

MDT, DXCM

Takeaways from the ADA conference
and our proprietary June diabetes survey

3 July 2007

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Issuer of report: HSBC Securities (USA) Inc

Disclaimer & Disclosures.

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- ▶ **Increased enthusiasm for the next generation of continuous glucose monitors (CGMs) available from Medtronic and DexCom, and the pending US introduction of Abbott's CGM, currently under FDA review**
- ▶ **Medtronic's Paradigm insulin pump integrated with its Guardian CGM provides the company a competitive advantage in the CGM market and over the other leading insulin pump manufacturers – Roche, Johnson & Johnson, Smiths Group, Insulet**
- ▶ **We maintain our Overweight (V) rating and USD10 price target for DexCom, and Neutral rating and USD55 price target for Medtronic**

We have adjusted our continuous glucose monitoring (CGM) model through 2009 based on seeing the new features and updated accuracy data for the next-generation CGM devices from Medtronic (Guardian Real-Time) and DexCom (7-day STS) at the American Diabetes Association (ADA) meeting on June 22-26, the results of our June 2007 diabetes survey of 280 insulin pump users on pumps and CGM published separately today, the latest CGM sales figures from MDT and DXCM, and assuming Abbott's Navigator CGM is not available until 2008. We still reflect about 140,000 CGM users in the US by the end of 2009 (compared to about 15,000 today).

We believe Medtronic should meet its target goal to grow its diabetes division at a 15-17% CAGR over the next five years; we currently model its diabetes division growing at a 19% fiscal 2007-2010e CAGR.

For DexCom, we are lowering our sales estimates for 2008 and 2009, but we have increased confidence in the CGM market, particularly when these devices get more broadly reimbursed by third-party payers. We would view a partnership between DexCom and any of the leading insulin pump manufacturers as a positive for both parties.

HSBC healthcare equipment & supplies: Company valuation summary (USD)

Ticker	BCR	BSX	DXCM	ISRG	MDT	POSS	STJ	STXS	THOR
Company name	C.R. Bard	Boston Scientific	DexCom	Intuitive Surgical	Medtronic	Possis Medical	St. Jude Medical	Stereotaxis	Thoratec
Current price (06/28/07 close)	82.4	15.5	8.0	138.5	51.8	11.0	41.4	12.8	18.8
Market capitalization (USDbn)	8.5	23.0	0.2	5.2	59.1	0.2	14.0	0.5	1.0
Price target	96	17	10	146	55	12	48	16	23
Rating	Overweight	Neutral	Overweight (V)	Overweight (V)	Neutral	Neutral (V)	Overweight	Overweight (V)	Overweight (V)
Fiscal year ends	Dec	Dec	Dec	Dec	April	July	Dec	Dec	Dec
EPS includes FAS No. 123?	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	No
EPS FY 2005	3.03	1.82	-3.38	2.51	1.86	0.33	1.54	-1.60	0.45
EPS FY 2006	3.30	0.81	-1.71	1.89	2.21	0.21	1.51	-1.39	0.38
EPS FY 2007	3.81e	0.42e	-1.53e	2.85e	2.41	0.02e	1.75e	-1.02e	0.36e
EPS FY 2008	4.37e	0.68e	-1.20e	3.70e	2.70e	0.13e	2.05e	-0.44e	0.51e
EPS FY 2009	5.03e	0.86e	-0.40e	4.71e	3.04e	0.25e	2.35e	0.19e	0.69e
P/E - FY2005	27.2x	8.5x	-	55.2x	27.8x	33.2x	26.9x	-	41.8x
P/E - FY2006	25.0x	19.1x	-	73.3x	23.4x	52.2x	27.4x	-	49.5x
P/E - FY2007	21.6x	36.9x	-	48.6x	21.5x	548.5x	23.7x	-	52.2x
P/E - FY2008	18.9x	22.8x	-	37.4x	19.2x	84.4x	20.2x	-	36.9x
P/E - FY2009	16.4x	18.0x	-	29.4x	17.0x	43.9x	17.6x	67.5x	27.2x

Source: Company reports, HSBC

Diabetes

- ▶ Continued enthusiasm around continuous glucose monitoring (CGM) at ADA and in our June survey of 280 insulin pump users
- ▶ We forecast 140,000 CGM users in the US by the end of 2009 versus the approximate 15,000 using CGMs today
- ▶ Medtronic's Paradigm insulin pump integrated with CGM provides a competitive advantage in both the pump and CGM markets

Summary

At this year's American Diabetes Association (ADA) meeting on June 22-26, CGMs from DexCom, Medtronic, and Abbott received a lot of attention and enthusiasm at the company exhibits, physician presentations, and poster sessions, and company-sponsored symposiums. Despite much anticipation since the beginning of 2007, there was no update on the timeline for FDA approval of Abbott's FreeStyle Navigator CGM at the ADA.

Insulin pump integration with CGM is also emerging as a competitive advantage for Medtronic in the insulin pump market, the market leader in the US with about 75% of the 320,000 insulin pump user base. Also receiving continued interest were disposable insulin pumps, like Insulet's OmniPod system. As of March 2007, there were 1,750 people using the OmniPod system due to its tubeless design, ease of use, and cost structure (USD800 upfront and USD345 per month) relative to traditional insulin pumps (USD5,000-6,000 upfront plus USD1,500 per year for infusion/tubing sets).

