Off Wall Street
Consulting Group, Inc.

P.O. Box 382107
Cambridge, MA 02238

tel: 617.868.7880
fax: 617.868.4933
internet: research@offwallstreet.com
www.offwallstreet.com

New Rec: Patterson Companies (PDCO: $37.18) April 6, 2008

Position: Sell **Target: $25**

	4/26/08	7/26/08	10/25/08	1/24/09			
$MM	**F4Q08e**	**F1Q09e**	**F2Q09e**	**F3Q09e**	**F2008e**	**F2009e**	**F2010e**
Revenue	771.5	729.5	766.9	793.5	2,991.8	3,088.1	3,228.5
EPS	0.48	0.37	0.42	0.48	1.66	1.76	1.78
Y/Y Gro	9%	8%	7%	7%	11%	6%	1%
PE	n/a	n/a	n/a	n/a	22	21	21
PSR	n/a	n/a	n/a	n/a	1.5	1.4	1.4
Consen	0.51	0.39	0.45	0.52	1.69	1.92	2.13

Shares Out: 120M **Market Cap: $4.5B** **FYE: Apr**

Summary: Patterson is one of the two largest dental products distributors in the US, with 32% market share. Sales of dental consumables and equipment represent

74% of sales and 78% of operating profit. The company also has a veterinary product distribution business (14% of sales, 6% of operating profit), and a rehabilitation product distribution business (12% of sales, 15% of operating profit). Shares trade at 19x F2009 EPS even though y-y net income growth in F2009 is expected to be only 2%. EPS is expected to increase 14% y-y in F2009 due to recent debt-financed share repurchases that reduced the company's share count by 10%.

Bulls view PDCO shares as a defensive investment with minimal exposure to recessionary pressures and health care reimbursement risk (e.g., Medicare, insurance company payments). They argue that patients will continue to see the dentist even in an economic downturn, so dental consumables (41% of total revenue) will continue to grow at 6% per year. They also argue that, despite a weak economy, spending on equipment (25% of total revenue) will continue to grow 5% per year, as dentists compete for new patients with the latest technologies. However, one could also view PDCO as the beneficiary of discretionary consumer spending on expensive and unnecessary procedures, for which credit is most often used. This type of spending and its financing may be vulnerable in an economic slowdown, as we discuss.

About 44% of the $96B in annual dental spending in the US is paid out of pocket. This spending includes basic dental care for people without insurance, but also includes cosmetic dentistry spending. According to the American Academy of Cosmetic Dentistry (AACD), spending in this segment is growing 11%-15% per year versus the 5%-6% growth in overall dental spending. We estimate that cosmetic dental care by specialists and general dentists now accounts for about 17% of the total dental care market. If, as we expect, cosmetic dentistry spending slows to 5% y- in F2009, total dental care spending growth would slow to 4% y-y. We think PDCO's dental consumable revenue will follow suit, and model 4% y-y growth in F2009 and F2010 versus "street" expectations of 6% growth.

Coincident with the rapid growth cosmetic dental spending has been the increased availability and use of consumer financing to pay for big-ticket procedures, which averaged $5,640 in 2006. In a recent survey, 87% of cosmetic dentists reported that they offer third party financing (e.g., GE's CareCredit, which financed an estimated $4B in dental spending in 2007) for their procedures, sometimes with a no interest option. Industry insiders with whom we have spoken tell us that it is the availability of consumer credit that has permitted the rapid increase in expensive cosmetic dentistry procedures such as veneers, implants, and crowns. If consumer credit standards tighten (as has already occurred for mortgages and auto loans), many patients may no longer be able to access the credit to finance what appears to be a significant piece of cosmetic dentistry growth.

Our research suggests a slowdown in dental care spending is already occurring. We spoke with a number of CPAs who specialize in cosmetic dentistry practice management. In weak housing markets such as San Diego and LA, revenue in some cosmetic dentistry practices is actually down 5%-10% y-y, and some practices are cutting their hygienist's appointment schedules for lack of demand. Even where housing is more stable, such as in Atlanta and Dallas, practice revenue growth has slowed y-y in the past few months from 8%-12% to 3%-5%.

Our research provides some evidence that sales of dental equipment are beginning to weaken. The CEO of a major dental equipment manufacturer with whom we spoke told us that sales on items like chairs and hand pieces are actually down y-y, with weakness beginning in November 2007. He attributed the weakness to dentists' worries about their investment portfolios and 401Ks. According to this executive, declining portfolio values make dentists feel less wealthy, and so less apt to spend on renovations or expensive equipment. Dental CPAs with whom we have spoken do not yet see a significant pullback in their clients' spending plans, but we think it may be too soon in the recessionary cycle for such change to be evident.

PDCO management acknowledged on a recent conference call that it has no good system for gathering information about its customers' capital equipment spending plans. It says it takes 3-4 months for customer comments from the field to make it to management. Moreover, it said that the impact of a recession usually hits it six months into recession since renovation plans are made far in advance. If communication with the field is so poor and the impact of recession so delayed, we wonder how management will be able to guide the "street" with any confidence for F2009.

PDCO is losing dental equipment share to competitor Henry Schein (HSIC). This is evident in comparing HSIC's equipment sales to PDCO's over the past few quarters. The share shift is due in part to HSIC's increased focus on equipment sales/service over the past several years, which has yielded important contracts with manufacturers. In 2006, HSIC also became the exclusive distributor of Biolase dental lasers, and Imaging Science's i-CAT cone beam 3-D imaging system. In May 2006, Danaher cut PDCO out of two important product lines (KaVo drills, Gendex x-ray equipment), generating important share gains for HSIC.

PDCO's sales of Sirona's (SIRO) CEREC CAD/CAM dental restoration systems have fallen dramatically over the past two years, declining 13% y-y in F2007 and about 5% y-y in F2008e. However, if we remove about $40M in F2008 sales from a one-time upgrade of the installed base, CEREC new system revenue will likely decline 56% y-y in F2008. This will have a significant impact in F2009, when the one-time upgrade revenue will disappear. While CEREC equipment represents about 10% of PDCO's dental equipment revenue, or 3% of total revenue, its margins and the margins on the consumables it sells for the systems are higher than average, giving it an outsized impact on the bottom line.

