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PEMBA Assignment for Dr. Behn

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**Financial Analysis of Edwards Lifesciences and St. Jude Medical**

For this assignment, I have imagined a spectacular outcome for my startup Company, MGI Medical, which was formed to commercialize the Pulse Flowmeter, a new medical device for the early detection of shock due to unrecognized blood loss. That spectacular outcome would be that we did so well over the next 5 years, that St. Jude Medical and Edwards Lifesciences, two giants in the medical device field would be fighting for the privilege of buying out MGI Medical (I only wish !). Developing a business plan for the purpose of raising capital for MGI Medical is the subject of my OAP (my OAP advisor is Lynn Youngs from the UTK entrepreneurial center).

Both St. Jude and Edwards have US Divisions that represent, respectively, 25% and 28% of their worldwide business. This following analysis is based upon the 10-K statements of the USA Divisions of these companies. St. Jude is significantly larger than Edwards; it has 2.8 times the sales and 2.9 times the assets of its competitor. Both companies specialize in heart valves. However, both sell patient monitoring equipment. This is more of a priority at Edwards than at St. Jude.

Background:

Edwards Lifesciences was started in 1958 by Miles Edwards when he set out to build an artificial heart. Instead, he teamed up with Albert Starr and developed the famous “Starr-Edwards” tissue heart valve. In 1966 Edwards Laboratory was purchased by American Hospital Supply Corporation and in 1985 it was acquired by Baxter International. In 2000 it was spun off as an independent publicly held company, “Edwards Lifesciences.” Edwards remains the world leader in tissue valves. Currently, their most significant and exciting new product is the Sapien line of transcatheter placed artificial aortic valves. In addition to their heart valve business, about 1/3 of their product line is devoted to critical care monitoring products including the Swan-Ganz Catheter, Flo-Trac Cardiac Output Monitor and Clearsight non-invasive cardiac output monitor. Edwards’ current market cap is $7.8B and its stock is trading at about $70/share. Most analysts rate it as a “buy” stock.

St. Jude Medical was founded in 1976 to advance the development of artificial heart valves. The company was founded by Manny Villafana who took it public in 1977. In 1981 they started development of the “St Jude” heart valve which was made of carbon fiber. It was first placed in humans in 1986. It was and continues to be an outstanding aortic valve replacement. In 1993, Ronald Matricaria took over as CEO and pushed for diversification. In 1994 they acquired Pacesetter, a large heart pacemaker company. In 2010 they acquired CardioMems, which monitors pulmonary artery pressure wirelessly. Although, they do not currently manufacture blood flow monitors, it would be a natural extension of their product line. Their stock is selling at about $50/share. The current market cap is $14.2B. Most analysts rate it as a “buy” stock” but not as enthusiastically as they do Edwards.

Short Term Liquidity:

The current ratio, quick and cash flow liquidity ratio ratios are respectively (in 2014) 3.6, 3.9 and 5.5 times higher at Edwards than at St. Jude. The Edwards cash flow liquidity ratio in 2014 is particularly high because Edwards received a large patent litigation settlement in 2014 (This is gone into more detail in the profitability section of this report). Furthermore all of these ratios are trending downward at St. Jude and upward at Edwards. The average collection period at Edwards is consistently shorter at Edwards than at St. Jude; 51.4 days at Edwards vs 79 days at St. Jude (2014). Furthermore this is constantly improving at Edwards vs St. Jude where it is not. Days payable are longer at Edwards (41 days) vs St Jude (33 days) in 2014. The cash conversion cycle is comparable at both companies, about 219 days. Thus Edwards is in a much stronger liquidity position than St. Jude and this gap is increasing over time. Also, Edwards is more effective at collecting payments than St. Jude and is better at holding on to payables. Thus, Edwards appears to have a much stronger liquidity position than St. Jude.