We published a separate note today entitled *Diabetes: Updated survey on insulin pumps and continuous glucose monitoring* that also includes background information on diabetes, insulin pumps, and CGMs; about 280 insulin pump users responded to our survey in June 2007. These results confirmed the large market opportunity for real-time CGM and also highlighted the opportunity for new insulin pump technologies, such as insulin pumps integrated with CGM and disposable insulin pumps.

In our survey, we asked pumpers whether they considered switching to a pump made by a different manufacturer. Overall, pumpers preferred to stay with their current pump manufacturer: only 11% (n=32) said Yes (22% or 61 people said Maybe, and 67% or 187 said No). For those pump users considering switching to a different pump manufacturer (n=93), we asked to which manufacturer(s) would they switch. Interestingly, 25% were undecided, 11% did not mention any specific manufacturer but wanted to switch to a pump with CGM integration, 19% said Medtronic (MiniMed), 18% said Insulet, 13% said Johnson & Johnson (Animas), and 11% said Smiths Group (Deltec).

Medtronic disclosed at its June 20 investor meeting that about 11,000 Guardian CGM systems have been sold to date, primarily in combination with the Paradigm pump; this is a much stronger adoption of Guardian than we had estimated. This compares to the approximate 3,600 STS CGM systems DexCom has sold since March 2007 – to both insulin pump users and diabetics taking insulin and not on pumps.

We have adjusted our CGM model through 2009 based on seeing the new features and updated accuracy data for the next-generation CGM devices from Medtronic (Guardian Real-Time over Guardian RT) and DexCom (7-day STS over 3-day STS) at ADA, our June 2007 diabetes survey, the latest CGM sales figures from Medtronic and DexCom, and assuming Abbott's Navigator is not available until 2008.

About 73% of the 280 insulin pumpers we surveyed were interested in CGM, compared to the 23% that are currently using any of the CGMs. About 82% of the pumpers in our June 2007 survey currently using a CGM are paying out of pocket for the sensors (USD35 for Medtronic's 3-day Guardian sensor, USD35 for DexCom's 3-day STS sensor, and USD60 for DexCom's 7-day STS sensor).

We still reflect about 140,000 CGM users in the US by the end of 2009 (compared to about 5,000 at the end of 2006 and 15,000 today), but assume about 60% of the CGM mix are insulin pumpers (versus our prior 43% estimate). We expect higher adoption of CGM in the insulin pump population versus the 1.1m subgroup of Type 1 and Type 2 diabetics who take insulin and measure blood glucose at least twice per day and are not using insulin pumps (i.e. non-pumper subgroup). Overall, insulin pump users test their blood glucose levels four or more times a day, are highly motivated to control their diabetes and

HbA1c glycemic levels, and have already committed to wearing an external device 24/7.

In terms of market share, we now assign more CGM market share to Medtronic in the insulin pump subgroup, as 75% of the US insulin pump installed base is on a Medtronic pump, and our survey confirmed the preference for MDT's CGM from current Medtronic pumpers due to the integration with its Paradigm pump. Animas pumpers had a preference for DexCom's STS, and Deltec and Insulet pumpers had a preference for Abbott's Navigator, which makes sense given that both companies' insulin pumps are integrated with an Abbott Freestyle blood glucose meter.

In the non-pumper subgroup, we have given DexCom more CGM market share to reflect Abbott receiving approval for Navigator in 2008 versus 2007, and assuming both Medtronic and DexCom are closing in on the accuracy gap based on the new Guardian and STS CGM data previewed at ADA. Abbott has an advantage for the subgroup of people who currently use Abbott's FreeStyle single-point blood glucose meters, but we believe Navigator's 10-hour warm-up period (both Guardian and STS have two-hour warm-up periods) will be viewed as a significant disadvantage for some people in real-world use.

We believe Medtronic should meet its target goal to grow its diabetes division at a 15-17% CAGR over the next five years; we currently model its diabetes division growing from USD863m in fiscal 2007 to USD1.44bn in fiscal 2010e (19% CAGR). We maintain our USD55 price target and Neutral rating on MDT shares.

For DexCom, we are lowering our sales estimates for 2008 to USD20m from USD25m, and for 2009 to USD49m from USD55m; our 2007 sales estimate of USD7m remains unchanged. Our price target for DXCM shares remains USD10, and we rate the stock Overweight (V). Although our sales

estimates for DexCom in 2008 and 2009 have decreased, we have increased confidence in the CGM market, particularly when these devices get more broadly reimbursed by third-party payers.

We would view any such collaboration between DexCom and any of the leading insulin pump manufacturers – Johnson & Johnson (Animas), Roche (Disetronic), Smiths Group (Deltec), or Insulet – as a positive for both parties, as both companies would better compete with Medtronic in their respective markets.

Insulet has an agreement with Abbott to develop a product that will integrate the receiver portion of Abbott's Navigator with its OmniPod insulin pump system, but no market introduction timeline has been disclosed. Johnson & Johnson and Becton Dickinson have both disclosed internal programs to develop CGMs.

Neither Roche nor Bayer has broadly discussed with the investment community plans to develop and launch a real-time CGM (although Bayer has a relationship with Sontra Medical, which is developing a CGM for hospital use).

