

BUY (1) Medium Risk (M) Target Price: \$64.00

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Varian Medical Systems Inc (VAR)

Citigroup Investment Research

VAR: Model Update Based on Recent News; Still Buyers of the Stock

BUY (1)

Medium Risk (M)

Mkt Cap: \$6,529 mil.

January 10, 2007

SUMMARY

\* We have made several revisions to our model

EMERGING MEDICAL TECHNOLOGY ahead of the quarter given a number of recent

Amit Bhalla +1-212-816-4069 <a href="mailto:amit1.bhalla@citigroup.com">amit1.bhalla@citigroup.com</a>	announcements, which collectively lead to our revised F2007 EPS of \$1.86 (from \$1.87) and F2008 EPS of \$2.20 (from \$2.13).
Eric Li Cheung +1-212-816-1916 <a href="mailto:eric.li.cheung@citigroup.com">eric.li.cheung@citigroup.com</a>	* These revisions take into account the estimated impact of the recently announced agreement on 1/4/07 to acquire ACCEL Instruments (which we estimate will lead to EPS dilution of \$0.06 in F2007 and \$0.01 in F2008), the 11/20/06 approval of additional share repurchases during F2007, and greater interest income in forward years due to higher cash balances. * Given the weakness in VAR shares and our belief that company fundamentals remain strong, a good buying opportunity exists ahead of the quarter. * There is no change to our \$64 price target, which is based on our revised P/E multiple of 28x (from 29x) our revised C2008E EPS (including stock option expense) of \$2.30 (from \$2.20).

## FUNDAMENTALS

P/E (9/07E)	25.7x
P/E (9/08E)	21.7x
TEV/EBITDA (9/07E)	15.4x
TEV/EBITDA (9/08E)	13.0x
Book Value/Share (9/07E)	\$6.46
Price/Book Value	7.4x
Revenue (9/07E)	\$1,840.1 mil.
Proj. Long-Term EPS Growth	14%
ROE (9/07E)	30.1%
Long-Term Debt to Capital(a)	5.7%
VAR is in the S&P 400(R) Index.	

(a) Data as of most recent quarter

SHARE DATA		RECOMMENDATION	
Price (1/10/07)	\$47.73	Rating (Cur/Prev)	1M/1M
52-Week Range	\$60.63-\$41.33	Target Price (Cur/Prev)	\$64.00/\$64.00
Shares outstanding(a)	136.8 mil.	Expected Share Price Return	34.1%
Div(E) (Cur/Prev)	\$0.00/\$0.00	Expected Dividend Yield	0.0%
		Expected Total Return	34.1%

## EARNINGS PER SHARE

FY ends		1Q	2Q	3Q	4Q	Full Year
9/06A	Actual	\$0.30A	\$0.41A	\$0.41A	\$0.54A	\$1.66A
9/07E	Current	\$0.35E	\$0.48E	\$0.47E	\$0.56E	\$1.86E
	Previous	\$0.36E	\$0.49E	\$0.47E	\$0.55E	\$1.87E
9/08E	Current	NA	NA	NA	NA	\$2.20E
	Previous	NA	NA	NA	NA	\$2.13E
9/09E	Current	NA	NA	NA	NA	\$2.59E
	Previous	NA	NA	NA	NA	\$2.44E

First Call Consensus EPS: 9/07E \$2.02; 9/08E \$2.37; 9/09E \$2.81

Calendar Year EPS: 12/06 \$1.71; 12/07 \$2.06; 12/08 \$2.30; 12/09 \$2.69

\*Our EPS estimates include the impact of stock option expense

\*\*First Call consensus EPS estimates exclude the impact of stock option expense

## INVESTMENT CONCLUSION

We have made several revisions to our model ahead of the quarter given a number of recent announcements, which collectively lead to our revised F2007 EPS of \$1.86 (from \$1.87) and F2008 EPS of \$2.20 (from \$2.13). These revisions take into account the estimated impact of the recently announced agreement on January 4 to acquire ACCEL Instruments GmbH (a manufacturer of proton therapy systems), the 11/20/06 approval of additional share repurchases during F2007, and greater interest income in forward years due to higher cash balances. In addition, given the recent weakness in VAR shares and our belief that fundamentals at the company remain strong, we believe a good buying

opportunity exists ahead of the quarter. As a reminder, Varian will host its F1Q07 earnings call after the close on January 24.

