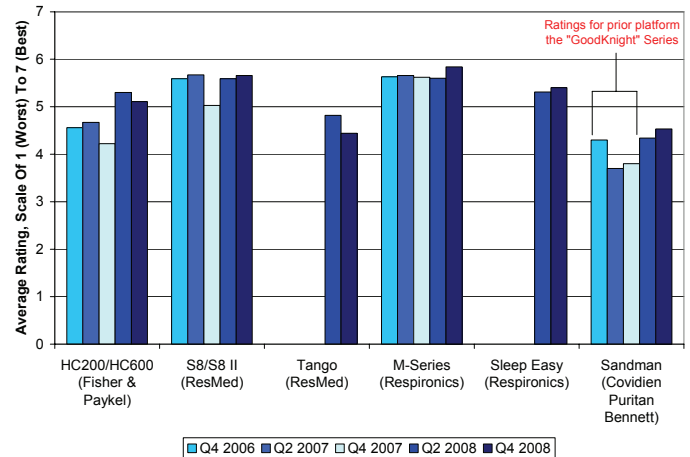
ResMed's newest flow generator, the S8 II rated about in line with our Q2 2008 survey at 5.7 out of 7.0. Respironics' M-Series received the highest rating at 5.8 which may indicate that Respironics' product cycle remains fresh. Fisher & Paykel's HC200/HC600 was rated 5.1, in line with our last survey, while the new Covidien Sandman lagged the group at 4.5 but showed some improvement over the prior GoodKnight series which consistently rated below 4.0. We also had the HMEs rate the newer low-end flow generators from ResMed and Respironics. The HMEs gave ResMed's Tango a 4.4 and Respironics' Sleep Easy a 5.4.

Figure 14: Flow Generator Platform Ratings



Source: Wachovia Capital Markets, LLC Q4 2008 HME Survey

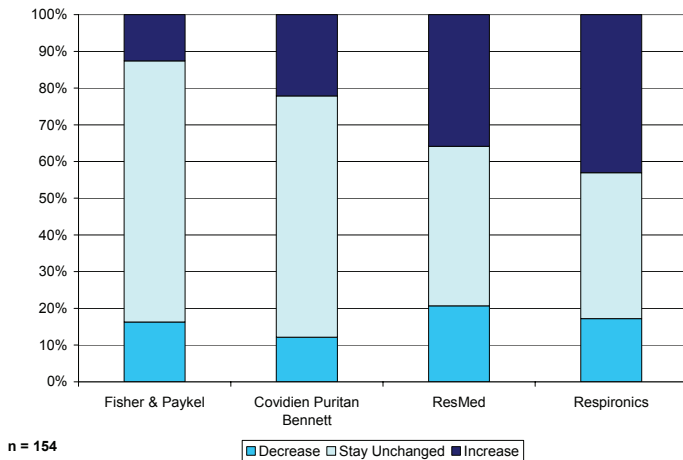
Figure 15: Flow Generator Platform Ratings (Time Series)



Source: Wachovia Capital Markets, LLC Q4 2008 HME Survey

Consistent with the ratings, the HMEs indicated that they intend to increase their purchases of Respironics' flow generators by more than any other companies' flow generators (43% of respondents expect to increase Respironics' flow generator purchases vs. 18% that expect to decrease purchases). ResMed still appears to have a strong trajectory (36% expect to increase purchases, 21% to decrease) while Fisher & Paykel looks likely to hold flow generator market share and Covidien (COV) could continue to lose flow generator market share despite its improved product line-up.

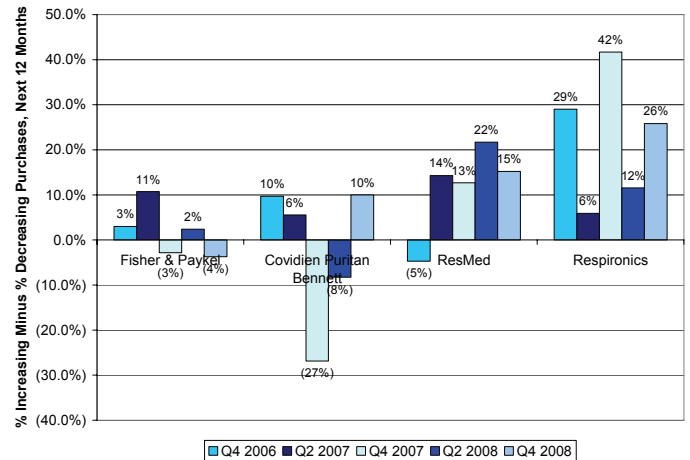
Figure 16: In Next 12 Months Will Your Flow Generator Purchases Decrease, Increase, Or Stay Unchanged...