Patient selection and education key to CGM success

One of the themes from the physician presentations at ADA was that patient selection is important to ensure success with CGM. This was

supported by the mixed results of Medtronic's STAR 1 trial.

In the STAR 1 trial, 138 patients were randomized to an insulin pump group or a CGM sensor-augmented insulin pump group. At 26 weeks, the overall difference in HbA1c levels (measure of glycemic control; normal is between 3.5% and 5.5%, and a healthy goal for diabetics is under 7%) were no different between the two groups; although 38% of patents in the CGM sensor-augmented group reached the "7% or below A1c target" versus 19% in the control insulin pump group.

The STAR 1 results were negatively impacted by patient compliance. For patients in the sensor-augmented group with 60% sensor compliance or better, A1c's were significantly different at six months and baseline: 7.5-7.7% final versus 8.2-8.6% at baseline. For the nine patients in the sensor group with less than 60% compliance, A1c's did not change: 9.6% final versus 9.5% baseline. CGMs, like insulin pumps, are best suited for highly motivated patients who want to utilize the best available tools to better control their diabetes.

Other CGM presentations at ADA focused on improving patient education, guidance on when to calibrate the system (when blood glucose levels are relatively steady), and other tips and pitfalls to

Medtronic's first-generation Guardian RT CGM system as a standalone device



Source: Company reports

Medtronic's Paradigm Real-Time system combines Paradigm insulin pump with the NEW Guardian Real-Time CGM



Source: Company reports

keep in mind when training patients how to utilize CGMs.

Better published results with CGM should drive patient and physician adoption, and help convince third-party payers to reimburse CGMs, as payers are focused on hard endpoints such as HbA1c reduction.

Medtronic's next-generation CGM

Medtronic recently introduced its Guardian Real-Time CGM system with the MiniLink transmitter. Compared to the prior Guardian RT generation, the Guardian Real-Time's transmitter is much smaller and integrated into the sensor component, making it as discreet to wear as the DexCom STS and Abbott Navigator CGMs. The MiniLink transmitter is waterproof and rechargeable. The Guardian can be purchased in addition to Medtronic's Paradigm insulin pump for USD1,000 (i.e. Paradigm Real-Time system), or as a standalone device for USD1,300; the list price for DexCom's STS is USD800.

At Medtronic's June 20 investor meeting, management disclosed that about 11,000 Guardian CGM systems have been sold to date, primarily in combination with the Paradigm pump; this is a much stronger adoption of Guardian than we had estimated. This compares to the approximate 3,600 STS CGM systems DexCom has sold since March 2007 – to both insulin pump users and diabetics taking insulin not on insulin pumps.

Also at the investor meeting, management discussed future enhancements to the Guardian CGM system: room temperature shipping and storage, extending sensor life from three to six days, decreasing the start-up time from two hours to 30 minutes, improved accuracy, and ultimately a fingerstick replacement claim.

The Children with Diabetes website provides a detailed comparison of Medtronic's Paradigm

Real-Time system and Guardian Real-Time CGM, DexCom's STS CGM, and Abbott's FreeStyle Navigator CGM:

<http://www.childrenwithdiabetes.com/continuous.htm>.

DexCom's STS CGM sensor/transmitter and receiver



STS™ Sensor & STS™ Transmitter



STS™ Receiver

Source: Company reports

Abbott's FreeStyle blood glucose meter and FreeStyle Navigator CGM sensor/transmitter and receiver



Source: Company reports

With further delays, Abbott's Navigator losing some edge

At the ADA meeting, Medtronic reported additional accuracy data on Guardian demonstrating comparable results to Abbott's Navigator. Some physicians and diabetics view Abbott's Navigator CGM as more accurate than both Guardian and DexCom's STS.

In our June 2007 survey, respondents stating a preference for Navigator over Guardian and STS listed the following reasons: superior accuracy, positive user feedback, already using FreeStyle meter, and waterproof. Publication of the updated Guardian data should help close the accuracy gap between Abbott and Medtronic, and additional data presented on 7-day STS at ADA could also

help close the accuracy gap between DexCom and Abbott.

The 5-day sensor life of the Navigator used to be the longest, but DexCom recently launched the 7-day STS. Versus the first-generation 3-day STS system launched in the US in March 2006, the 7-day STS system has a longer on-label sensor life, improved accuracy and stability, smaller needle size that improves comfort and performance, new transmitter to better process glucose data, and next-generation software in the receiver to improve ease-of-use, and is water-resistant.

Navigator has a 10-hour warm-up period. Although this did not seem to distract people from being interested in wearing the Navigator in our survey, we have heard some user feedback that the longer warm-up time will be a significant disadvantage, relative to the current two-hour warm-up for DexCom and Medtronic's CGMs.

First key step to a closed-loop system

On the insulin pump side, most of the excitement at ADA focused on Medtronic's Paradigm insulin pump, which when integrated with its Guardian Real-Time CGM is called the Paradigm Real-Time system. This CGM integration has given Medtronic a major competitive advantage, in our view, over the other leading insulin pump manufacturers – Roche (Disetronic), Johnson & Johnson (Animas), Smiths Group (Deltec), and Insulet. About 73% of the 280 insulin pumpers we surveyed in June 2007 were interested in CGM.

