

ArthroCare Closes Opus Medical Acquisition

BY [JOHN MCCORMICK](#), NOVEMBER 22, 2004

Last week ArthroCare Corp. (NASDAQ: ARTCE - note new ticker symbol) completed its acquisition of privately held Opus Medical, Inc.. ArthroCare paid with a combination of cash and stock for this privately-held arthroscopic surgery innovator. The terms of the \$130 million minimum consideration to the Opus shareholders breaks down as follows:

Exhibit 1. ArthroCare Consideration for Opus

US\$mm	
Cash (today)	30.0
Stock (today)	60.0
Cash or Stock (1Q:06)	40.0
Contingent Payment (1Q:06)	<u>scale</u>
TOTAL	<u>> \$130.0</u>

Our reaction (we have had two months to reflect on this) is that the deal makes strong strategic sense for ArthroCare. Both companies are important innovators in sports medicine surgical technologies and ArthroCare's acquiring Opus is a highly attractive way to round out the company's sports medicine product suite. ArthroCare offers cannulas and retractors for tissue access, Coblation' tools and wands for tissue removal and now Opus' AutoCuff' knotless suture product for tissue repair. This considerably augments the one-stop-shopping equation for ArthroCare's shoulder docs. Combining Opus' approximate 10 sales reps with ArthroCare's 45 (worldwide) reps with fuller bags also makes a case for further market penetration.

EXHIBIT 2. KNOTLESS SUTURING TECHNOLOGY - THE WAVE OF THE FUTURE?



One must carefully consider how Opus fits into the broader ArthroCare core competence, however. To the positive, ArthroCare's management has done a superb job of scaling its platform Coblation' technology into multiple surgical uses. To the positive, Opus brings an IP basket to the table for ArthroCare's strong development team to work with. However, we do note that from a scalability standpoint, there is a risk that the Opus knotless suturing technique may represent a one-trick pony for shoulder repair for some time. Getting granular, we highlight that Opus is a rotator cuff repair product that delivers a knotless solution the soft tissue to bone aspect of the repair, but does not fully address the soft tissue to soft tissue aspect of the repair, especially where substantial L-shaped rotator cuff tears occur. The requirements for soft tissue anchoring to bone elsewhere in the body are potentially more limited than shoulder as compared to the opportunities for tissue ablation that ArthroCare has so successfully captured. That being said, Opus has a strong R&D effort and a sophisticated patent portfolio.

Financially, Opus has done exceedingly well. The company is near breakeven and expects to achieve \$16 - \$17 million of revenues in FY 2004 from a near standing start. This spectacular revenue ramp has caught the jealous attention of the industry stalwarts and the company's success has not escaped notice. Certainly the AutoCuff' and its short learning curve has

caught the imagination (and wallets) of the early adopter shoulder docs that we constantly see hovering at the Opus booth during surgeon conventions. This is all happening despite the product's premium \$1,000-plus price point.

Without a doubt Opus' investor base is making off like bandits. The investors are mainly sophisticated venture capital firms such as Apax, Three Arch and Prospect. The most recent round prior to the acquisition, May 2003, was priced at \$43.8 million post-money, according to VentureSource.

Wall Street analysts have, for the most part, applauded the move as ArthroCare management revised its 2005 financial guidance for the investing public when the acquisition was announced. Since Opus is near breakeven and the acquisition is late in the year, there is no meaningful expected EPS impact (absent one-time charges connected with the transaction) for ArthroCare's 2004. Analyst consensus earnings for 2004 is currently \$0.59 per share. 2004 revenue estimates are in the \$150 million area. Revenues for Opus are expected to grow at least 50% in 2005 and Opus is expected to be operating earnings accretive to the company in 2005 due to the expected transfer of manufacturing to ArthroCare's existing Costa Rica facilities and added sales and marketing capabilities. Highlighting how the Company is seeking to strengthen its distribution, the Company noted that it is adding 12 sales reps to its sports med sales force. Including shares issued for the Opus Medical acquisition, ArthroCare expects EPS to meet or exceed the current 2005 analyst consensus of \$0.87.

Our view is that this transaction is positive for ArthroCare solidifying the company's position as an innovator in the sports medicine industry. While the majors are competing for doctor's attention with modest tool and wand upgrades, ArthroCare has been creatively leveraging Coblation' for years. While the majors are at war brandishing glossy braided suture product brochures, ArthroCare is going knotless. Any major competitor seeking to enter the knotless area by building a competing product should take note of the Opus IP portfolio that ArthroCare is acquiring and how the company cleaned Smith & Nephew's clock in a patent infringement suit just three months ago (see our [6.14.04 article](#)).

We do think that some subtle - but not insurmountable - challenges are ahead of ArthroCare with this acquisition. Its long term success may well depend on the penetration rate of arthroscopic shoulder repairs versus open and mini-open techniques. Our current estimate for the US shoulder repair market hovers around \$300 million with a modest 9% growth per annum. So Opus' immediate revenue ramp to \$16 - \$17 million out of nowhere almost certainly means that the Smith & Nephews and Arthroteks of the world stand to be displaced if Opus is going to meaningfully grow.

Since the introduction of arthroscopic techniques in the 1980's, almost all ACL and meniscus repairs have been done arthroscopically, but only 15% to 20% of the approximate 400,000 worldwide (250,000 USA) rotator cuff surgeries have been performed arthroscopically. Ergo, despite all the snazzy videos at AAOS, arthroscopic shoulder surgery is the exception, not the rule. Does this mean that Opus is limited to 15% to 20% of a \$300 million market? This could be the case if the penetration rate does not change and if ArthroCare does not leverage the existing Opus technology into other areas. One issue we encounter with many of the sports medicine doctors we talk to is: knot tying is a way of life (not all of these doctors are Luddites, by the way). A second issue we have come across is the apparent lack of clinical literature on serious complications associated with knots or knot bundles in the shoulder after rotator cuff repair. A third issue is that many tacks, screws and other knotless technologies have come to the market over the years only to be quietly withdrawn while residents practice Tennessee Slider knots with their gym shoes. Furthermore, as we highlighted above, Opus doesn't completely solve the problem suturing soft tissue to soft tissue. Does that mean ArthroCare overpaid because Opus only turns out to be a niche premium product attracting only early adopter surgeons? Perhaps'

ArthroCare's management has argued that Opus is so compelling that it may actually *increase* the rate of arthroscopic repairs because of the reduced O.R. time due to the elimination of complex suturing requirements. The result is a cascade of higher patient satisfaction, attractive reimbursement levels and the like. After all it is hard to argue against the unusually rapid adoption of Opus' AutoCuff' by physicians. Right? So, if this rapid adoption causes more and more surgeons to embrace Opus' elegant knotless suturing technologies will there be a tipping point away from stodgy old knots to knotless technologies? If

that tipping point occurs is a revolution at hand where more shoulder surgeries go arthroscopic? If this tectonic shift is at hand, has ArthroCare just purchased an island called Manhattan for \$24? Perhaps'

The deciding factors to us are: (i) if ArthroCare can leverage its core competence and move up the penetration of arthroscopic shoulder repairs and (ii) if ArthroCare can scale the existing Opus technology into other areas. Both are ambitious scenarios, but ArthroCare is an expert in getting surgeons to adopt. Just look at how ArthroCare is creating a revolution in tonsillectomies with its ENT products. Whatever the outcome, at least from a 30,000 foot perspective, it looks like ArthroCare has beat competitors to the punch and solidified its unique strategic position as the leading sports medicine industry innovator.