PDCO and the "street" blame weak CEREC sales on the anticipated launch of a competing system, the E4D, recently launched by HSIC. They believe that once dentists have a chance to compare both systems, the CAD/CAM space will reaccelerate, and CEREC sales will increase. Our industry contacts think this makes little sense, since the E4D launch has been delayed for four years or more. Why would it have held back dentists' investments for the past two years?

We think a more likely reason for the decline in CEREC sales is the recent launch of chair-side digital impression systems and dental lab-based CAD/CAM systems (e.g., 3M's Lava, Cadent's iTero) that produce crowns/bridges that are superior in quality to the CEREC. The digital impression systems purchased by the dentist cost $25,000, a fraction of the $100,000 for the CEREC. The digital impression of the patient's teeth is sent via email to a lab that creates a physical model, which is sent to the dental lab where it is used to create the restoration. Even SIRO is getting into the act. In January 2008, it began offering dentists the ability to use the CEREC intra-oral camera to create a digital impression that is then emailed to the lab for milling.

PDCO's veterinary and rehabilitation segments are also facing challenges. As evidenced by recent weakness in revenue for WOOF, consumer spending on veterinary services appears to be under recessionary pressure, which we think is likely to slow veterinary division growth to 7.5% y- versus the 8.7% expected by the "street." Growth in rehabilitation segment revenue has benefited in recent quarters from acquisition of several distributors, and equipment spending by physical and occupational therapy practices. We think equipment spending growth is likely to slow significantly in 2009, and project total rehab segment revenue growth of 2% in F2009 versus the "street's" expected 6% growth.

Despite the myriad of problems facing PDCO, analysts remain optimistic about sales and earnings in F2009 and beyond. The "street" expects total revenue to increase 6% in F2009 to $3.2B. EPS is expected to increase 14% to $1.93 on expanding margins and a lower share count. Given the macroeconomic and company specific issues facing PDCO, we expect sales to increase only 3% in F2009 to $3.1B. We expect operating margins to be about 50 bp lower than "street" estimates due to increased equipment competition and lower sales of high margin CEREC equipment and consumables. We expect EPS to increase 6% to $1.76.

PDCO Expectations: "Street" vs. OWS

$M	F2007a	"Street" F2008e	"Street" F2009e	OWS F2008e	OWS F2009e
Dental Consumables	1,154	1,220	1,292	1,214	1,263
Dental Equipment	714	750	786	746	735
Dental Other	196	225	243	223	240
Total Dental	2,065	2,195	2,321	2,183	2,238
Rehabilitation	334	367	390	362	369
Veterinary	400	450	489	447	481
Total Revenue	2,799	3,012	3,200	2,992	3,088
Total Op Margin	12.0%	12.0%	12.3%	11.9%	11.8%
Net income	207	226	231	221	211
EPS	1.50	1.70	1.93	1.66	1.76

Y-Y change	F2007a	"Street" F2008e	"Street" F2009e	OWS F2008e	OWS F2009e
Dental Consumables	5.7%	5.7%	5.9%	5.2%	4.0%
Dental Equipment	1.6%	5.0%	4.8%	4.4%	(1.4%)
Dental Other	14.1%	14.8%	8.0%	13.7%	7.8%
Total Dental	5.0%	6.3%	5.7%	5.7%	2.5%
Rehabilitation	10.7%	9.7%	6.4%	8.3%	2.0%
Veterinary	15.4%	12.7%	8.7%	11.9%	7.5%
Total Revenue	7.0%	7.6%	6.2%	6.9%	3.2%
Total Op Profit	3.9%	7.7%	8.6%	6.2%	2.3%
Net income	4.1%	9.5%	2.2%	7.0%	-4.6%
EPS	5.2%	13.4%	13.5%	10.7%	5.9%

The company's chairman may agree with our analysis, as he sold 250,000 shares (4.6% of his holdings) at the end of February, even as the company began its 6.3M share repurchase in March.

Our target of $25 is 14x our F2009 EPS estimate. This multiple is below PDCO's current multiple of 19x, and reflects a continuation of the multiple contraction PDCO shares have experienced since trading at 32x forward earnings in 2005. This multiple contraction is a reflection of lower expectations for earnings growth, as Patterson's size has made increasing growth more difficult. As we discuss in detail, there are a number of reasons we expect multiple contraction to continue, including lower acquisition activity, maturity of the market, and a more competitive business environment.

Our target multiple of 14x is comparable to the multiples awarded distributors such as CTAS (13x), CAH (13x) and ABC (14x). At our target, the EV/EBITDA multiple including the new $525M in debt taken on in March would be 10x, and the FCF yield would be 6.8%.

Background

Patterson Companies is a distributor of dental, veterinary, and rehabilitation supplies. It is the second largest dental consumables and equipment distributor in North America, with 32% market share versus Henry Schein's (HSIC) 38%. Aside from a few mid-size suppliers (e.g., Benco Dental, Atlanta Dental), the remaining 30% of the market is highly fragmented.

In F2007, sales of dental consumables and equipment represented 74% of sales and 78% of operating profit. PDCO's 1,566 dental representatives call on the 135,000 office-based dental practices in the US to take orders for consumables and sell equipment. The company offers a full line of equipment, from chairs, operatories, cabinets, and lighting, to high tech offerings such as digital radiography, soft tissue lasers, and the CEREC in-office CAD/CAM ceramic restoration system.

PDCO's Webster Veterinary division was 14% of sales and 6% of operating profit in F2007. It is the second largest distributor of veterinary supplies in the US, with a 14% market share. Webster's 175 sales reps call on the nation's 27,000 veterinary clinics, offering a full line of consumables, equipment, and animal pharmaceuticals/vaccines.