In an ADA presentation by Dr. Lutz Heinemann, the top reasons for starting insulin pump therapy were poor glucose control with insulin syringe/pen, more flexible lifestyle, dawn phenomenon (high blood glucose levels in the morning), and unpredictable blood glucose fluctuation.

Advances in CGM

In our June 2007 survey, we asked pumpers how important 10 specific advances were in CGM. The advances are listed below, ranked in order based on percentage of pumpers that noted the particular advance as "very important", with our comments:

- ▶ **Reimbursement for CGM devices/sensors, 86%:** In our view, the most important milestone towards getting broad reimbursement for CGM is the completion of the enrollment of a randomized, 450-patient CGM trial sponsored by the Juvenile Diabetes Research Foundation in the October 2007 timeframe (we believe the 12-month follow-up data will support broad reimbursement by year-end 2008). In the interim, JDRF has reported that more than 75 health plans provide CGM coverage on a case-by-case basis; but overall insurers are looking for more clinical evidence to support coverage.
- ▶ **More affordable CGM devices/sensors, 79%:** DexCom has priced its 7-day STS CGM sensors at USD60 each; assuming the system is used on-label for 7 days equates to USD8.60 a day. This list price per day is more favorable than the prior 3-day STS. Medtronic has priced its 3-day Guardian sensors at USD35 each; assuming the system is used on label for 3 days equates to USD11.70 a day. Each blood glucose test strip costs about USD0.80, therefore testing four to 15 times a day cost USD3 to USD12 a day. Some current CGM users are using sensors off-label for up to two weeks each to control un-reimbursed CGM costs.
- ▶ **More integration of CGM with insulin pumps, 68%:** As Medtronic is the only insulin pump manufacturer with an integrated CGM system in the market, we would view a partnership between DexCom and one of the key insulin pump manufactures as a positive

for both parties. Abbott and Insulet have agreed to develop a product that will integrate the receiver portion of Abbott's Navigator with the OmniPod.

▶ **Non-invasive CGM devices, 55%:**

Privately-held OrSense recently received European CE Mark approval for its NBM non-invasive CGM system. The feasibility data presented at ADA were promising, but the company is about one to two years away from developing a second-generation system that is wireless for home use, and we still need to see additional data from a broader clinical setting. Other companies continue to invest in this area. The GlucoWatch is non-invasive, but user issues with skin irritation, pain/burns, poor accuracy, discomfort, long calibration period, size/bulkiness, and cost/reimbursement limit adoption. The GlucoWatch is currently available for sale from Johnson & Johnson (Animas), but the company does not actively promote the device (GlucoWatch was not displayed at the company's ADA exhibit booth, while we were able to see Medtronic's Guardian, DexCom's STS, and Abbott's Navigator).

Johnson & Johnson (Animas) GlucoWatch



Source: Company reports

▶ **Improvements in current FDA-approved CGM devices, 54%:**

Medtronic and DexCom have made good progress towards introducing their respective second-generation devices, Guardian Real-Time and the 7-day STS, with improved features and accuracy.

▶ **FDA approval for CGM as a standalone device (no confirmatory fingersticks), 52%:**

We do not believe that any of the current minimally invasive CGM systems will get approval as a standalone device in the near term, i.e. not requiring confirmatory fingersticks to double-check a CGM glucose reading before taking any action, until better sensor algorithms are developed to minimize lag time. For all three minimally invasive CGM devices – Guardian, STS, and Navigator – the sensor is inserted just below the skin to measure the glucose level in interstitial fluid (ISF). There is about a 5- to 15-minute lag (depending on how rapidly one's glucose level is changing) in ISF glucose values compared to fingerstick measurements, which directly measure blood glucose.

▶ **New CGM manufacturers receiving FDA approval, 50%:**

We continue to believe the market introduction of Abbott's Navigator will be positive for the CGM market, and Medtronic and DexCom, as Abbott will be able to help educate patients and physicians on CGM. Also, we believe Abbott's entry will allow some potential patients who are waiting to compare all three devices to make a purchasing decision.

▶ **Additional clinical data with CGM, 35%:**

Additional clinical data on CGM is published and presented on a rolling basis in diabetes journals and at diabetes conferences throughout the year.

▶ **More users to report their experiences with CGM, 27%:**

Internet blogs and online diabetes communities are allowing people to share their individual CGM experiences – both good and bad – in real time with other potential users.

- ▶ **Doctor/CDE to recommend CGM, 25%:**
Continued physician education from the CGM manufacturers should increase the number of endocrinologists that are comfortable recommending CGM to patients. At the Medtronic-sponsored symposium at the ADA, which had over 500 attendees, we believe physician interest in CGM by the end of the educational symposium increased. The moderators conducted two polls during the symposium. At the beginning of the symposium, only 6% of the respondents were using CGM in 30% or more of their patients. At the end of the symposium, 90% of the respondents planned to use CGM with their patients, of which 41% planned to use CGM in 30% or more of their patients.

JDRF-sponsored CGM trial

The Juvenile Diabetes Research Foundation (JDRF) is working closely with the medical devices industry to develop the artificial pancreas. In September 2006, the JDRF announced that it will sponsor the Continuous Glucose Sensor Human Clinical Trial to compare clinical outcomes such as HbA1c levels (a measure of glycemic control) and avoidance of hypoglycemia (low blood sugar from too much insulin or too little glucose in the blood) of people who utilize CGM and people who do not; enrollment commenced in January 2007.

