PARTNER PASS
EXCLUSIVE REPORT

Porter & Co.

ActivistInvestor

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THIS IS SPINAL TAP

- An Orthopedic Whiz Kid Gets the Activist It Deserves
- New Board Saves Necks, Backs – And EBITDA

This Is Spinal Tap

An Orthopedic Whiz Kid Gets the Activist It Deserves

New Board Saves Necks, Backs – and EBITDA

Randy thought he had the flames under control.

Then the roof collapsed on him.

After 30 years serving his community as a firefighter in Pantego, Texas – and working his way up to fire chief – 49-year-old Randy Fulton's career… and his life… nearly ended on the second floor of a burning house. He'd gotten the family out safely – but then a pile of smoldering debris fell on him, pinning him to the floor.

The adrenaline rush at the real possibility of death masked the pain in his neck… at first.

Thankfully, Randy's fellow firefighters were able to haul him out of the rubble in time. Before long, he was back at work, happy to be alive… while trying to shrug off the persistent ache in his neck and shoulder. But over the next few months – as the pain spread down into his right arm and hand – he couldn't even shrug.

He started popping more over-the-counter pain medicine… and his wife, Dana, started to worry.

Fearing the worst, Randy finally visited an orthopedist for a series of X-rays and MRIs. Then came the news: the injury he'd suffered months prior had dislodged a cervical disc in his spine. Now, inflammation was pressuring the nerves that powered his upper right side.

Randy needed spinal surgery, stat.

And the surgery would end life as he knew it.

The standard "fix" for Randy's type of injury is a surgery called spinal fusion. The injured disc comes out and the remaining vertebrae are fused together with a metal rod, taking pressure off the spinal cord.

Fusion surgery can often significantly limit the patient's range of motion. Randy wouldn't be able to drive his beloved fire truck anymore – and he'd be stuck at a desk pushing papers for the rest of his career.

To him, that sounded *worse* than excruciating back pain.

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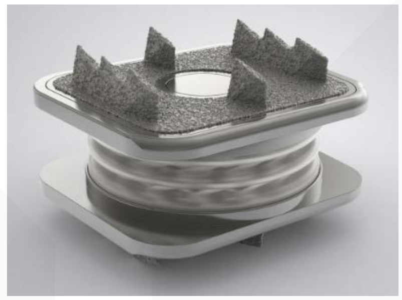
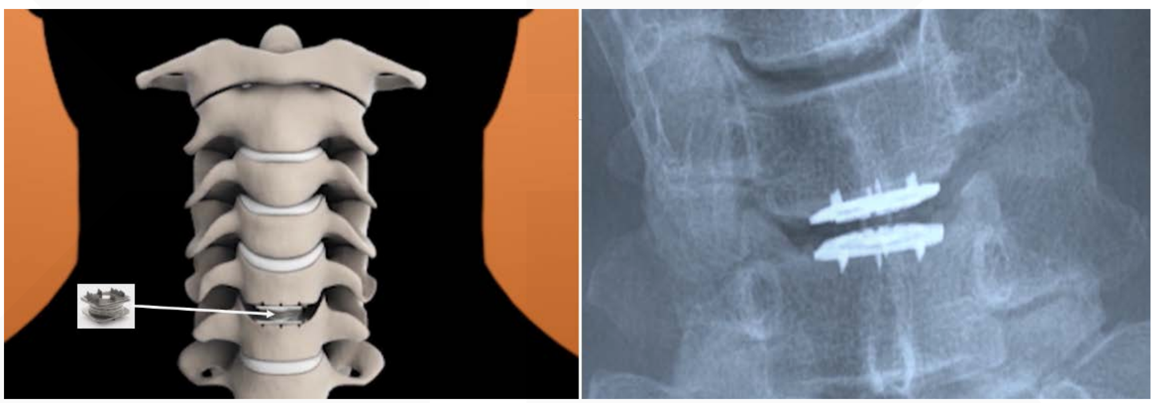
Fortunately for Randy, it was 2019, and the surgeon had another trick up the sleeve of his white lab coat: an alternative protocol called an artificial cervical disc ("ACD").

Instead of the rigid metal rod, Randy would get a replacement disc – complete with cushioning fluid – that allowed him full range of motion:



As shown below, the ACD is inserted between the vertebrae. The X-ray image shows the actual disk placed in the spine after recovery. Note the ability to tilt the neck – which would be limited with spinal fusion.



Randy's story has a happy ending. His surgery was a complete success. The ACD replaced his damaged disk, allowing him to return to work as a firefighter full time with no restrictions. (As a bonus, his recovery time was incredibly short – just a day or two.) He will be able to continue to do the job he loves for years to come.