The Patterson Medical division was 12% of sales and 15% of operating profit in F2007. It has about a 6% share of the US market for rehabilitation supplies (e.g., splints, supports, compression products) and equipment (e.g., continuous passive motion equipment, whirlpools, exercise equipment). Its 200 representatives primarily call on physical and occupational therapists, and the median order size is $70. About 20% of the division's sales are in the UK and France through its Homecraft and Kinetic divisions, respectively.

Discussion:

1. Dental care spending of $96B growing at 5%-7% per year, likely to slow to 4% due to slowdown in cosmetic dentistry growth

According to US government estimates, spending on dental care is increasing at 5%-7% per year, and totaled about $97B in 2007. About 50% of this spending is covered by private insurance, 6% by Medicare/Medicaid, and 44% out-of-pocket. This out-of-pocket spending includes both basic dental care and cosmetic dentistry. With 32% of the market, PDCO's dental consumable revenue growth closely reflects growth in dental care spending.

While a little over 1% of annual dental spending growth can be attributed to population growth (0.9% per year for the general population, 1.6% per year for those 45 and older who use more dental services), and 3% or so from price increases, growth above 4% is most likely attributable to increased discretionary cosmetic dentistry services.

According to a 2007 survey by the American Academy of Cosmetic Dentistry, practice revenue for the estimated 5,550 specialty cosmetic dentistry practices in its membership increased 15% y-y in 2006, and was projected to increase 11% in 2007. Total cosmetic dentistry revenue generated by these specialists in 2006 was estimated at $2.8B, or $500,000 per practice (about 50% of total practice revenue).

However, the cosmetic dentistry market is much larger, since more and more general dentists are offering services such as tooth whitening, veneers, porcelain crowns, orthodontics, and even implants. If we assume 15%, or $100,000, of the general dentist's $700,000 in annual revenue is from cosmetics, cosmetic dentistry revenue for the remaining 130,000 practices in the US would be $13.6B. According to these assumptions, total cosmetic dentistry spending in 2007 was $16.4B, or 17% of total dental spending of $96B.

Estimate of Cosmetic Dentistry Market Size, 2007

	Practices	Annual Rev/ Practice	Total Revenue	% Cosmetic	Annual Cosmetic Rev
Cosmetic Specialists	5,550	$1M	$6.2B	50%	$3.1B
General Dentists	129,450	$700,000	$90.6B	15%	$13.6B
Total	135,000	--	$96.8B	17%	$16.7B

Sources: AACD, PDCO filings, OWS estimates

With 15% growth in 17% of the market, and 4% growth in the remaining 83%, total market growth would have been 6% in 2007, in line with government estimates. If, as we expect, cosmetic dentistry growth slows to 5% in F2009 due to recessionary pressures, total dental revenue growth would be 4%. A further slowdown could occur if consumers delay out-of-pocket basic dentistry expenditures in a rough economic environment. In our model, we grow PDCO's dental consumable revenue at 4% y-y for F2009 and F2010, below "street" assumptions of 5.9% growth.

2. Consumer credit has become an important factor in cosmetic dentistry revenue growth

Industry insiders with whom we have spoken tell us that the easy credit environment of 2000-2007 was a key factor in the rapid growth in expensive dental procedures. According to the AACD, the average cosmetic dentistry patient spent $5,640 in 2006. Some procedures, such as whitening, cost $500-$800, while a full mouth restoration can cost well over $50,000. Without debt financing, fewer patients would have been able to afford such procedures.

While many patients use their own credit cards or home equity loans if they finance their dental work, most practices offer some form of consumer credit to their patients. A recent survey by the AACD showed that 87% of cosmetic dentists offer third party financing. The most popular is GE's CareCredit, which offers monthly payments as well as no interest payment options. According to dentists with whom we have spoken, those offering the no interest option accept a 10% discount on their fee, which goes to CareCredit. The benefit for the dentist is more procedure volume and instant collections.

Quantifying the impact of easy credit on dental spending is difficult, since little is known about credit card charges and use of home equity loan funds. However, one industry source with whom we spoke estimates that GE's CareCredit financing for dental practices was about $4B in 2007, or 8% of total out-of-pocket dental spending.

3. Spending on dental care may be slowing

Our field research suggests that a slowdown in dental care spending may already be occurring. We spoke to a number of CPAs in various locations around the US. These CPAs are members of the Academy of Dental CPAs, whose members specialize in serving high-end dental practices. Our view is that if these types of practices are seeing weakness, then things could be even worse at lower end practices that deal with more cash-strapped clientele.

We found that in areas with weak housing markets (e.g. San Diego and LA), revenue in some cosmetic dentistry practices is actually down 5%-10% over the past few months, with practices expecting revenue to be even lower in 2008. One CPA told us that this is the first time in his experience he has had clients in stable practices telling him that practices are slow, and that they are cutting back on their hygiene schedules. In more stable markets, such as Atlanta and Dallas, practice revenue growth has slowed from 8%-12% y-y in 2006 to 3%-5% in the past few months.

PDCO's dental consumable sales were up 4% (or 5%-6% adjusted for one less business day) in F3Q08. This is a slowdown from 7% growth in F2Q08. Similarly, HSIC's dental consumable revenue (which includes ex-US revenue) was up 4.6% in C4Q07, versus 6% growth in C3Q07.

4. Sales of dental equipment may be weakening

Our research provides some evidence that sales of dental equipment are beginning to weaken, though since orders are placed with manufacturers months before delivery, the impact on PDCO's numbers may be delayed. The CEO of a major dental equipment manufacturer with whom we spoke told us that sales on items like chairs and hand pieces area actually down y-y, with weakness beginning in November 2007. He attributed the weakness to dentists' worries about their investment portfolios and 401Ks. According to this executive, declining portfolio values make dentists feel less wealthy, and, so, less apt to spend on renovations or expensive equipment. Dental CPAs with whom we have spoken do not yet see a significant pullback in their clients' spending plans, but we think it may be too soon in the recessionary cycle for such change to be evident.

