

Shareholder Value Analysis

Visualizing Stock Valuation™



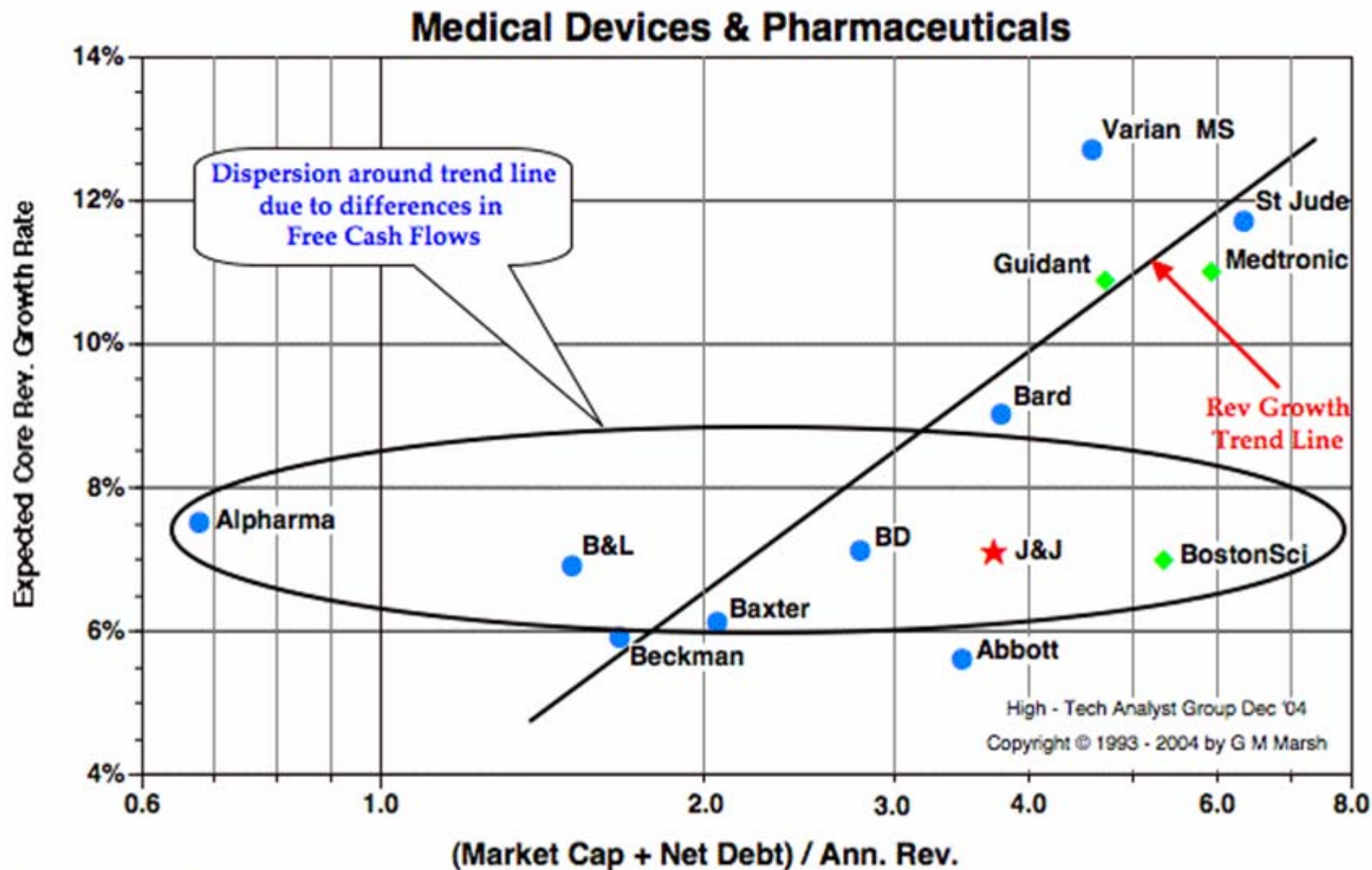
**Improving Stock Price & Competitiveness
Through
Operational Excellence**

SVA - Shareholder Value Analysis

- **A financially based analytical methodology that:**
 - links operational performance improvements to stock price via impacts on free cash flow generation
 - uses standard Discounted Cash Flow (DCF) techniques to quantify stock price impacts
- **Familiar Capital Budgeting techniques are at the heart of the DCF approach to stock valuation & used extensively by Buy-Side Analysts:**
 - DCF stock valuation is based on the Net Present Value method
 - the Bond Valuation Model is a real world example of the debt market applying the DCF approach to price bonds
- **Stocks are priced by taking the NPV of future free cash flows instead of future interest payments and repayment of principal**

