

EARLY WARNING

Equity Risk Ranking
Potential for Substantial Underperformance

1

ORTHOFIX INTERNATIONAL NV (NASDAQ: OFIX)

The Accounting and Governance Risk rating for Orthofix has dropped from *Average* to *Very Aggressive* in the 3Q 2006. While the Company has had *Aggressive* and *Very Aggressive* ratings before, *the current score of 24* is a new low. In addition, our Equity Risk ranking of 1 places the company in the worst of 5 relative market performance categories for the first time.

Key AGR® Concerns

- ▶ Overall, a very high number of accounting metrics were red flagged (11), indicating significant volatility in measures associated with transparency and financial reporting
- ▶ All three of the accounting risk categories - Revenue Recognition, Expense Recognition, and Asset-Liability Valuation - have multiple red flags, which indicates a pattern of aggressive behavior
- ▶ The AGR rating deteriorated significantly in the most recent quarter, due in large part to the impact of the Blackstone Medical purchase on Asset-Liability valuation measures, and a related decline in the quality of assets

Additional Risks

- ▶ Moving forward, the Blackstone acquisition may effectively mask potential slow growth in their core business
- ▶ The high cost of borrowing (\$330M) to support the acquisition of Blackstone Medical, and the potential for further M&A activity via debt financing, raises leverage concerns

Background

Orthofix is a diversified orthopedic products company with surgical and non-surgical products for the spine, reconstruction and trauma market sectors. In September 2006, they broadened their surgical spinal line with the purchase of Blackstone Medical for \$333 million which was financed primarily by borrowing. Although these events contributed to the deterioration of its rating, metrics related to the merger and restructuring were not the dominating factors in the score.

The following chart shows a Flagged Metric report from the Audit Integrity website (Company>Forensics>Flagged Metrics). It identifies thirteen metrics that directly impact the Company's Accounting and Governance Risk score.

AGR® Rating:
Very Aggressive (24)

Current Stock Price: \$52.70
52 Week Hi/Lo: \$53.30/\$35.00

Industry: Medical Equipment & Supplies
Market Cap: \$839.76mm (Small Cap)

Auditor: Ernst & Young
Period End: 09/30/2006
SEC Filing: 11/09/2006
Rating Published: 01/17/2007

1 Year Equity Chart



Fundamentals

	Company	Industry
Trailing P/E 12 Mths	NM	29.21
Price to Book	2.19	4.99
Price to Sales	2.36	4.44
Financial Condition	WEAK	AVERAGE

*Data provided by Reuters and Audit Integrity

Orthofix International NV Flagged Metrics									
Metric			AGR® Impact		Metric		Metric Operations		
							Comparison	Change	Volatility
Order	Risk	Metric	Metric Impact	Cumul. Pct.	Company Value	Industry Avg./Med.	Co./Industry Difference	1-Year Change	2-Year Volatility
1	Revenue Recognition	Cash Conversion Cycle (Avg Days), Prior Qtr	-9.3	12.3%	300.915	111.706	🚩	🚩	-
2	Asset-Liability Valuation	Intangible Assets over Assets	-8.9	24.0%	0.677	00.077	-	🚩	🚩
3	Expense Recognition	Selling General and Administrative Expenses over Operating Expenses	-8.2	34.8%	0.422	0.454	-	🚩	🚩
4	Asset-Liability Valuation	Asset Turnover, Prior Qtr	-7.9	45.2%	0.493	0.804	🚩	🚩	-
5	Expense Recognition	Prepaid Expenses over Operating Expenses	-7.7	55.3%	0.166	00.089	🚩	-	🚩
6	Revenue Recognition	Accounts Receivable over Sales	-5.7	62.8%	1.226	00.650	🚩	-	-
7	Governance	Compensation Average Options Exercised over Total Compensation, Last Yr	-5.2	69.6%	1.264	0.000	🚩	-	-
8	Asset-Liability Valuation	Altman Z-Score (Partial), Prior Qtr	-4.2	75.2%	0.570	0.533	-	🚩	-
9	Expense Recognition	Depreciation Expense over Property, Plant and Equipment	-4.0	80.5%	0.158	00.086	🚩	🚩	-
10	High Risk Events	Corporate Restructuring Occurred, Trailing 12 Mths	-3.8	85.5%	1.000	00.000		-	-
11	Revenue Recognition	Inventory over Operating Revenues	-3.8	90.5%	0.767	0.595	-	🚩	-
12	Asset-Liability Valuation	Accrued Expenses Payable over Operating Expenses	-3.6	95.3%	0.173	0.253	-	🚩	-
13	Expense Recognition	Deferred Income Tax Assets Current over Operating Expenses	-3.5	100.0%	0.047	0.115	-	-	🚩

Accounting Risks

Metrics were flagged for extreme values in all three of the accounting risk categories we monitor (**Revenue Recognition**, **Expense Recognition**, and **Asset/Liability Valuation**) in order to assess potential manipulation or misreporting:

➤ **Accounts Receivable over Sales, Inventory over Operating Revenues (Revenue Recognition), and Cash Conversion Cycle (Avg Days)**

Within Revenue Recognition, we find a very high Cash Conversion Cycle at 2.7X the industry median – a 39% jump on a year-over-year basis. Accounts Receivable over Sales, which are usually higher than the industry average for Orthofix also jumped by 15% for the quarter. Inventory over Sales were up 65% year-over-year explained in part by the opening of a new international distribution center, and the purchase of safety stock of A-V Impulse Impads to support the transfer of production from the UK to Mexico.