PDCO management acknowledged on a recent conference call that it has no good system for gathering information about its customers' capital equipment spending plans. It says it takes 3-4 months for customer comments from the field to make it to management. Moreover, it said that the impact of a recession usually hits it six months into recession since renovation plans are made far in advance. If communication with the field is so poor and the impact of recession so delayed, we wonder how management will be able to guide the "street" with any confidence for F2009.

5. PDCO is losing equipment share to HSIC

HSIC has gained equipment share at the expense of PDCO. An industry expert speaking on a "street" conference call attributed HSIC's gains to its willingness to take bigger risks on new technology than PDCO, and to commit to exclusive deals. For example, in 2006, HSIC became the exclusive distributor of Biolase dental lasers and Imaging Science's i-CAT cone beam 3-D imaging system. According to this consultant, the i-CAT is selling much better than a similar Planmeca product distributed by PDCO.

In May 2006, PDCO also lost distribution rights to two important equipment lines from Danaher: KaVo drills and Gendex X-ray equipment. Losing these established lines helps competitors to gain entrance to accounts that may have relied on PDCO in the past for related consumables/service.

The loss in share is evident in PDCO's equipment sales growth as compared to HSIC's. As shown below, PDCO's dental equipment/service growth has been increasing by single digits y-y for most of the last eight quarters, and was even down y-y in 3Q07. In contrast, HSIC's dental equipment revenue (excluding acquisitions, local currency) has been increasing in excess of 15% y-y for the past seven quarters.

Comparison of Dental Equipment/Other Y-Y Growth Rates for PDCO and HSIC

	4Q06 4/29/06	1Q07 7/29/06	2Q07 10/28/06	3Q07 1/27/07
PDCO Equip/Other Rev	7.3%	7.2%	6.7%	-1.7%
HSIC Equip/Other Rev*	8.4%	18.0%	15.4%	20.6%

	4Q07 4/28/07	1Q08 7/28/07	2Q08 10/27/07	3Q08 1/26/08
PDCO Equip/Other Rev	5.6%	5.7%	0.9%	14.3%
HSIC Equip/Other Rev*	23.5%	22.3%	25.9%	15.9%

*Local currency internal growth
Source: SEC filings

Industry contacts tell us that HSIC has been aggressively pursuing the dental equipment market, and is much more willing to wheel and deal than PDCO to get business. Interestingly, PDCO may have finally responded to the pressure on its equipment sales in 3Q08. While equipment/other revenue increased 14% y-y, dental operating margins were down 60 bp y-y to 13.7%, which the company blamed on an equipment financing promotion.

6. CEREC sales excluding upgrade revenue have fallen off a cliff

PDCO has been the exclusive distributor of Sirona's CEREC CAD/CAM restoration milling system since 1998. The CEREC is a $100,000 chair-side system that allows dentists to create a place a crown or other limited restoration during one visit to a dentist's office. The dentist is able to capture fees formerly outsourced to dental labs, and reduce the number of visits patients much make to get their restoration.

Sales of the CEREC have been an important component of PDCO's dental equipment growth. While the company does not break out CEREC sales, the "street" provides estimates that we will use in our analysis. As shown below, CEREC will represent about 10% of dental equipment sales in F2008. CEREC sales will decline about 5% y-y this fiscal year, versus a 13% decline in F2007. We discuss the reasons for this decline later in this report.

PDCO: CEREC and Other Dental Equipment Sales

	F2005a	F2006a	F2007a	F2008e
CEREC Rev	89.0	91.7	79.4	75.2
Other Dental Equip/Software	589.4	611.6	635.0	670.5
Dental Equip/Software	678.3	703.3	714.4	745.8

Source: "Street" estimates

Y-Y chng	F2005a	F2006a	F2007a	F2008e
CEREC Rev	35.1%	3.0%	-13.4%	-5.3%
Other Dental Equip/Software	21.8%	3.8%	3.8%	5.6%
Dental Equip/Software	23.4%	3.7%	1.6%	4.4%

% Total	F2005a	F2006a	F2007a	F2008e
CEREC Rev	13.1%	13.0%	11.1%	10.1%
Other Dental Equip/Software	86.9%	87.0%	88.9%	89.9%
Dental Equip/Software	100.0%	100.0%	100.0%	100.0%

Sales in F2008 benefited from an upgrade to about 20% of its installed base of 7,250 systems that PDCO says generated about $40M in sales. If we exclude revenue from the upgrades, sales of new units will likely be only $35M in F2008, down 56% from $79.4M in F2007. According to PDCO, this upgrade will be largely complete in F2008, making for tough comps in F2009 and beyond.

CEREC Sales from Upgrades and New Systems

	1Q08a	2Q08a	3Q08a	4Q08e	F2008e
Upgrade Sales	4.0	9.5	16.5	10.0	40.0
New System Sales	8.7	9.5	8.5	8.5	35.2
Total CEREC Sales	12.7	19.1	24.9	18.5	75.2

Source: Company conference calls

	1Q08a	2Q08a	3Q08a	4Q08e	F2008e
Upgrade Sales	n/a	n/a	n/a	n/a	n/a
New System Sales	-69.4%	-37.8%	-56.4%	-62.5%	-55.6%
Total CEREC Sales	-17.0%	-2.0%	10.0%	-15.7%	-5.3%

7. CEREC faces new competition that may permanently depress sales

PDCO has blamed the slowdown in CEREC sales on the long anticipated launch of a competing chair-side system, the E4D, which will be distributed by HSIC. PDCO management says that before committing to such a significant capital investment, dentists want to compare both systems. PDCO and the "street" believe that once dentists have a chance to compare both systems, sales for the entire chair-side CAD/CAM space will reaccelerate, and help PDCO achieve the 5% equipment growth expected for F2009. Industry contacts with whom we have spoken find this argument less than compelling, since the E4D launch has been delayed repeatedly for the past four or more years. Why should it now stall CEREC sales?