n = 154

Source: Wachovia Capital Markets, LLC Q4 2008 HME Survey

Figure 17: Difference In % Of Respondents Increasing Vs. Decreasing Purchases (Time Series)

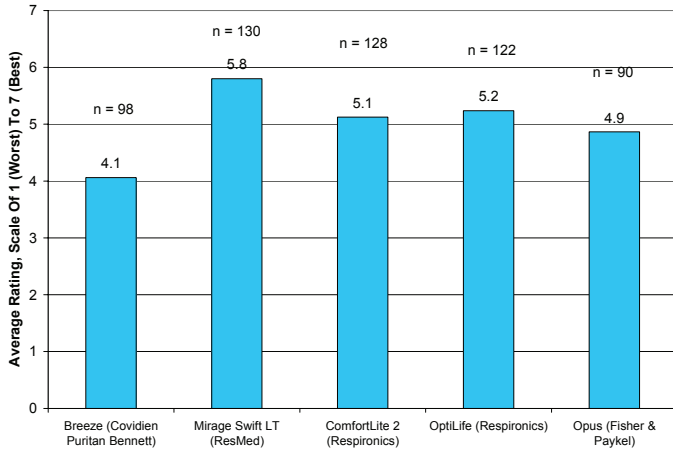


Source: Wachovia Capital Markets, LLC Q4 2008 HME Survey

...ResMed's Masks Were Rated Highest But Respironics Looks Likely To Gain Some Mask Market Share

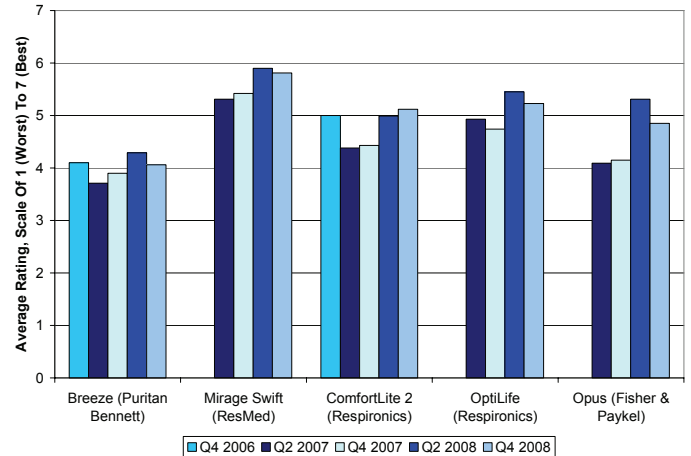
ResMed continues to have the best masks according to our survey. In the nasal pillow category, ResMed's Swift LT was the highest rated at 5.8 (out of 7.0) followed by Respironics' OptiLife (5.2) and ComfortLite 2 (5.1) while trailed by Fisher & Paykel's Opus (4.9). These results are largely consistent with our prior HME surveys though nearly all the masks were rated less highly in this survey.

Figure 18: Nasal Pillow Mask Ratings



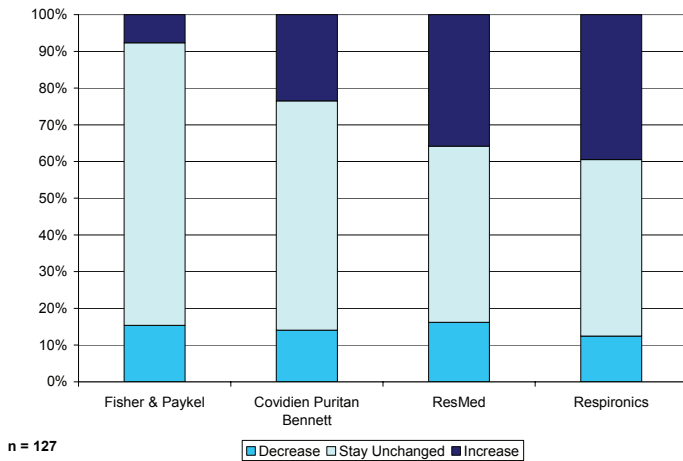
Source: Wachovia Capital Markets, LLC Q4 2008 HME Survey

Figure 19: Mask Ratings (Time Series)