The stock we recommend today manufactures the ACD that saved Randy's neck (literally) – as well as his job and his zest for living. The company makes many other orthopedic and spinal products that help with pain or restricted movement.

These products will continue to see strong demand as life expectancy grows and an aging population stays increasingly active.

Unfortunately for shareholders, the company has fallen on some troubling times. A financial storm blew in a couple years ago and has yet to clear.

In fact, the board of directors made a move in September 2023 that is exceedingly rare for any company. This move put the company on our radar screen… and now we put it on yours.

The Activist Angle

In this issue, we recommend **Orthofix Medical (Nasdaq: OFIX)**, a $490 million market capitalization medical-device company specializing in orthopedic and spinal products.

We pitched this stock as "a company ripe for an activist" at Porter & Co.'s October 2023 conference. The company and its story were compelling then – and remains so today.

However, at the time it lacked one key component: an activist.

That changed less than a month later, when Engine Capital Management acquired 8.2% of the company, and began a process to improve corporate governance and profitability.

Engine Capital is not a household name. Founded in 2013, it focuses on mispriced stocks with potentially enormous value to be unlocked. Many of its investments are in off-the-radar stocks and it has a good track record.

In December 2023, it launched a campaign with $166 million market cap drug developer called 2seventy Bio (Nasdaq: TSVT). In the month since, the stock has soared 89% – from about $1.80 to $3.40 – as Engine demanded a new CEO and a refreshed board. It now predicts positive free cash flow ("FCF") in 2024.

Another example is Parkland Corporation (OTC: PKIUF). Engine is a longer-term shareholder in this Canadian petroleum distributor owning the stock for over a year. It was successful in refreshing the board, improving operations, and driving positive FCF. The stock rose 43% in 2023.

In each of these examples, Engine owned just 2% to 3% of the shares outstanding. Based on the activist campaigns Engine chooses to make public, this appears to be the size of most of its positions.

This is important for two reasons.

First, Engine is achieving great gains with much smaller investment than is typical with an activist campaign. Often we see ownership of 5% and 10%. As an example, Cannell Capital owns 9.9% of Sportsman's Warehouse (Nasdaq: SPWH), which we recommended in September.

Second, Engine took a much larger position in Orthofix, at 8.2%. This suggests significant confidence on its part.

In our view, Engine Capital is looking to:

- Refresh the board of directors with new, independent members
- Force management changes to institute real change
- Improve profitability
- Evaluate the potential sale of the company

Let's get into the details.

Getting the Back Story

Orthofix is a medical-device company that specializes in both orthopedic and spinal products used by doctors and surgeons across the globe. As illustrated by firefighter Randy's story, the company's products can change lives.

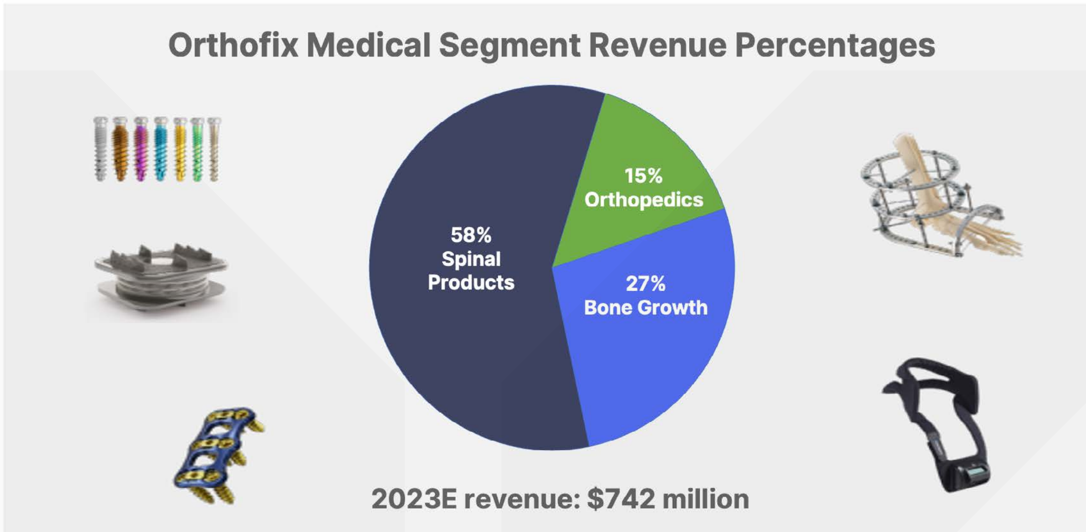
Headquartered in Lewisville, Texas, Orthofix has facilities in Brazil, Canada, France, Germany, and around the U.S.