We summarize the cumulative impact of the three aforementioned factors in the following table, and also provide a separate table summarizing the impact of the ACCEL acquisition on Varian's income statement on the following page, which we estimate will lead to EPS dilution of \$0.06 in F2007 and \$0.01 in F2008.

We estimate a positive impact of \$0.05 to F2007 EPS and \$0.07 to F2008 EPS due to additional share repurchases. With respect to average shares outstanding for F2007, the company announced on November 20, 2006 that its board of directors approved the repurchase of an additional 4.5 million shares through the end of F2007, in addition to the 1.5 million shares that remained available for repurchase under the company's previous share repurchase plan (effective of November 21, 2005). In our model, we assume that Varian will repurchase a total of 5 million shares by the end of F2007 (1 million shares at \$50 and 4 million at \$55), leading to our revised F2007 average shares outstanding of 130.8 million (from 134.0 million) and F2008 average shares outstanding of 129.0 million (from 133.0 million).

In addition, Varian has continued to build cash balances, which we believe will increase interest income. Accordingly, we are increasing interest income estimates to \$11 million in F2008, \$16 million in F2009, and \$24 million in F2010 (from \$10 million for each year).

We believe the pending acquisition of ACCEL will be \$0.06 dilutive to GAAP EPS in F2007 and \$0.01 dilutive in F2008. Importantly, these figures include \$1.1 million in amortization of intangible assets (no in-process R&D charges are expected). Our assumptions and comments concerning the impact of this transaction on Varian's income statement are summarized in the table below:

As a reminder, on January 4, Varian announced that it had agreed to purchase Germany-based ACCEL Instruments GmbH, a privately-held company that manufactures proton therapy systems for cancer treatment and research instruments, for \$30 million. The \$30 million consists of about \$20 million in cash and the assumption of about \$10 million in debt. Management estimates that the acquisition will reduce the \$2.08-2.10 operating EPS guidance (excluding stock options expense) that it gave at the end of F2006 by about 3% in F2007, be about neutral in F2008, and accretive thereafter. The transaction is expected to close in late January and management estimates it will contribute about \$30 million in annualized revenues in F2007, which we have added to our models.

We believe the acquisition makes sense for Varian from an R&D perspective, as it will enable the company to enter the proton therapy market. Although proton therapy systems have traditionally been prohibitively expensive (currently available units generally cost about \$150 million and require 90,000-100,000 square feet of clinic space), management hopes to combine ACCEL's superconducting cyclotron technology with its own treatment

planning and image guidance software technology to produce more affordable systems for small, single-room centers as well as multi-room facilities. Importantly, Varian will be able to develop a low-cost cyclotron (about \$30 million) that would be more affordable for more cancer centers. Management estimates that proton therapy could benefit approximately 10% of all cancer patients, which include pediatric patients as well as those suffering from tumors adjacent to sensitive tissues such as eye tumors.

ACCEL has about 250 employees and manufactures research instruments and proton therapy systems for cancer treatment. Proton therapy radiation beams can be delivered directly at the tumor without harming surrounding healthy tissue.

They differ from standard x-ray beams, which pass all the way through the patient's body thereby exposing both cancerous and healthy tissue to radiation. Thus, proton therapy machines can potentially offer significantly greater tumor targeting precision compared to conventional external beam radiation therapy modalities.

Management estimates that there are only about 30 proton therapy centers in the world (operating or being built), and that it takes nearly three years to build a system. As such, the proton therapy market remains relatively nascent. We expect orders for such systems will initially be gradual (we expect most of ACCEL to contribute primarily to Varian's revenues through sales of research instruments in the near-term), as the proton therapy business is still developing with key competitors such as IBA, Hitachi, and Still River Systems.

Overall, Varian hopes to penetrate the market by combining its software platforms with ACCEL's proton therapy technology in order to produce more affordable systems that will be available in a shorter period of time.

## VALUATION

There is no change to our \$64 price target or our Buy/Medium Risk (1M) rating.

