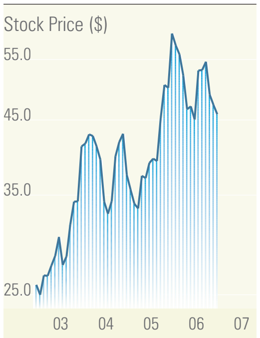
Varian Medical Systems VAR

Morningstar Rating	Last Price	Fair Value	Consider Buy	Consider Sell	Business Risk	Economic Moat	Stewardship Grade	Industry	Sector
Under Review	$47.47	—	—	—	Average	Narrow	B	Medical Equip.	Healthcare

Varian Medical is far and away the leader in radiation technology in the United States.

by Bill Buhr
Stock Analyst
Analysts covering this company do not own its stock or those of its closest competitors.

Report updated on February 08, 2007.
Data and Rating updated as of February 07, 2007.



Thesis 02-08-07

Varian Medical Systems has a dominant market position in the radiation technology space. Current demographic trends, coupled with emerging opportunities overseas, should provide the company with ample opportunities for growth.

Varian Medical's primary business provides radiation technology to hospitals and cancer clinics all over the world, with a primary focus on intensity modulated radiation therapy (IMRT), as well as more advanced forms like image guided radiation therapy (IGRT), and stereotactic radiosurgery. These technologies help focus radiation directly on the tumor and account for tumor movement during treatment while sparing the surrounding tissue from exposure.

Varian Medical has been able to consistently realize double-digit returns on invested capital for several reasons. The company's systems are expensive and represent a significant capital investment. Because of that, hospitals and clinics that purchase from Varian Medical are more likely to upgrade current systems than purchase new equipment from a competitor, which we think creates high switching costs and customer loyalty. Another key to the company's success is its open-systems approach, which allows for compatibility and integration with other third-party systems and products.

We look for Varian Medical to drive future growth in the U.S. by delivering its cutting-edge radiation technology to hospitals and clinics. Historically, there has been a one- to two-year lag in radiation technology available in the U.S. and international markets. While IMRT technology, which has been around a couple of years longer, is well-established in the U.S., it's still in its infancy in places like Europe and Asia. This should create a substantial opportunity for Varian Medical to bolster overall growth through the increasing adoption of IMRT technology abroad. We expect further growth will come from the eventual introduction of IGRT and stereotactic radiosurgery to these markets over the next two years.

We do see some risks, however. Varian Medical has market share of nearly 70% in the U.S., so further gains may be more difficult to achieve. The company will have to fight off a slew of competitors, including large players such as Siemens and Philips, and smaller companies like Elekta, all with innovation capabilities. Furthermore, Varian Medical's X-ray products are essentially commodities, and the business produces inferior returns compared with the oncology segment. However, Varian Medical's economic moat and potential for international growth should more than offset these risks.

Valuation

Our fair value estimate for Varian Medical is $52 per share, based on compound annual sales growth of 12.5% through 2011. We expect Varian will continue to grow through increased overall demand for its oncology systems and equipment. We estimate oncology sales will increase by 11% in 2007, driven by improving deployment of higher-priced IGRT technology in hospitals and cancer clinics in the U.S. and increased acceptance of IMRT technology abroad. We estimate that operating margins will expand 2% by 2011. Our fair value estimate is sensitive to changes in our sales growth estimates, primarily in the company's oncology segment. A 1-percentage-point change in the estimated five-year compound annual growth rate for this segment moves our fair value estimate by $2 per share. We include the impact of future option-related expenses as part of our valuation.

Risk

Demand for Varian Medical's products could suffer from the emergence of new technologies or alternate methods to effectively treat cancer. Furthermore, changes in the insurance reimbursement environment for radiation treatments could have an effect on the overall demand for the company's radiation systems. Varian Medical is also

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Close Competitors	Market Cap $Mil	TTM Sales $Mil	Oper Income $Mil	Net Income $Mil
Varian Medical Systems	6,128	1,598	309	245
Siemens AG ADR	97,128	107,241	3,708	3,725
Philips Electronics NV AD	46,541	38,062	1,660	3,591
TomoTherapy	—	—	—	—

Morningstar data as of February 07, 2007.

vulnerable to reductions in hospital or clinical budgets given that its products are big-ticket items.