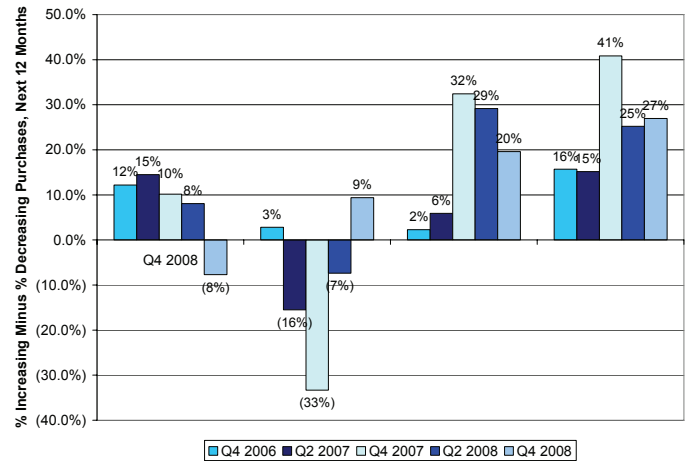
Source: Wachovia Capital Markets, LLC Q4 2008 HME Survey

Figure 20: In Next 12 Months Will Your Mask Purchases Decrease, Increase, Or Stay Unchanged...



Source: Wachovia Capital Markets, LLC Q4 2008 HME Survey

Figure 21: Difference In % Of Respondents Increasing Vs. Decreasing Purchases (Time Series)

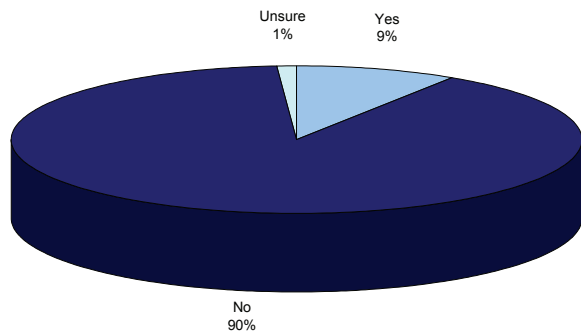


Source: Wachovia Capital Markets, LLC Q4 2008 HME Survey

...Only A Small Number Of HMEs Currently Administer Home Sleep Apnea Tests Though More Plan To Start Over Next 12 Months

Only 9% of respondents currently offer patients home testing for sleep apnea. Another 16% of respondents plan to begin offering home testing over the next 12 months (down from 43% in our last survey) with the bulk starting in 6 months or more. This supports our view that home testing while home testing could be a significant driver, recent Local Coverage Determinations (LCDs) have somewhat constrained the incentives for HMEs to participate and the impact of any uptake is not likely to kick in until late 2009 at the earliest.

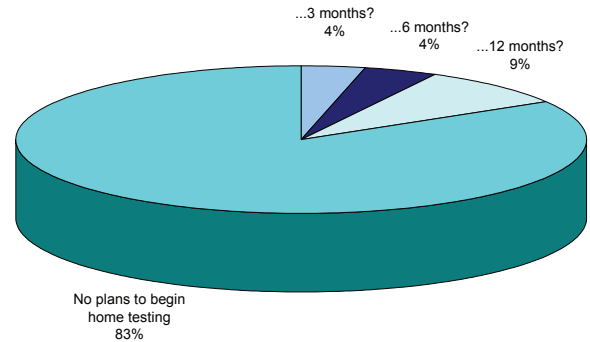
Figure 22: Does Your Firm Currently Administer Home Tests For Sleep Apnea?



n = 162

Source: Wachovia Capital Markets, LLC Q4 2008 HME Survey

Figure 23: Does Your Firm Plan To Begin Administering Home Tests For Sleep Apnea In The Next...



n = 141

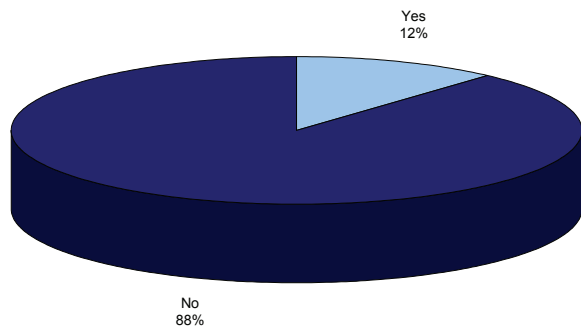
Source: Wachovia Capital Markets, LLC Q4 2008 HME Survey

Negative Pressure Wound Therapy (NPWT) Questions

...A Minority Of HMEs Participating Offer Negative Pressure Wound Therapy (NPWT) But More Plan To Offer It In The Next 6 Months

Most HMEs in our survey are not participating in the NPWT market (only 12% currently offer NPWT products) but more plan to enter in the next 6 months (14% expect to begin offering NPWT products). These numbers are consistent with our prior survey (in which 12% currently offered NPWT product and 16% expected to begin offering NPWT products).