Our price target is based on our revised P/E multiple of 28x (from 29x) our revised calendar 2008E EPS (including stock option expense) of \$2.30 (from \$2.20). We revised our P/E multiple to be more in-line with competitor companies given that gross margin expansion has been slightly slower than we initially expected, but still maintain a slight premium to its historical P/E average. We believe this multiple is appropriate given that (1) the company's base oncology systems business should remain a source of steady growth in the coming years, (2) IGRT product sales have been encouraging so far, and we expect utilization to continue to ramp as hospitals increasingly recognize its benefits over IMRT and older radiotherapy modalities, (3) the Security and Inspection Products (SIP) business could become a meaningful revenue source if the government continues to increase investment in novel defense and security solutions, (4) the international oncology markets remain underpenetrated and represent a significant expansion opportunity for Varian, and (5) the flat-panel detector (FPD) is a high-margin business that is expected to emerge as a key growth catalyst as people progressively recognize the benefits of digital imaging technology.

## RISKS

We rate Varian shares Medium risk, as the company is a top player in a radiation oncology capital equipment (linac) market that requires significant investment from new competitors in order to compete, Varian's balance sheet carries minimal debt (about \$49 million at the end of F2006) compared to its strong cash position (about \$366 million at the end of F2006), and it remains a market leader in technology advancement in the market segments in which it competes.

Potential downside risks to our target price include the following: (1) There are several players in the radiation oncology linac market that could gain market share from Varian. (2) The company's oncology backlog conversion has taken longer to complete in recent months, as sales mix continues to shift towards the international markets and as technology becomes more complex. Any significant delays in conversion could adversely affect the stock price. (3) Changes to hospital and free standing clinic reimbursement are continually scrutinized by investors, and any drastic cuts in coverage will impact VAR. (4) Lengthy linac installation times could lead to increases in deferred revenues, thus hindering gross margin expansion. (5) The corporate gross margin in 2006 has come under pressure, but this is believed to be temporary. However, if margin contraction persists, it could place pressure on the stock.

#### INVESTMENT THESIS

We rate Varian Buy/Medium Risk (1M), and our positive investment thesis is as follows:

(1) With 1.4 million people in the US expected to be diagnosed with cancer in 2006, we expect the incidence of cancer to continue to increase throughout the world, thereby driving continued demand for sophisticated cancer therapies (such as IMRT, IGRT, and SRS). Currently, about 50% of all cancer patients receive some form of radiation therapy during an overall treatment and we expect demand to persist going forward.

(2) Varian is currently the worldwide market share leader in new linac placements and installed units. We expect the company to maintain its market share leadership position as well as an ongoing 10-15% oncology segment growth rate, which will be driven by increased linac placements outside North America and the increasing adoption of IMRT technology. We believe North America is in the early stages of IGRT and SRS adoption, which should also support the business segment's growth rate once the technologies are more widely adopted.

(3) Varian's x-ray products segment growth rate should accelerate as its high-margin flat panel detector (FPD) business benefits from the move to digital technology and away from conventional fluoroscopic and radiographic panels.

The business should comfortably continue to grow in the high single-digit, low double-digit range.

(4) Varian's Security and Inspection Products (SIP) business manufactures linear accelerators to scan shipping containers at seaports (for manifest verification and

detection of illegal weapons). Presently, the US government has only received orders for 10 linacs throughout the entire country, while about 130 are used outside of the US. Thus, if homeland and port security were to become a true priority for the US government, Varian could potentially benefit.

## COMPANY DESCRIPTION

Varian Medical Systems (VAR) manufactures products that are used in the treatment of cancer with radiation therapy, and is also a leading manufacturer of x-ray tubes and flat-panel detectors. Its Oncology Systems segment is the company's largest business unit, and offers advanced hardware that treats cancer using external beam radiation such as linear accelerators (also known as 'linacs'), accessories and software that enhance linacs, and brachytherapy products. These products are offered for conventional radiotherapy treatments as well as advanced modalities such as intensity-modulated radiation therapy (IMRT) and image-guided radiation therapy (IGRT). The X-Ray Products segment is a leading independent supplier of x-ray tubes and flat-panel digital detectors. Finally, the other segment consists of the Ginzton Technology Center for internal R&D as well as the Security and Inspection Products business, which manufactures high-energy linear accelerators for security and inspection purposes.