Our field research suggests there is another reason for the slowdown in CEREC sales that could cause new system sales to remain at their present low level or decline even further. Over the past few months, new chair-side digital impression systems and dental lab-based CAD/CAM systems have launched that produce crowns/bridges that are superior in quality to those produced by the CEREC. These systems require a much lower investment by the dentist ($25,000 versus $100,000 for the CEREC), and remove all of the headaches and training issues that have long dogged CEREC users manufacturing restorations in-house rather than through a dental lab.

The systems generating the most interest among industry experts with whom we have spoken are the Lava system from 3M and the iTero from Cadent. Both companies are selling their products directly. The systems take a digital impression of the patient's teeth, which the dentist then sends via email to a lab that creates a physical model. This model is sent to the dental lab, which uses it to create a restoration that is superior in quality to those made with traditional paste impression materials, since the fit is more precise. Moreover, the system checks the digital impression before it is sent to the lab. Traditional impressions, on the other hand, sometimes miss important features due to lack of coverage, meaning the patient has to come back to the dentist for a redo.

According to our sources, the restorations created on the Lava and iTero systems are superior in quality to those made on the CEREC, since the materials used to create the restorations generate better gradations in color to mimic an actual tooth, and are less likely to crack over time. Finally, the Lava and iTero are more versatile than the CEREC, since they can be used to create impressions for many different kinds of restorations in one sitting. In contrast, the CEREC is only really useful for creating one or two crowns at a time, since more would require the patient to come in for more than one visit, obviating its one visit advantage over the dental lab.

Our sources think that dentists will increasingly opt to purchase a digital impression system and allow the dental lab to take on the investment in the more expensive CAD/CAM and milling equipment. In the Atlanta market, for example, there are already five Lava systems in dentists' offices, even though the system was just launched at the beginning of 2008.

8. Slow CEREC sales could result in write-down/refund of distribution agreement fees

In 2006, PDCO signed a 10 year extension of its exclusivity agreement for the CEREC through 2017, and paid Sirona $100M for the privilege. PDCO's 10-K says it will amortize the fee over ten years in an amount per quarter that "will reflect the pattern in which economic benefits of the fee are realized." For the first full quarter of the deal (3Q08), PDCO amortized only $1.2M versus the $2.5M that would have been expected if the agreement were being amortized on a straight-line basis.

Should sales continue to be disappointing, PDCO may be forced to write down the fee. PDCO may also just stop selling the product, in which case Sirona might terminate the agreement to release it of its exclusivity obligation to PDCO. Should this happen, PDCO would recoup some of the fee, by an amount which declines by $15M per year during 2008-2012, and $5M per year thereafter. Clearly, as originally conceived, the value of exclusivity was heavily front end loaded (75% in the first five years). That amortization by PDCO is only half of even a straight line amortization schedule suggests performance is seriously below original expectations.

9. Veterinary business faces recessionary pressures

PDCO's veterinary supply business faces recessionary pressures that may be even greater than those in dental. While consumer spending on veterinary services is often thought of as "recession proof" by bulls, recent results from WOOF and MWIV suggest otherwise. It blamed weakness in 4Q07 on weak consumer spending, and expects same store animal hospital revenue growth of 3%-5% in 2008, down from 5.2% in 2007.

10. Rehabilitation results boosted by recent distributor acquisitions

PDCO's rehabilitation supply revenue grew at about 10% per year in F2007 and F2008e. Growth in F2007 was boosted 3% by dealer acquisitions and 1.5% by currency, for organic growth of about 6%. Organic growth for the first three quarters of F2008 has not been disclosed, but also benefited from dealer acquisitions.

Despite the acquisitions, operating margins were down 280 bp y-y in F2007 to 15.3%, and are likely to be down another 140 bp in F2008 to 13.9%. This is far below the F2008 operating margin of 15.8% for the segment that management expected as recently as 2Q08.

We think revenue growth will slow to about 2% y-y in F2009 as a result of fewer distributor acquisitions, and reduced equipment spending by physical and occupational therapy practices. Consumable revenue could be hurt as well if employer use of higher copays to cut insurance rate hikes results in fewer patient visits to PT and OT practices.

11. Further multiple compression likely as hopes of renewed growth fade

PDCO shares currently trade at 19x forward "street" earnings, significantly below the 32x multiple of February 2005 and the five year average multiple of 24x. We think the downward trend in valuation is likely to continue, and so apply a multiple of 14x to our F2009 EPS number to arrive at our target price. Aside from our expectation that earnings will grow only 6% y-y in F2009 and 1% in F2010, we see the following factors holding down valuations:

Reduced acquisition activity: PDCO's loftiest valuations came at a time when it was consolidating a number of large acquisitions. As shown in the table below, between F2002-F2005, PDCO spent $795M on acquisitions expanding its footprint in dental (Thompson) and entering the veterinary (Webster) and rehabilitation supply (AbilityOne) markets. From F2006-F2008e, the company has spent less than a tenth of the prior period's investment, or just $75M.

PDCO Acquisitions: F2002-F2008e

	Spending	Acquisitions
F2002	$109M	Thompson Dental, Webster Vet Supply
F2003	$6.5M	---
F2004	$606M	AbilityOne Rehab Supply, ProVet
F2005	$73M	Medco Rehab, CAESY dental patient education, Milburn Vet
F2006	$39M	Intracorp Vet Software, Accu-bite Dental Supply
F2007	$23M	Theraquip, Metro Medical, Dade Surgical rehab dealers
F2008e	$13M*	Rehab dealers

*Excludes two small acquisitions announced in 4Q08

PDCO is now using cash and debt to buy back shares rather than to make large acquisitions, suggesting that it may have run out of room to find acquisitions large enough to generate the growth it needs.