The company was founded in Verona, Italy. It was the brainchild of Italian orthopedic researcher Giovanni De Bastiani. De Bastiani's work focused on the natural ability of bone to repair itself. The process which he called "dynamization" used a device to accelerate bone growth and healing. His work in the 1970s was commercialized in 1980 when Orthofix was founded.

In its modern form, Orthofix's products range from relatively simple surgical components such as spinal screws, all the way up to more complex devices like exterior ring fixation structures that hold bones in place.

They also include electronic devices using a technology called bone growth stimulation ("BGS") for healing minor fractures. Orthofix's BGS products are the number-one prescribed in the U.S.

The following chart illustrates the company's revenue segments for 2023E and some pictures of its products.



Source: Factset and company reports.

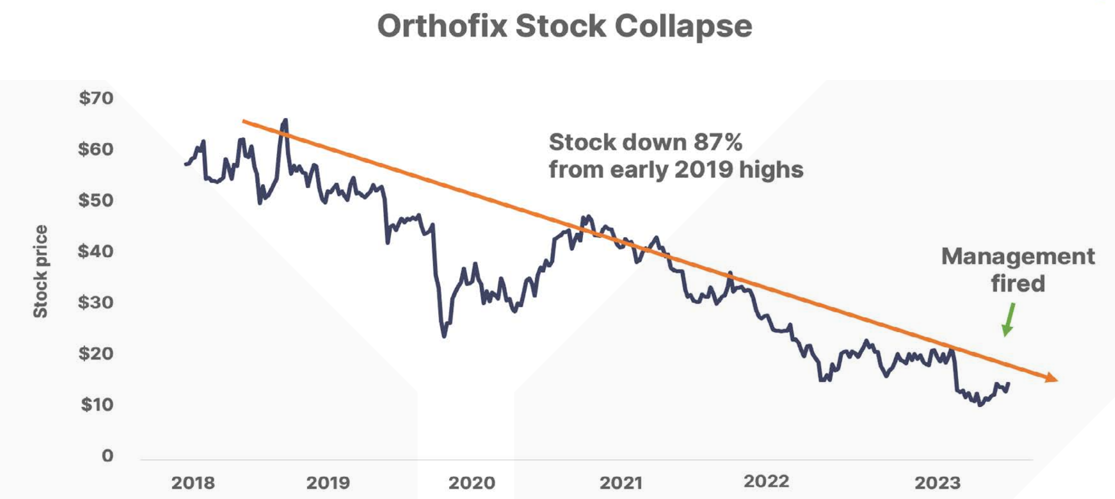
So how did this relatively small medical-device stock hit our radar screen?

It started the way many interesting stock ideas come to us: with a giant sell-off in the shares.

On the morning of September 12, 2023, the company released a startling piece of news. It announced that the board fired the CEO, CFO, and the Chief Ethics and Compliance Officer. The board also demanded that the CEO resign his position on the board.

This came as a giant shock to the market – and the shares sold off 30% by the end of the day. Two months later, on November 13, shares closed at $9.69 – a 48% decline since management was fired. More striking, this closing price was 87% below the stock's peak in early 2019.

The abrupt management change was merely the latest in a multi-year storm of operating decisions that put the stock into a tailspin. But, in our opinion, the firing was the ultimate catalyst for the activist. This stock has fallen sharply.



What Got the Company Into Trouble

Orthofix had its share of problems before the board fired top management. A new CEO, a change in strategy, and then the pandemic upended the steady path the company had followed in prior years.

During the five years from 2014 through 2018, the stock was up 139% – returning 24% a year on average. Management strategy was to maintain the company's size and maximize the revenue and earnings it could easily make without investing much in growth initiatives. It was like a popular restaurant with only 10 tables where the owners were satisfied with the sales they could get without adding more tables.

As such, management was gliding and not investing in research and development (R&D) nor pursuing acquisitions to drive growth. Instead, it skillfully managed expenses and drove consistent sales. This meant almost guaranteed revenue of about $420 million a year with gross margins at or above 70%.

At this time, Orthofix was focused on orthopedic products and the healing of bones throughout the body. For example, components to repair major joint damage such as broken ankles, hips, and knees. This means everything from external structures holding parts together to tiny screws mending fractures. The company had limited solutions for spinal injuries or diseases.