Bulls Say

- Varian Medical is the market leader in radiation technology globally, with almost 70% market share in the U.S. and 50% internationally.
- Demographic trends, including the aging of the population, should support continued demand for the company's technology, as people over the age of 55 make up more than 75% of all cancer cases.
- Varian Medical has substantial growth potential overseas, as these markets are currently underserved by radiation technology.
- Demand for the company's products remains strong, as Varian Medical recently ended 2006 with a record sales backlog of $1.4 billion.

Bears Say

- Unexpected cuts in Medicare reimbursement rates for radiation procedures could cause a decrease in the demand for the company's technology and drive hospitals and clinics toward other treatment methods.
- Varian's large market share in oncology services in the U.S. may reach a saturation point, forcing the company to find other opportunities to fuel growth.
- Varian generates around 50% of its revenues from international markets, which exposes the company to currency and political risk.

Financial Overview

Growth: We project sales will grow 13.7% in 2007 driven by the recent acquisition of Accel Instruments, which will add $30 million to the top line, as well as increased deployment of the company's oncology technology both in the U.S. and abroad.

Profitability: We estimate Varian Medical will expand operating margins by nearly 200 basis points over the next five years, as we expect the company will leverage its fixed cost structure and increase profitability through increased demand for its technology.

Financial Health: Varian Medical has historically stable cash flows and total cash of $362.7 million as of December 2006, with almost no debt. The company has announced that it will repurchase an additional 4.5 million shares in 2007.

Company Overview

Profile: Varian Medical Systems manufactures and sells technology systems for treating cancer through radiation therapy. The company also designs and sells equipment for X-ray imaging. The firm offers its oncology systems primarily to hospitals and cancer clinics that treat patients through intensity modulated radiation therapy (IMRT) and image guided radiation therapy (IGRT). The company's X-ray products are used in a number of applications including CT scanning and mammography.

Strategy: Varian Medical focuses on deploying its radiation technology worldwide to cancer clinics, hospitals, and health-care agencies. The company will market its advanced external beam technology for use with IGRT and stereotactic radiosurgery in the U.S., and focus on underserved and lagging international markets through the deployment of IMRT technology.

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Management: Timothy Guertin has been Varian Medical's CEO for about one year, as he replaced Richard Levy, who retired from the role in February 2006. Guertin has worked for the company in various capacities since 1992, primarily as president of its Oncology Systems business. He earned a salary and bonus of $1.3 million in 2006 based on a weighted average of company earnings and revenue goals not defined in the proxy statement. The company has enacted several shareholder-friendly policies that we like, including the separation of the CEO and chairman roles, cumulative voting for the election of directors, and an aggressive share buyback program, with almost 25 million shares repurchased since 2001 and another 4.5 million authorized for 2007. There are some related-party transactions that slightly annoy us, involving investments and loans made to one of the company's suppliers. Furthermore, Varian has significant takeover defenses in the form of staggered board elections and punitive golden parachutes that are triggered by a change in control. However, all things considered, we give management a better-than-average grade for shareholder friendliness.

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Analyst Notes

01-26-07 **Varian 1Q in Line**

Varian Medical's fiscal first-quarter 2007 results fall in line with our current near-term modeling assumptions. The oncology group notched 15% growth, and customer demand continues to reflect a rapid adoption of Varian's next-generation image-guided radiation therapy (IGRT), one of the key postulates in our thesis. The X-ray products business reported even higher growth, expanding by 19% year over year. Varian's flat panel revenues have doubled thanks to robust demand from multiple end markets, including dental, veterinary, and industrial inspection. Order growth was virtually flat, consistent with management's earlier guidance that growth in 2007 will slow down. Overall guidance was unchanged, with management anticipating 13% sales growth in fiscal 2007. This expectation is right in line with previous forecasts and our current model, so we are leaving our fair value estimate unchanged.