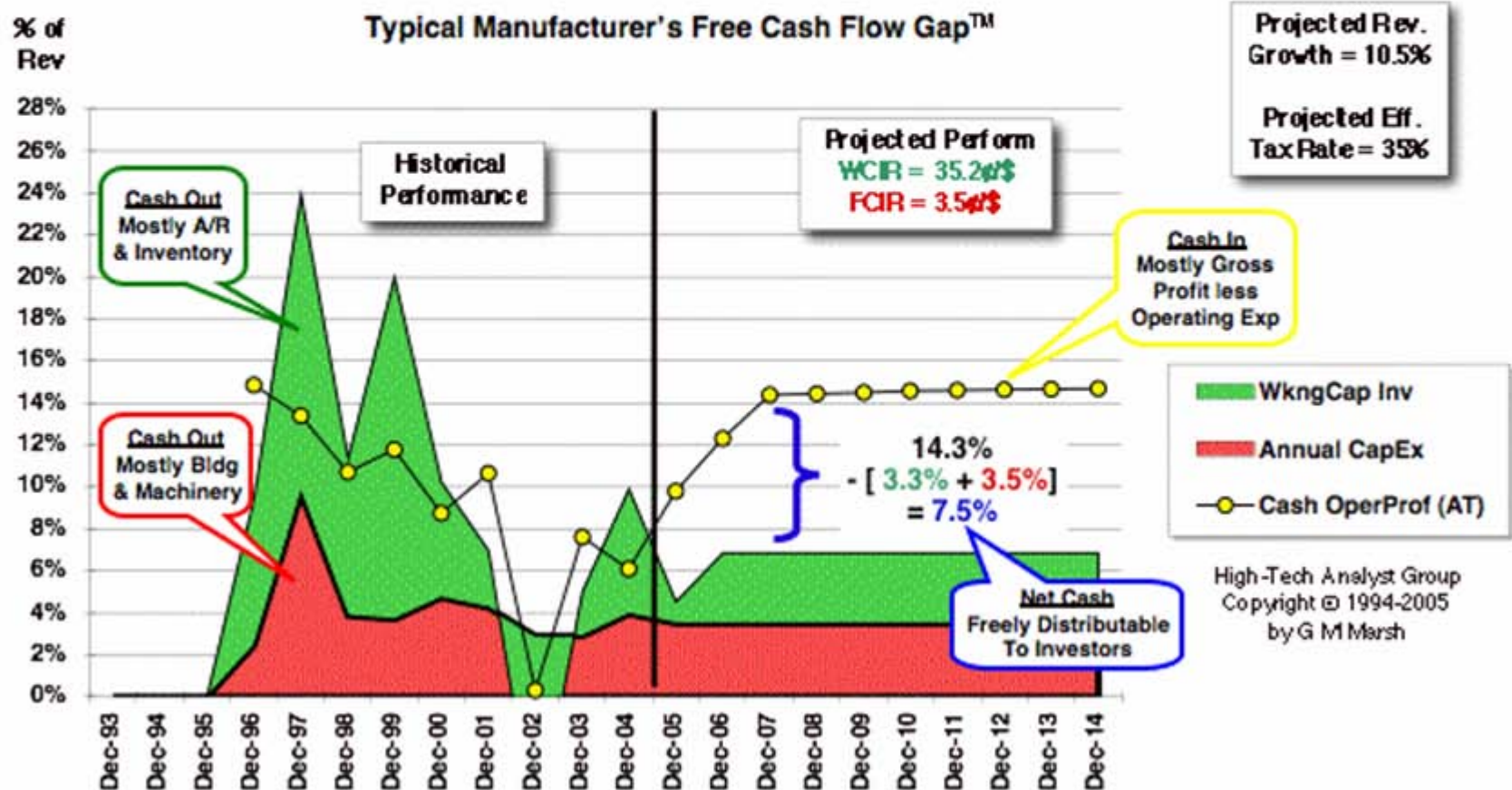
Business enterprise values assigned by the market ...

- A snapshot of the value assigned to future operating performance
 - Future free cash flow supports current stock price & repays debt

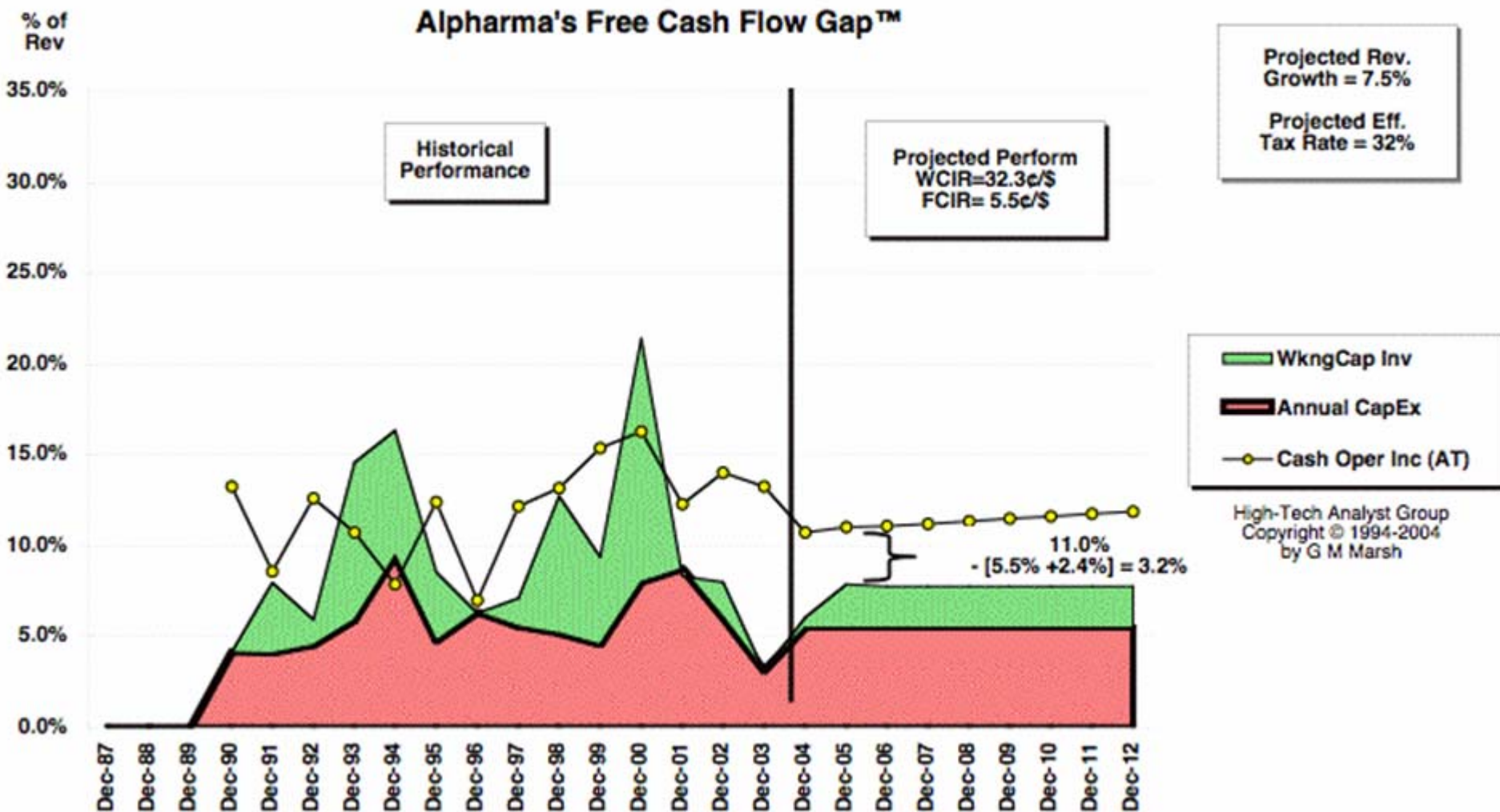


Free Cash Flow Gap - after tax cash inflow less the amount of cash reinvested in fixed assets and working capital:

- It's the cash that can be freely distributed to investors / Rev \$
- It is also called the free cash flow return on sales

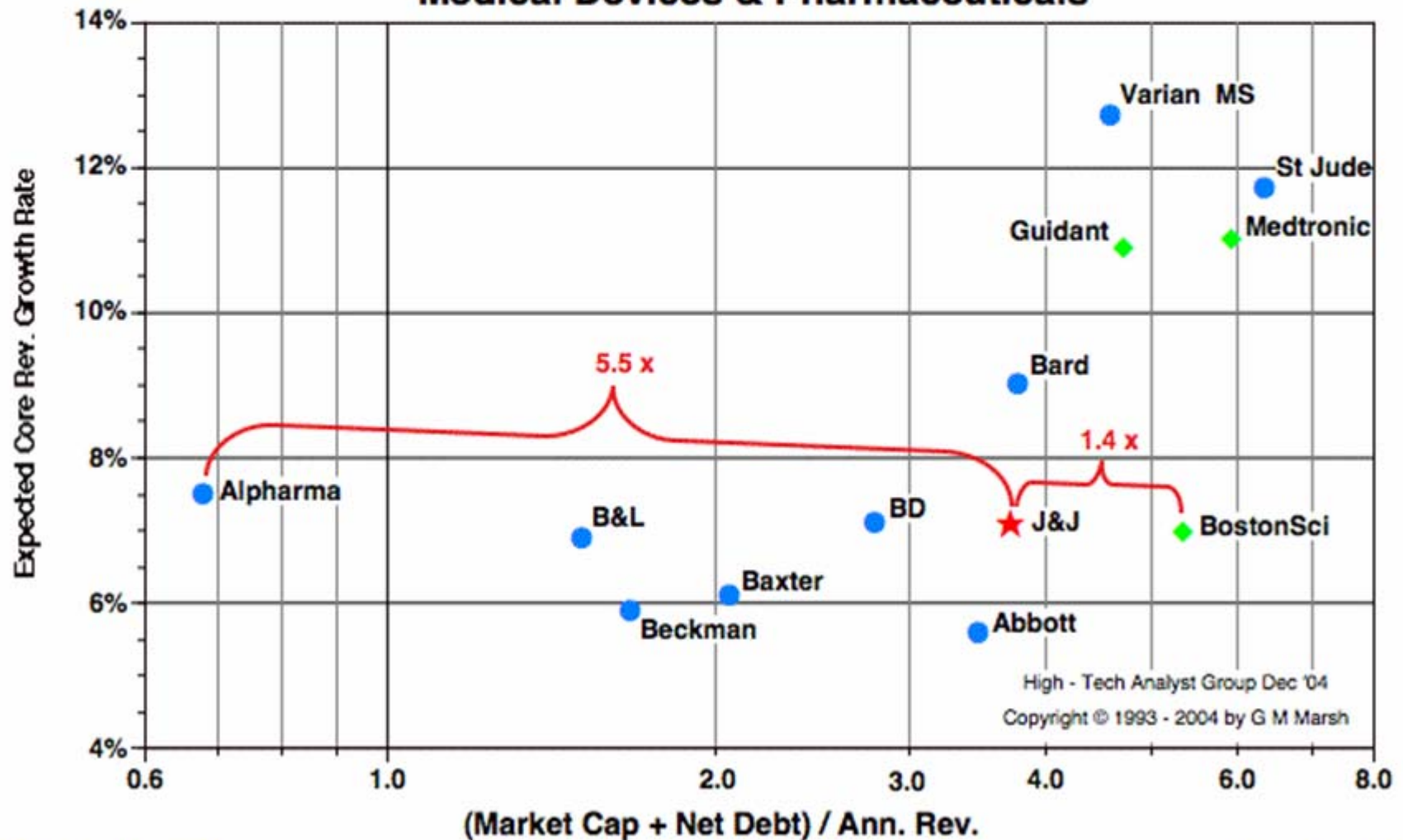


Alpharma's Free Cash Flow Gap™ is typical of businesses with little IP and low margins ...