Maturing market: According to the Centers for Medicare and Medicaid Services (CMS), dental care spending increased 9% y-y in the 1980s and 7% in the 1990s. While spending growth has remained at 6%-7% through the first seven years of the 2000s, we think 2%-3% of this growth was fueled by rapid growth of cosmetic dentistry due to easy consumer credit. With that credit now gone, we think the market growth will slow to a mature rate of 4% per year.

Outsized growth from the veterinary and rehab segments also seems unlikely. These markets remain very competitive and highly fragmented, and have both underperformed versus expectations at the time of PDCO's entry into the market.

More competition: Finally, PDCO is faced with a much more competitive environment than in the past. Not only does it now have an aggressive competitor in HSIC, but important manufacturers (e.g., Danaher and Dentsply) appear to be gaining more control over the distribution channel, which could pressure margins.

Our target multiple of 14x is comparable to the multiples awarded distributors such as CTAS (13x), CAH (13x) and ABC (14x). At our $25 target, the EV/EBITDA multiple including the new $525M in debt taken on in March would be 10x, and the FCF yield would be 6.8%.

12. Insider sales

The company's chairman sold 250,000 shares (4.6% of his holdings) at the end of February, even as the company began its 6.3M share repurchase in March.

13. Balance sheet analysis

On March 24, PDCO announced that it had borrowed $525M. The average interest on the $450M in fixed rate debt is 5.3%. Another $75M is floating rate debt at LIBOR plus 0.5%-1.25%.

Of the $525M in debt, $250M was used to purchase 6.3M shares as part of an accelerated share repurchase program, $60M was used to pay off a revolving credit line, and the remaining $215M will be used for general corporate purposes.

The analysis below includes our estimates of the impact of the March capital restructuring.

Current debt	655.1
Current equity	1026.5
Current tangible book value	155.6
Current market value	4585.8
Current cash	386.2
Current DSO	42
Current DIO	51

	F2008e	F2009e	F2010e
EBIT	356.0	364.4	372.9
EBITDA	387.0	395.4	403.9
FCF (Net income + D&A - Capex- chng WC)	202.4	201.4	197.0
Capex	30.0	25.0	25.0
EV/EBITDA	12.5	10.2*	9.9†
EV/(EBITDA-capex)	13.6	10.8*	10.6†
FCF Yield	4.4%	6.8%	6.6%

*At our target price of $25

14. Financials

	2007a	2008e	2009e	2010e	Jul-07 1Q08a	Oct-07 2Q08a	Jan-08 3Q08a	Ap-08 4Q08e	Jul-08 1Q09e	Oct-08 2Q09e	Jan-09 3Q09e	Ap-09 4Q09e	Jul-09 1Q10e	Oct-09 2Q10e	Jan-10 3Q10e	Ap-10 4Q10e
Dental Consumables	1,154	1,214	1,263	1,313	295	310	295	314	307	323	306	327	320	335	319	340
CEREC Rev	79	75	38	26	13	19	25	19	11	10	10	8	8	6	6	6
Other Equip/Sftwr	635	671	697	737	140	150	207	174	143	157	214	183	154	166	224	193
Tot Dental Equ/Sftwr	714	746	735	763	153	169	232	193	154	167	224	191	162	172	230	199
Dental Other	196	223	240	258	52	55	59	57	56	60	62	62	60	64	66	68
Total Dental Supply	2,065	2,183	2,238	2,335	500	535	585	564	517	549	592	579	541	572	615	607
Rehab Consumables	241	257	262	267	66	70	58	62	68	71	60	63	69	73	61	65
Rehab Equip/Soft	77	87	89	91	21	24	21	21	22	24	22	21	22	25	22	22
Rehab Other	16	18	19	19	4	5	5	5	4	5	5	5	4	5	5	5
Rehabilitation Supply	334	362	369	377	91	99	84	88	93	101	86	90	95	103	88	92
Vet Consumables	362	408	440	475	102	100	97	109	110	108	104	118	119	117	113	127
Vet Equip	29	32	33	35	7	7	9	9	7	8	9	9	8	8	10	10
Vet Other	8	7	7	7	2	2	2	2	2	2	2	2	2	2	2	2
Veterinary Supply	400	447	481	517	110	109	108	120	119	117	115	129	128	126	124	139
Total Revenue	2,798	2,992	3,088	3,228	701	742	777	772	730	767	793	798	764	800	827	837
Cost of Sales	1,830	1,967	2,031	2,123	464	490	508	505	482	506	520	523	505	528	542	548
Operating Expenses	633	669	701	728	162	167	172	168	175	177	176	174	180	183	185	180
Total Operating Expense	2,463	2,636	2,732	2,858	626	656	680	673	657	683	695	697	685	711	726	736
Dent Supply Op Profit	262	282	288	296	58	66	80	78	59	68	81	80	61	70	83	82
Rehab Supp Op Profit	51	51	52	53	13	14	11	12	13	14	12	13	13	14	12	13
Vet Supply Op Profit	22	24	25	24	5	5	6	8	5	6	6	8	6	6	6	7
Total Op Profit	336	356	364	373	75	86	97	98	77	88	99	101	80	90	101	101
Finance Income	8	9	5	2	2	3	3	1	2	1	1	1	1	1	1	1
Interest Expense	(14)	(12)	(32)	(33)	(3)	(3)	(2)	(5)	(7)	(8)	(8)	(8)	(8)	(8)	(8)	(8)
Net Income Before Taxes	330	354	337	342	76	86	98	95	72	81	91	93	72	83	93	94
Taxes	123	133	127	128	28	33	37	35	27	30	34	35	27	31	35	35
Net Income After Taxes	207	221	211	214	48	54	60	59	45	51	57	58	45	52	58	59
EPS	1.50	1.66	1.76	1.78	0.35	0.39	0.45	0.48	0.37	0.42	0.48	0.49	0.38	0.43	0.49	0.49
S/O	138	133	120	120	137	137	135	124	120	120	120	120	120	120	120	120

