

New BUY: Back to doing what they are world's best at

We upgrade SomnoMed to a BUY rating with a new price target of \$2.00 per share. Important new information in the 1H19 earnings release included: segment-level margin expansion across all three reporting geographies, confidence that the SomnoMed brand in USA will survive any damage it suffered in recent years (during the RSS debacle) and that management has regained control over the cash flow. Investors should also get to see a new product cycle this year. A 'connected' device could ultimately integrate SomnoMed into the 'connected care' theme that has changed obstructive sleep apnoea treatment in all major markets. Their medical device business is innovating again.

Key points

1H19 result snapshot: 1H19 core revenue and EBITDA of \$28.8m and \$1.3m (\$1.6m underlying) respectively, ahead of our initial \$27.6m and \$1.1m forecast. The RSS business closure seems well contained and the cash position is back under control, closing the period with \$8.5m and all operating segments profitable. Core business EBITDA guidance maintained at \$5.0m to \$5.5m.

Highlights: a) Encouraged by the 12% revenue growth achieved in USA, the work done to rebuild trust in the brand following the damaging RSS experience and the steady execution on new channels including larger dental services organisations; b) Segment-level margin improvements across all three geographies (USA +440bps; Europe +270bps; AsiaPac +760bps) with low incremental opex planned over the short-to-medium term. This instils faith that the FY19 guidance can be delivered (upside to our forecasts). c) Confident that European growth can rebound back >20% with transitory disruptions in Sweden and France now cleared and new countries developing sales traction; and d) Renewed vigour in the AsiaPac business – primarily a function of market share gains at the expense of both direct and indirect (dental lab) competitors.

Long term strategy—new connected device is likely. A new oral appliance device is close, expected to achieve FDA clearance imminently and launch mid-year. Longer term, the company is articulating plans to 'connect' their medical devices, an approach that links patients and their treatment data to sleep physicians, and potentially to payers. This could also create a path for market share gains, recurring revenue and higher profitability.

Model changes: Our 8.5% EPS upgrade in FY20 reflects margin improvement owing to opex restraint, coupled with modest increases to US sales estimates.

Valuation: Revised target of \$2.00/sh using a risk-adjusted DCF valuation. Standalone, the unrisks value for Core business is \$2.85-\$3.00/sh, contingent upon: a) Restoration of US Core growth rates to high single or low double-digit percentages; and b) Realisation of long-promised margin leverage.

Earnings forecasts					
Year-end June (AUD)	FY17A	FY18A	FY19F	FY20F	FY21F
NPAT rep (\$m)	-3.3	-8.6	-8.6	3.3	4.3
NPAT norm (\$m)	-2.4	-7.7	-3.6	3.3	4.3
Consensus NPAT (\$m)			-5.1	3.4	4.3
EPS norm (cps)	-4.4	-13.8	-6.3	5.2	6.9
EPS growth (%)	-1476.9	-213.3	54.7	183.0	31.9
P/E norm (x)	-39.4	-12.6	-27.7	33.4	25.3
EV/EBITDA (x)	-60.9	-16.0	20.8	17.3	13.2
FCF yield (%)	-4.7	-10.5	-5.7	2.0	2.7
DPS (cps)	0.0	0.0	0.0	0.0	0.0
Dividend yield (%)	0.0	0.0	0.0	0.0	0.0
Franking (%)	0	0	0	0	0

Source: Company data, Wilsons estimates, S&P Capital IQ

Wilsons Equity Research

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Recommendation	BUY
12-mth target price (AUD)	\$2.00
Share price @ 21-Feb-19 (AUD)	\$1.74
Forecast 12-mth capital return	15.3%
Forecast 12-mth dividend yield	0.0%
12-mth total shareholder return	15.3%

Market cap	\$109m
Enterprise value	\$103m
Shares on issue	63m
Sold short	0.0%
ASX 300 weight	n/a
Median turnover/day	\$0.0m

Shane Storey

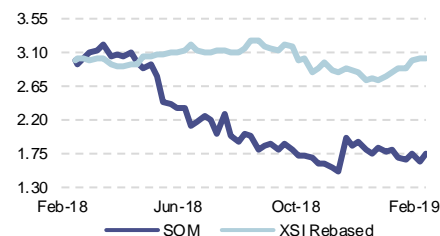
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12-mth price performance (\$)

