

SomnoMed

Muddy result, clearer outlook

ADD (no change)

Current price:	A\$2.00
Target price:	A\$2.49 ▲
Previous target:	A\$2.17
Up/downside:	24.5%
Reuters:	SOM.AX
Bloomberg:	SOM AU
Market cap:	US\$85.14m
	A\$125.6m
Average daily turnover:	US\$0.03m
	A\$0.04m
Current shares o/s	57.87m
Free float:	67.1%

Key changes in this note



Price performance	1M	3M	12M
Absolute (%)	29	9.3	-2.4
Relative (%)	31.3	8.2	-5.6

Iain WILKIE

T (61) 7 3334 4521

E iain.wilkie@morgans.com.au

Scott POWER

T (61) 7 3334 4884

E scott.power@morgans.com.au

Analyst(s) own shares in the following stock(s) mentioned in this report:

- N/A

- As well flagged, a messy FY19 result with substantial costs to close out the RSS business and a new set of restated accounts.
- Backing out RSS, we get a clearer picture of the business going forward which is a profitable company with strong operating leverage.
- With clearer skies ahead, the optics of the business becomes increasingly positive with a strong core business with multiple cost levers to drive profit growth over the coming years.
- We have made minor changes to our assumptions and upgrade our target price to A\$2.49 (from A\$2.17). Add recommendation maintained.

FY19 results – no point looking back

SOM posted an FY19 net loss of A\$15.9m, up from a loss of A\$9.7m in the pcp. dragged down by A\$16.4m in losses from the discontinued RSS business. Revenue from the core business improved to A\$59.0m (from A\$52.4m). Underlying results were stronger with a 27% improvement in EBITDA to A\$5.0m from A\$3.9m in the pcp. The results were driven by a strong turnaround in the North American business in 2H19 and continued (albeit slower than historical) growth in Europe. MAS margins contracted to 70% (from 73%) due to the impact of lower direct sales with the RSS exit and group gross margins remaining steady at 59%. Operating cashflow improved on a full-year basis (loss of A\$6.2m versus loss of A\$9.5m in the pcp), in particular a healthy ~A\$2m operating surplus in 4Q19 (ex RSS closure costs) shows the underlying potential of the business going forward. SOM's balance sheet remains sound with a cash balance of A\$7.7m and A\$3m in debt.

Outlook and guidance

Already there are signs of an improved outlook and signs of a turnaround in the North American business. SOM provided revenue guidance for FY20 with a range of A\$67m – \$69m (+14% to 17%) and EBITDA of between A\$6.3m to \$6.7m (+26% to 34%) of which we suspect has left some risk to the upside.

Changes to forecasts

We have rolled forward our model and made a number of minor changes to our forecasts. Our changes include a reduction in D&A assumptions to reflect a more streamlined business going forward as well as paring back gross margins on the core device sales. We have reset our margins to 59% (from 61%), setting a base-case scenario for the core business and will look to upgrade on evidence of cost-outs in the base business.

Investment view – positive view maintained

Given the changes to forecasts our DCF valuation has increased to A\$2.49 (from A\$2.17). We set the target price at the same level. We are becoming increasingly positive given RSS has been closed. Questions remain as to the potential remaining cash-costs to the RSS exit although we don't expect this to be material. Key downside risks to our targets are slower-than-expected growth in the core markets of North America and Europe. We retain our Add recommendation.

Financial Summary	Jun-18A	Jun-19A	Jun-20F	Jun-21F	Jun-22F
Revenue (A\$m)	63.61	58.89	67.75	75.72	83.85
Operating EBITDA (A\$m)	-6.42	2.73	6.49	7.91	9.93
Net Profit (A\$m)	-9.71	0.46	3.64	4.64	6.11
Normalised EPS (A\$)	-0.16	0.01	0.06	0.07	0.10
Normalised EPS Growth	83%		694%	28%	32%
FD Normalised P/E (x)	NA	271.6	34.2	26.8	20.4
DPS (A\$)	-	-	-	-	-
Dividend Yield	0%	0%	0%	0%	0%
EV/EBITDA (x)	NA	43.85	17.97	14.29	10.89
P/FCFE (x)	NA	12.78	20.18	15.79	11.95
Net Gearing	(37.1%)	(26.3%)	(36.2%)	(44.7%)	(52.5%)
P/BV (x)	3.44	6.98	5.86	4.88	4.00
ROE	(28.4%)	1.7%	18.6%	19.9%	21.6%
% Change In Normalised EPS Estimates			(0.6%)	8.3%	15.8%
Normalised EPS/consensus EPS (x)			1.08	1.10	1.23

