



Michael Brush

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## Company Focus

### Broken-heart stocks on road to recovery

Serious issues are plaguing cardiac-device companies like Boston Scientific and St. Jude Medical. But some believe the prognosis is good and the slumping stocks are bargains.

By [Michael Brush](#)

Steep declines in the stock prices of cardiac-device makers Boston Scientific and **St. Jude Medical** ([STJ](#), [news](#), [msgs](#)) have shareholders reaching for the heart paddles.

But the worries about these stocks will likely turn out to be just a false alarm. The prognosis is better than people think.

On the surface, the situation does look dire. Safety concerns have sparked a sharp slowdown in demand for heart devices. Medicare has proposed draconian cuts in reimbursements for cardiac procedures.

These worries have pushed St. Jude Medical's stock down 27% since December, to under \$39. **Boston**

**Scientific** ([BSX](#), [news](#), [msgs](#)), which sells stents used to prop open ailing arteries, has fared even worse. Faced with concerns about increased competition in stents and worries about its merger with cardiac-device maker Guidant, Boston Scientific's stock has fallen over 50% since July 2004 -- to trade recently for \$22.

But analysts and institutional investors who own these stocks believe the fears are overblown. Insiders apparently agree, and have purchased an impressive \$7.7 million worth of stock at these two companies since Feb. 9.

Here's a look at the main issues facing these cardiac-device makers, and why they may not be as bad as the bears seem to think.

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### Product recalls and slowdown in growth

St. Jude Medical makes most of its profits by selling heart devices like defibrillators, or implanted gadgets that use electronic signals to correct irregularities in the way the heart beats. It also sells pacemakers, which speed up the heart if it beats too slowly.

Boston Scientific chiefly makes drug-eluting stents, or devices used to keep the inner walls of arteries open. But to manage the threat of increased competition in the maturing stent market, Boston Scientific recently purchased Guidant, which makes cardiac devices similar to those sold by St. Jude.

As the population ages, many more patients have turned to heart devices sold by these companies rather than face unattractive alternatives like chronic fatigue, fluid build-up in the body and death. This helps explain why sales growth for cardiac-rhythm-management (CRM) devices clocked in at a healthy 15% to 20% a year, in recent years.

Last year, however, Guidant shocked the medical world when it told doctors that a small percentage of the defibrillators it makes may have defects. The news grabbed headlines, and CRM sales plummeted. Although one of the three main defibrillator producers, **Medtronic** ([MDT](#), [news](#), [msgs](#)), still hasn't reported, it looks like first-quarter sales growth for these devices slipped to under 10%.

Certainly, the safety problems with defibrillators have caused tragedy for victims and their families. But analysts believe the overall safety record of these devices -- and the strong underlying need for them as the population ages -- mean that sales growth will be back on track in a few quarters.

"These systems are 99.7% reliable," says A.G. Edwards analyst Jan David Wald, who used to develop defibrillators at Guidant. "That is a really good number. Any device is going to have a failure rate, but for these devices it is very low."

Institutional investors who hold these stocks are making the same bet. "I am fairly upbeat that the business will rebound and be back up to double-digit growth and that we will see very robust growth for several years," says David

Heupel, portfolio manager of the **Thrivent Large Cap Growth Fund** ([AAAGX](#)), which owns shares of Boston Scientific and St. Jude. "The incidence of heart failure is not going away, and there is really only one viable treatment -- and that is the defibrillator." A.G. Edwards' Wald also believes annual growth could be back up in the 16%-18% range in two to three quarters.

### Proposed Medicare cutbacks

Cardiac-device makers have also been hit by Medicare proposals to make huge cuts in reimbursements for many kinds of heart procedures. The proposals are part of a backlash against doctor-owned hospitals that specialize in cardiac procedures. Critics claim doctors at these hospitals "cherry pick" the most profitable cases, sending more problematic patients elsewhere.

The Centers for Medicare & Medicaid Services (CMS) recently proposed an "unexpectedly large" cut in reimbursement for cardiac rhythm management implant procedures of about 20%, and a 30% reduction for stents, Wald says. To put that in context, the biggest cut in reimbursements in recent history was an 8% reduction in payments for orthopedic implants several years ago, says Wald.

Like many analysts, however, Wald believes the proposed cuts for cardiac procedures was just an opening bid in a negotiating process that will result in less severe cuts.

"Officials at CMS with whom we spoke emphasized that these cuts are only proposals and that a revision in the magnitude and even the timing of the cuts remains under review," Deutsche Bank Securities analyst Tao Levy wrote in a recent report on cardiac-device makers. "We continue to believe the stocks' reaction to the proposals is overdone."

### Merger worries

Investors worry Boston Scientific's merger with Guidant was a big mistake. "We believe Boston Scientific is significantly overpaying for Guidant, leading to massive earnings dilution and a high debt load," says Citigroup Research analyst Matthew Dodds. He has a "hold" rating on the stock and a 12-month price target of \$22, where it trades now.

But **Goldman Sachs Group** ([GS](#), [news](#), [msg](#)) analyst Lawrence Keusch thinks the acquisition will pay off in the long run. He says the \$2 billion a year in operating cash flow at the company can be used to both pay down debt from the Guidant purchase and fund research into new products.

"We believe that the acquisition of Guidant is a solid strategic move for Boston Scientific, which should drive long-term shareholder value," says Keusch. He thinks the fair value for the company right now is \$25-\$30, and that the stock could see \$37 in a year or so.

### Insiders see value

Both Boston Scientific and St. Jude trade at the lowest price-earnings ratios they've seen in five years. "They are at a multiyear low versus both the S&P 500 and the broader med-tech universe, suggesting sentiment on cardio stocks in particular has bottomed out," says Deutsche Bank's Levy.

Insiders appear to think those levels make the stocks a bargain. During the second half of April, four directors at St. Jude Medical purchased over \$1.7 million worth of their stock for prices between \$38.19 and \$39.95. Since February, insiders at Boston Scientific -- including finance chief Lawrence Best -- have purchased \$6 million worth of stock for prices between \$21.88 and \$24.45, according to Thomson Financial.

### Acquirers and short sellers

Thrivent's Heupel thinks St. Jude could be a takeover candidate. **Johnson & Johnson** ([JNJ](#), [news](#), [msgs](#)) showed an interest in Guidant before it was purchased and could now set its sights on St. Jude Medical, says Heupel. Or a big pharmaceutical company might buy it.

Phil Erlanger, a technical analyst at [erlangersqueezeplay.com](#), believes a big buildup in the short position in Boston Scientific is bullish. Investors short stocks by borrowing shares and selling them, hoping to be able to replace them at a lower price later. The short position in Boston Scientific has more than doubled in the past three months.

But the more investors who are short a stock, the more people there are that have to buy it back to "cover" their short positions if the stock advances -- creating what's known as a "short squeeze," which can drive a stock even higher. Erlanger believes all the bad news for Boston Scientific has been priced in and that the stock is now bottoming at around \$22. If he's right, a rebound in the stock could be magnified by shorts rushing to cover.

### Expert picks

To catch that bounce, I'll add Boston Scientific to my stock-tracking portfolio in MSN Money's [expert picks section](#). I'll also add St. Jude.

*At the time of publication, Michael Brush did not own or control shares of companies mentioned in this column.*

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