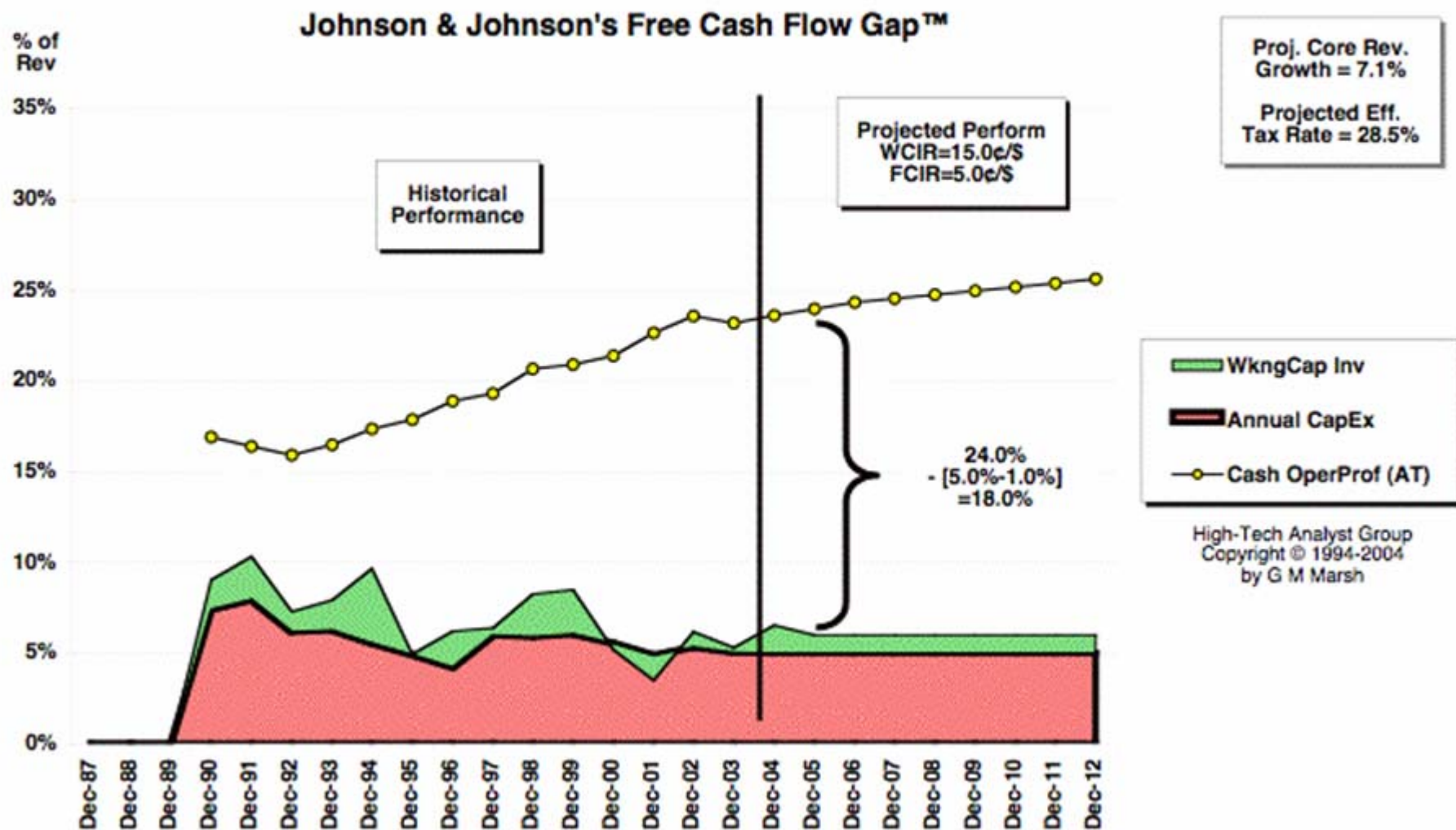
Valuation is driven by differences in free cash flow per \$ of revenue at a given growth rate ...

Medical Devices & Pharmaceuticals

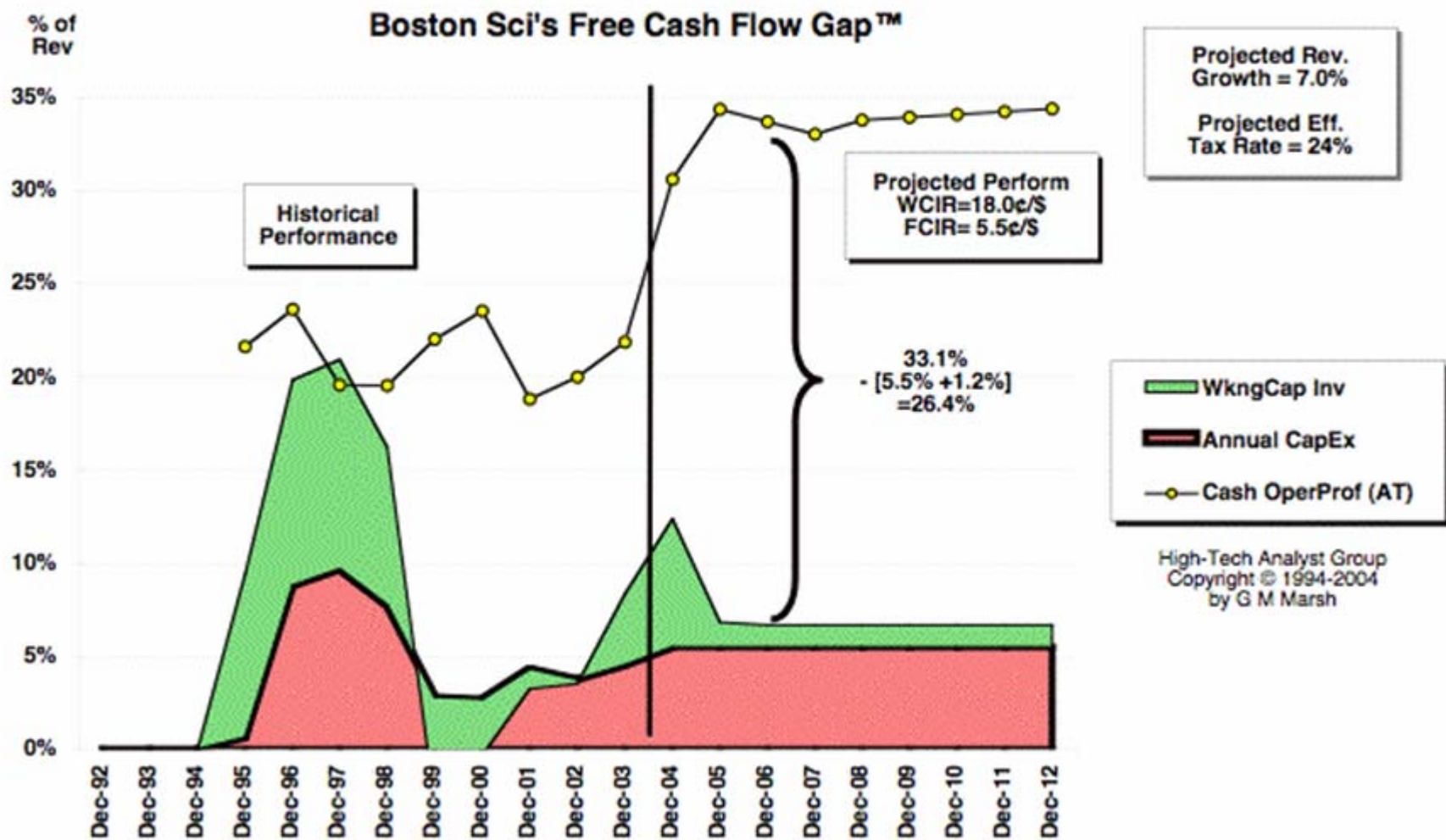


High - Tech Analyst Group Dec '04
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J&J has 5.6x the free cash flow and gets 5.5x the valuation due to a slower expected growth rate ...



