



Intuitive Surgical

David Gardner | March 16, 2005

CURRENT PRICE: [ISRG](#) \$ 555.11 \$ 0.15 (0.0%) Cväti GI Yr B~ÄÖG "Å~Å~Å~Å~ v~N~U

Intuitive Surgical

- Holds a near-monopoly in robotic technology that brings the benefits of minimally invasive surgery to many procedures.
 - Sales growth of 51% in 2004 with solid prospects for years to come.
 - Future growth will be driven by increasing cost-benefit for hospitals and by patient demand.
 - Nasdaq: ISRG
 - www.intuitivesurgical.com
 - Ph: 408-523-2100

Recent Price: \$15.08-\$49.43

If you lock your keys in your car, help is never farther than the nearest brick. Still, you probably call a locksmith because, with some specialized tools and skills, he can get you back on the road without spraying glass all over your interior and leaving you with an unwanted breeze. Call this a "minimally invasive lockout service."

In the past 30 years, surgery has been revolutionized by a similar concept. Operations that once routinely called for open incisions, long recovery times, risk of infection, and significant pain are now often performed laparoscopically -- that is, through tiny keyhole incisions, thin flexible instruments, and the use of fiber-optic cameras to guide the surgeon's hand. Gall bladder removal, ligament repair, hysterectomies, biopsies, and many other procedures are now done this way as a matter of course.

Minimally invasive surgery, enabled by fiber-optic technology in the 1970s and 1980s, was a disruptive innovation. Surgeons had to relearn their craft and become familiar with new instruments in order to practice these new techniques. Many resisted; others simply chose to retire. But the benefits of the new approach -- including improved survival, less pain, shorter recovery time, smaller scars, and more -- helped the new techniques win out.

A Surgical Revolution

We are in the early stages of a new surgical revolution, being brought to us by **Intuitive Surgical** ([NASDAQ: ISRG](#)) and its da Vinci robots. These four-armed machines are, as the company puts it, "taking surgery beyond the limits of the human hand." That really gets right to the point. The robot can enter the body through 1-cm. incisions (or "ports") and perform tiny, precise cuts and sutures that humans simply cannot. Physicians sit at a console where they can see a 3-D visualization of images delivered by the robot's camera.

By manipulating tools at the console, the surgeon's hand movements are exactly replicated by the robot. With different attachments to the robot's arms, different procedures can be accomplished -- and the company is constantly seeking to expand the versatility of the da Vinci system through new, FDA-approved accessories. Each new tool makes the machine a more compelling investment for hospitals.

In some cases, the da Vinci system makes minimally invasive procedures possible when the alternative would be open incision. In other cases, the machine improves upon extremely difficult laparoscopic techniques that can be done using handheld tools by a few talented surgeons but that aren't widespread -- for instance, radical prostatectomy or mitral heart valve repair. The da Vinci system is changing that, making minimally invasive surgery available to a larger number of patients.

When You Play Monopoly, Buy Boardwalk

Ensconced in its profitable med-tech niche, ISRG has no real competition -- it acquired its nearest competitor, Computer Motion, in 2003. This unchallenged dominance gives the company a protective moat that gets deeper and wider each day, as the installed base of da Vinci machines grows and the number of procedures for which the machines are approved expands.

In addition, the company has room to run. In its most recent quarter, Intuitive's revenues were up 64% over the prior year. Total 2004 revenues came in at \$139 million, and should grow 21% to \$168 million in 2005, with rich net profit margins (about 20%) staying strong.

The technology is accelerating into adoption both by providers and increasingly by patients, who request the surgical robot because it means less pain and scarring, and faster recovery times. No surprise then that of the installed base of da Vinci machines -- almost 300 of which have been sold at a cost of about \$1 million each -- fully half were sold in just the past two years. And yet lots of room for growth remains: For instance, only 3.4% of radical prostate surgeries performed in 2003 used a robot.

Intuitive doesn't just sell robots and move onto the next customer, either. Recurring revenue accounted for 43% of total sales in 2004. These are the "razor blades" sold after the da Vinci "razor" is placed in a hospital, and includes accessories and instruments for the robot, as well as training and service (the attachments that do the cutting, clamping, and suturing, for instance, can be used in about five to 20 procedures before being replaced).

Recurring revenue is important, because it allows the company to leverage growth from an increasingly large installed base and not simply rely on finding new customers (though there are still plenty of these out there).

Intuitive stock, like Monopoly's Boardwalk, ain't cheap. While the trailing P/E multiple of 71 appears to highlight that fact, a five-year growth rate of 45% reduces the sticker shock considerably. I feel this stock is fairly valued given the following assumptions: (1) the company hits its numbers; (2) the company does not exceed its numbers; and (3) the company does not open new business lines or get expanded FDA approval for its products.

Now, if the company is able to exceed its estimates, develop new business lines, and gain FDA approval for its products in the future, it's presently undervalued and represents a good opportunity for investors. I'm willing to make a bet that this excellent company will exceed what it looks capable of doing now.

The Foolish Bottom Line

Intuitive, as you may notice from the dilution rate (the percentage by which total diluted shares outstanding have increased from year to year), issued a lot of shares over the last couple years. Dilution is a legitimate concern for a shareholder, but this is a part of the company's pre-profitable history unlikely to be repeated in the future.

Financial Snapshot

Anyway, like any company that trades with an expectation of strong growth, bumps along the road are going to have a substantial impact on stock price. The bumps are almost inevitable -- ISRG is small enough that a couple of delayed sales in a given quarter will have a significant impact on the bottom line. By the same token, great quarters like we just saw can catapult this stock higher. Right now, the company is only lightly followed by Wall Street -- just four analysts cover it -- so we have the advantage of getting in before the crowds. I expect the company's future performance to be about as subtle as a brick through a window.

David owns no shares of companies mentioned here.



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Market data provided by FactSet and Web Financial Group.