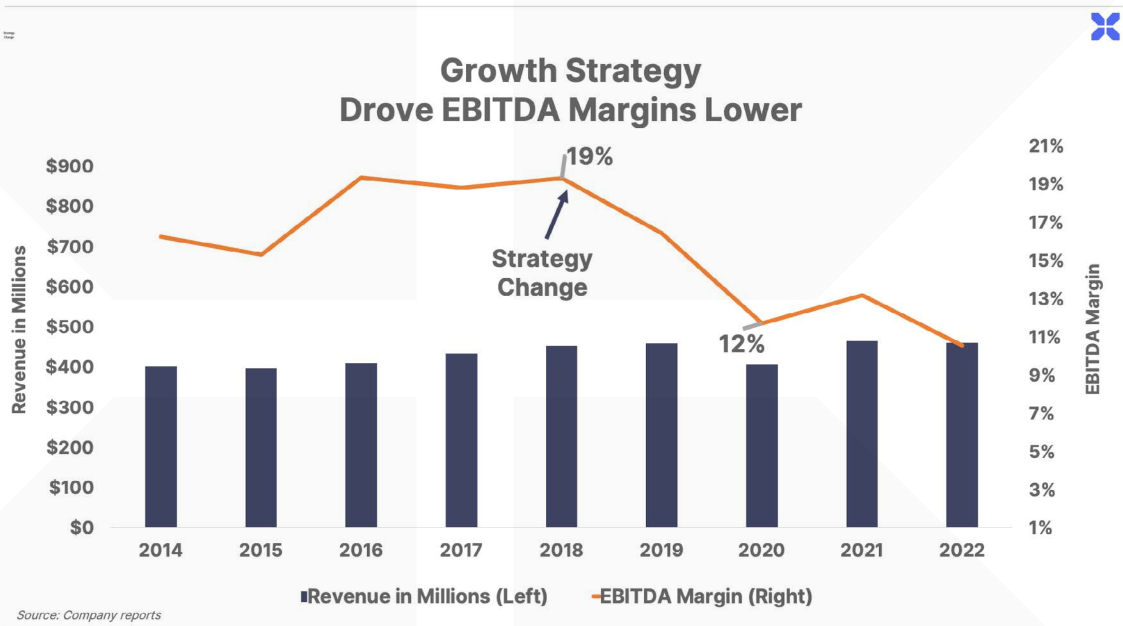
Then, in 2018, the strategy changed. The board hired medical-device veteran Jon Serboursek as CEO with the mandate to prioritize growth and innovation. This strategy adjustment would require increased capital investment and added operating expenses. But the plan was to reinvigorate sales and grow the overall business.

R&D spending increased immediately – rising 12% in 2018 compared with 3% the prior year. In 2020, it rose 13% and another 27% in 2021. As a percentage of sales, R&D rose from 7% in 2016 to almost 11% in 2022 – a 70% increase in dollar terms.

CEO Serboursek also went on a buying spree. In 2018 and 2019, Orthofix acquired three private companies. Prior to this, the most recent acquisition was in 2013.

This sustained change disrupted the consistent operations of the prior years. Increased costs began eating into EBITDA (earning before interest, taxes, depreciation, and amortization) margins. Then the pandemic hit, complicating the company's operations.

The chart below depicts this story of essentially flat revenue and rising expenses.



The decline continued in 2022 with another drop in EBITDA margin.

Investors fled, and the stock fell another 34% in 2022.

The board and CEO needed to do something transformational to kick start the company into a better direction.

Serboursek learned that a spine-focused company called SeaSpine – about a third of Orthofix's size – might be interested in joining forces. SeaSpine's CEO, Keith Valentine, was a known successful spinal executive. His reputation would help Orthofix shareholders approve the deal. On its face, a merger would be complementary. The SeaSpine spinal business would add incrementally to Orthofix's orthopedic products.

The merger was announced on October 11, 2022, and closed a few months later on January 5, 2023. Serboursek became chairman of the board and Valentine took over as CEO.

But the market hated the deal. Orthofix stock fell 19% on the day the news became public.

Why so much investor angst? Broadly speaking, spinal products are a commodity and the companies that make them have stocks that tend to trade at lower-valuation multiples. Orthofix as an orthopedic company enjoyed higher profit margins. But SeaSpine was a lower-valuation business, and analysts feared the merger of the two companies would ultimately drag down margins for Orthofix.

The deal was also very dilutive. SeaSpine investors would receive 0.42 Orthofix shares for every SeaSpine share. This increased total shares outstanding by 76%. Making matters worse, combined revenues would rise only 34%, assuming no market cannibalization. Cannibalization occurs when one company's products replace the other in a merger. It almost always happens.

From our research, we also learned it was rumored that a group of private equity firms even considered buying Orthofix and taking the company private to maintain its ortho focus and eliminate the dilution. While a deal never materialized, it hints at the potential locked up value in the company.

The merger created a clash of cultures. In the medical-device business, spinal companies tend to have a "frat boy" reputation with hard-charging sales policies that seek to maximize profits no matter what. Orthopedics tends to be the exact opposite.