Boston Sci has about 1.5x the free cash flow and gets 1.4x the valuation at a slightly slower growth rate ...



You can change the market's view of what the business is worth:

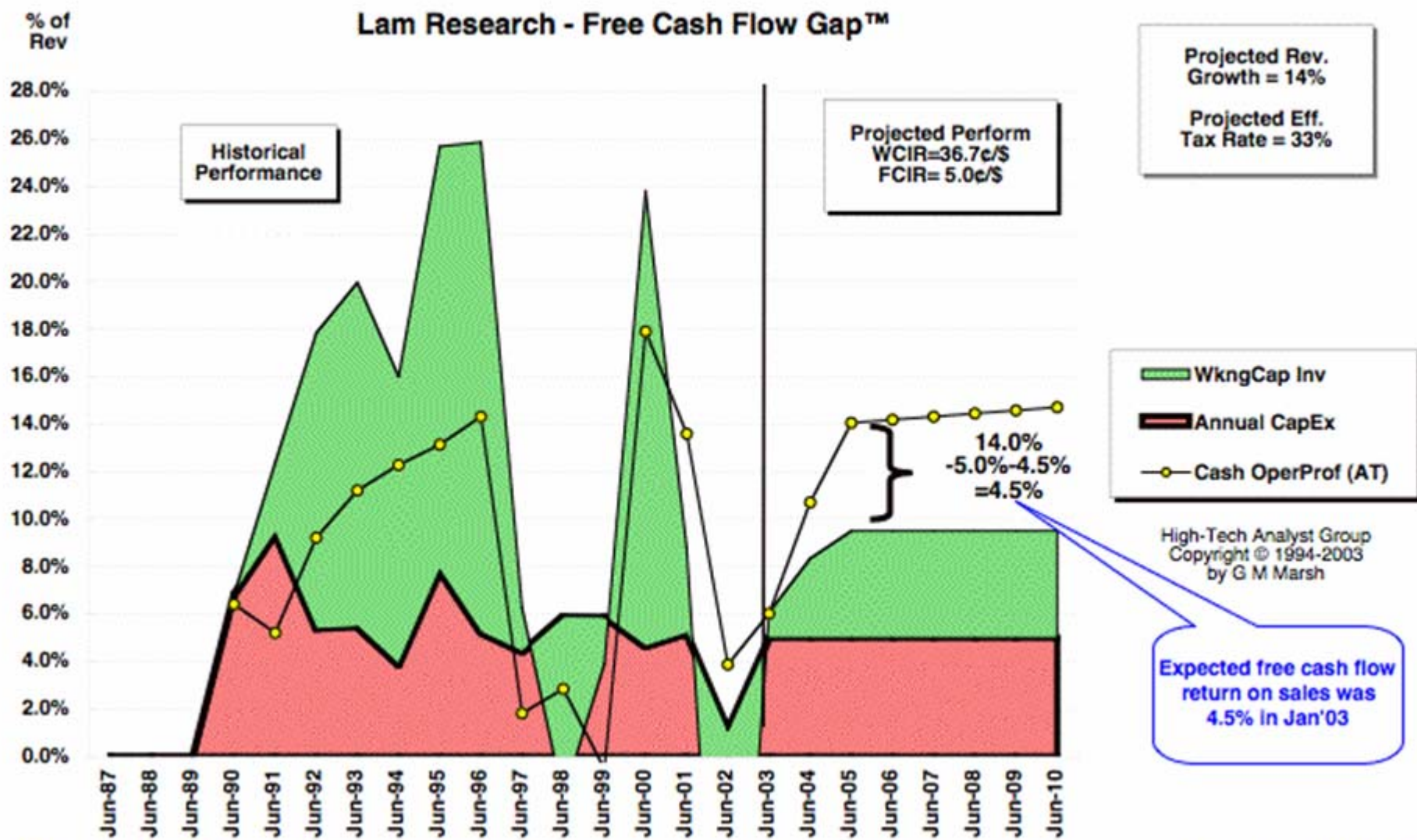
- Increase free cash flow via **sustainable** operating improvements

- Since the market prices a stock on the basis of expected free cash flow generation, then ...

- Sustainable improvements in free cash flow should lead the market to revise its view of what the business is worth.