SOURCE: MORGANS, COMPANY REPORTS

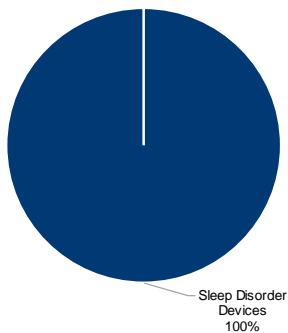
Figure 1: Business snapshot

SomnoMed (as at 21-08-19)		SOM AU / SOM.AX	Health Care Equipment & Services
Market cap (A\$m):	115.7	Rating:	ADD
Shares outstanding (m):	57.9	Price (A\$):	2.00
Free float (%):	67%	Target price (A\$):	2.49
Company website:	www.somnomed.com.au	Upside/downside to target price (%):	24.5%

Company description

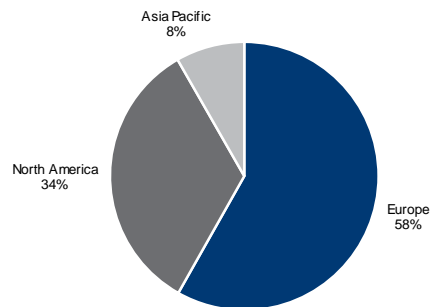
SomnoMed Limited (SOM) provides diagnostic and treatment solutions for Sleep-related Breathing Disorders including obstructive sleep apnea, snoring and bruxism. SOMNODENT : SomnoDent is an Oral Sleep Apnea (OSA) Appliance consisting of two dental plates, which look similar to a sports mouth guard. SomnoDent product has a number of designs including a Flex, Classic and G2. SomnoDent is custom made to fit patient's mouth and should be worn at night whilst sleeping in order to bring lower jaw forward and open up the airway. SomnoDent is designed for the patient who suffers from mild to moderate OSA.

Business segmentation by revenue



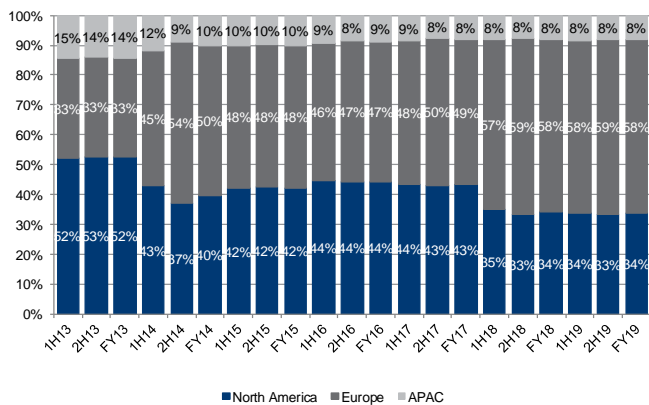
SOURCE: COMPANY

Geographical segmentation by revenue



SOURCE: COMPANY

Revenue splits by geography (core business)



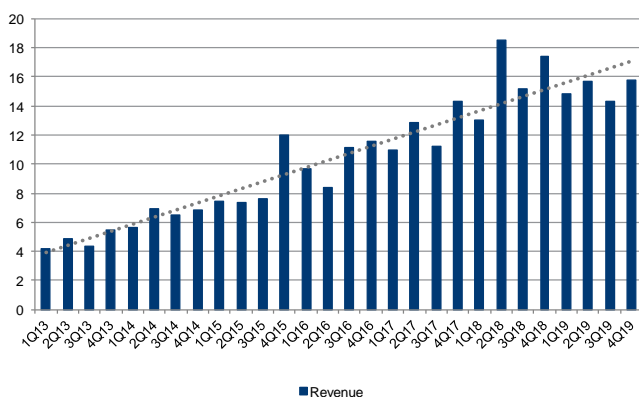
SOURCE: MORGANS, COMPANY

Upcoming catalysts

- Confirmation of orderly exit from RSS business. Existing lease arrangements for clinics to be wound up or sub-let on reasonable terms.
- Evidence of turnaround in US sales post RSS exit
- Continued product development and margin improvements

SOURCE: MORGANS, COMPANY

Quarterly sales revenue



SOURCE: MORGANS, COMPANY

Key drivers / risks

Key Drivers

- Compliance** - Higher compliance rates (80% for COAT vs <50% for CPAP) and lower cost than CPAP competitors.
- Expansion** - European expansion continuing to show strong growth. Underserved market for treatment modality
- Turnaround** - Watching for evidence of a US turnaround after a direct retail channel move was received poorly by existing wholesale customers.