Approximately 450 Type 1 diabetics (children eight years or older and adults) who have been using insulin for at least one year, have an HbA1c level of 10% or less, are on an insulin pump or take at least three shots/injections of insulin per day, and are testing blood glucose at least four times a day, will be randomized to either CGM or fingersticks at 10 separate centers (www.clinicaltrials.gov: Randomized Study of Real-Time Continuous Glucose Monitors).

Devices from DexCom, Medtronic, and Abbott will be utilized, including Abbott's Navigator pending FDA approval. The choice of which CGM to use is up to the physician (although patients also have a say); the JDRF expects close to an equal distribution of trial participants using each manufacturer, as the centers will likely use this opportunity to get more familiar with all three companies. After six months, patients in the CGM arm will continue to use CGM to evaluate whether any benefits seen in the first six months are sustained, and patients in the control/fingerstick arm will cross over to CGM use.

Primary endpoints for the JDRF CGM trial include (at six months and one-year follow-up): HbA1c, episodes of severe hypoglycemia, percentage of sensor values in range (70mg/dL to 180mg/dL), biochemical hypoglycemia (percentage of sensor values < 70mg/dL), quality of life, and measures of variability (mean amplitude of glycemic excursions/MAGE, standard deviation, mean absolute rate of change).

The JDRF worked closely with payers to design the study, and we believe that the study will be positive and provide compelling support for CGM reimbursement. We expect enrollment to be completed by October 2007. Although the patient follow-up period for this trial is 12 months, the six-month follow-up data could be available in mid-2008 to share with the public and/or third-party payers if the JDRF deems it appropriate.

An increasing number of highly motivated and very determined families are going through the CGM reimbursement process. The JDRF is anecdotally hearing cases in which both adults and children are receiving CGM reimbursement across over 75 payers on a case-by-case basis, and offers tips for seeking reimbursement on its website. We have also read a number of patient Internet blogs exchanging tips on seeking reimbursement.

The JDRF believes that people are very enthusiastic about CGMs and understand that the current generation of devices are first generation, and has seen tremendous value from the systems when they work properly. JDRF believes that the CGM market is currently being driven by patients pushing doctors to prescribe CGMs, and could further accelerate when more endocrinologists are educated about CGMs and start pushing these devices on potential patients.

CGM model summary

We estimate that there are 1.5m diabetics (1.2m Type 1 and about 0.3m Type 2) in the US who use insulin and measure blood glucose levels at least twice a day (using single-point capillary blood glucose meters – i.e. fingerstick measurements) that could benefit from CGM.

We expect the number of diabetics in the US using real-time CGMs (with frequency of use varying from 24/7 to one per month) to increase to 140,000 in 2009 from 5,000 exiting 2006 and 15,000 today, and expect US system and disposables revenue associated with these real-time CGMs to increase to USD130m in 2009 from USD5m in 2006.

In 2009, we forecast 21% adoption within the 400,000 insulin pump user market, and 5% adoption from the 1.1m Type 1 and Type 2 diabetics who take insulin and measure blood glucose at least twice per day and are not using insulin pumps. This compares to an estimated 1% adoption within the 300,000 insulin pump user market, and 0.2% adoption from the 1.1m diabetic subgroup in 2006 (taking insulin but not on pumps). We expect higher adoption of CGM in the insulin pump population as overall, as insulin pump users test their blood glucose levels four or more times a day, are highly motivated to control their diabetes and HbA1c glycaemic levels, and have already committed to wearing an external device 24/7.

Our model is predicated on these CGM devices receiving broad (versus case-by-case) reimbursement from third-party payers by end-2008.

Valuation and risks

DexCom

Our mid-2008 USD10 target price is based on a price-to-sales multiple of 6x applied to our new 2009 revenue estimate of USD49m. Previously, our end-2007 USD10 target price was based on a price-to-sales multiple of 12x applied to our prior 2008e revenue of USD25m.

Under our ratings model, our target price suggests a potential total return of 26% from the 28 June 2007 close of USD7.95. As this is above the Neutral band for volatile US stocks of plus or minus 10 percentage points around our 8.3% hurdle rate, we rate DexCom shares Overweight (V).

Key downside risks include the inability of DexCom to: (1) drive future STS CGM system and sensor sales following the US launch of the next-generation 7-day STS system; (2) compete effectively with Medtronic and Abbott once both competitive CGM systems are launched in the US nationwide; (3) demonstrate long-term (i.e. one year) improved clinical outcomes with CGM versus standard fingerstick measurements in the general patient population; and (4) obtain broad third-party payer reimbursement for CGM.

Medtronic

Our mid-2008 target price of USD55 is derived by applying a PE multiple of 18x to our fiscal 2009 (April) EPS estimate of USD3.04. Our prior end-2007 target price of USD55 was derived by applying a PE multiple of 20x to our fiscal 2008 EPS estimate of USD2.70.

Under our ratings model, our target price suggests a potential total return of 6% from the 28 June 2007 close of USD51.80. As this is within the Neutral band for volatile US stocks of plus or minus five percentage points around our 8.3% hurdle rate, we rate Medtronic shares Neutral.

