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SuperInvestor INSIGHT

From the Editors of *Value Investor Insight*

Testing Patience

Multiple SuperInvestors appear to believe Thermo Fisher Scientific is a high-quality, stable business with attractive growth prospects. The market, for the time being at least, has yet to concur.

Shareholders of medical instrument and supply company Thermo Fisher Scientific might be at somewhat of a loss to explain their treatment by the market in 2008. Considered well-managed and defensively positioned against a souring economy, the company posted a 20% earnings increase last year, at a time when profits of the average S&P 500 company were down 20%. Yet Thermo's share price for the year fell more than 40%, even worse than the S&P's 37% decline.

From such dynamics are potential investment opportunities born, which helps explain why four SuperInvestors – Atlantic Investment, Blue Ridge Capital, Eminence Capital and Viking Global – significantly increased their stakes in Thermo last quarter. The market, however, remains unmoved: at a recent $35.30, the shares in 2009 have barely budged.

Thermo Fisher Scientific is the product of the 2006 merger between Thermo Electron, an instrument manufacturer supplying research labs with products ranging from low-tech centrifuges to high-end mass spectrometers, and Fisher Scientific, primarily a seller of laboratory consumables such as storage containers, pipettes and cell cultures. The company is by far the largest player in its markets, generating more than $10 billion in annual sales and $1.2 to $1.3 billion in annual free cash flow from a diverse base of more than 350,000 customers worldwide. Roughly 70% of revenues come from recurring consumables and service contracts, with the balance coming from

INVESTMENT SNAPSHOT

Thermo Fisher Scientific
(NYSE: TMO)

Business: Global provider of instruments, equipment, consumables, software and services, used primarily in a variety of research, diagnostic and analytical functions.

Share Information
(@5/21/09):

Price	**35.32**
52-Week Range	26.65 – 62.77
Dividend Yield	0.0%
Market Cap	$14.77 billion

Financials (TTM):

Revenue	$10.20 billion
Operating Profit Margin	11.5%
Net Profit Margin	9.0%

Valuation Metrics
(@5/21/09):

	TMO	S&P 500
Trailing P/E	16.7	14.9
Forward P/E Est.	11.0	15.7

Largest Institutional Owners
(@3/31/09):

Company	% Owned
Barclays Global Inv	4.2%
Vanguard Group	3.4%
State Street Corp	3.3%
Goldman Sachs	3.1%
Jennison Assoc	2.9%

Short Interest (@4/27/09):

Shares Short/Float	2.8%

TMO PRICE HISTORY

THE BOTTOM LINE

The quality and stability of the company's businesses and its ability in tough times to capitalize on its market leadership are not adequately appreciated by the market, says Atlantic Investment's Bryan Carlson. Even returning to the lower end of the stock's historical multiple range would result in a 50% increase in the share price, he says.

Sources: Company reports, other publicly available information instruments and software products.

"This is a perfect example of the type of company we follow and admire for years but is always way too expensive for us to buy," says Bryan Carlson of Atlantic Investment. "But now it's both absolutely cheap and even trades at a discount to smaller, lower-quality and less-diversified peers, which just isn't reasonable." The shares today trade at less than 11x his 2010 earnings estimate of $3.25 per share. The *low end* of the historic multiple range for the company, he says, is a 16x EPS.

What is the market missing? For one, says Carlson, it appears to underestimate Thermo's capacity to capitalize on trying economic times to further strengthen its market position. Its size and rock-solid balance sheet – he expects Thermo to have no net debt at the end of this year – should allow it to compete aggressively for market share against highly leveraged competitors like VWR International in consumables, and with much smaller instrument makers like Waters [WAT] and Agilent Technologies [A].

With debt not an issue, Thermo is likely to direct some of its prodigious cash flow to strategic acquisitions that expand distribution in geographic regions it believes it underserves, such as China and India, or that add niche products in fast-growing diagnostic and bioscience areas. In April the company paid $120 million (roughly 1x revenue) to acquire Biolab, a leading instrument and consumables provider in Australia and New Zealand. Carlson expects several such acquisitions to come as the company continues to consolidate a still-fragmented industry. "Thermo has an opportunity to make it increasing difficult for smaller players with less product and service depth to compete," he says. "As customers everywhere look to be smarter about buying and to consolidate their vendors, Thermo typically has by far the broadest offering to help them accomplish that."

Carlson expects market concerns over prospective healthcare regulatory reforms to prove overblown in Thermo's case. Some of its key customers, particularly big pharmaceutical manufacturers, may certainly be negatively impacted by tightened government control over healthcare spending, but he believes other positive regulatory trends will more than compensate. Bans on stem-cell research have been lifted. Plans have been put forward to better test and improve the quality and safety of food, air and water. Most concretely, the Obama administration's stimulus package is highly supportive of science and scientific research, allocating an additional $10 billion to the National Institutes of Health, which funds 80% of the U.S.'s academic and government research. All such activity should increase demand for the types of instruments and supplies Thermo provides.

The market's most pressing question about the company is likely how defensive in nature its business actually is. First quarter revenues declined an unexpected 12%, leading to a 15% decline in earnings per share. Parsing that decline, Carlson believes the revenue shortfall isn't indicative of the business' future prospects. Roughly 5% of revenue decline, for example, came from adverse foreign currency effects. Another large part came from an unprecedented destocking of inventories of the company's products, particularly among healthcare buyers. Given that end-consumer demand – particularly in consumables – is far less volatile than the inventory changes would imply, Carlson expects those sales to rebound quickly as the destocking ends. His field checks indicate that process is already underway. Overall, he expects Thermo to produce mid-single-digit organic revenue growth over time, with acquisitions fueling growth on top of that.

The upside for Thermo's shares? Even returning to the lower end of the stock's historical P/E range would translate into a roughly 50% increase in the share price, Carlson says. "We usually expect that type of gain over two to three years, but I believe there's a good chance we'll make progress toward that target more quickly here." SII