10-26-06 **Varian Finishes Year on High Note**

Varian Medical Systems finished its fiscal year slightly ahead of our expectations, posting strong fourth-quarter revenue growth of 18% year over year. All the parts of the Varian engine seem to be firing together, as the company enjoyed robust international demand for its core radiotherapy systems while also notching nice results in smaller segments such as X-ray products. The company expects sales growth of 13% in its upcoming fiscal year, in line with our current modeling assumptions. Once audited full-year results are available, we will raise our fair value estimate to account for booked earnings and balance sheet improvements.

10-17-06 **Varian Still Going Strong**

Varian Medical holds a number-one position in the global market for radiation-based oncology treatment systems. We expect the company to maintain a low- to mid-teen growth rate as Varian's customers continue to migrate to IGRT (image-guided radiation therapy) systems and the company increases its presence abroad. While we appreciate Varian's fundamental strength, saturation of the U.S. market and the unpredictable nature of Medicare reimbursement continue to concern us. We believe our fair value estimate reasonably reflects the company's growth prospects and its legitimate risks.

Disclaimers & Disclosures

No Morningstar employees are officers or directors of this company. Morningstar Inc. does not own more than 1% of the shares of this company. Analysts covering this company do not own its stock or those of its closest competitors. The information contained herein is not represented or warranted to be accurate, correct, complete, or timely. This report is for information purposes only, and should not be considered a solicitation to buy or sell any security.

Varian Medical Systems VAR

Sales Mil	Mkt Cap Mil	Industry	Sector
$1,598	$6,128	Medical Equip.	Healthcare

Varian Medical Systems manufactures and sells technology systems for treating cancer through radiation therapy. The company also designs and sells equipment for X-ray imaging. The firm offers its oncology systems primarily to hospitals and cancer clinics that treat patients through intensity modulated radiation therapy (IMRT) and image guided radiation therapy (IGRT). The company's X-ray products are used in a number of applications including CT scanning and mammography.

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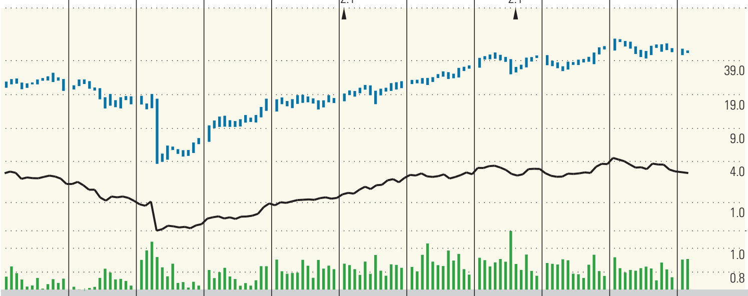
Under Review	$47.47	—	Average	Narrow	B

1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	YTD	
30.58	26.64	19.63	17.75	19.31	25.65	35.65	46.49	52.92	61.70	50.21	Annual Price High
20.94	14.41	4.06	6.88	13.50	15.80	23.70	29.63	31.65	41.10	44.01	Low
					2:1		2:1				Recent Splits



Price Volatility
Monthly High/Low
Rel Strength to S&P 500
52 week High/Low $
61.70 - 41.10
10 Year High/Low $
61.70 - 4.06
Bear-Market Rank
3 (10=worst)
Trading Volume Million

1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	YTD	Stock Performance
0.8	-23.5	72.5	127.9	4.9	39.2	39.3	25.1	16.4	-5.5	-0.2	Total Return %
-30.2	-50.2	53.0	138.0	17.9	62.6	12.9	16.1	13.4	-19.1	-2.4	+/- Market
-13.3	-46.6	73.5	80.1	1.5	51.4	5.5	10.4	12.9	-10.7	-6.2	+/- Industry
0.7	1.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	Dividend Yield %
1518	1133	910	2196	2396	3374	4714	5874	6622	6140	6128	Market Cap $Mil