Key downside risks for MDT shares, in our view, include a softer implantable defibrillator (ICD) market growth; the ability of St. Jude Medical, Boston Scientific, or both to take more ICD market share from Medtronic than modeled; an inability to launch a competitive drug-eluting stent (DES) within anticipated timelines in the US and Japan or to gain DES share from Boston Scientific or Johnson & Johnson; a delay of the introduction of Medtronic's artificial spinal discs; and an unanticipated slowdown in diabetes revenue. Key upside risks, we believe, include Medtronic's ability to gain or retain ICD market share, and gain more DES share than we anticipate through 2009.

DexCom: Income statement (USDm)

	2004	2005	2006	Q1a	Q2e	Q3e	Q4e	2007e	2008e	2009e
Revenue	0.0	0.0	2.2	1.0	1.1	2.0	3.0	7.1	20.2	48.8
Systems	-	-	1.1	0.4	0.4	0.8	1.2	2.8	6.9	10.8
Disposables	-	-	1.0	0.6	0.7	1.3	1.8	4.3	13.4	38.0
Cost of sales	0.0	0.0	11.0	3.1	3.2	3.5	3.8	13.5	16.2	19.5
Gross margin	0.0	0.0	-8.8	-2.1	-2.1	-1.4	-0.9	-6.4	4.0	29.3
Research and development	12.5	26.8	19.4	4.0	4.2	4.4	4.7	17.4	18.3	19.2
Selling, general and admin	1.6	5.7	21.1	5.4	5.5	5.6	5.7	22.1	23.2	24.4
Total operating expense	14.1	32.4	40.5	9.4	9.7	10.0	10.4	39.5	41.5	43.6
Interest and other income	0.1	1.7	2.7	0.5	0.5	0.6	0.6	2.2	2.2	2.3
Income before taxes	-13.9	-30.8	-46.6	-10.9	-11.2	-10.9	-10.7	-43.7	-35.2	-12.0
Income tax expense	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net income (loss)	-13.9	-30.8	-46.6	-10.9	-11.2	-10.9	-10.7	-43.7	-35.2	-12.0
EPS (USD)		-3.4	-1.71	-0.39	-0.39	-0.38	-0.37	-1.53	-1.20	-0.40
Diluted shares (m)		18.9	27.2	28.2	28.5	28.8	29.1	28.6	29.4	29.7
As a percentage of sales, %										
Cost of sales			505%	303%	286%	171%	129%	190%	80%	40%
Gross margin			-405%	-203%	-186%	-71%	-29%	-90%	20%	60%
Research and development			895%	399%	385%	219%	158%	245%	90%	39%
Selling, general and administrative			973%	531%	497%	275%	193%	312%	115%	50%
Operating margin			1868%	929%	882%	495%	351%	557%	205%	89%
Interest and other Income, net			125%	52%	49%	28%	19%	31%	11%	5%
Net margin			-2148%	-1080%	-1019%	-538%	-360%	-616%	-174%	-25%

Source: Company reports, HSBC

DexCom: Quarterly revenue breakdown for 2006 and 2007e (USD000)

	Q106	Q206	Q306	Q406	2006	Q107	Q207e	Q307e	Q407e	2007e
STS system and disposables	15	479	841	835	2,169	1,012	1,101	2,029	2,958	7,101
Systems	15	337	409	377	1,138	434	383	765	1,170	2,752
Seqn growth, %	na	2168%	21%	-8%	na	15%	-12%	100%	53%	na
Disposables	0	142	432	458	1,031	578	719	1,264	1,788	4,349
Seqn growth, %	na	na	205%	6%	na	26%	24%	76%	41%	na
DXCM new STS units, #	35	865	930	840	2,670	965	850	1,700	2,600	6,115
Seqn growth STS units, %	na	2371%	8%	-10%	na	15%	-12%	100%	53%	na
DXCM cum. STS unit sales, #	35	900	1,830	2,670	2,670	3,635	4,485	6,185	8,785	8,785

Source: Company reports, HSBC

Medtronic: Income statement (USDm; fiscal year ends in April)

