The Medical Supplies (Non-Invasive) Industry includes a wide array of companies that make medical devices that do not involve a break in the skin (as opposed to the Medical Supplies Invasive Industy). Many companies in this sector have traditionally offered some of the best risk-adjusted returns in the market, thanks to their strong balance sheets, high free cash flow due to limited capital spending needs, and consistent earnings growth owing to the non-discretionary nature of most of their products.

The implementation of the Affordable Care Act, colloquially known as Obamacare, has the potential to be a disruptive force in the industry. The new regulations are likely to push some medical providers to reduce costs. This may affect their ability to spend on medical devices, which would likely limit the pricing power of medical device manufacturers in the future.

Overall, the industry still provides exceptional safety, particularly in large caps. However, valuations have reached levels that limit long-term appreciation potential for several industry players. Too, this industry is ranked to underperform over the next six to 12 months.

Accretion from Acquisitions

Many companies in the industry are seeing rapid gains in revenues and earnings due to large acquisitions that have been made over the past year. For example, *McKesson Corporation* acheived a 32% jump in earnings per share in fiscal 2013 (fiscal year ended March 31, 2014), with an especially sharp rise in its Medical Surgical segment's revenues reflecting the inclusion of *PSS World Medical*, which it acquired last year. The company is likely to see even larger accretion from its acquisition of *Celesio*, a generic drug producer based in Germany with a large share of the European drug market. McKesson should take operational control of Celesio in the coming months and we have raised our estimates significantly to reflect the addition. *Thermo Fisher Scientific*'s acquisition of *Life Technologies* has led it to create a new business segment altogether. The Life Sciences Solutions segment will combine most of Life Technologies' businesses and Thermo Fisher's biosciences segment. We expect very high revenue growth for the company this year, due in large part to the acquisition. *Teleflex*, meanwhile, has seen revenue growth led by contributions from recent acquisitions, specifically the purchase of *Vidacare* at the end of 2013, and *Mayo Healthcare* in February of this year. *Bio-Rad Laboratories*, meanwhile, has revived the fortunes of its once-struggling Life Sciences segment with the addition of AbD Serotec to its operations last year. Its Clinical Diagnostics segment has benefited from the purchase of GnuBio, which should help the company expand and improve its DNA sequencing products. With strong free cash flow, we expect the company to continue to make bolt-on acquisitions in the coming quarters.

Emerging Market Growth

Cepheid, a developer and manufacturer of genetic analysis systems, has received a major boost from its Highly Burdened Developing Country (HBDC) program.

INDUSTRY TIMELINESS: 80 (of 97)

Initially started as a goodwill project, the HBDC has developed unmatched brand awareness in developing nations such as South Africa, which now makes up 40% of HBDC revenues. The segment is growing rapidly, and now makes up 17% of companywide sales. However, since part of the segment offers products at a reduced price, profitability is still low relative to the company's other divisions. Teleflex, which has seen mixed results in its other units, continues to see rapid growth in its Asia business, which increased revenues at a 17% annual clip.

Safe Large Caps

Some of the largest companies in the industry by market cap also provide exceptional safety for investors. *Johnson & Johnson* is the largest company in the industry by a wide margin. It boasts our Highest Safety rank (1) as well as a perfect score for Earnings Predictability (100 out of 100). However, it has experienced slow earnings growth of late, seeing a year-over-year rise of just 4% in the first quarter. Part of the reason for the modest growth was a decline in Worldwide Consumer segment sales. However, some of that drop was due to the divestiture of a sanitary protection business. Better results in some of the unit's strongest brand names, such as *Aveeno, Listerine, and Zyrtec* helped to mitigate the drop. Global Pharmaceutical segment revenues rose 11%, with international growth considerably outstripping domestic growth. Solid demand for *Stelara, Prezista, and Velcade* led the way in boosting the top line. The company's medical device sales, on the other hand, have been flat, and it has agreed to sell the Ortho-Clinical Diagnostics business for about $4 billion. McKesson, meanwhile, has a market cap of over $40 billion and a Safety rank of 1, as well as top scores for Price Growth Persistence and Earnings Predictability.

Conclusion

The main factor tempering our outlook for this sector is the historically high valuations of many of these stocks. However, with increasing acquisition activity and strong business fundamentals, potential still resides here.

Adam J. Platt