Research Note:
Zimmer Holdings (ZMH)
June 8, 2009

A Poor CEO “Skill Fit” at Zimmer Likely to Disappoint

CEO David Dvorak (45) deserves credit for stepping up and fixing a major regulatory issue with the US Government in 2007 but under his leadership the company continues to experience quality control issues, a high degree of management churn, and a poorly executed acquisition integration which has resulted in lost sales traction and serial guidance revisions. We think CEO Dvorak lacks the correct “skill fit” and necessary operating experience to recapture Zimmer’s former leadership position in the $12 billion orthopedic implant market.

Dvorak became CEO of Zimmer Holdings (ZMH) in May of 2007. His legal background and internal promotion was a good fit at the time for the urgent regulatory problems the Company faced but our research suggests lawyers are generally poor picks for leading companies over extended time periods. As an attorney with an extensive background in compliance and regulatory affairs, he was well-suited to guide ZMH through a 2005 U.S. Attorney’s Office probe regarding improper payments to orthopedic surgeons and oversee the building of a more robust compliance model for the company. These issues were “successfully” resolved, resulting in a $169.5 million fine and DOJ oversight which expired in March 2009. David Dvorak originally joined Zimmer in 2001 and previously served as president of its global business unit, chief legal officer and chief compliance officer. Prior to this, he served as senior vice president, general counsel and secretary for STERIS Corporation and prior to that, was a practicing attorney. He is also a director of the Advanced Medical Technology Association.

There has been a lot of recent management churn in ZMH’s line officers but the key positions of CFO and Chief Scientist have been stable. In the same month Dvorak became CEO, James Crines (age 49) was promoted to CFO. Jim Crines has been a ZMH executive since 1999 and previously served as the company’s senior vice president and Controller. Prior to joining ZMH, he held various financial management roles at American Cyanamid and worked as a senior auditor with PricewaterhouseCoopers. Chief Scientific officer Dr. Cheryl Blanchard has ironically been one of the few senior executives to stay in place, having been in her current role since 2005. She joined ZMH in 2000 from various research and academic stints and holds degrees in ceramic engineering and materials science.

CEO Dvorak installed new presidents in ZMH’s trauma, spine, dental and OSP divisions, terminated the company’s Chief Marketing Officer in May 2008 and hired new executives to lead the reconstructive and global business groups last year. That’s a lot of change to add to an already struggling operation and may delay operational traction. The CEO was forced to substantially revise and change his strategy for the Company after less than a year on the job and the integration of Endius and Abbott Spine into ZMH’s business has not gone smoothly. In the 4th quarter of 2008 CEO Dvorak said that disruptions in the newly combined sales force resulted in a lower annualized run rate for sales which as of the 1st quarter of this year had not yet shown any signs of recovery. Worse, in 2008 ZMH began to experience increasing quality control issues which has caused the suspension of sales of its orthopedic surgical products (OSP) line, and the market withdrawal last July of its Durom Cup hip implant (for which the company has provisioned nearly $100 million against future customer claims).

As the impact of these problems became increasingly apparent during 2008, management revised its earnings guidance downward and seemed reactive in its operations plans. The company’s original 2008 guidance called for 10-11% top-line growth and EPS in a $4.20-$4.25 range. During the second quarter ‘08 call, management recast guidance to 4.5-5.0% top-line growth and EPS in a $4.05-$4.10 range. Actual 2008 results were 6% sales growth and EPS of $4.05. We worry that there may be still another revision on the horizon for this team as they struggle to stabilize and restore growth in the core knee and hip franchises.

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We think management pay is badly aligned with shareholders at ZMH. All the senior executives received annual salary increases in 2008 and, despite guidance misses and sharply slowed revenue and EPS growth, CEO Dave Dvorak's total compensation was $5.76 million in his first full year as CEO. His base salary is $742K, and he received a $691K bonus in 2008 with stock awards totaling $1.28 million. and option awards worth $2.77 million. As a percentage of compensation paid out to all ZMH executives last year, Dvorak's share of team pay was modest at 27.4% of cash and 38.3% of overall compensation. CFO Jim Crines is paid a salary of $456K, received a bonus of $274K and had total compensation of $3 million in 2008. Bruno Melzi, Chairman of EMEA region, received a salary of $586K, a bonus of $301K, and had total compensation of $2.4 million in 2008. Stephen Ooi, president of the Asian Pacific region, was paid $387K received a $200K bonus, and had total compensation of $2.6 million. Cheryl Blanchard, CSO, received a salary of $384K, a bonus of $198K, and had a total compensation of $1.8 million.

Total compensation of over $12 million paid to the management team is high but pure cash compensation is a more reasonable 1.05% of ZMH's operating income. The Company uses Watson Wyatt as its compensation consultant and sets an 18 month compounded annual growth rate in EPS to determine performance based stock awards. No awards are made unless executive achieve at least 85% of the target and management missed the 2008 target of 18% CAGR by 50% so no awards were made. Sizable (million-plus) option awards to executives in 2008 increased the nominal value of executives total compensation but ZMH management's "skin-in-the-game" equity ownership is comparatively low, at only 1.49 million shares, or less than 1% of the outstanding stock. Major chunks of management's options were granted in the high $60's and low $70's price range as well so they are deeply out-of-the-money and we question the value of such distant strike prices to focus executives on good capital allocation. CEO Dvorak owns about one third of the total option grants, or some 480K shares. At the recent $46 ZMH share price, Dvorak's beneficial stock ownership is valued at roughly $21 million. One positive is that the CEO is required to own ZMH stock with a value equal to at least five times his base salary and other senior managers must own at least 3x their salaries.

Management's capital allocation plans for 2009 are better than last year but still expansive and somewhat contradictory. The management team says expenditures for 2009 are focused on restoring growth in the hip and knee franchise and restoring R&D spending to an historical range of 5-6% of sales levels. ZMH also added 100,000 square feet of manufacturing capacity in Ireland last year and announced plans last July to invest more than $19 million to add approximately 50,000 square feet to its foundry operations, increasing annual output by approximately 1.3 million castings a year. Additionally, management says that ZMH still plans to use available free cash flow for share repurchases, having repurchased over $1.5 billion of its stock since 2007. ZMH currently has $833 million remaining under its the existing repurchase program, and a further repurchase of 12-14 million shares is implicit in management's 2009 EPS guidance. We note that EPS is a critical bonus factor for executives and that, to our eye, ZMH has a lot of capital commitments for a management team struggling to restore top line momentum and to fully integrate recent acquisitions. Shareholders should also note that ZMH has an unusually low definition of change-in-control (only 20% of shares outstanding) which could discourage activist investors.

In summary, we think CEO David Dvorak and his team have successfully addressed compliance and regulatory issues but are far less impressive in operating the Company in a tough economic environment. We do not think the CEO's core legal skills are a good fit for the operating challenges the Company now faces. Add to that a fairly grim management forecast for declining profit growth and shrinking margins in 2009, a disjointed capital allocation strategy, and low executive stock ownership. We think there is major risk of further negative surprises and we have low confidence that this CEO and his team will deliver meaningful results. *End*