These two very different corporate cultures were thrown together – with the SeaSpine executives taking over the C-suite. In less than a year, there was so much internal turmoil that something needed to give.

The growth-at-all-costs CEO, Serboursek, did not stand for reelection as board chair and key members of Valentine's C-suite were fired. An interim chair was named and the search for a new CEO began immediately.

Phew. What a story of corporate drama. It is easy to see why we believed in October that Orthofix was "ripe for an activist." And as we said above, this is exactly what happened. Engine Capital Management took its 8.2% ownership position and began to influence change possibly to prepare it for a sale.

And that leaves us where we are today. Orthofix is now a more diversified company with higher revenues but still lacks a common culture under new leadership.

Now let's look at why we believe things are on the mend. In a relatively short period of time, Engine has influenced change for the better.

We Like Orthofix...

Four reasons we believe Orthofix is a great investment today:

1. Engine Capital has made quick progress with Orthofix
2. Revenue and EBITDA are set to grow
3. The stock remains undervalued relative to its peers
4. We can easily calculate a target price well above current levels

New Blood – CEO and the Board...

Engine Capital has been pushing hard for change. Two important steps have been accomplished since late summer 2023.

First – Orthofix got a new CEO. In November 2023, the board named Massimo Calafiore as CEO, to start this month. Calafiore was previously CEO of LimaCorporate, a small medical-device company with similar traits as Orthofix. In a little over a year, he cut expenses, improved profits, and sold the company to Enovis, a $3 billion market cap medical-device maker.

We believe there are many parallels to Calafiore's new role at Orthofix, which he has started in this month.

Second – Engine and Orthofix's board recently signed a cooperation agreement.

On December 12, 2023, Orthofix announced it had reached an agreement with Engine Capital. The Orthofix board agreed to appoint three new independent directors to the current slate of nine board members – bringing the total to 12. Engine selected all three of them.

The first two are as we would expect – experienced medical-device executives with great track records. Michael Finegan and Charles Kummeth are exactly the people we want to see as independent board members.

Finegan is the current CEO of Acera Surgical and the former chief strategy officer at Orthofix, where he spent 14 years. He also held a variety of roles at Boston Scientific.

Kummeth is the current CEO of Bio-Techne Corporation, a life-science focused medical-device maker. He has held this role since 2013 and been in the industry since the mid-1980s.

The third new board member is Alan Bazaar, the CEO of Hollow Brook Wealth Management. In our view, this is a curious choice for the board of a medical-device company. He looks nothing like the others. As such, we did more digging on his background and wondered if he had been chosen for a specific reason.

Bazaar spent 14 years at his prior role with Richard L. Scott Investments (now called Scott Capital), a private equity investment firm that buys private companies looking to grow and generate cash flow… or which are sold to larger companies at a premium.

While working at Scott, Bazaar has served on a number of boards over the years. He is currently a board member at a number of other firms.

We believe that the choice of Bazaar as a new board member is directly related to his private equity experience and contacts. His charge could be to put together a group of investors to buy Orthofix.

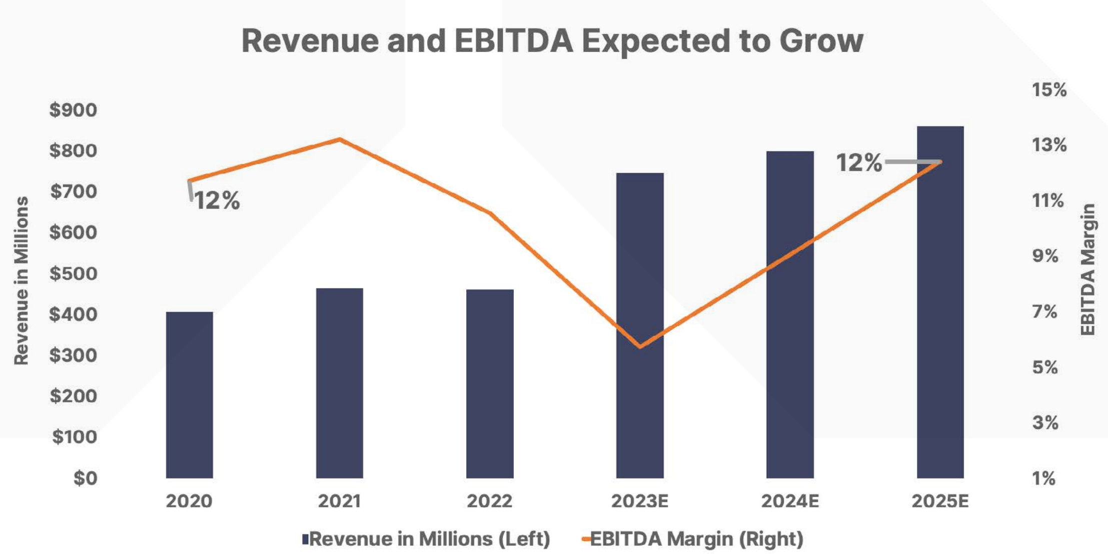
This theme fits nicely with the recent experience of incoming CEO Calafiore, who sold the company he previously worked for – and in short order.