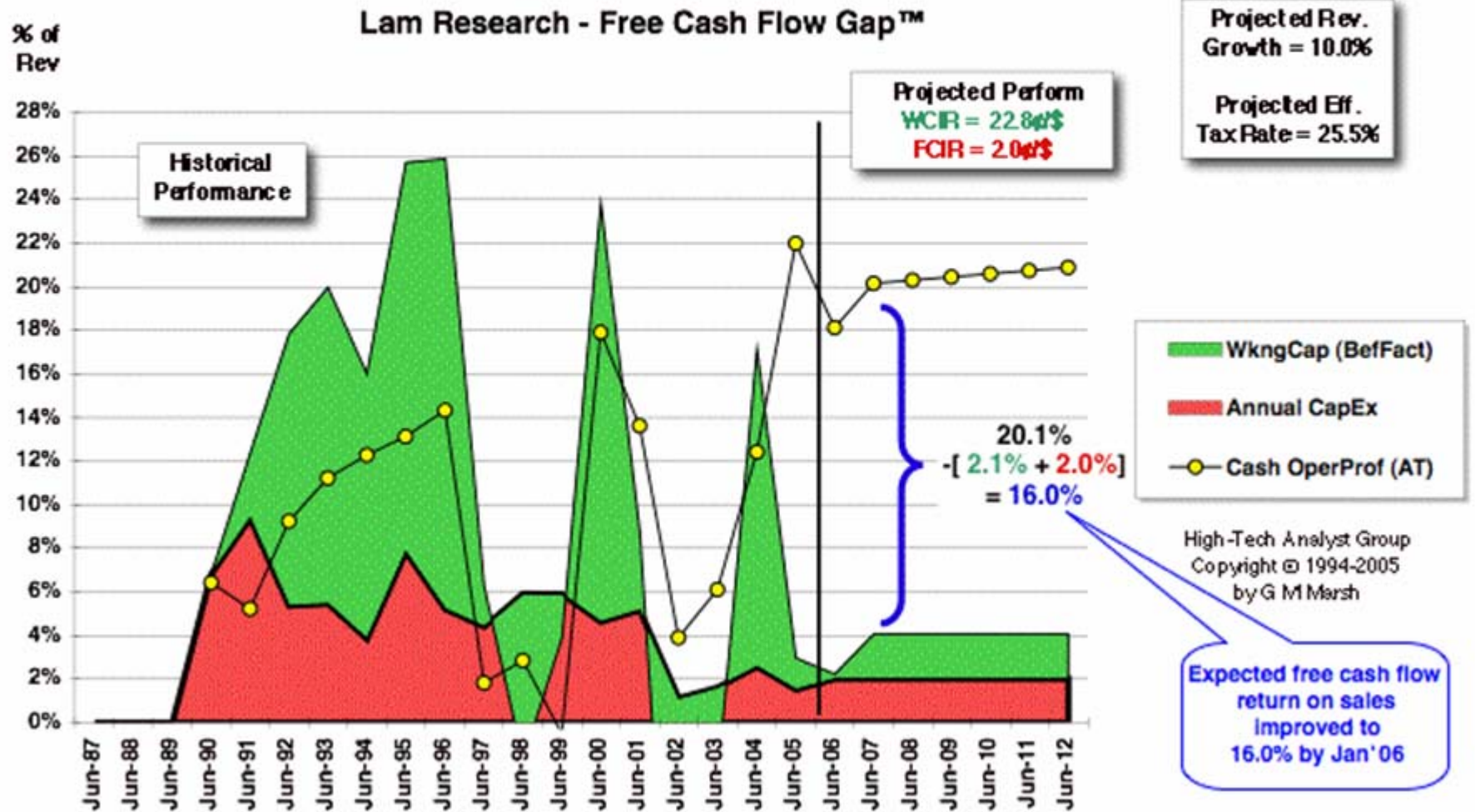
- Lam Research's business transformation is the proof of the above assertion:
 - Lam illustrates the opportunity you have to manage your way to a stronger competitive position and a higher stock valuation.

Lam's prospective free cash flows in Jan'03 were low and so was its stock valuation relative to peers ...

