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Reason for Report:
Industry Overview

Related Companies:	Share Price:
KCI	33.89

Health Care

Dinner with Privately-Held NPWT Player, Prospera

KEY POINTS:

- We hosted a dinner for investors with privately-held Prospera to discuss the company's Negative Pressure Wound Therapy (NPWT) offering and their views of the evolving market
- We continue to rate KCI at Underweight as we see the stock underperforming relative to our universe. Overweight-rated SNN also competes in the NPWT market, but this is not a significant driver for the stock, in our view.

Conclusion: Our dinner discussion with Prospera CEO Hamid Khosrowshahi uncovered a number of interesting insights on NPWT, but in the end did not materially change our view of the market. In some ways, we came away feeling that KCI is as formidable a competitor as ever, leveraging its service and support infrastructure, extensive line of NPWT devices, entrenched mindshare with prescribing physicians and long-term contracts to defend its market share against the likes of Smith & Nephew and Prospera. However, our dinner also reinforced our view that KCI remains vulnerable on several fronts due to price and to some degree the basis of shifting clinical evidence that foam may not always be the optimal solution for all patients, at all stages of wound healing. We maintain our Underweight rating on the stock, as we continue to expect KCI to underperform our coverage universe over the next 12 months.

What's New? We hosted a dinner in New York for investors with Hamid Khosrowshahi, CEO of privately-held Prospera. Prospera is a regional developer and marketer of a line of gauze-based NPWT systems through a collection of local and national distributors. We invited Mr. Khosrowshahi to discuss his line of products, his views on the clinical benefits of gauze vs. foam and the competitive dynamics across the U.S. market for NPWT.

Implications: We do not expect our insights from our dinner to have a significant impact on KCI. That said, our discussion enhanced our view of the competitive environment, highlighting: 1) The importance of upcoming peer-reviewed papers in influencing prescribing physicians, 2) the strength of KCI's position on long-term contracts and the company's flexibility in pricing strategies across its broad portfolio, and 3) the potential damage to market perceptions of gauze-based NPWT caused by smaller, poorly designed and weakly supported gauze systems over the past few years. We continue to be cautious on KCI over the longer term, and believe the stock's modest earnings multiple reflects the market's concern over KCI's long term prospects as well, due in part to pressures from competition, pricing and reimbursement. We expect KCI management to update investors on its longer term outlook at the company's upcoming analyst meeting, scheduled for November 10.

RISKS

Greater than expected impact of slowing procedures, pricing pressure, or reimbursement and regulatory changes, potentially related to US healthcare reform.

Additional details and takeaways:

Prospera's view is that gauze and lower variable NPWT are *better* than foam
Prospera's approach has been to promote the use of AMD (Anti-Microbial Dressing) gauze with the use of variable NPWT at lower pressures over constant pressure with foam. The company maintains that gauze allows caregivers to avoid the pain and trauma associated with foam dressing changes, citing that granulation tissue can often grow into foam, making removal of the dressing difficult without causing trauma to the wound bed.

Clinical data will be critical in expanding acceptance of gauze among physicians
Mr. Khosrowshahi noted several recent and upcoming studies and peer-reviewed papers which he views as important steps in raising the profile of gauze and variable, low-pressure NPWT while at the same time raising questions about the suitability of foam for certain patients. Prospera is sponsoring several studies, including a study of tissue in-growth and histology, which has been submitted for publication in Advances in Skin and Wound Care (*Negative pressure wound therapy Using gauze and foam*, O. Borgquist, R. Ingemansson, et al). That said, it remains early, and developing evidence evaluating the benefits of gauze over foam will take time.

Competition continues to bid at prices 40-50% below KCI's pricing
Most competitors in NPWT are bidding for business at rental rates of around $50-75/day, which is a substantial discount to KCI. Prospera views more aggressive pricing of $40/day or less by some smaller competitors day as unsustainable given the service and support required by hospitals and caregivers.

Service, Contracts and Mindshare – Three of KCI's Most Effective Competitive Weapons
KCI commands approximately 95% market share in the US NPWT market, and probably a similar footprint within the mindshare of prescribing physicians. Prospera feels that it can make inroads with nurses and caregivers closer to the patient, however it will take peer-reviewed articles and clinical evidence to convert physicians. Hence the company's focus on clinical studies.