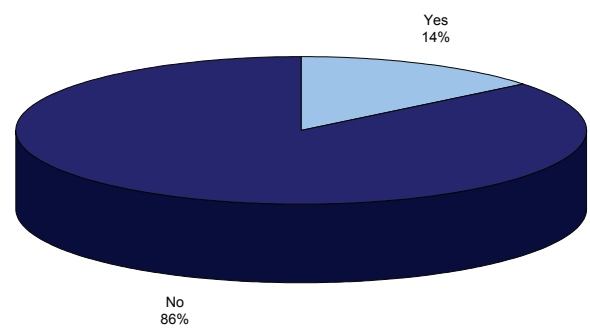
Figure 24: Do You Currently Offer NPWT?



n = 188

Source: Wachovia Capital Markets, LLC Q4 2008 HME Survey

Figure 25: Do You Plan To Begin Offering NPWT In Next 6 Months?



n = 163

Source: Wachovia Capital Markets, LLC Q4 2008 HME Survey

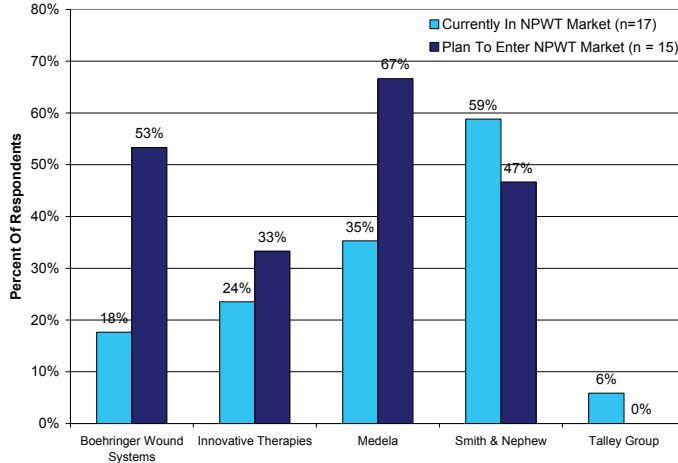
...Smith & Nephew, Medela, & Innovative Therapies Are Most Common NPWT Suppliers; HMEs Are Focused On Home Setting But Some Sell Into Extended & Acute Settings

Most HMEs that offer or plan to offer NPWT are purchasing products from Smith & Nephew, Innovative Therapies, and Medela. Not surprisingly, the HMEs are mainly focused on offering NPWT in the home care setting (90%) but some are offering NPWT in the acute care (50%) and even extended care (45%) settings.

Medical Technology/Devices

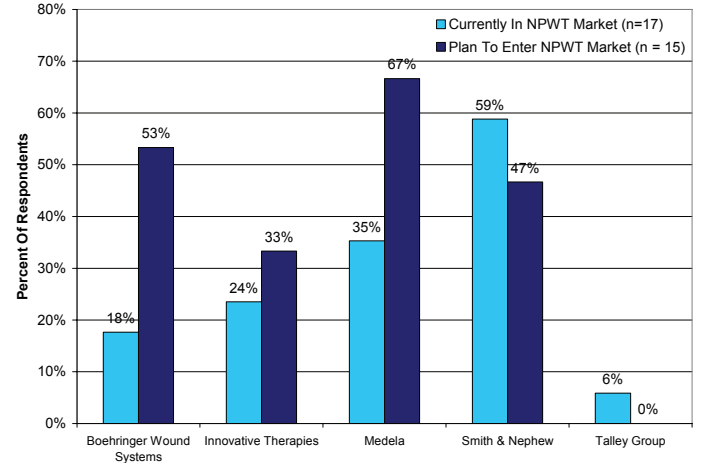
We note that while CMS data shows that HMEs have struggled to collect Medicare payments for home-based NPWT (rejection rates are >75%), payments in the other care settings are from the facilities not insurers which may make it easier to collect payments.

