

Align Technology (NASDAQ: ALGN) – Short Recommendation with \$140 Price Target, 51% Return

Company Overview & Industry Context

Company Overview:

- ALGN is the manufacturer and distributor of Invisalign clear orthodontic aligners (86% of FY18 rev) and iTero digital scanners (14% of FY18 rev)
- Until recently, ALGN has enjoyed 80%+ market share in the clear aligner market due to patent protections. However, beginning in October 2017, several key patents (described by ALGN's CEO as the patents that "choked most companies from getting into the marketplace" by preventing them from scaling) expired, opening the door for a huge influx of new competition

Timeline of Competitive Developments:

- March 2019: Smile Direct Club wins arbitration agreement, forces Align to shut down Invisalign retail stores
- September 2018: Dentsply Sirona announced new SureSmile aligner product with options including pay-per-aligner and in-office "DIY" aligner
- May 2018: Henry Schein introduces SLX clear aligners, 3M Oral launches Clarity clear aligners
- August 2017: Straumann acquires ClearCorrect for \$150mm

Target Price & Key Metrics

	Share Price (4/4/19)	\$288.0	Estimates		Multiples		Delta	Target Price	
			AZ	Street	AZ	Street			
Diluted S/O		80.9							
Market Cap (\$mm)		23,308.3						25x FY20 EPS (AZ)	\$140
(+) Debt		0.0						FCF Yield (AZ)	3.5%
(-) Cash		(636.9)						Delta to Current Px	-51%
Enterprise Value (\$mm)		22,671.4						Risk Price	
52W High / Low	\$398.88 / \$177.92		FY19 Sales CY	2,418.1	2,426.6	9.4x	9.3x	50x FY20 Street EPS	\$350
Avg. Daily Volume (\$mm)	306.0		FY19 EBITDA	566.6	627.3	40.0x	36.1x	FCF Yield (Street)	2.0%
Short Interest	4.0%		FY19 EPS	\$4.60	\$5.15	62.6x	56.0x	Delta to Current Px	22%
			FY20 Sales (FY1)	2,910.7	2,989.1	7.8x	7.6x	Risk / Reward	2.4x
			FY20 EBITDA	707.4	824.7	32.1x	27.5x		
			FY20 EPS	\$5.68	\$6.98	50.7x	41.3x		
			FY21 Sales (FY2)	3,396.0	3,568.9	6.7x	6.4x		
			FY21 EBITDA	799.0	988.8	28.4x	22.9x		
			FY21 EPS	\$6.41	\$8.46	44.9x	34.0x		

Investment Thesis / Variant View

1. Market still does not fully appreciate the commodity-nature of clear aligners

- Street values ALGN as though it were a medtech company (comps include ILMN—leader in gene sequencing, ABMD—manufacturer of artificial heart and other complex implants, ISRG—manufacturer of surgical robots)
- Dentists can establish in-house 3D print system for clear aligners for \$30K – 50K in start-up costs and \$100 / aligner vs. \$1800 / aligner from ALGN) – for most general practitioners, system pays for itself in months
- Patent library, though robust in number (mgmt. likes to cite 400+ remaining patents), is increasingly narrow in scope and not relevant in terms of stemming competitive pressure. The most important patents have expired and the newer patents don't move the needle much

Key Expired Patents	Examples of Remaining Patents (Relevant ones marked with *)
US6309215B1 (exp. Oct 2017) – creating a clear aligner based on tooth molds as alternative to braces	US6227850B1 (will exp. May 2019)* – using a computer to create a successive plan for repositioning teeth after receiving initial digital dataset
US5975893A (exp. Oct 2017) – system for repositioning the teeth using succession of individual appliances	WO2018187434A1 (pending) – method for inkjet printing onto aligner
US6664986B1 (exp. May 2018) – using computer to create, store, and view a 3D dental model that shows how teeth would move	US20180228359A1 (pending) – cheek retractor with markings to determine tooth size and attached arm to hold mobile device
US6334853B1 (exp. May 2018) – method for obtaining 3D dental occlusion map	US20180064514A1 (exp. Nov 2022) – methods to estimate surface texture of tooth

2. Street estimates don't capture the extent of pricing pressure that I anticipate both from new entrants in the market and continued mix headwinds.

