01 June 2016

SOMNOMED (SOM)

BUY HOLD SELL

Company update

MAS Appeal

SomnoMed is planning a direct to patient marketing strategy that could triple the medium-term earnings outlook if executed well. The company has formed a venture with one of its most successful US customers and plans to roll out 15 treatment centres by the end of FY18, specialising in oral appliance treatment for sleep apnoea. The initiative targets an adjacent pool of untreated patients who are poorly served by traditional medical channels. The new centres may also work synergistically with SomnoMed's existing business, particularly in the managed care setting. Our price target is revised up to $4.50 per share, with potential upside to $7.50 per share if the company hits its stated roll-out targets. BUY rating.

Key points

Introducing the SCA initiative. SomnoMed has announced plans to initiate a direct to patient channel for SomnoDent sales in the US market. The company will invest to create a network of treatment centres targeting "lapsed", untreated sleep apnoea patients who have rejected or have otherwise failed to comply with CPAP therapy. The operating model is exclusively licensed from Simple Sleep Services (S3), a company based in Texas, which has grown to be one of SomnoMed's largest US customers. Sleep Centres America (SCA) is a new subsidiary: 84% owned by SomnoMed; 16% owned by S3 and its founders. SCA will exploit the S3 roll-out model outside Texas. S3 remains independent of SomnoMed and continues as a customer.

WHTM view. SCA is complementary to SomnoMed's traditional business, yet may also streamline some aspects of their existing direct sales channel.

Forecasts. We reduce our FY16 outlook consistent with SomnoMed's revised guidance. The addition of SCA also reduces our profit forecast for FY17 but is accretive from FY18. Our preliminary forecasts suggest SCA could develop into the dominant source of earnings and growth from FY19. SomnoMed should benefit from both the incremental volume and attractive margins on SCA's service component.

Valuation. Our revised target price of $4.50 per share is set at a "risked" discount to our DCF valuation of ~$7.50 per share. SCA-related milestones are potential future catalysts for target price and valuation upgrades.

Risks and catalysts

Catalysts: **a**) quarterly volumes; b) US managed care progress; c) margin improvement; d) SCA centre roll-out. **Risks**: a) execution on US strategy; b) competition; c) ASP erosion; d) SCA rollout execution; e) working capital and liquidity pressure; f) adverse pricing and/or reimbursement outcomes.

12-mth target price (AUD)	**$4.50**
Share price @ 26-May-16 (AUD)	$3.32
Forecast 12-mth capital return	35.5%
Forecast 12-mth dividend yield	0.0%
12-mth total shareholder return	**35.5%**
Market cap	$180m
Enterprise value	$183m
Shares on issue	54m
Sold short	0.0%
ASX 300 weight	n/a
Median turnover/day	$0.0m

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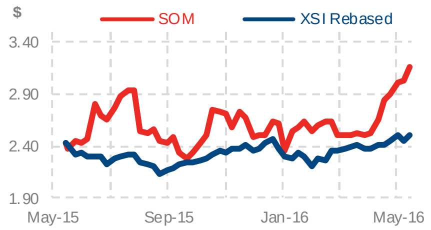
12-mth share price performance



	1-mth	6-mth	12-mth
Abs return (%)	13.8	15.4	30.0
Rel return (%)	8.4	10.3	27.0

Year-end June (AUD)	FY14A	FY15A	FY16F	FY17F	FY18F
NPAT rep ($m)	0.2	0.5	0.4	1.1	5.5
NPAT norm ($m)	0.2	0.5	0.4	1.1	5.5
Consensus NPAT ($m)			1.7	3.7	5.4
EPS norm (cps)	0.9	1.2	0.9	2.2	10.8
EPS growth (%)	-41.5	30.5	-24.5	147.0	386.0
P/E norm (x)	363.7	278.8	369.1	149.4	30.7
EV/EBITDA (x)	220.2	154.5	130.5	103.1	20.5
FCF yield (%)	-0.3	-0.8	0.1	-1.4	1.8
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, WHTM estimates, S&P Capital IQ