➤ **Prepaid Expenses over Operating Expenses, Deferred Income Tax Assets Current over Operating Expenses (Expense Recognition), and Selling General and Administrative Expenses over Operating Expenses**

High and volatile Prepaid Expenses over Operating Expenses relative to the industry are a sign that the company may be capitalizing certain expenses that would be better expensed in the current period. Likewise, Deferred Income Taxes were up sharply year-over-year and the ratio of deferred taxes to operating expenses has been volatile. We are concerned about high levels of Deferred Tax Assets or changes in these levels because of the great difficulty in judging the adequacy of valuation allowances set up against these assets and the appropriateness of the timing of their draw-downs.

Operating Expenses were inflated in the third quarter by the inclusion of \$40 million of In-Process Research & Development in the R&D account. By excluding this non-recurring amount from the denominator, large changes in SG&A over Operating Expense would not have been flagged. However, Cost of Goods Sold (which we measure relative to Revenues and is therefore not affected by the non-recurring charge) is low relative to industry peers at roughly half the median value and has been declining for the last 7 quarters. When viewed in combination with high Inventories this can be an indicator of deferred expense recognition.

➤ **Intangible Assets over Assets, Asset Turnover, and Altman Z-Score (Partial) (Asset/Liability Valuation)**

Since less than 5% of the acquisition cost of Blackstone Medical was allocated to Net Property, Plant & Equipment, the quality of Assets deteriorated as Goodwill grew by 80% and Intangibles by almost 300%. Intangibles over Assets more than doubled to 29%, which is very high relative to the 7.7% median for the industry. Asset Turnover was also negatively impacted, dropping from .66 a year ago to .49 in 3Q 2006, placing it in the 15th percentile relative to industry peers. At the same time, the Altman-Z score dropped from 2.05 to 0.57 indicating deterioration in the company's financial health.

Corporate Governance and High Risk Events

➤ **Corporate Restructuring Occurred**

A corporate restructuring of the international operations including the establishment of a new distribution center and a newly appointed President of the International Division was initiated in the first quarter of 2006. Audit Integrity flags restructurings as high risk events because any associated layoffs, facility closings and the like, often result in unusual charges and write-offs which obscure the underlying operating picture. The Company has stated that they continue to search for acquisition candidates to expand their global presence, so merger announcements in this division in the future would not be unexpected.

➤ **Compensation Average Options Exercised over Total Compensation**

We highlight high Options Exercise over Total Compensation (of the Top Directors and Officers) relative to industry norms. As with other compensation metrics tracked by Audit Integrity, large-scale exercise of options may indicate that company executives have incentives to act in ways that will maximize short-term stock gains but may not be in the longer-term best interests of the company.

In addition there has been some turnover in executive ranks over the past year as the Company's COO was named Group President and Chief Executive Officer as well as being appointed to the Board of Directors to replace one of Orthofix' founders who retired. A successor COO has not yet been named.

Conclusion

A large number of accounting-related red flags point to a troubling pattern of behavior. High Accounts Receivable and Inventory relative to Sales indicate potential revenue recognition issues, while high and volatile Prepaid Expenses and Deferred Income Tax Assets along with other metrics raise questions surrounding expense recognition.

The Blackstone acquisition caused a jump in Intangibles and in Long-term Debt, and thus a decline in the quality of assets, accompanied by a rise in leverage from almost zero to 36% of assets. Further mergers and debt financing can be anticipated as the company pursues expansion in global markets.

In the Governance and Event arena, our assessment of risk has increased due to officer turnover, a restructuring, and high option exercises. Event risk related to M&A restructurings and motivation by management to focus on short-term goals (as indicated by option compensation) supports a portrait of a company at risk. Based on the recent decline in the Company's AGR rating, and the resultant Equity Risk Ranking of 1 (substantial underperformance potential) Audit Integrity has significant concerns for investors over the next 3-6 months.



Audit Integrity Client Services
Phone: (877) 880-8820
E-mail: support@auditintegrity.com

Audit Integrity, Inc. and its affiliates, Directors and Officers of the company may own stock or options to purchase or sell stock in the companies mentioned on our website and in our publications and may elect to increase or decrease the size of these positions at any time.

Audit Integrity, Inc. however, is not directly or indirectly compensated for the specific views, opinions or recommendations expressed in its research reports. This document is for information purposes only and is not to be considered a solicitation to buy or sell any security. Neither Audit Integrity nor any other party guarantees its accuracy nor makes any warranties regarding its usage. Modification or reproduction of this report is forbidden without explicit permission. Copyright © 2007 Audit Integrity, Inc.