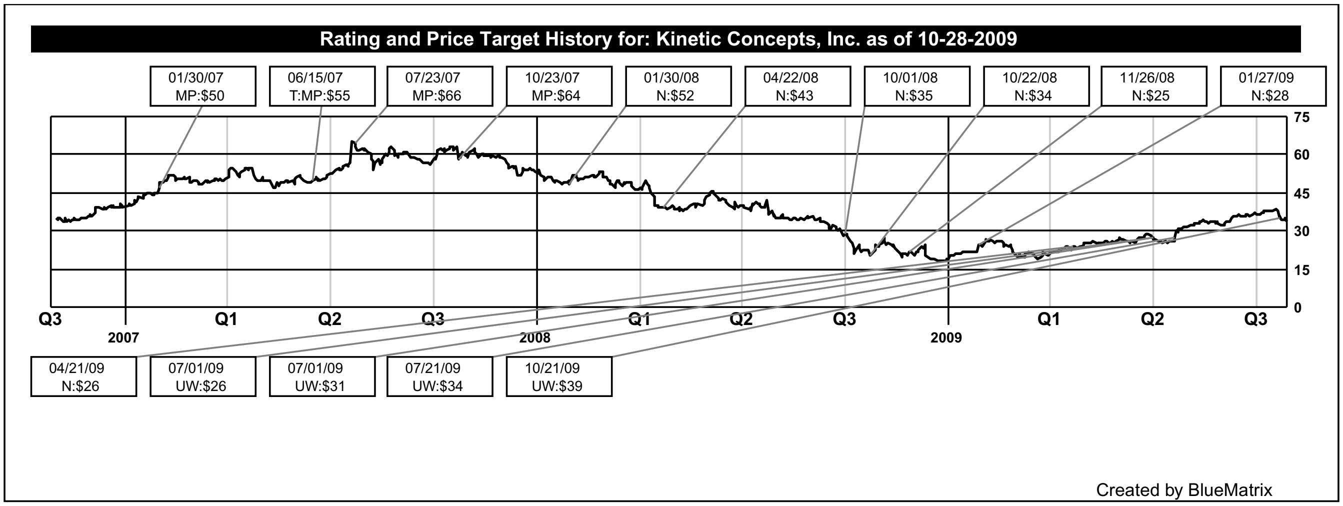
Long term contracts are another barrier to entry for competitors, enabling KCI to adjust, extend and renew contracts before other companies even are aware there's an opportunity. Finally, we believe the company's "360 care" model, providing clinical support, express order fulfillment and reimbursement support is virtually impossible to match, even for larger players like SNN.

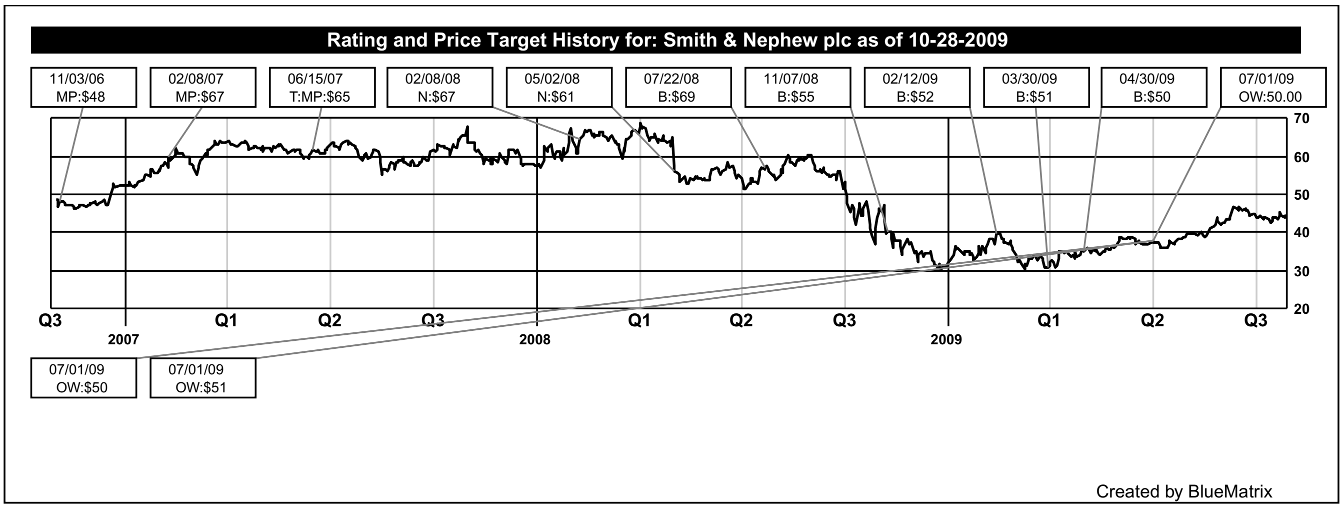
Risks, Ratings, and Price Targets

Kinetic Concepts (KCI): We have an Underweight rating and $39 price target on KCI. Our price target is based on on 10.5x our 2010 EPS of $3.71. Risks to our target price include, increasing competitive pressure in the wound management market, potential changes in reimbursement from Medicare and/or private payors and other pressures on pricing, and patent litigation risk.

Smith & Nephew (SNN): We have an Overweight rating and a $51 price target on SNN. Our price target is based on 15x 2010E EPS of $3.40. Risks: 1) Slower than expected procedure volumes; (2) Pricing pressure; (3) Failure of management to execute on the company's earnings improvement program (EIP); and (4) Potential implications of ongoing healthcare reform debate.

Important Research Disclosures





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			IB Serv./Past 12 Mos.	
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Analyst Certification — Matt Miksic, Sr Research Analyst

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