- The entire industry model is evolving in a way that will further pressure ASPs due to the proliferation of low-cost direct-to-consumer businesses
- Though other big players have announced competing products (XRAY: SureSmile; 3M: Clarity; HSIC: SLX aligners), they have been measured and deliberate about the rollout (e.g. HSIC has only launched with orthodontists and will launch with dentists in '19)
 - ALGN faces mix pressure from their loyalty initiatives— more growth is coming from lower complexity / lower ASP cases and from high-loyalty providers who enjoy hefty volume discounts (est. 15 pt difference in GM between sales to new providers vs. loyalty members, which implies a ~75pt headwind to GMs for every 5pt shift to loyalty sales)
 - In addition to customer mix, ALGN faces pure price erosion—ASP declined 7% in 2H18. Every 1% decrease in ASP translates to a 25bp GM headwind. Despite these headwinds, street is modeling GMs up 90bps in 2020

3. Market is overestimating the effectiveness of ALGN's go-to-market strategy of partnering with orthodontists and brand value amongst consumers

- Many investors believe that the loyalty of orthodontists will result in sufficient customer stickiness, but they are missing the broader industry shift towards general practitioners servicing low-complexity cases at lower ASPs
- Takeaways from conversation with Daniel Hanover, Co-Founder & CEO of Orthly:
 - Much of the price erosion will come from general practitioners entering the market and direct-to-consumer businesses that sidestep orthodontists altogether
 - Customers don't care about brand of aligner; they care about end results—what impacts results more than the brand of clear aligner is the orthodontist or dentist supervising the process
 - DTC entrants are still in the very early stages (comparable to Tuft & Needle in 2012, Casper in 2014): one indication of this is that Google Adwords are still cheap, haven't seen the full extent of competition
 - Every week new manufacturers reach out to him about making clear aligners for Orthly—this accelerated post patent-expiration
- Although DTC players are firmly targeted at the lower end of the market (total customer cost of \$1,850 for SDC vs. \$3,500 – 8,000 for Invisalign), their marketing operations are changing the narrative around clear aligners and diluting Invisalign's brand equity

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Risks & Mitigants

- Risk: the clear aligner market overall is growing rapidly, so as one of the largest players in the space, ALGN will continue to benefit from industry tailwinds
 - Mitigants: ALGN's multiple already reflects the expectation for this growth (trading at 59X LTM P/E). Risk is to the downside on both volume and pricing given the cadence of new entrants
- Risk: transition away from traditional orthodontics model is slow than expected due to customer stickiness from both orthodontists and patients
 - Mitigants: Invisalign does not have the advantage of being covered by insurance the way certain high-price medications enjoy greater stickiness because patients do not foot the full bill. Invisalign coverage is usually limited to \$500 – 1500 (8 – 26% of avg. treatment cost). As cheaper options proliferate (Smile Direct Club is \$1500), would expect consumers to switch to more fully covered treatments

Catalysts

- Near-term: 1Q19 EPS in April, new clear aligner releases / promotional pricing from competitors

Financial Projections

(\$ in mm)	Actuals			Quarterly Projections				Projections		
	FY16A	FY17A	FY18A	1Q19E	2Q19E	3Q19E	4Q19E	FY19E	FY20E	FY21E
Income Statement										
Americas	571.6	754.0	903.3	233.9	256.8	272.9	275.8	1,039.5	1,185.0	1,322.5
International	323.7	473.5	684.2	194.7	214.8	218.5	247.8	875.8	1,115.8	1,378.0
Non-Case	63.0	81.7	104.0	29.1	32.8	34.1	35.5	131.5	164.3	205.4
Total Clear Aligner Revenues	958.3	1,309.3	1,691.5	457.7	504.5	525.6	559.1	2,046.8	2,465.2	2,905.9
Scanner & Services Revenues	121.5	164.2	275.0	69.4	77.0	105.6	119.3	371.3	445.5	490.1
Total Revenue	1,079.9	1,473.4	1,966.5	527.1	581.4	631.2	678.4	2,418.1	2,910.7	3,396.0
Y/Y Growth	27.7%	36.4%	33.5%	20.6%	18.6%	24.9%	27.0%	23.0%	20.4%	16.7%
Gross Profit	815.3	1,116.9	1,447.9	373.4	412.4	447.7	473.9	1,707.5	2,018.5	2,315.1
Gross Margin	75.5%	75.8%	73.6%	70.8%	70.9%	70.9%	69.9%	70.6%	69.3%	68.2%
Y/Y Change in GM (bps)	(21)	31	(218)	(409)	(364)	(264)	(188)	(301)	(126)	(118)
EBIT	248.9	353.6	466.6	77.4	117.9	144.3	150.6	490.1	615.2	691.4
EBIT Margin	23.1%	24.0%	23.7%	14.7%	20.3%	22.9%	22.2%	20.3%	21.1%	20.4%
EPS	\$2.33	\$2.83	\$4.92	\$0.79	\$1.09	\$1.33	\$1.39	\$4.60	\$5.68	\$6.41
Y/Y Growth	32.0%	21.4%	73.7%	-32.3%	-16.6%	7.4%	15.1%	-6.6%	23.5%	13.0%
Cash Flow										
Net Income,		231.4	400.2	64.1	87.3	107.1	111.9	370.3	462.6	530.4
(+) Depreciation		37.7	54.7	19.5	19.0	19.0	19.0	76.5	92.2	107.6
(+) SBC		58.9	70.8	19.0	19.4	22.1	21.7	82.2	90.4	99.4
(-) Increase in WC		110.5	29.0	(45.8)	4.2	(37.9)	108.5	29.0	29.0	29.0
CFO		438.5	554.7	56.8	129.8	110.2	261.0	557.9	674.1	766.4
(-) Capex		(195.7)	(223.3)	(62.5)	(66.4)	(61.8)	(62.4)	(253.1)	(278.4)	(306.2)
FCF	177.1	242.8	331.4	(5.7)	63.5	48.4	198.6	304.8	395.7	460.1
FCF Yield								1.3%	1.7%	2.0%
Street Estimates										
Total Revenue				531.0	590.9	630.3	674.2	2,426.6	2,989.1	3,568.9
Gross Profit				374.6	422.5	457.2	495.4	1,753.8	2,187.1	2,587.6
Gross Margin				70.5%	71.5%	72.5%	73.5%	72.3%	73.2%	72.5%
Y/Y Change (bps)				(439)	(306)	(104)	175	(135)	89	(66)
EBIT				292.1	280.0	295.2	319.4	1,182.4	1,436.4	1,689.6
EBIT Margin				55.0%	47.4%	46.8%	47.4%	48.7%	48.1%	47.3%
EPS				\$0.86	\$1.24	\$1.43	\$1.58	\$5.15	\$6.98	\$8.46