We see no other reason why the CEO of a private wealth management company would be chosen as a board member of a medical-device company when he has zero medical-device or healthcare experience.

Revenue and EBITDA Set to Grow

With fresh faces – and new expertise – on the board, we believe Orthofix is ready to grow revenue and earnings on a more consistent basis. This is clearly the goal of CEO Calafiore as he takes over this month.

The chart below illustrates revenue and EBITDA margin from 2020 through the estimated 2025 results. Revenue is forecast to grow simultaneously with expanding EBITDA margins.

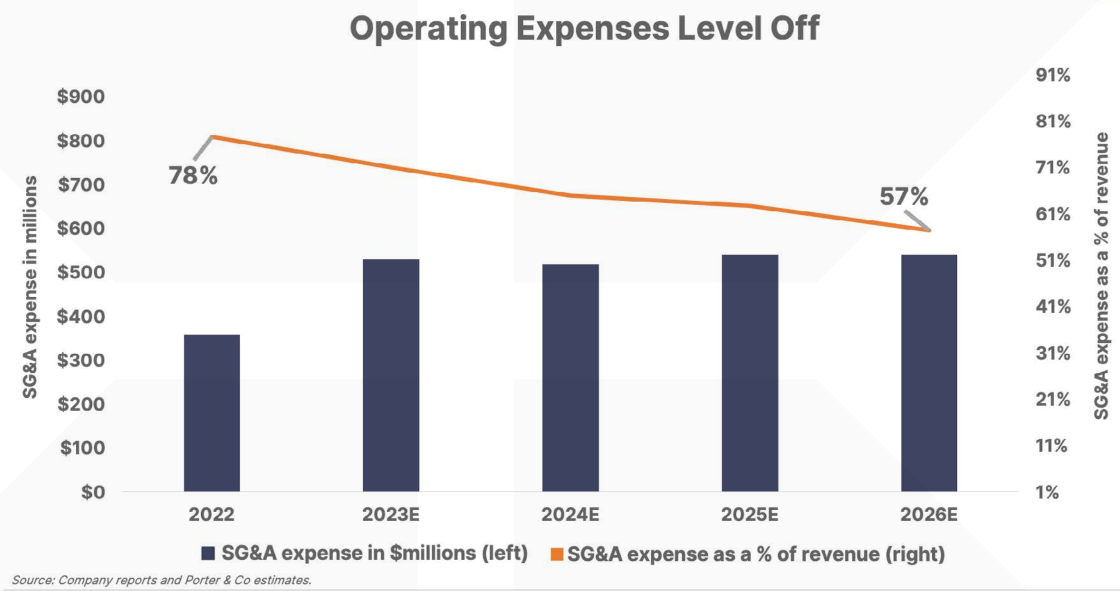


Source: Factset, company reports, and Porter & Co estimates.

The increase in revenue in 2023 is from the January 2023 merger with SeaSpine as its financials get added to the combined company. In our view, these estimates are visible and likely to be realized.

What will be done? There will be a focus on all operating costs, including labor, which is usually a big expense. We expect lingering redundancies from the merger with SeaSpine to be evaluated again and changes made. (Redundancies refer to the same functions at each company. For example, once merged, a company does not need two HR departments. By eliminating one, costs are saved.)

We expect sales, general, and administrative (SG&A) expenses to stabilize, and decline materially as a percentage of total revenue. The chart below illustrates this forecast.



The decline as a percentage of revenue is what will drive EBITDA margins higher. If the company is not spending this on SG&A, it can contribute to profits instead.

R&D spending is also a focus. After increasing for the last several years, it will flatten and decline slightly in 2024.

Again, these are estimates. While the forecast suggests improvement, the crux of our discussion here is to evaluate how realistic the forecast may be. While both the revenue and operating expense forecasts appear to be reasonable, let's ask ourselves one more question:

Given revenue and expense forecasts, are the resulting EBITDA results realistic?

In our view, yes, they are realistic. Given the anticipated operating improvements, the 2025 EBITDA estimates equate to a 12% margin. For context, Orthofix was averaging 16% to 18% EBITDA margins in the years prior to the return-to-growth strategy. As such, the EBITDA forecast may even be conservative.