1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	TTM	Financials
1426	1422	590	690	774	873	1042	1236	1383	1598	1598	Revenue $Mil
36.7	37.0	35.6	37.3	37.1	38.9	40.5	41.9	42.9	41.5	41.5	Gross Margin %
130	115	24	88	110	145	198	256	305	309	309	Oper Income $Mil
9.1	8.1	4.1	12.7	14.2	16.6	19.0	20.7	22.1	19.4	19.4	Operating Margin %
116	74	-24	53	54	94	131	167	207	245	245	Net Income $Mil
0.92	0.61	-0.20	0.41	0.40	0.67	0.92	1.18	1.50	1.81	1.81	Earnings Per Share $
0.09	0.10	0.03	—	—	—	—	—	—	—	—	Dividends $
121	121	122	129	136	140	142	142	137	135	135	Shares Mil
4.36	4.66	1.51	2.09	2.94	3.48	4.14	4.58	5.01	6.18	6.18	Book Value Per Share $
45	128	-34	84	118	156	210	234	252	202	202	Oper Cash Flow $Mil
-55	-47	-39	-19	-17	-26	-19	-24	-44	-41	-41	Cap Spending $Mil
-10	81	-73	65	102	130	191	210	208	160	160	Free Cash Flow $Mil

1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	TTM	Profitability
10.9	6.4	-2.8	9.3	8.0	11.2	13.3	15.0	16.6	17.3	17.3	Return on Assets %
23.3	13.6	-7.0	23.9	16.6	21.6	25.3	28.4	32.4	33.7	33.7	Return on Equity %
8.1	5.2	-4.1	7.7	7.0	10.7	12.6	13.5	14.9	15.3	15.3	Net Margin %
1.34	1.22	0.67	1.21	1.14	1.05	1.06	1.11	1.11	1.13	1.13	Asset Turnover
2.1	2.1	2.5	2.6	2.1	1.9	1.9	1.9	2.0	2.0	2.0	Financial Leverage

1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	09-06	Financial Health
349	335	112	201	334	293	396	424	473	512	512	Working Capital $Mil
73	111	59	59	59	59	59	53	57	49	49	Long-Term Debt $Mil
525	558	185	270	394	473	564	614	659	797	797	Total Equity $Mil
0.18	0.28	0.51	0.22	0.15	0.12	0.10	0.10	0.09	0.07	0.07	Debt/Equity

1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	TTM	Valuation
17.0	14.5	81.0	27.6	32.2	32.3	31.2	29.3	26.3	29.7	26.4	Price/Earnings
0.7	0.5	2.5	1.1	1.4	1.4	1.6	1.4	1.4	1.7	1.3	P/E vs. Market
1.3	0.8	1.1	2.1	2.8	3.5	3.9	4.0	3.9	4.5	4.0	Price/Sales
3.6	1.9	3.6	5.4	5.5	6.2	6.9	7.5	7.9	8.6	7.7	Price/Book
42.0	8.4	—	17.5	18.5	19.4	19.5	21.0	21.6	35.8	31.9	Price/Cash Flow

Growth Rates Compound Annual

Grade: B	1 Yr	3 Yr	5 Yr	10 Yr
Revenue %	15.6	15.3	15.6	0.0
Operating Income %	1.4	16.0	23.0	5.0
Earnings/Share %	20.0	25.1	29.3	6.6
Dividends %	—	—	—	-100.0
Book Value/Share %	23.3	14.2	16.0	5.0
Stock Total Return %	-20.2	3.9	18.9	22.5
+/- Industry	-29.6	-2.1	10.0	11.4
+/- Market	-35.8	-4.4	12.8	16.3

Profitability Analysis

Grade: A+	Current	5 Yr Avg	Ind	Mkt
Return on Equity %	33.7	28.3	15.7	20.1
Return on Assets %	17.3	14.7	7.9	8.0
Fixed Asset Turns	13.1	13.1	6.6	7.9
Inventory Turns	5.3	5.2	3.3	11.4
Revenue/Employee $K	409.7	—*	380.3	867.2
Gross Margin %	41.5	41.1	65.0	33.5
Operating Margin %	19.4	19.6	16.1	17.6
Net Margin %	15.3	13.4	10.0	11.5
Free Cash Flow/Rev %	10.0	15.1	-7.1	10.2
R&D/Rev %	6.3	5.9	13.9	4.1