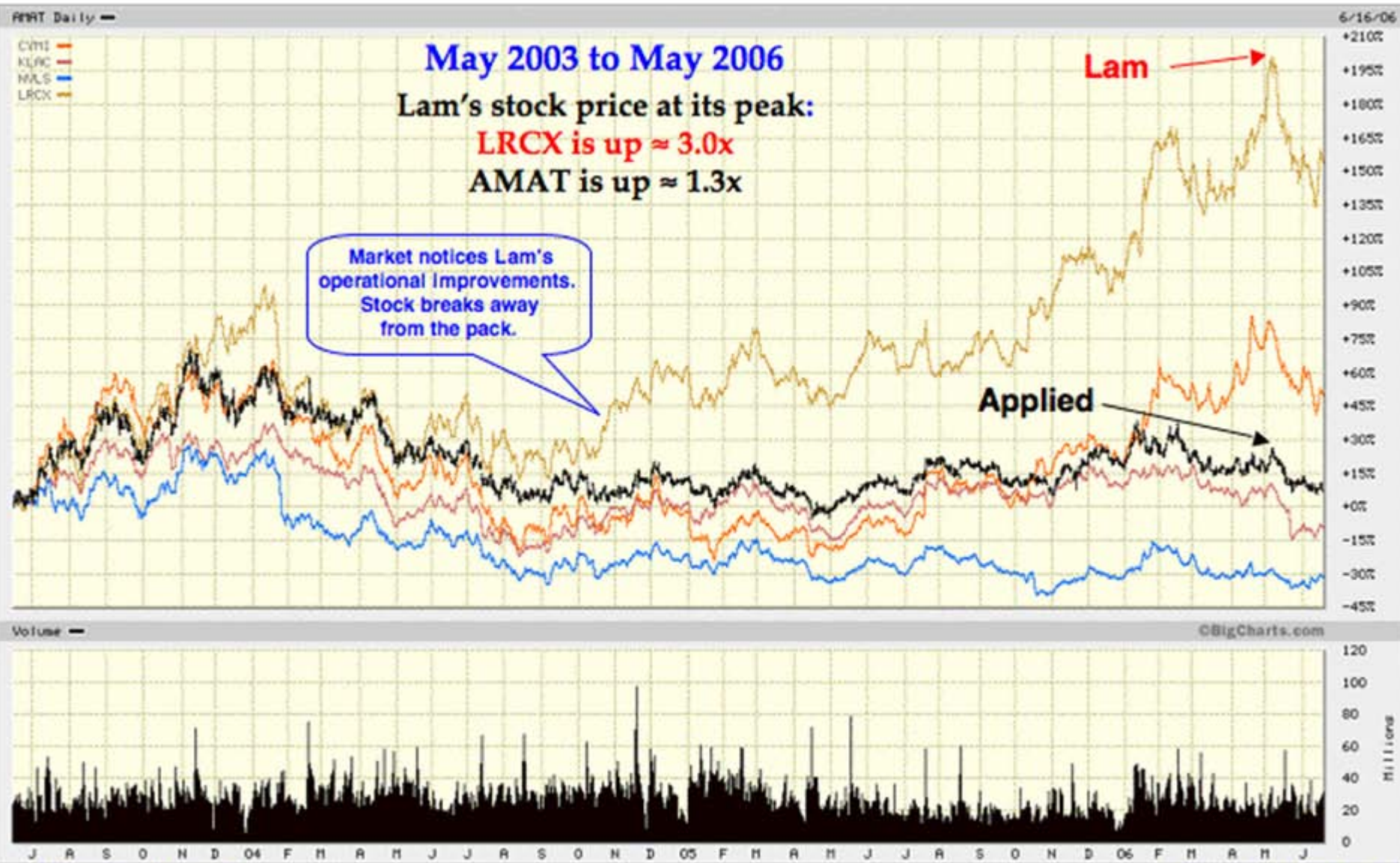


Newberry executed operational improvements that expanded the Free Cash Flow Gap™ 3 1/2 fold:

- Prospective Free Cash Flow return on sales went from 4.5% to 16.0%



Lam's 3.5x boost in expected free cash flows drove its vastly superior stock price performance ...