Key risks:

- FX** - Majority of revenues generated outside of Australia.
- Substitution** - A number of new and existing alternative products exist in the sleep apnea space which may impact SOM's ability to gain market share.
- Reimbursement** - Risk that insurance companies/governments which partially or fully subsidise the products reduce or exclude the reimbursement for the treatment.

SOURCE: MORGANS, COMPANY

Figure 2: Financial summary

Income statement						Valuation metrics						
	FY18A	FY19A	FY20F	FY21F	FY22F						Price Target (A\$)	
Total revenue	63.6	58.9	67.8	75.7	83.8	DCF valuation inputs					\$2.49	
EBITDA	-6.4	2.7	6.5	7.9	9.9	Rf	4.00%	10-year rate			4.00%	
Associate income	0.0	0.0	0.0	0.0	0.0	Rm-Rf	6.00%	Margin			2.0%	
Depreciation	-1.7	-1.4	-1.4	-1.4	-1.4	Beta	1.70	Kd			4.20%	
EBITA	-8.1	1.3	5.0	6.5	8.5	CAPM (Rf+Beta(Rm-Rf))	14.2%	Ke			18.0%	
Amortisation/impairment	0.0	0.0	0.0	0.0	0.0	Equity (E/EV)	60.0%	NPV cash flow (A\$m)			141.5	
EBIT	-8.1	1.3	5.0	6.5	8.5	Debt (D/EV)	40.0%	Minority interest (A\$m)			0.0	
Net interest expense	0.0	-0.2	0.1	0.2	0.3	Interest rate	4.20%	Net debt (A\$m)			-13.4	
Pre-tax profit	-8.1	1.1	5.2	6.6	8.7	Tax rate (t)	30.0%	Investments (A\$m)			0.0	
Income tax expense	-1.6	-0.6	-1.5	-2.0	-2.6	WACC	12.5%	Equity market value (A\$m)			154.8	
After-tax profit	-9.7	0.5	3.6	4.6	6.1						Diluted no. of shares (m)	62.2
Minority interests	0.0	0.0	0.0	0.0	0.0						\$2.49	
NPAT	-9.7	0.5	3.6	4.6	6.1	Multiples						
Significant items	0.0	-16.4	0.0	0.0	0.0	Enterprise value (A\$m)	137.8	135.1	138.1	141.8	146.8	
NPAT post abnormal	-9.7	-15.9	3.6	4.6	6.1	EV/Sales (x)	2.2	2.3	2.0	1.9	1.8	
Cash flow statement						EV/EBITDA (x)	-21.5	49.5	21.3	17.9	14.8	
EBITDA	-6.4	2.7	6.5	7.9	9.9	EV/EBIT (x)	-17.0	105.4	27.4	22.0	17.3	
Change in working capital	-3.1	7.8	-0.4	-0.6	-0.7	PE (x)	-12.8	271.6	34.2	26.8	20.4	
Net interest (pd)/rec	0.0	0.0	0.0	0.0	0.0	PEG x)	0.2	-2.6	0.0	1.0	0.6	
Taxes paid	1.6	0.6	1.5	2.0	2.6	Per share data						
Other oper cash items	0.0	0.0	0.0	0.0	0.0	No. shares	62.2	62.2	62.2	62.2	62.2	
Cash flow from ops (1)	-7.9	11.2	7.6	9.3	11.9	EPS (cps)	-15.6	0.7	5.8	7.5	9.8	
Capex (2)	-1.7	-1.4	-1.4	-1.4	-1.4	Dividend per share (c)	0.0	0.0	0.0	0.0	0.0	
Disposals/(acquisitions)	0.0	0.0	0.0	0.0	0.0	Dividend payout ratio (%)	0.0%	0.0%	0.0%	0.0%	0.0%	
Other investing cash flow	0.0	0.0	0.0	0.0	0.0	Dividend yield (%)	0.0%	0.0%	0.0%	0.0%	0.0%	
Cash flow from investing (3)	-1.7	-1.4	-1.4	-1.4	-1.4	Growth ratios						
Incr/(decr) in equity	10.4	0.0	0.0	0.0	0.0	Sales growth	29.0%	-7.4%	15.0%	11.8%	10.7%	
Incr/(decr) in debt	0.0	0.0	0.0	0.0	0.0	Operating cost growth	32.8%	-19.8%	9.1%	10.7%	9.0%	
Ordinary dividend paid	0.0	0.0	0.0	0.0	0.0	EBITDA growth	-88.9%	142.6%	137.8%	21.8%	25.5%	
Preferred dividends (4)	0.0	0.0	0.0	0.0	0.0	EBITA growth	-74.9%	115.8%	293.7%	28.0%	31.3%	
Other financing cash flow	0.0	-0.6	0.0	0.0	0.0	EBIT growth	-74.9%	115.8%	293.7%	28.0%	31.3%	
Cash flow from fin (5)	10.4	-0.6	0.0	0.0	0.0	NPAT growth	-97.2%	104.7%	694.4%	27.7%	31.6%	