Financial Position

Grade: A	09-05 $Mil	09-06 $Mil
Cash	243	273
Inventories	165	190
Receivables	352	472
Current Assets	1017	1156
Fixed Assets	115	130
Intangibles	121	121
Total Assets	1317	1512
Payables	71	78
Short-Term Debt	3	8
Current Liabilities	544	644
Long-Term Debt	57	49
Total Liabilities	658	715
Total Equity	659	797

Valuation Analysis

	Current	5 Yr Avg	Ind	Mkt
Price/Earnings	26.4	29.8	31.4	21.1
Forward P/E	25.1	—	25.1	18.3
Price/Cash Flow	31.9	23.5	25.5	15.1
Price/Free Cash Flow	40.1	27.9	34.1	28.6
Dividend Yield %	—	—	0.5	1.7
Price/Book	7.7	7.4	5.9	4.2
Price/Sales	4.0	4.0	4.8	3.0
PEG Ratio	1.6	—	1.6	1.7

*3Yr Avg data is displayed in place of 5Yr Avg

Quarterly Results

Revenue $Mil	Dec 05	Mar 06	Jun 06	Sep 06
Most Recent Period	334.2	413.9	395.7	454.1
Prior Year Period	299.0	350.9	346.5	386.2

Rev Growth %	Dec 05	Mar 06	Jun 06	Sep 06
Most Recent Period	11.8	17.9	14.2	17.6
Prior Year Period	12.0	9.4	14.3	12.0

Earnings Per Share $	Dec 05	Mar 06	Jun 06	Sep 06
Most Recent Period	0.30	0.41	0.49	0.60
Prior Year Period	0.29	0.39	0.37	0.45

Industry Peers by Market Cap

	Mkt Cap $Mil	Rev $Mil	P/E	ROE%
Varian Medical Syste	6128	1598	26.4	33.7
Siemens AG ADR	97128	107241	26.8	10.6
Philips Electronics	46541	38062	13.1	17.9

Major Fund Holders

	% of shares
American Century Ultra Inv	1.73
Franklin Small-Mid Cap Growth A	1.68
TCW Select Equities I	1.67

Morningstar's Approach to Rating Stocks

Our Key Investing Concepts

- Economic Moat
- Discounted Cash Flow
- Discount Rate
- Fair Value
- Business Risk
- Margin of Safety
- Consider Buying/Consider Selling
- Stewardship Grades

At Morningstar, we evaluate stocks as pieces of a business, not as pieces of paper. We think that purchasing shares of superior businesses at discounts to their intrinsic value and allowing them to compound their value over long periods of time is the surest way to create wealth in the stock market.

We rate stocks 1 through 5 stars, with 5 the best and 1 the worst. Our star rating is based on our analyst's estimate of how much a company's business is worth per share. Our analysts arrive at this "fair value estimate" by forecasting how much excess cash--or "free cash flow"--the firm will generate in the future, and then adjusting the total for timing and risk. Cash generated next year is worth more than cash generated several years down the road, and cash from a stable and consistently profitable business is worth more than cash from a cyclical or unsteady business.

Stocks trading at meaningful discounts to our fair value estimates will receive high star ratings. For high-quality businesses, we require a smaller discount than for mediocre ones, for a simple reason: We have more confidence in our cash-flow forecasts for strong companies, and thus in our value estimates. If a stock's market price is significantly above our fair value estimate, it will receive a low star rating, no matter how wonderful we think the business is. Even the best company is a bad deal if an investor overpays for its shares.

Our fair value estimates don't change very often, but market prices do. So, a stock may gain or lose stars based just on movement in the share price. If we think a stock's fair value is $50, and the shares decline to $40 without much change in the value of the business, the star rating will go up. Our estimate of what the business is worth hasn't changed, but the shares are more attractive as an investment at $40 than they were at $50.

Because we focus on the long-term value of businesses, rather than short-term movements in stock prices, at times we may appear out of step with the overall stock market. When stocks are high, relatively few will receive our highest rating of 5 stars. But when the market tumbles, many more will likely garner 5 stars. Although you might expect to see more 5-star stocks as the market rises, we find assets more attractive when they're cheap.