	FY05	FY06	FY07	FY08e	FY09e	FY10e	5-yr CAGR
Revenues	10,055	11,293	12,300	13,669	15,213	16,807	11%
YoY growth, %	11%	12%	9%	11%	11%	10%	
Cardiac rhythm management	4,616	5,205	5,264	5,368	5,444	5,768	5%
ICD/CRT-Ds	2,379	2,932	2,918	3,139	3,384	3,666	9%
Pacemakers/CRT	1,756	1,795	1,895	1,952	1,991	2,031	3%
Automated external defibrillator	413	411	386	210	0	0	
Vascular	851	940	1,204	1,476	1,848	1,862	17%
Coronary stents	317	365	561	768	1,077	1,021	26%
US	38	24	60	227	443	291	50%
International	279	341	501	542	634	731	21%
Other vascular	534	575	643	707	771	840	9%
Cardiac surgery	669	663	705	748	790	831	4%
Heart valves	230	229	249	269	288	308	6%
Neurological & diabetes	1,794	1,974	2,308	2,683	3,100	3,564	15%
Neurological	1,145	1,252	1,445	1,647	1,878	2,122	13%
Diabetes (MiniMed)	649	722	863	1,036	1,222	1,442	17%
Spinal, ENT, and SNT	2,125	2,511	2,819	3,395	4,030	4,783	18%
Spinal (Sofamor Danek)	1,785	2,137	2,415	2,946	3,536	4,243	19%
Ear, Nose, Throat (ENT/Xomed)	241	266	276	295	313	332	7%
SNT (Surgical Navigation Tech)	99	108	128	154	181	208	16%
Cost of products sold	2,446	2,811	3,168	3,458	3,849	4,202	
Gross profit	7,608	8,482	9,132	10,211	11,364	12,605	
Sales, marketing and admin	3,214	3,661	4,153	4,511	4,990	5,496	
Research & development	951	1,113	1,239	1,312	1,476	1,647	
Operating profit	3,443	3,708	3,740	4,388	4,899	5,462	
Excluding special charges							
Other (income)/expense	291	167	212	205	213	235	
Interest (income)/expense	-45	-87	-153	-170	-195	-210	
Income before taxes	3,198	3,629	3,681	4,353	4,881	5,437	
Income taxes	927	945	884	1,045	1,171	1,305	
Net income	2,270	2,684	2,797	3,117	3,496	3,897	11%
EPS (USD) as of FY 2007, includes FAS No. 123	1.86	2.21	2.41	2.70	3.04	3.42	13%
YoY growth	14%	19%	9%	12%	13%	13%	
Diluted weighted avg. shares outstanding (m)	1221	1223	1162	1155	1150	1140	
Tax rate (ex specials)	29.0%	26.0%	24.0%	24.0%	24.0%	24.0%	
As a pct of revenue							
Cost of products sold	24.3%	24.9%	25.8%	25.3%	25.3%	25.0%	
Gross margin	75.7%	75.1%	74.2%	74.7%	74.7%	75.0%	
Sales, marketing and admin	32.0%	32.4%	33.8%	33.0%	32.8%	32.7%	
Research & development	9.5%	9.9%	10.1%	9.6%	9.7%	9.8%	
Operating margin	34.2%	32.8%	30.4%	32.1%	32.2%	32.5%	
Pre-tax margin (ex specials)	31.8%	32.1%	29.9%	31.8%	32.1%	32.3%	
Net margin (ex specials)	22.6%	23.8%	22.7%	22.8%	23.0%	23.2%	
YoY growth							
Cardiac rhythm management	9%	13%	1%	2%	1%	6%	
ICD/CRT-Ds	21%	23%	0%	8%	8%	8%	
Pacemakers/CRT	-4%	2%	6%	3%	2%	2%	
Vascular	1%	10%	28%	23%	25%	1%	
Coronary stents	-13%	15%	54%	37%	40%	-5%	
Other vascular	11%	8%	12%	10%	9%	9%	
Cardiac surgery	6%	-1%	6%	6%	6%	7%	
Neurological & Diabetes	11%	10%	17%	16%	16%	15%	
Neurological	9%	9%	15%	14%	14%	13%	
Diabetes (MiniMed)	16%	11%	20%	20%	18%	18%	
Spinal, ENT, and SNT	20%	18%	12%	20%	19%	19%	
Spinal (Sofamor Danek)	22%	20%	13%	22%	20%	20%	
Ear, Nose, Throat (ENT/Xomed)	11%	10%	4%	7%	6%	6%	
SNT (Surgical Navigation Tech)	18%	9%	19%	20%	18%	15%	

Source: Company reports, HSBC

Diabetes: US continuous glucose monitoring (CGM) market

	2005	2006	2007e	2008e	2009e
Cumulative insulin pump users (000)	270	302	334	367	401
Medtronic MiniMed	197	225	250	278	304
Other (incl Roche/Disetronic, JNJ/Animas, Smiths/Deltec, Insulet)	73	77	84	89	97
Cumulative CGM adoption within insulin pump, %	0.1%	1.0%	6.0%	12.0%	21.0%
Number of cumulative pump patients on CGM (000)	0.3	3.0	20.0	44.0	84.1
New CGM patients - on insulin pumps (000)	0.3	2.7	17.0	24.0	40.1
Non-insulin pump users that measure BG at least twice a day	1,120	1,121	1,121	1,118	1,115
Type 1 diabetics not on insulin pumps	855	848	840	830	819
Type 2 diabetics on insulin and testing at least twice a day	265	273	281	288	296
Cumulative CGM adoption within non-insulin pump, %	0.0%	0.2%	0.5%	2.0%	5.0%
Number of cumulative non-pump patients on CGM (000)	0.0	2.2	5.6	22.4	55.7
New CGM patients - not on insulin pumps (000)	0.0	2.2	3.4	16.8	33.4
No cumul pump and non-pumping pts on CGM	0.3	5.2	25.6	66.4	139.9
<i>Percent on insulin pumps</i>	100%	58%	78%	66%	60%
New patients (000)	0.3	4.9	20.4	40.8	73.5
Market share of new continuous monitoring users					
Insulin pumps					
Medtronic (MDT)	100%	75%	80%	60%	60%
DexCom (DXCM)	0%	25%	20%	25%	25%
Abbott (ABT)	0%	0%	0%	15%	15%
Non-insulin pumps					
MDT	100%	9%	21%	20%	20%
DXCM	0%	91%	79%	60%	50%
ABT	0%	0%	0%	20%	30%
Combined					
MDT	100%	46%	70%	44%	42%
DXCM	0%	54%	30%	39%	36%
ABT	0%	0%	0%	17%	22%
New continuous monitoring users (000)	0.3	4.9	20.4	40.8	73.5
MDT	0.3	2.3	14.3	17.8	30.7
DXCM	0.0	2.7	6.1	16.1	26.7
ABT	0.0	0.0	0.0	7.0	16.0
Cumulative continuous monitoring users (000)	0.3	5.2	25.6	66.4	139.9
MDT	0.3	2.5	16.9	34.6	65.3
DXCM	0.0	2.7	8.8	24.8	51.5
ABT	0.0	0.0	0.0	7.0	23.0
Continuous monitor and disposables revenue	0.6	5.5	20.9	54.0	132.4
MDT	0.6	3.3	13.8	28.1	62.2
DXCM	0.0	2.2	7.1	20.2	48.8
ABT	0.0	0.0	0.0	5.7	21.4