KEY CHANGES		21-Apr	After	Var %
NPAT:	**FY16F**	1.6	0.4	-75.6%
norm	**FY17F**	3.1	1.1	-64.2%
($m)	**FY18F**	4.4	5.5	23.8%
EPS:	**FY16F**	3.7	0.9	-75.5%
norm	**FY17F**	6.8	2.2	-67.5%
(cps)	**FY18F**	9.9	10.8	9.2%
DPS:	**FY16F**	0.0	0.0	0.0%
(cps)	**FY17F**	0.0	0.0	0.0%
	FY18F	0.0	0.0	0.0%
Price target:		3.47	4.50	29.6%
Rating:		BUY	BUY	

PRICE TARGET

	Valuation	Price target
WACC (%)	12.1	
Terminal growth (%)	3.4	
NPV forecast FCF (A$m)	110.9	
NPV perpetuity (A$m)	300.6	
Net debt /(cash) (A$m)	17.3	
DCF Valuation (A$m)	428.8	
DCF valuation (A$/sh)		7.51
Price target (A$/sh)		**4.50**

INTERIMS ($m)

Half-year (AUD)	Dec 14	Jun 15	Dec 15	Jun 16
	1HA	2HA	1HA	2HE
Sales revenue	14.8	19.6	21.3	23.0
EBITDA	0.3	0.9	0.7	0.7
EBIT	0.0	0.5	0.2	0.3
Net profit	**0.0**	**0.6**	**0.2**	**0.2**
Norm EPS	**-0.1**	**1.3**	**0.3**	**0.5**
EBIT/sales (%)	0.0	2.8	1.1	1.4
Dividend (c)	0.0	0.0	0.0	0.0
Franking (%)	0.0	0.0	0.0	0.0

FINANCIAL STABILITY

Year-end June (AUD)	FY15A	FY16F	FY17F
Net debt	-8.3	-17.3	-14.5
Net debt/equity (%)	<0	<0	<0
Net debt/EV (%)	**<0**	**<0**	**<0**
Current ratio (x)	5.1	6.0	5.3
Interest cover (x)	<0	<0	<0
Adj cash int cover (x)	**9.5**	**<0**	**<0**
Debt/cash flow (x)	0.0	0.0	0.0
Net debt (cash)/share ($)	<0	<0	<0
NTA/share ($)	0.4	0.6	0.5
Book value/share ($)	0.5	0.7	0.7
Payout ratio (%)	0	0	0
Adj payout ratio (%)	0	0	0

EPS RECONCILIATION ($m)

	FY15A		FY16F	
	Rep	Norm	Rep	Norm
Sales revenue	34	34	44	44
EBIT	0.6	0.6	0.6	0.6
Net profit	**0.5**	**0.5**	**0.4**	**0.4**
Notional earn	0.0	0.0	0.0	0.0
Pref/conv div	0.0	0.0	0.0	0.0
Profit for EPS	**0.5**	**0.5**	**0.4**	**0.4**
Diluted shrs (m)	44	44	45	45
Diluted EPS (c)	**1.2**	**1.2**	**0.9**	**0.9**

RETURNS

	FY15A	FY16F	FY17F	FY18F
ROE (%)	3	1	3	15
ROIC (%)	3	3	4	27
Incremental ROE	6	-1	12	142
Incremental ROIC	8	0	8	162

KEY ASSUMPTIONS

Year-end June (AUD)	FY13A	FY14A	FY15A	FY16F	FY17F	FY18F	FY19F	FY20F
Revenue growth (%)	21.3	40.1	33.0	28.7	20.5	42.6	49.5	42.2
EBIT growth (%)	-52.1	-14.9	152.7	1.0	56.5	775.7	142.1	124.0
NPAT growth (%)	-7.2	-69.5	148.3	-24.8	173.3	399.8	124.5	114.6
EPS growth (%)	**-0.6**	**-41.1**	**30.5**	**-25.1**	**147.0**	**386.0**	**123.2**	**114.2**
EBIT/sales (%)	1.4	0.8	1.6	1.3	1.6	10.0	16.2	25.5
Tax rate (%)	-123.7	-6.7	23.5	32.0	26.6	27.0	27.0	27.0
ROA (%)	**1.6**	**1.1**	**2.0**	**1.4**	**2.0**	**14.2**	**28.5**	**57.2**
ROE (%)	**6.4**	**1.7**	**2.5**	**1.2**	**3.1**	**12.9**	**23.6**	**44.4**

PROFIT AND LOSS ($m)