Comparable Company Analysis

Company	Ticker	Price	Market Cap (mm)	Net Debt	EV	P/E		EV / EBITDA		PEG		Sales Growth		EBITDA Margin	
						FY19	FY20	FY19	FY20	FY19	FY20	FY19	FY20	FY19	FY20
ALIGN TECHNOLOGY INC	ALGN US Equity	\$287.96	23,033.7	(744.5)	22,289.3	56.0x	41.3x	35.5x	27.0x	1.8x	1.8x	23.2%	19.4%	25.9%	27.6%
Dental Distributors															
HENRY SCHEIN INC	HSIC US Equity	\$61.36	9,290.1	1,884.1	12,066.8	17.8x	16.5x	13.7x	13.1x	3.9x	3.5x	4.2%	4.2%	8.9%	8.9%
DENTSPLY SIRONA INC	XRAY US Equity	\$50.26	11,218.9	1,347.7	12,578.5	21.8x	19.1x	14.7x	13.6x	5.9x	5.4x	3.3%	3.1%	21.2%	22.3%
PATTERSON COS INC	PDCO US Equity	\$22.18	2,110.8	951.6	3,062.5	15.5x	14.3x	12.0x	11.0x	5.3x	4.7x	2.7%	2.8%	4.6%	4.8%
Average						18.4x	16.6x	13.5x	12.6x	5.0x	4.5x	3.4%	3.4%	11.6%	12.0%
<i>Premium / (Discount) to Avg.</i>						204.8%	147.9%	163.9%	114.8%						
Diversified Manufacturers															
3M CO	MMM US Equity	\$215.03	123,835.1	11,389.0	135,276.1	20.4x	18.9x	14.0x	13.3x	6.2x	7.0x	3.0%	2.6%	29.1%	29.7%
DANAHER CORP	DHR US Equity	\$130.47	93,376.5	8,952.5	102,341.3	27.3x	24.1x	20.5x	17.6x	2.2x	3.7x	11.2%	5.9%	24.4%	25.5%
Average						23.8x	21.5x	17.3x	15.5x	4.2x	5.3x	7.1%	4.2%	26.8%	27.6%
<i>Premium / (Discount) to Avg.</i>						134.8%	92.0%	106.0%	74.5%						
Medical Technology															
INTUITIVE SURGICAL INC	ISRG US Equity	\$570.28	65,788.3	(3,063.1)	62,733.9	46.7x	40.9x	37.7x	33.0x	2.8x	2.5x	14.9%	14.3%	38.6%	38.4%
HOLOGIC INC	HOLX US Equity	\$47.31	12,656.2	2,660.2	15,316.4	19.6x	18.0x	14.1x	13.2x	4.9x	4.5x	3.7%	3.7%	32.8%	33.5%
ABIOMED INC	ABMD US Equity	\$282.87	12,753.4	(399.8)	12,353.7	76.6x	57.2x	48.6x	38.1x	2.1x	1.7x	26.6%	26.6%	32.5%	32.8%
ZIMMER BIOMET HOLDINGS INC	ZBH US Equity	\$126.56	25,891.6	8,395.9	34,292.3	16.2x	15.2x	12.7x	11.8x	6.3x	5.3x	2.4%	2.7%	33.9%	35.6%
Average						39.8x	32.8x	28.3x	24.0x	4.0x	3.5x	11.9%	11.8%	34.4%	35.1%
<i>Premium / (Discount) to Avg.</i>						40.7%	25.7%	25.6%	12.4%						