Orthofix Shares Remain Undervalued…

This is still a developing situation. Engine Capital has only recently achieved its governance goals and the new CEO just started this month.

As such, the market has yet to react in a meaningful way. Consider Orthofix's price-to-sales (P/S) and Enterprise Value-to-EBITDA (EV/EBITDA) multiples compared to five peer companies.

Orthofix Trades Below Peer Stocks

Company	Ticker	Price	Mkt. Cap ($m)	2025	
				P/S	EV/EBITDA
Orthofix Medical	OFIX	$13.30	$490	0.6	4.9
Globus Medical	GMED	$54.92	$7,568	2.9	7.2
Integra Life Sciences	IART	$41.89	$3,275	1.9	10.8
Enovis	ENOV	$57.58	$3,144	1.5	9.5
ZimVie	ZIMV	$16.76	$445	0.5	7.1
Bioventus	BVS	$4.85	$305	0.7	7.8
Average				1.5	8.5

Source: Factset, company reports, Porter & Co estimates.

Assuming the 2025 estimates discussed above come to fruition, looking at EV/EBITDA, Orthofix trades at 39% discount (as of January 17, 2023, closing prices) to the peer group average – 5.2x compared with 8.5x. On a P/S basis, Orthofix trades well under half the average – 0.6x versus 1.5x.

Even if we focus only on the two smaller peer companies – Bioventus and ZimVie – Orthofix is cheaper on an EV/EBITDA basis and roughly in line with P/S.

To estimate where the stock should trade, we put together three scenarios: a bear case, bull case, and a middle-of-the-road case. Each scenario considers an alternative result for expected EBITDA and the EV/EBITDA multiple they market applies.

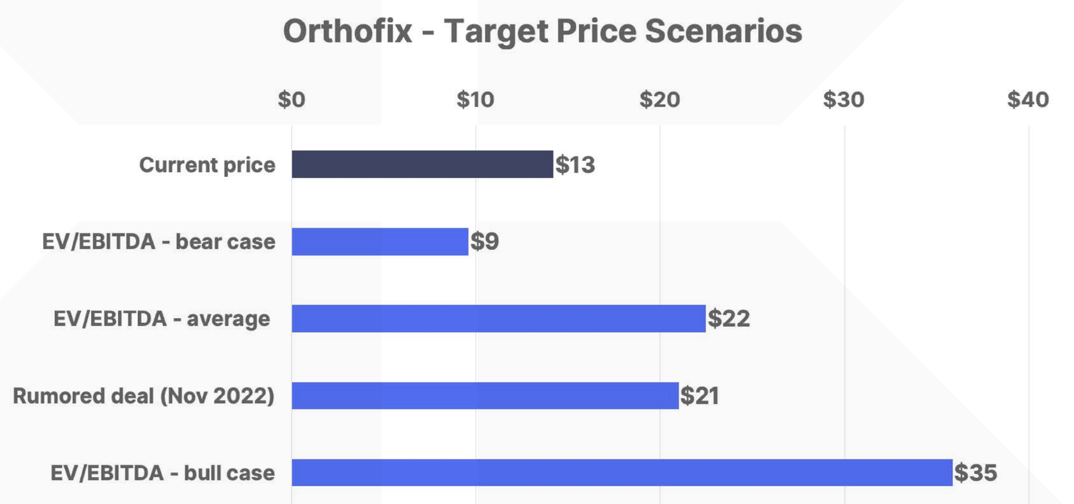
Bear case. In our downbeat scenario, we assume EBITDA for 2025 comes up about 20% short of the current analyst forecast. This means the company does not meet its cost-savings targets. As a result, we assume the stock stays at the current EV/EBITDA multiple of 4.9x. This equates to a target price of $9 per share and suggests the price would decline from current levels.

Bull case. In our optimistic scenario, we assume EBITDA is roughly 30% higher than the current average expectation, meaning operating improvements are very successful. In such a case, the market would be pleased and willing to pay a higher multiple of EBITDA for the stock. We assume the multiple returns to the average 10.1x seen from 2019 through the 2025E forecast. This provides a target price of $35, or 163% greater than the current price.

Middle-of-the-road. This scenario takes the midpoint of the bear and bull cases. It yields a target price of $23 a share.

But let's include one more estimate. Since nothing values a company like a deal, let's also include a potential private equity deal we've heard about in our research on this stock.

Interestingly, that estimate falls within the range of our scenarios that are based on financial fundamentals.



Source: Factset, company reports, Porter & Co estimates.

The chart above summarizes the results of each analysis. Adding it all up, we get an average of $22 a share. This feels reasonable to us over a 12-to-18-month holding period.

Orthofix – A Stock Now Fully Ripened With an Activist

Orthofix has all the makings of a special-situation investment where an activist has become involved.