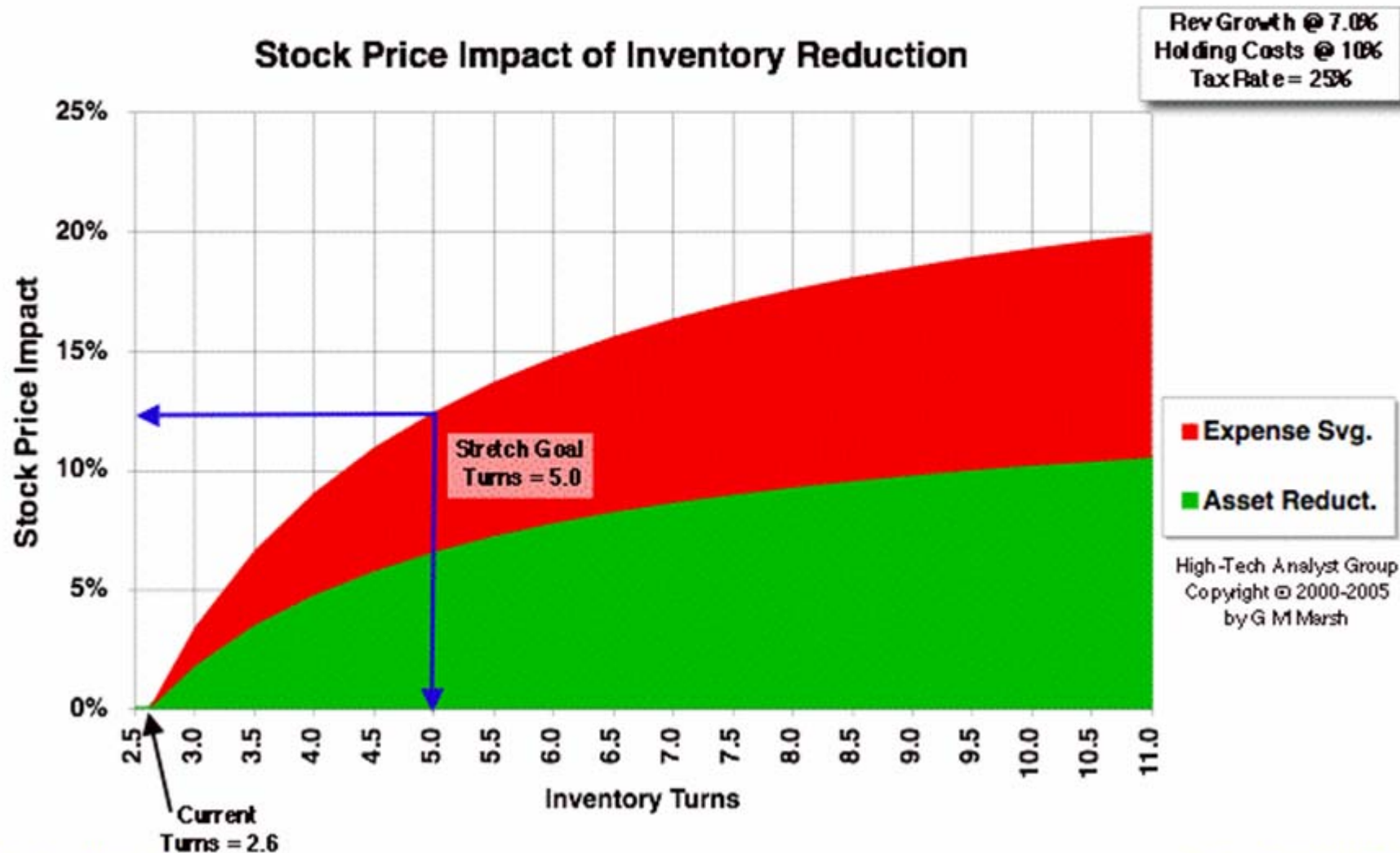


Wealth Creation Power & Market Valuation

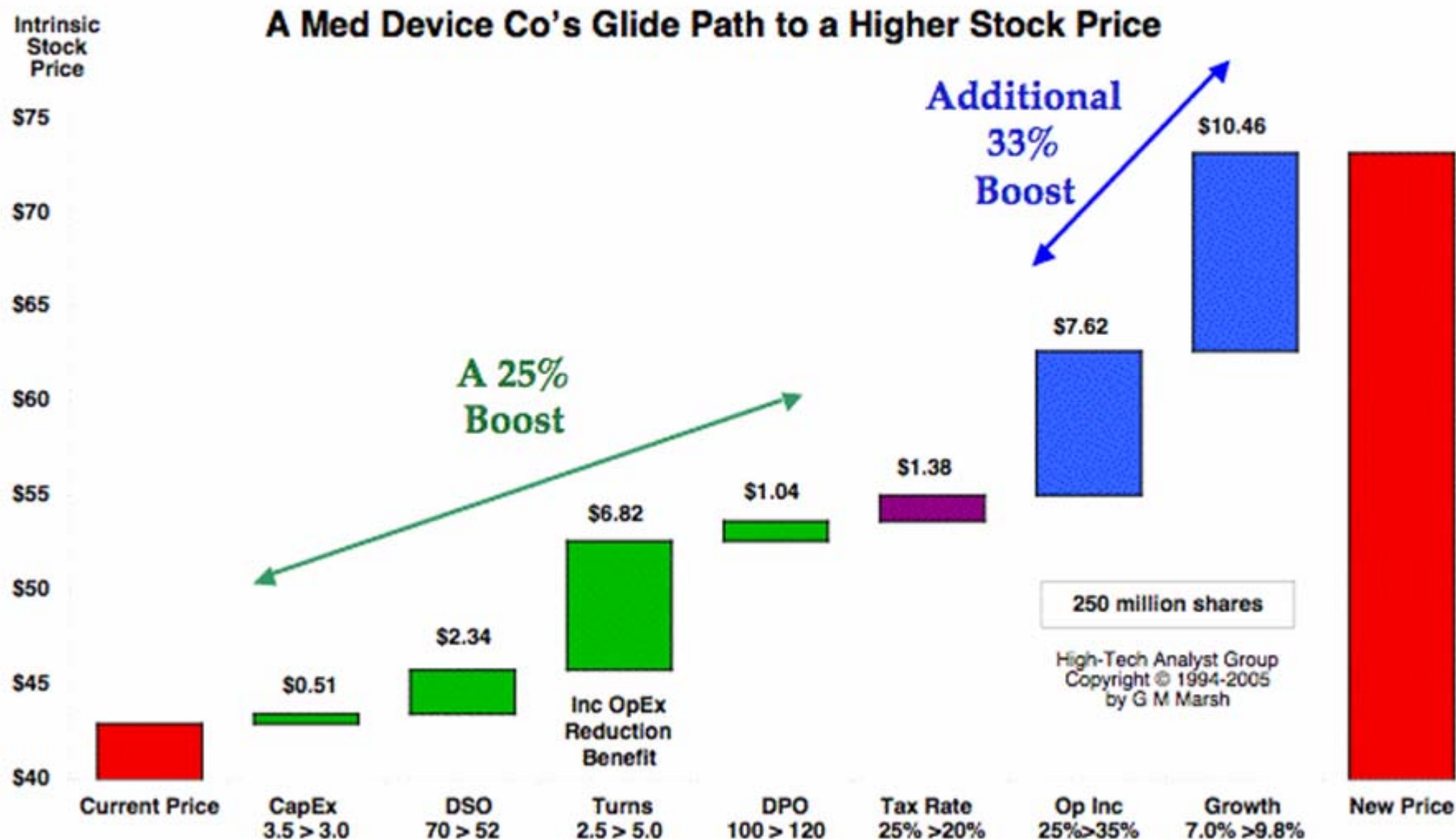
- **The market values a business on the basis of its prospective wealth creation:**
 - free cash flow generation is the economic measure of wealth creation power that matters the most to the market.
- **Free Cash Flow is a comprehensive measure of business performance:**
 - it includes the heart of the Income Statement; core operating income and income taxes (the yellow dots) and;
 - It also includes the capital investment needed to generate the profit and to support revenue growth (the green & red bars).
- **Markets recognize and reward a sustainable increase in free cash flow generation as shown by Lam Research:**
 - tax rate, working capital, and fixed capital efficiency are all largely within management's control.

Inventory reduction produces two benefit streams:

- OpEx savings
- Capital investment (asset) reduction



Capital Efficient Profitable Growth is the right mantra for most med device companies ...



Leading companies now get the link between operations, free cash flow, and stock valuation ...



Dec '02 Annual Report

- The Company's objective is to achieve superior levels of **capital efficient profitable growth**.
- We monitor **free cash flow**:
 - the portion of operating cash flow that remains after the necessary investments through capital expenditures to support the growth of the business



Dec '02 Letter to Shareholders

- Increasingly, the focus of our operating rigor is on cash flow:
 - cash represents **60%** of the measurement used for **incentive compensation**
- Six Sigma is creating repeatable and **reliable processes**:
 - allows us to reduce cash tied up in **receivables and inventory**
- Through **digitization** we are getting more from our **fixed assets**.



- A global business unit recently internalized the relationship between **working capital investment & shareholder value** and committed to a **50%** reduction in inventory within **3 years**

P&G CEO Lafley adopted individual stock value drivers as corporate key performance indicators:

- **Organic Revenue Growth Rate:** **4% to 6% CAGR**
 - defined as sales growth excluding the impacts of acquisitions, divestitures and foreign exchange
- **Net Operating Working Capital:**
 - defined as Accounts Receivable + Inventory - Accounts Payable as per Balance Sheet
- **Capital Expenditures (CapEx):** **not > 4% of rev.**
 - defined as Additions to Property, Plant & Equipment as per Cash Flow Statement
- **Free Cash Flow Generation (FCF):** **FCF productivity > 90%**
 - FCF defined as Cash From Operations less CapEx
 - FCF Productivity = FCF/Net Earnings

The neglected path to a higher stock price ...

- It's **not** all about EPS and EPS growth; rather it **is** all about:
 - expected free cash flow generation compounded by the expected revenue growth rate
 - the smart money gets the Bond Valuation Model
 - buy-side analysts adapt this model to price stocks
- Operational excellence impacts free cash flows dramatically:
 - supply chain management is the path to greater operational excellence
- Supply chain effectiveness derives from:
 - people; process; and technology
- Manage your supply chain from the perspective of:
 - capital efficient profitable growth
- Focus the right people on the right metrics:
 - reward the right performance handsomely
 - nobody can afford to pay for the wrong performance