Operating Efficiency:

Days inventory held (2014) is shorter at St. Jude (173) than at Edwards (207 days). Similarly, inventory turnover is faster at St. Jude (2.11) than at Edwards (1.76). Fixed asset turnover is consistently higher at Edwards (4.62 in 2014) than at St. Jude (4.19). Total asset turnover is also consistently higher at Edwards (.66 in 2014 vs .55 at St. Jude). Accounts receivable turnover is considerably higher at Edwards (7.10 vs 4.63). It appears that St. Jude moves inventory more efficiently than Edwards, but in all other respects, Edwards exhibits greater operating efficiency.

Capital Structure and Long-Term Solvency:

St. Jude functions with much greater debt than Edwards. In 2014, its debt ratio was greater (.58 vs .38), its long term debt to total capitalization was greater (.35 vs .21), its debt to equity ratio was greater (1.41 vs .61) and its financial leverage was greater (2.41 vs 1.66). Despite this, Edwards has consistently higher return on equity. For St Jude the return on equity is greater than its return on assets (.24 vs .13) showing effective use of financial leverage. For Edwards, the return on equity is less than the return on assets (.18 vs .29) showing relatively ineffective use of financial leverage. How well are these companies covering fixed charges ? Edwards has considerably higher times interest earned than St. Jude (53.24 vs 13.54) and cash instant coverage (105.32 vs 17.67). These figures indicate a widely divergent philosophy between these companies when it comes to accumulating debt. Edwards is very conservative compared to St. Jude. Thus, although Edwards is in a much better position to cover its debt it does so at a considerable loss in leverage, with an accompanying decrease in return on equity.

Profitability:

To evaluate profitability, it is important to note that Edwards was in major patent litigation against Medtronic during the years 2012 to 2014. In 2012, they had a litigation expense of $14.4M. In 2013, they received a $61.5M settlement from the patent litigation, and in 2014, they received $740.4M. These expenses and income do not affect gross or operating profit, but they have a major effect on net income and those indices derived from net income. Given that preface – gross profit margin was similar in the two companies; in 2014, the gross profit margin and operating profit margin for St. Jude and Edwards were respectively 71% vs 73% and 20% vs 22%. The high gross profit margins are due to the high markup in medical device sales prices. In 2014 the net profit margin for Edwards shot up to 35% due to the patent litigation settlement. Other parameters that were similarly affected (2013 vs 2014) were cash flow margin (went up from 23% to 44%), return on investment (went up from 14% to 23%), return on investment (went up from 14% to 23%), return on equity (went up from 25% to 37%), cash return on assets (went up from 17% to 29%) and return on net worth (went up from 25% to 37%). But even before the large settlement, in 2013, all of these parameters were considerably higher for Edwards. Net profit margin was 49% higher, cash flow margin was 32% higher, return on investment was 104% higher, return on equity was 53% higher, cash return on assets was 86% higher and return on net worth was 53% higher. These numbers indicate that Edwards is a considerably more profitable company than St. Jude.

Market:

Both companies exhibited marked growth in earnings per share from 2012 to 2014. St. Jude went from $2.40 to $3.52. Edwards went from $2.54 to $7.26, a growth rate more than double that of St. Jude. St. Jude paid out a small dividend all 3 years (0.11% of net earnings in 2014) and Edwards did not pay any dividends. I looked at the stock price history to estimate the average market price of these two companies’ shares during the years 2012 to 2014. This data was used to calculate approximate PE ratios. The PE ratios varied considerably over the years 2012 to 2014 with no clear winner between the two. These market ratios indicate that Edwards’ earnings per share performance was superior to St. Jude. But with the volatility in stock prices, neither company had a clearly superior performance in regards to PE ratio.

DuPont Analysis:

As mentioned above, St. Jude has used considerably more leverage than Edwards. Despite that, because of higher net profit margins and higher asset turnover, Edwards has consistently higher return on equity. This was true all three years and exaggeratedly so in 2014 because of the patent litigation settlement.

Summary:

Edwards has superior liquidity, operating efficiency, profitability and market performance than St. Jude. St. Jude uses leverage more effectively than Edwards. Of course, high leverage can be a mixed blessing – it increases the return on equity, but places the company at greater risk in meeting their debt obligations.

Conclusion:

When the day comes that MGI Medical is pursued by these two companies (in my dreams !), everything else being equal (especially sale price) I would choose Edwards over St. Jude.