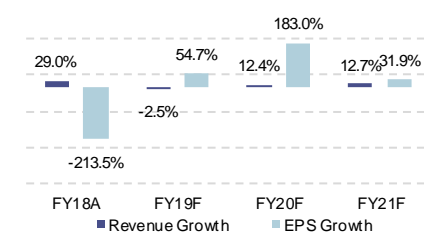


	1-mth	6-mth	12-mth
Abs return (%)	-4.1	-15.4	-42.2
Rel return (%)	-9.2	-10.0	-42.8

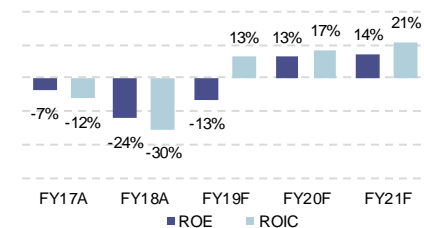
Key changes

		30-Jan	After	Var %
NPAT:	FY19F	-7.0	-3.6	N/A
norm	FY20F	3.0	3.3	8.5%
(\$m)	FY21F	4.3	4.3	0.3%
EPS:	FY19F	-11.2	-6.3	N/A
norm	FY20F	4.8	5.2	8.5%
(cps)	FY21F	6.8	6.9	0.3%
DPS:	FY19F	0.0	0.0	0.0%
(cps)	FY20F	0.0	0.0	0.0%
	FY21F	0.0	0.0	0.0%
Price target:		1.75	2.00	14.3%
Rating:		HOLD	HOLD	

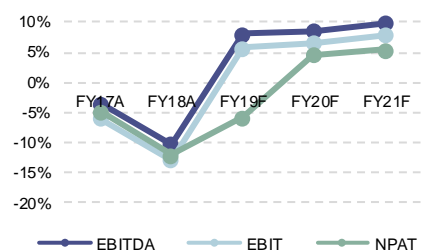
Growth rates



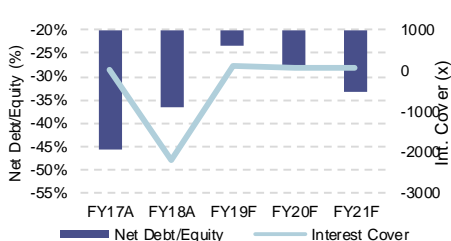
Returns



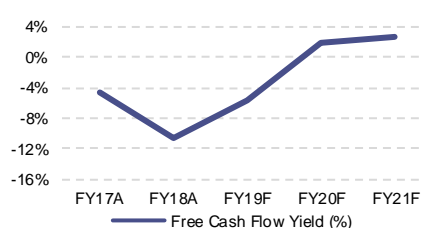
Margin trends



Solvency



Free cash flow yield



Interims (\$m)

	1H18A	2H18A	1H19E	2H19E
Sales revenue	31.6	32.0	28.8	33.2
EBITDA	-3.4	-3.1	1.6	3.4
EBIT	-4.1	-4.0	0.9	2.7
Net profit	-5.1	-2.5	-7.5	3.9
Norm EPS	-9.4	-4.5	-12.9	6.6
EBIT/sales (%)	-13.1	-12.5	3.0	8.1
Dividend (c)	0.0	0.0	0.0	0.0
Franking (%)	0.0	0.0	0.0	0.0
Payout ratio (%)	0.0	0.0	0.0	0.0
Adj payout (%)	0.0	0.0	0.0	0.0

Key assumptions

	FY14A	FY15A	FY16A	FY17A	FY18A	FY19F	FY20F	FY21F
Revenue Growth (%)	40.1	33.0	28.0	11.9	29.0	-2.5	12.4	12.7
EBIT Growth (%)	35.0	-45.7	90.2	-747.2	178.2	-143.7	27.4	38.2
NPAT Growth (%)	-9.2	-4.8	-72.4	-1,534.2	224.6	-52.6	-189.7	31.9
EPS Growth (%)	75.4	-55.3	-73.3	-1,476.9	213.3	-54.7	-183.0	31.9
EBIT / Sales (%)	1.7	0.7	1.0	-5.9	-12.8	5.7	6.5	8.0
Tax Rate (%)	3.4	44.8	85.0	-14.3	-19.8	-2.6	27.0	30.6
ROA (%)	2.3	0.9	1.1	-7.1	-19.4	9.0	10.1	12.9
ROE (%)	5.1	2.8	0.5	-7.4	-26.1	-14.6	11.1	13.5