Figure 26: From Which Supplier Do You Purchase NPWT Pumps?



Source: Wachovia Capital Markets, LLC Q4 2008 HME Survey

Figure 27: In Which Care Settings Do You Offer NPWT?

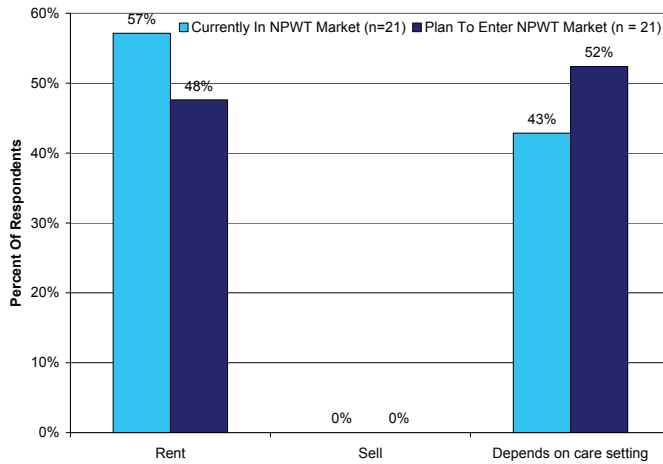


Source: Wachovia Capital Markets, LLC Q4 2008 HME Survey

...Most HMEs Offer NPWT Pumps On A Rental Basis

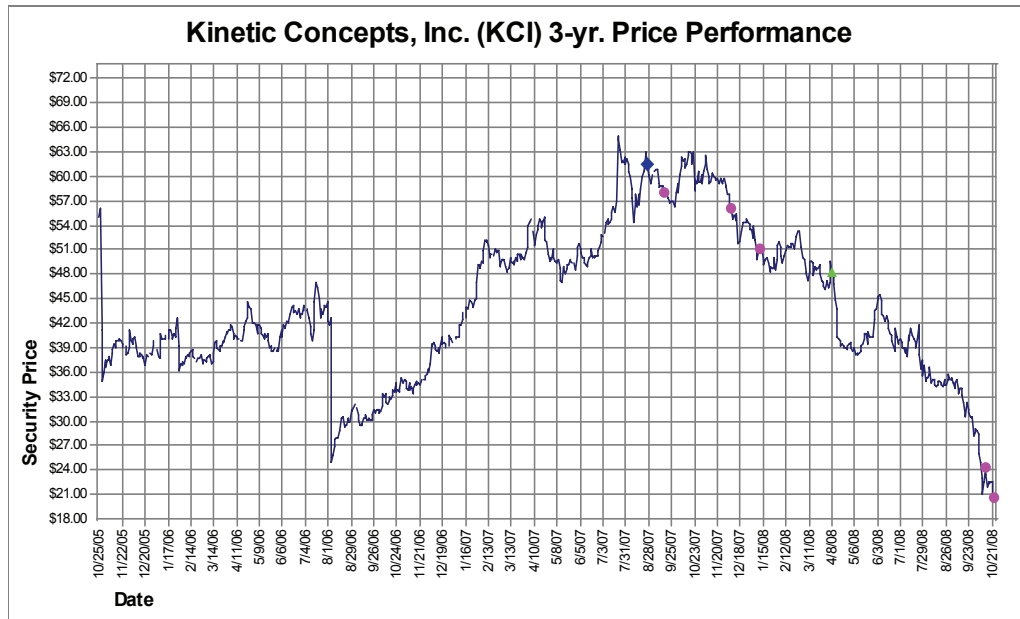
We asked HMEs about their sales model for NPWT to determine if they were renting or selling the pumps. The majority of HMEs rent the pumps although some said that the sales model depends on the care setting. While we think it makes more sense economically for HMEs to rent pumps, it is possible that more cost sensitive customers may prefer to purchase rather than rent the pumps.