- Corporate drama catalyzing corporate action – Management was fired and refreshed along with the board
- An undervalued security – OFIX shares trade well below peer valuation multiples
- A realistic upside investment outlook – Our multifaceted target-price analysis suggests meaningful upside
- Minimal risk – Currently, the shares remain down about 30% from recent highs

While the stock is off its lows, we continue to like Orthofix. Our $22 target price offers 64% upside based primarily on financial fundamentals looking out to 2025. This by itself supports our positive outlook.

In our view, the original board, new board members, and the new CEO all share a common goal – the sale of the company, if a deal makes sense for shareholders. We see this with the reported private equity sale of the company in 2022, the recent experience of the new CEO, and the appointment of Bazaar to the board.

Our gut belief is that Orthofix will be sold to a larger medical-device company or taken public by a syndicate of private equity firms.

That said, if this is completely wrong, the improved operating outlook supports a very solid investment return from current levels.

We certainly hope that Randy the firefighter is a shareholder.

Action to Take: Buy Orthofix Medical (Nasdaq: OFIX) up to $22 per share.

Portfolio Review

The Porter & Co. Activist Investor Portfolio

	Ticker	Description	Purchase Date	Cost Basis	Closing Price	Yield	Income Received	Total Return	Status
SPORTSMAN'S WAREHOUSE	SPWH	Sporting Goods Stores	09-22-2023	$3.53	$4.04	0.00%	$0.00	14.45%	Buy Under $15
CATALENT	CTLT	Health Care Services	09-22-2023	$45.34	$48.58	0.00%	$0.00	7.15%	Buy Under $80
MERCURY SYSTEMS	MRCY	Defense Technologies	11-15-2023	$34.78	$30.97	0.00%	$0.00	-10.95%	Buy Under $60
ORTHOFIX MEDICAL	OFIX	Medical Devices	01-17-2024	$13.30	$13.30	0.00%	$0.00	0.00%	Buy Under $22

Disclaimer: this hypothetical portfolio should not be considered investment advice or a recommendation to buy/sell any financial instrument. For informational purposes only. Investors should perform their own due diligence before buying or selling any financial instrument. No express or implied guarantee of accuracy or applicability to real-world trading.

GLP-1 Weight-Loss Drugs a Focus at the JPMorgan Healthcare Conference

Catalent (NYSE: CTLT) shares have risen 10% since our last update report on December 22, and are up 7% since our initial recommendation.

During the second week of January, the company participated in the 2024 JPMorgan Healthcare Conference in San Francisco. This is one of the largest healthcare investor conferences of the year. Many companies use the event to provide updated financial information on the prior year and often update their expectations for the upcoming year.

In the case of Catalent, the company reiterated its market positioning for the manufacture of GLP-1 diabetes and weight-loss drugs and the audience liked it. Recall, this is one of our primary reasons to own Catalent shares. It is also a key part of the activists' thesis for the company.

At the conference, Catalent's CEO again confirmed that the company has "a leading position as a provider of capacity to manufacture GLP-1s." He reiterated his view of total revenue from this business to "exceed $500 million" a year.

Overall, the discussion at the conference was positive and the outlook continues to improve.

Action to Take: Buy Catalent up to $80 per share.

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Analyst Forgets About the Activist Angle

Mercury Systems (Nasdaq: MRCY) was downgraded by financial-services firm Jefferies on January 3. The move caused the stock to drop 8.5% on the day. Then, on January 11, Goldman Sachs downgraded the stock to Sell, but the shares did not react.

Jefferies believes the company may need to lower its financial guidance again, causing shares to decline. The Goldman Sachs downgrade is more administrative. Goldman Sachs equity research is based on a market neutral system. If an analyst upgrades a stock to Buy, he or she must downgrade another stock to Sell. As such, and in our opinion, a Sell rating at Goldman does not carry the same weight as other equity research firms.

In our view, there is nothing new in these reports.

A key component missing in the analysis is the activist angle. The activist thesis remains in place. Management and the board continue to focus on its shift in strategy to improve operations. Shares are still 40% below 2023 highs.

Should Mercury decide to lower the bar further with a cut in 2024 financial guidance, we would use any resulting drop in the stock price as an opportunity to add shares and reduce our cost basis.

Out of an abundance of caution, we have re-evaluated our target-price methodology and lowered our EV/EBITDA multiple from 24x to 18x. We do this to account for a potential change in market expectations brought about by the Jefferies downgrade.

Even after this adjustment, we continue to believe Mercury shares are worth $60 over the next two years, offering 94% upside to the current price.

Action to Take: Buy Mercury Systems (Nasdaq: MRCY) up to $60 per share.