	FY14A	FY15A	FY16A	FY17A	FY18A	FY19F	FY20F	FY21F
SomnoMed EBITDA (\$m)	1.1	0.9	1.5	2.4	3.9	4.4	6.0	7.8
RSS EBITDA (\$m)				-4.1	-10.4	-10.2	0.0	0.0

Financial ratios

	FY14A	FY15A	FY16A	FY17A	FY18A	FY19F	FY20F	FY21F
PE (x)	64.6	144.6	541.8	-39.4	-12.6	-27.7	33.4	25.3
EV/EBITDA (x)	98.5	118.9	70.1	-60.9	-16.0	20.8	17.3	13.2
Dividend yield (%)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
FCF yield (%)	-0.4	-1.3	0.2	-4.7	-10.5	-5.7	2.0	2.7
Payout ratio (%)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Adj payout (%)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Profit and loss (\$m)

	FY14A	FY15A	FY16A	FY17A	FY18A	FY19F	FY20F	FY21F
Sales revenue	25.9	34.4	44.1	49.3	63.6	62.0	69.7	78.6
EBITDA	1.1	0.9	1.5	-1.7	-6.5	5.0	6.0	7.8
Depn & amort	0.6	0.6	1.0	1.2	1.7	1.4	1.5	1.5
EBIT	0.4	0.2	0.5	-2.9	-8.2	3.6	4.5	6.3
Net interest expense	0.0	-0.1	0.0	-0.1	0.0	0.0	0.1	0.1
Tax	0.0	0.2	0.4	0.4	1.6	-0.1	1.2	1.9
Minorities/pref divs	-0.2	0.1	0.1	-0.8	-2.1	-1.0	0.0	0.0
Equity accounted NPAT	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net profit (pre-sig items)	0.6	0.1	0.0	-2.4	-7.7	4.6	3.3	4.3
Abns/exts/signif	-0.2	0.5	0.2	-1.0	-0.9	-13.2	0.0	0.0
Reported net profit	0.4	0.6	0.2	-3.3	-8.6	-8.6	3.3	4.3

Cash flow (\$m)

	FY14A	FY15A	FY16A	FY17A	FY18A	FY19F	FY20F	FY21F
EBITDA	1.1	0.9	1.5	-1.7	-6.5	5.0	6.0	7.8
Interest & tax	-0.5	0.1	-0.2	-1.2	-0.6	-1.0	-0.9	-1.7
Working cap/other	-1.3	-1.2	0.9	0.2	-2.4	-8.9	-0.9	-1.1
Operating cash flow	-0.8	-0.2	2.1	-2.7	-9.5	-4.9	4.2	5.0
Maintenance capex	0.3	-1.2	-1.9	-2.4	-2.0	-1.4	-2.0	-2.0
Free cash flow	-0.5	-1.4	0.2	-5.1	-11.5	-6.2	2.2	3.0
Dividends paid	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Growth capex	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Invest/disposals	-0.3	-0.2	-1.3	-0.3	-0.2	0.0	0.0	0.0
Oth investing/finance flows	-0.4	-0.3	-0.4	-0.1	-0.6	-0.2	0.0	0.0
Cash flow pre-financing	-1.2	-1.9	-1.5	-5.5	-12.3	-6.5	2.2	3.0
Funded by equity	0.0	7.3	10.7	2.4	11.2	0.0	0.0	0.0
Funded by debt	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Funded by cash	1.2	-5.3	-9.2	3.1	1.1	6.5	-2.2	-3.0

Balance sheet summary (\$m)

	FY14A	FY15A	FY16A	FY17A	FY18A	FY19F	FY20F	FY21F
Cash	2.9	8.3	16.7	14.2	13.4	7.0	9.2	12.2
Current receivables	5.5	7.2	9.4	10.2	13.6	13.2	15.0	17.0
Current inventories	1.0	1.3	1.8	1.9	2.0	2.3	2.7	3.1
Net PPE	1.3	2.1	3.8	4.5	6.6	4.4	4.6	4.8
Intangibles/capitalised	8.5	8.9	10.2	10.4	10.1	10.4	10.8	11.1
Total assets	19.1	27.8	42.0	41.2	45.7	37.9	42.9	48.7
Current payables	3.3	3.9	6.9	8.0	8.4	6.9	7.6	8.2
Total debt	0.0	0.0	0.0	0.0	1.4	1.5	1.5	1.5
Total liabilities	6.6	6.2	8.8	10.3	12.9	14.1	15.4	16.7
Shareholder equity	12.6	21.5	33.2	31.0	32.8	23.8	27.5	32.0
Total funds employed	12.6	21.5	33.2	31.0	34.2	25.3	29.0	33.5