Figure 28: Sales Model For HMEs Offering Or Planning To Offer NPWT Products



Source: Wachovia Capital Markets, LLC Q4 2008 HME Survey

Required Disclosures



	Date	Publication Price (\$)	Rating Code	Val. Rng. Low	Val. Rng. High	Close Price (\$)
	8/27/2007		Matson			
◆	8/27/2007	61.48	2	62.00	65.00	61.48
●	9/17/2007	58.11	2	60.00	65.00	58.11
●	12/6/2007	56.04	2	57.00	63.00	56.04
●	1/11/2008	51.10	2	52.00	57.00	51.02
▲ ●	4/8/2008	49.57	1	58.00	62.00	48.30
●	10/13/2008	22.44	1	45.00	50.00	24.21
●	10/23/2008	20.39	1	38.00	42.00	20.61

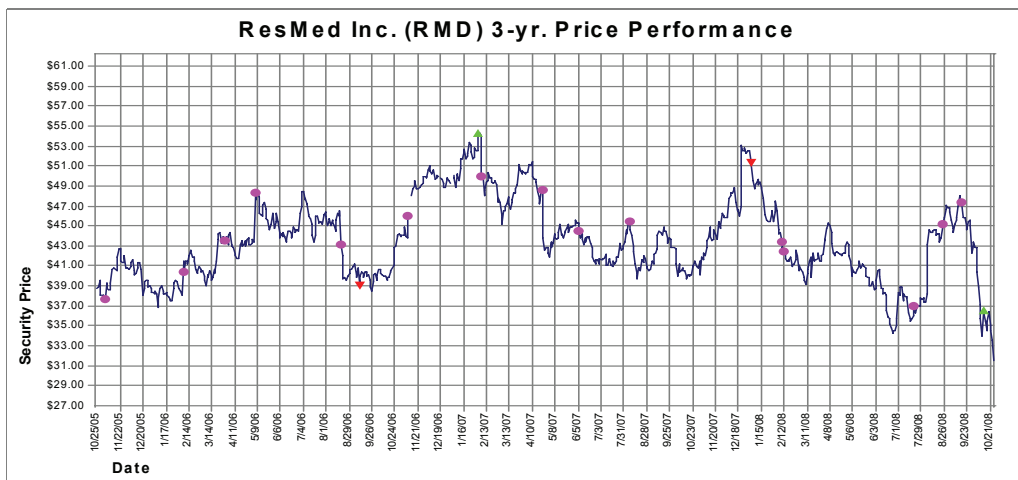
Source: Wachovia Capital Markets, LLC estimates and Reuters data

Symbol Key

- ▼ Rating Downgrade
- ▲ Rating Upgrade
- Valuation Range Change
- ◆ Initiation, Resumption, Drop or Suspend
- Analyst Change
- Split Adjustment

Rating Code Key

- 1 Outperform/Buy
- 2 Market Perform/Hold
- 3 Underperform/Sell
- SR Suspended
- NR Not Rated
- NE No Estimate



	Date	Publication Price (\$)	Rating Code	Val. Rng. Low	Val. Rng. High	Close Price (\$)
	10/25/2005		Matson			
	10/25/2005	NA	1	39.00	40.50	38.74
●	11/3/2005	NA	1	42.00	44.00	37.60
●	2/8/2006	NA	1	46.00	48.00	40.41
●	3/30/2006	NA	1	48.00	50.00	43.48
●	5/5/2006	NA	1	49.00	52.00	48.36
●	8/18/2006	NA	1	52.00	55.00	43.10
▼ ●	9/11/2006	NA	2	40.00	44.00	39.04
●	11/9/2006	NA	2	42.00	47.00	46.02
▲ ●	2/2/2007	NA	1	61.00	66.00	54.26
●	2/7/2007	NA	1	60.00	65.00	50.00
●	4/23/2007	NA	1	50.00	55.00	48.64
●	6/6/2007	NA	1	52.00	56.00	44.44
●	8/7/2007	NA	1	50.00	54.00	45.40
▼ ●	1/2/2008	52.53	2	51.00	55.00	51.31
●	2/8/2008	44.33	2	40.00	45.00	43.36
●	2/12/2008	42.49	2	38.00	43.00	42.49
●	7/21/2008	37.00	2	36.00	39.00	37.00
●	8/25/2008	45.17	2	43.00	47.00	45.17
●	9/16/2008	47.40	2	44.00	48.00	47.40
▲ ●	10/13/2008	33.90	1	40.00	44.00	36.54

Source: Wachovia Capital Markets, LLC estimates and Reuters data

Symbol Key		Rating Code Key	
▼ Rating Downgrade	◆ Initiation, Resumption, Drop or Suspend	1 Outperform/Buy	SR Suspended
▲ Rating Upgrade	■ Analyst Change	2 Market Perform/Hold	NR Not Rated
● Valuation Range Change	□ Split Adjustment	3 Underperform/Sell	NE No Estimate

Additional Information Available Upon Request

I certify that:

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