Y-Y change	2007a	2008e	2009e	2010e	Jul-07 1Q08a	Oct-07 2Q08a	Jan-08 3Q08a	Ap-08 4Q08e	Jul-08 1Q09e	Oct-08 2Q09e	Jan-09 3Q09e	Ap-09 4Q09e	Jul-09 1Q10e	Oct-09 2Q10e	Jan-10 3Q10e	Ap-10 4Q10e
Dental Consumables	5.7%	5.2%	4.0%	4.0%	5.7%	7.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%
CEREC Rev	-13.4%	-5.3%	-49.1%	-30.9%	-17.0%	-2.0%	10.0%	-15.7%	-11.5%	-49.8%	-61.6%	-57.4%	-30.0%	-35.3%	-35.3%	-21.4%
Other Equip/Sftwr	3.8%	5.6%	3.9%	5.7%	6.3%	-2.5%	13.2%	4.2%	2.1%	4.7%	3.6%	5.2%	7.7%	5.7%	4.7%	5.5%
Tot Dental Equ/Sftwr	1.6%	4.4%	-1.4%	3.8%	3.9%	-2.5%	12.8%	1.9%	1.0%	-1.4%	-3.5%	-0.8%	4.9%	3.4%	3.0%	4.4%
Dental Other	14.1%	13.7%	7.8%	7.5%	11.4%	12.9%	20.6%	10.0%	8.6%	8.3%	5.5%	8.8%	7.1%	6.7%	6.5%	9.7%
Total Dental Supply	5.0%	5.7%	2.5%	4.3%	5.7%	4.4%	8.9%	3.9%	3.6%	2.7%	1.2%	2.8%	4.6%	4.1%	3.9%	4.7%
Rehab Consumables	10.8%	6.4%	2.0%	2.0%	7.3%	9.2%	8.2%	1.1%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%
Rehab Equip/Soft	11.2%	13.1%	2.0%	2.0%	23.5%	28.8%	6.1%	-2.2%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%
Rehab Other	5.8%	14.1%	2.0%	2.0%	0.9%	15.6%	16.5%	22.5%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%
Rehabilitation Supply	10.7%	8.3%	2.0%	2.0%	10.4%	13.7%	8.1%	1.3%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%
Vet Consumables	12.3%	12.6%	8.0%	8.0%	9.9%	15.6%	15.4%	10.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Vet Equip	69.6%	9.9%	3.0%	3.3%	31.1%	5.5%	5.9%	4.5%	5.0%	5.3%	0.5%	2.2%	2.7%	2.7%	4.3%	3.3%
Vet Other	25.1%	-12.2%	1.2%	0.0%	-25.0%	-16.9%	-4.1%	-0.2%	3.0%	-0.4%	2.3%	0.0%	0.0%	0.0%	0.0%	0.0%
Veterinary Supply	15.4%	11.9%	7.5%	7.6%	10.3%	14.2%	14.1%	9.4%	7.8%	7.7%	7.3%	7.4%	7.6%	7.5%	7.6%	7.5%
Total Revenue	7.0%	6.9%	3.2%	4.5%	7.0%	6.9%	9.5%	4.4%	4.0%	3.4%	2.1%	3.5%	4.8%	4.4%	4.2%	4.9%
Cost of Sales	7.6%	7.5%	3.2%	4.5%	7.2%	6.8%	10.6%	5.6%	3.9%	3.4%	2.3%	3.5%	4.8%	4.4%	4.2%	4.9%
Operating Expenses	7.1%	5.6%	4.8%	3.9%	5.2%	5.8%	9.2%	2.4%	7.8%	6.2%	2.0%	3.6%	3.2%	3.4%	5.4%	3.4%
Total Operating Expense	7.4%	7.0%	3.6%	4.6%	6.7%	6.5%	10.2%	4.8%	4.9%	4.1%	2.3%	3.5%	4.3%	4.1%	4.4%	5.6%
Dent Supply Op Profit	5.0%	7.5%	2.1%	2.8%	16.6%	11.5%	4.2%	1.8%	2.4%	2.9%	0.9%	2.6%	3.4%	2.9%	2.5%	2.5%
Rehab Supp Op Profit	-6.6%	-1.3%	2.4%	2.0%	-8.6%	4.4%	2.7%	-3.0%	1.8%	-0.9%	7.6%	2.0%	2.0%	2.0%	2.0%	2.0%
Vet Supply Op Profit	20.1%	6.6%	4.7%	-2.0%	-5.9%	3.9%	20.6%	8.3%	6.6%	6.2%	-2.3%	7.4%	7.6%	7.5%	7.6%	-20.6%
Total Op Profit	3.9%	6.1%	2.3%	2.3%	9.8%	9.7%	4.9%	1.7%	2.6%	2.5%	1.5%	2.9%	3.4%	3.1%	2.7%	0.5%
Finance Income	9.9%	14.7%	-50.4%	-56.5%	20.5%	27.8%	50.3%	-34.6%	-36.2%	-48.3%	-57.3%	-64.3%	-66.7%	-64.3%	-58.3%	0.0%
Interest Expense	6.4%	-13.1%	155.2%	5.1%	-34.4%	-32.1%	-29.4%	51.7%	167.8%	219.2%	248.7%	69.4%	24.0%	0.0%	0.0%	0.0%
Net Income Before Taxes	3.9%	7.5%	-4.8%	1.3%	13.7%	12.9%	7.3%	-0.9%	-5.1%	-6.4%	-6.2%	-1.6%	0.1%	2.2%	2.1%	0.6%
Taxes	3.7%	8.4%	-5.1%	1.3%	12.6%	15.4%	9.0%	-0.5%	-4.6%	-7.1%	-7.6%	-1.0%	0.1%	2.2%	2.1%	0.6%
Net Income After Taxes	4.1%	7.0%	-4.6%	1.3%	14.4%	11.4%	6.3%	-1.1%	-5.4%	-6.0%	-5.3%	-1.9%	0.1%	2.2%	2.1%	0.6%
EPS	5.2%	10.7%	5.9%	1.3%	16.4%	12.9%	7.6%	9.0%	7.9%	7.3%	6.5%	1.4%	0.1%	2.2%	2.1%	0.6%
S/O	-1.1%	-1.4%	-9.9%	0.0%	-1.7%	-1.3%	-1.2%	-9.3%	-12.3%	-12.4%	-11.1%	-3.2%	0.0%	0.0%	0.0%	0.0%