Source: Company reports, HSBC

Disclosure appendix

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For each stock we set a required rate of return calculated from the risk free rate for that stock's domestic, or as appropriate, regional market and the relevant equity risk premium established by our strategy team. The price target for a stock represents the value the analyst expects the stock to reach over our performance horizon. The performance horizon is 12 months. For a stock to be classified as Overweight, the implied return must exceed the required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile*). For a stock to be classified as Underweight, the stock must be expected to underperform its required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile*). Stocks between these bands are classified as Neutral.

Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation of coverage, change of volatility status or change in price target). Notwithstanding this, and although ratings are subject to ongoing management review, expected returns will be permitted to move outside the bands as a result of normal share price fluctuations without necessarily triggering a rating change.

*A stock will be classified as volatile if its historical volatility has exceeded 40%, if the stock has been listed for less than 12 months (unless it is in an industry or sector where volatility is low) or if the analyst expects significant volatility. However,

stocks which we do not consider volatile may in fact also behave in such a way. Historical volatility is defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility has to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

Prior to this, from 7 June 2005 HSBC applied a ratings structure which ranked the stocks according to their notional target price vs current market price and then categorised (approximately) the top 40% as Overweight, the next 40% as Neutral and the last 20% as Underweight. The performance horizon is 2 years. The notional target price was defined as the mid-point of the analysts' valuation for a stock.

From 15 November 2004 to 7 June 2005, HSBC carried no ratings and concentrated on long-term thematic reports which identified themes and trends in industries, but did not make a conclusion as to the investment action that potential investors should take.

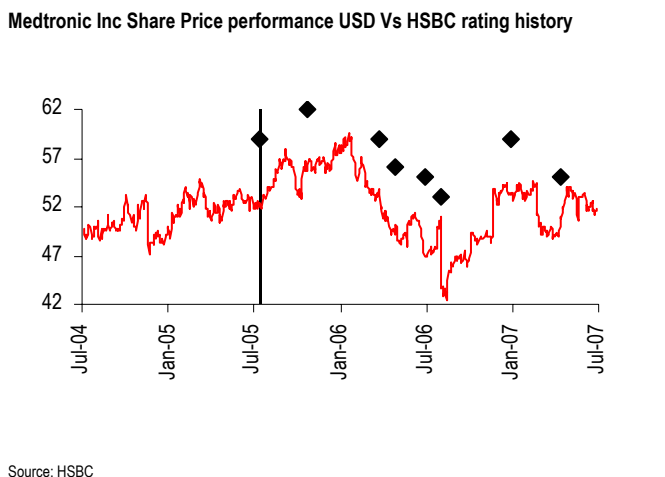
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Underweight (Sell)	20%	(19% of these provided with Investment Banking Services)

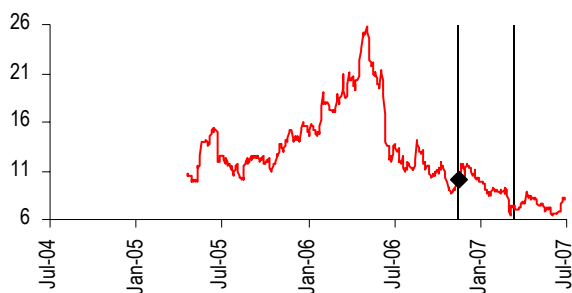
Share price and rating changes for long-term investment opportunities



Recommendation & price target history		
From	To	Date
N/A	Neutral	12 July 2005
Target Price	Value	Date
Price 1	59.00	12 July 2005
Price 2	62.00	24 October 2005
Price 3	59.00	22 March 2006
Price 4	56.00	25 April 2006
Price 5	55.00	29 June 2006
Price 6	53.00	03 August 2006
Price 7	59.00	29 December 2006
Price 8	55.00	13 April 2007

Source: HSBC

DexCom Share Price performance USD Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
N/A	Neutral	14 November 2006
Neutral	Overweight	12 March 2007
Target Price	Value	Date
Price 1	10.00	14 November 2006

Source: HSBC

HSBC & Analyst disclosures

Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
MEDTRONIC INC	MDT.N	51.86	30-Jun-2007	2, 5, 6

Source: HSBC

- 1 HSBC* has managed or co-managed a public offering of securities for this company within the past 12 months.
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