1H19 result variances

Table 1: 1H19 results vs pcp and Wilsons' forecasts

(\$ in mn)	1H18	1H19	%chg	Forecast	%chg	Var (abs\$)	%var
USA	8.7	9.7	12%	8.6	-1%	1.2	14%
Europe	14.2	16.6	17%	16.8	18%	(0.1)	-1%
APAC	2.1	2.4	19%	2.2	8%	0.2	10%
Net revenue	25.0	28.8	15%	27.6	10%	1.2	5%
COGS	10.2	11.8	15%	12.5	22%	(0.7)	-6%
Gross profit	14.7	17.0	15%	15.1	2%	1.9	13%
Underlying EBITDA	1.0	1.6	61%	1.6	60%	0.0	1%
Interest, other	(0.2)	(0.0)	-97%	0.1	-172%	(0.1)	-104%
Tax	1.9	0.1	-94%	1.9	-1%	(1.8)	-94%
Minorities	0.9	-	-100%	(0.9)	-199%	0.9	-100%
Reported NPAT	(5.6)	(12.4)	120%	(5.5)	nm	(6.9)	nm
NPAT (normalised)	(5.2)	(7.5)	43%	(5.5)	5%	(2.0)	-36%
Normalised EPS (cps)	(9.4)	(8.8)	-7%	(13.7)	45%	4.9	-36%
						-	
Operating cash flow	(6.4)	(4.3)	-33%	(12.9)	101%	8.6	-67%
% of net revenue	1H18	1H19		Wilsons			
Gross margin	59.1%	59.0%		54.7%			
MAS gross profit	71.0%	71.0%		70.0%			

FY19 Guidance

Revenue	>\$60m
EBITDA	\$5.0 - 5.5m

Source: Wilsons, company data



SomnoMed (SOM)

Business description

SomnoMed Limited (SOM) develops, manufactures and sells oral appliance devices for the treatment of obstructive sleep apnoea (OSA). The company has developed a global infrastructure to address the OSA market, with the majority of its sales derived from the US and Europe.

Investment thesis

We upgrade SomnoMed to a BUY rating with a new price target of \$2.00 per share. Important new information in the 1H19 earnings release included: segment-level margin expansion across all three reporting geographies, confidence that the SomnoMed brand in USA will survive any damage it suffered in recent years (during the RSS debacle) and that management has regained control over the cash flow. Investors should also get to see a new product cycle this year. A 'connected' device could ultimately integrate SomnoMed into the 'connected care' theme that has changed obstructive sleep apnoea treatment in all major markets. The medical device business is innovating again.

Revenue drivers

- Growth rates. Europe has sustained 20%+ growth for a number of years whilst US has slowed to single-digit.
- Regulatory and/or reimbursement approvals of new products, new territories

Margin drivers

- Making a high (c.70%) gross margin on its oral appliances
- We expect SG&A expense to increase modestly as the company develops and grows its market
- R&D expenditure

Key issues/catalysts

- Upside risks:
- Quarterly cash flow indicates SomnoMed's sales growth progress
- Product launches
- Progress developing links to medical diagnosis channels

Risk to view

- Downside risks:
- Relatively limited capital for business development investment
- Emerging competition
- If successful could face scale-up and logistics challenges when demand increases
- Reimbursement in the USA is improving, but still needs to develop and broaden

Balance sheet

- Forecasting \$1.1m net cash at the end of FY19.
-

Board

- Dr Peter Neustadt (Non-Executive Chairman)
- Ms Lee Ausburn (Non-Executive Director)
- Mr Robert Scherini (Non-Executive Director)

Management

- Neil Verdal-Austin (CEO)
- Kien T. Nguyen (President, North America)
- Dr Jagdeep Bijwadia (Chief Medical Officer)

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Recommendation structure and other definitions

Definitions at wilsonsadvisory.com.au/Disclosures.

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