Forex and disc ops (6)	0.0	0.0	0.0	0.0	0.0	Normalised EPS growth	-83.5%	-104.7%	694.4%	27.7%	31.6%	
Incr/(decr) cash (1+3+5+6)	0.8	9.1	6.2	7.9	10.4	Operating performance						
Equity FCF (1+2+4)	-9.6	9.7	6.2	7.9	10.4	Asset turnover (%)	36.6	36.6	49.6	52.8	50.9	
Balance sheet						EBITDA margin (%)	-10.1	4.6	9.6	10.4	11.8	
Cash & deposits	13.4	7.7	10.7	14.4	19.3	EBIT margin (%)	-12.7	2.2	7.4	8.5	10.1	
Trade debtors	14.1	10.7	8.4	9.3	10.3	Net profit margin (%)	-15.3	0.8	5.4	6.1	7.3	
Inventory	2.0	1.9	0.0	0.0	0.0	Return on net assets (%)	1.9	2.5	1.3	-14.4	-22.4	
Other current assets	0.0	0.0	0.0	0.0	0.0	Net debt (A\$m)	-13.4	-4.7	-7.7	-11.4	-16.3	
Goodwill	0.0	0.0	0.0	0.0	0.0	Net debt/equity (%)	-37.1	-26.3	-36.2	-44.7	-52.5	
Other intangible assets	0.0	0.0	0.0	0.0	0.0	Net interest/EBIT cover (x)						
Fixed assets	6.6	3.2	3.2	3.2	3.2	Invested capital	19.7	20.9	13.1	13.5	14.1	
Investments	0.0	0.0	0.0	0.0	0.0	ROIC (%)	-49.4	2.2	27.7	34.3	43.3	
Other assets	9.6	11.2	11.2	11.2	11.2	Internal liquidity						
Total assets	45.7	34.8	33.5	38.2	44.1	Current ratio (x)	3.5	2.5	5.4	6.1	7.0	
Short-term borrowings	0.0	0.0	0.0	0.0	0.0	Receivables turnover (x)	5.2	4.8	7.1	8.6	8.5	
Trade payables	8.4	8.2	3.5	3.9	4.2	Payables turnover (x)	8.5	6.8	10.5	18.3	18.1	
Long-term borrowings	0.0	3.0	3.0	3.0	3.0							
Other term liabilities	0.7	1.5	1.5	1.5	1.5							
Other liabilities	0.0	0.0	0.0	0.0	0.0							
Total liabilities	9.6	16.9	12.3	12.7	13.0							
Share capital	57.7	57.7	57.7	57.7	57.7							
Other reserves	6.1	7.7	7.7	7.7	7.7							
Retained earnings	-27.8	-47.5	-44.1	-39.8	-34.2							
Other equity	0.0	0.0	0.0	0.0	0.0							
Total equity	36.1	17.8	21.2	25.5	31.1							
Minority interest	0.0	0.0	0.0	0.0	0.0							
Total shareholders' equity	36.1	17.8	21.2	25.5	31.1							
Total liabilities & SE	45.7	34.8	33.5	38.2	44.1							

SOURCE: MORGANS RESEARCH, COMPANY

Changes to forecasts

We have pared back gross margin assumptions on the core device sales which had been elevated over the last few years with the contribution from the higher margin RSS segment now removed. Our margins decrease to 59% (from 61%), setting a base-case scenario for the core business going forward and look to upgrade on evidence of cost-outs in the base business. Our D&A forecasts were too high and we have reduced this to reflect the more streamlined business model.

Figure 3: Changes to forecasts (A\$m)

Metric	FY20F		FY21F		FY22F	
	Old	New	Old	New	0	0
Revenue	69.1	67.8	77.8	75.7	86.8	83.8
% change		-2%		-3%		-3%
EBITDA	8.0	6.5	8.9	7.9	10.2	9.9
% change		-19%		-11%		-3%
NPAT (normalised)	3.7	3.6	4.3	4.6	5.3	6.1
% change		-1%		8%		16%
EPS (c) normalised	5.9	5.8	6.9	7.5	8.5	9.8
% change		-1%		8%		16%
DPS (c)	0	0	0	0	0	0
% change		0%		0%		0%

SOURCE: MORGANS RESEARCH, COMPANY

Queensland

Brisbane	+61 7 3334 4888
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Western Australia

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South Australia

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