% Sales	2007a	2008e	2009e	2010e	Jul-07 1Q08a	Oct-07 2Q08a	Jan-08 3Q08a	Ap-08 4Q08e	Jul-08 1Q09e	Oct-08 2Q09e	Jan-09 3Q09e	Ap-09 4Q09e	Jul-09 1Q10e	Oct-09 2Q10e	Jan-10 3Q10e	Ap-10 4Q10e
Dental Consumables	55.9%	55.6%	56.4%	56.2%	59.1%	58.0%	50.4%	55.7%	59.4%	58.7%	51.8%	56.4%	59.0%	58.7%	51.8%	56.0%
CEREC Rev	3.8%	3.4%	1.7%	1.1%	2.5%	3.6%	4.3%	3.3%	2.2%	1.7%	1.6%	1.4%	1.5%	1.1%	1.0%	1.0%
Other Equip/Sftwr	30.8%	30.7%	31.1%	31.6%	28.0%	28.0%	35.3%	30.9%	27.6%	28.6%	36.1%	31.6%	28.4%	29.0%	36.4%	31.8%
Tot Dental Equ/Sftwr	34.6%	34.2%	32.9%	32.7%	30.6%	31.6%	39.6%	34.2%	29.8%	30.3%	37.8%	32.9%	29.9%	30.1%	37.4%	32.8%
Dental Other	9.5%	10.2%	10.7%	11.1%	10.3%	10.4%	10.0%	10.1%	10.8%	10.9%	10.5%	10.7%	11.1%	11.2%	10.7%	11.2%
Total Dental Supply	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Rehab Consumables	72.1%	70.8%	70.8%	70.8%	72.6%	70.8%	69.3%	70.5%	72.7%	70.8%	69.3%	70.5%	72.7%	70.8%	69.3%	70.5%
Rehab Equip/Soft	23.1%	24.1%	24.1%	24.1%	23.2%	24.3%	25.2%	23.9%	23.2%	24.3%	25.2%	23.9%	23.2%	24.3%	25.2%	23.9%
Rehab Other	4.8%	5.0%	5.0%	5.0%	4.1%	4.9%	5.5%	5.7%	4.1%	4.9%	5.5%	5.7%	4.1%	4.9%	5.5%	5.7%
Rehabilitation Supply	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Vet Consumables	90.6%	91.2%	91.6%	92.0%	92.2%	91.9%	89.8%	90.8%	92.4%	92.2%	90.4%	91.3%	92.8%	92.5%	90.7%	91.7%
Vet Equip	7.4%	7.3%	6.9%	6.7%	6.3%	6.5%	8.7%	7.5%	6.1%	6.4%	8.1%	7.1%	5.9%	6.1%	7.9%	6.9%
Vet Other	2.0%	1.6%	1.5%	1.4%	1.5%	1.6%	1.5%	1.7%	1.4%	1.4%	1.5%	1.6%	1.3%	1.3%	1.4%	1.4%
Veterinary Supply	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Total Revenue	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Cost of Sales	65.4%	65.7%	65.8%	65.8%	66.2%	66.0%	65.4%	65.5%	66.1%	66.0%	65.5%	65.5%	66.1%	66.0%	65.5%	65.5%
Operating Expenses	22.6%	22.3%	22.7%	22.5%	23.1%	22.5%	22.1%	21.8%	23.9%	23.1%	22.1%	21.8%	23.6%	22.9%	22.4%	21.5%
Total Operating Expense	88.0%	88.1%	88.5%	88.5%	89.3%	88.5%	87.5%	87.3%	90.0%	89.1%	87.6%	87.3%	89.7%	88.9%	87.8%	87.9%
Dent Supply Op Profit	12.7%	12.9%	12.9%	12.7%	11.5%	12.4%	13.7%	13.8%	11.4%	12.4%	13.7%	13.8%	11.3%	12.2%	13.5%	13.5%
Rehab Supp Op Profit	15.3%	13.9%	14.0%	14.0%	14.0%	14.4%	13.3%	14.0%	14.0%	14.0%	14.0%	14.0%	14.0%	14.0%	14.0%	14.0%
Vet Supply Op Profit	5.5%	5.3%	5.1%	4.7%	4.3%	4.9%	5.3%	6.5%	4.3%	4.8%	4.8%	6.5%	4.3%	4.8%	4.8%	4.8%
Total Op Profit	12.0%	11.9%	11.8%	11.6%	10.7%	11.5%	12.5%	12.7%	10.6%	11.4%	12.4%	12.6%	10.4%	11.3%	12.2%	12.1%
Finance Income	0.3%	0.3%	0.1%	0.1%	0.3%	0.4%	0.4%	0.2%	0.2%	0.2%	0.2%	0.1%	0.1%	0.1%	0.1%	0.1%
Interest Expense	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Pretax Income	11.8%	11.8%	10.9%	10.6%	10.8%	11.6%	12.6%	12.3%	9.9%	10.5%	11.5%	11.7%	9.4%	10.3%	11.3%	11.2%
Taxes	4.4%	4.5%	4.1%	4.0%	4.0%	4.4%	4.8%	4.6%	3.7%	4.0%	4.3%	4.4%	3.5%	3.9%	4.2%	4.2%
Net Income After Taxes	7.4%	7.4%	6.8%	6.6%	6.8%	7.2%	7.8%	7.7%	6.2%	6.6%	7.2%	7.3%	5.9%	6.5%	7.1%	7.0%