We calculate our star ratings nightly after the markets close, and issue them the following business day, which is why the rating date on our reports will always be the previous business day. We update the text of our reports as new information becomes available, usually about once or twice per quarter. That is why you'll see two dates on every Morningstar stock report. Of course, we monitor market events and all of our stocks every business day, so our ratings always reflect our analyst's current opinion.

Economic Moat

This is our assessment of a firm's ability to earn returns consistently above its cost of capital in the future, usually by virtue of some competitive advantage. Competition tends to drive down such economic profits, but companies

Morningstar Research Methodology for Valuing Companies

Competitive Analysis	Economic Moat Rating	Company Valuation	Fair Value Estimate	Risk Assessment	Stars
Analyst conducts company and industry research: • Management interviews • Conference calls • Trade shows visits • Competitor, supplier, distributor, and customer interviews	The depth of the firm's competitive advantage is rated: • None • Narrow • Wide	Analyst considers company financial statements and competitive position to forecast future cash flows. Assumptions are input into a discounted cash-flow model.	DCF model leads to the firm's fair value estimate, which anchors the rating framework.	A business-risk analysis establishes the margin of safety required for the stock rating.	★ ★★ ★★★ ★★★★ ★★★★★ The current stock price relative to fair value, adjusted for risk, determines the rating.

that can earn them for an extended time by creating a competitive advantage possess an economic moat. We see these companies as superior investments.

We're big fans of companies that are low-cost producers, create high switching costs for their customers, or have strong brands or long-lasting patents, because all of these characteristics allow companies to protect their competitive position. For example, Tiffany is far more profitable than a run-of-the-mill jewelry chain because it has a strong brand that creates a moat around its business, allowing it to charge more than competitors.

Discounted Cash Flow
This is a method for valuing companies that involves projecting the amount of cash a business will generate in the future, subtracting the amount of cash that the company will need to reinvest in its business, and using the result to calculate the worth of the firm. We use this technique to value nearly all of the companies we cover.

Discount Rate
We use this number to adjust the value of our forecasted cash flows for the risk that they may not materialize. For a profitable company in a steady line of business, we'll use a lower discount rate, also known as "cost of capital," than for a firm in a cyclical business with fierce competition, since there's less risk clouding the firm's future.

Fair Value
This is the output of our discounted cash-flow valuation models, and is our per-share estimate of a company's intrinsic worth. We adjust our fair values for off-balance sheet liabilities or assets that a firm might have--for example, we deduct from a company's fair value if it has issued a lot of stock options or has an under-funded pension plan. Our fair value estimate differs from a "target price" in two ways. First, it's an estimate of what the business is worth, whereas a price target typically reflects what other investors may pay for the stock. Second, it's a long-term estimate, whereas price targets generally focus on the next two to 12 months.

Business Risk
Based on fundamental factors such as cyclicality, leverage, competitive strength, and profitability, we divide our coverage universe into four broad risk categories: Below Average, Average, Above Average, and Speculative. Unlike some risk ratings, ours is not based on the volatility of the firm's shares, but rather the predictability and strength of the underlying business.

Margin of Safety
This is the discount to fair value we would require before recommending a stock. We think it's always prudent to buy stocks for less than they're worth.The margin of safety is like an insurance policy that protects investors from bad news or overly optimistic fair value estimates. We require larger margins of safety for less predictable stocks, and smaller margins of safety for more predictable stocks.

Consider Buying/Consider Selling
The consider buying price is the price at which a stock would be rated 5 stars, and thus the point at which we would consider the stock an extremely attractive purchase. Conversely, consider selling is the price at which a stock would have a 1 star rating, at which point we'd consider the stock overvalued, with low expected returns relative to its risk.

Stewardship Grades
We evaluate the commitment to shareholders demonstrated by each firm's board and management team by assessing transparency, shareholder friendliness, incentives, and ownership. We aim to identify firms that provide investors with insufficient or potentially misleading financial information, seek to limit the power of minority shareholders, allow management to abuse its position, or which have management incentives that are not aligned with the interests of long-term shareholders. The grades are assigned on an absolute scale--not relative to peers--and can be interpreted as follows: A means "Excellent," B means "Good," C means "Fair," D means "Poor," and F means "Very Poor."