Year-end June (AUD)	FY13A	FY14A	FY15A	FY16F	FY17F	FY18F	FY19F	FY20F
Sales revenue	18.5	25.9	34.4	44.3	53.4	76.1	113.8	161.8
EBITDA	0.8	0.8	1.2	1.4	1.8	8.9	20.0	43.0
Depn & amort	0.5	0.6	0.6	0.8	0.9	1.3	1.5	1.7
EBIT	**0.3**	**0.2**	**0.6**	**0.6**	**0.9**	**7.6**	**18.4**	**41.3**
Net interest expense	-0.1	0.0	-0.1	0.0	0.0	0.0	0.0	0.0
Tax	-0.4	0.0	0.2	0.2	0.2	2.1	5.0	11.2
Minorities/pref divs	0.0	0.0	0.0	0.0	-0.5	0.1	1.1	3.7
Equity accounted NPAT	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net profit (pre-sig items)	**0.7**	**0.2**	**0.5**	**0.4**	**1.1**	**5.5**	**12.3**	**26.4**
Abns/exts/signif	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Reported net profit	**0.7**	**0.2**	**0.5**	**0.4**	**1.1**	**5.5**	**12.3**	**26.4**

CASH FLOW ($m)

Year-end June (AUD)	FY13A	FY14A	FY15A	FY16F	FY17F	FY18F	FY19F	FY20F
EBITDA	0.8	0.8	1.2	1.4	1.8	8.9	20.0	43.0
Interest & tax	0.0	-0.5	0.1	-0.2	-0.2	-2.1	-5.0	-11.2
Working cap/other	-0.2	-1.1	-1.5	0.3	-0.1	0.6	-3.4	-2.0
Operating cash flow	**0.6**	**-0.8**	**-0.2**	**1.5**	**1.5**	**7.5**	**11.6**	**29.8**
Maintenance capex	-0.2	0.3	-1.2	-1.4	-4.0	-4.2	-4.3	-4.5
Free cash flow	**0.4**	**-0.5**	**-1.4**	**0.1**	**-2.5**	**3.3**	**7.3**	**25.3**
Dividends paid	0.0	0.0	0.0	0.0	0.0	0.0	-4.0	-19.1
Growth capex	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Invest/disposals	-0.5	-0.3	-0.2	-1.3	-0.3	0.0	0.0	0.0
Other inv flows	-0.1	-0.4	-0.3	-0.2	0.0	0.0	0.0	0.0
Cash flow pre-financing	**-0.2**	**-1.2**	**-1.9**	**-1.3**	**-2.8**	**3.3**	**3.2**	**6.2**
Funded by equity	0.5	0.0	7.3	10.2	0.0	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	-0.3	1.2	-5.3	-8.9	2.8	-3.3	-3.2	-6.2

BALANCE SHEET SUMMARY ($m)

Year-end June (AUD)	FY13A	FY14A	FY15A	FY16F	FY17F	FY18F	FY19F	FY20F
Cash	4.2	2.9	8.3	17.3	14.5	17.7	21.0	27.2
Current receivables	4.4	5.5	7.2	7.2	8.0	9.3	14.1	16.1
Current inventories	0.9	1.0	1.3	2.1	2.5	2.8	3.2	3.6
Net PPE	1.2	1.3	2.1	3.1	5.6	7.9	10.0	12.2
Investments	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Intangibles/capitalised	5.3	8.5	8.9	10.1	11.0	11.6	12.4	13.1
Other	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total assets	**16.1**	**19.1**	**27.8**	**39.7**	**41.6**	**49.4**	**60.6**	**72.2**
Current payables	3.5	3.3	3.9	5.0	6.0	8.0	9.6	9.8
Total debt	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other liabilities	1.0	3.2	2.4	2.3	2.5	2.7	3.0	3.3
Total liabilities	**4.5**	**6.6**	**6.2**	**7.3**	**8.5**	**10.7**	**12.6**	**13.1**
Minorities/convertibles	0.6	0.2	0.2	-0.4	-0.4	-0.4	-0.4	-0.4
Shareholder equity	**11.6**	**12.6**	**21.5**	**32.4**	**33.1**	**38.6**	**48.1**	**59.1**
Total funds employed	**11.6**	**12.6**	**21.5**	**32.4**	**33.1**	**38.6**	**48.1**	**59.1**

MAS Appeal – SomnoMed's direct to patient channel in the USA

SomnoMed's SCA initiative

SomnoMed is partnering with one of its largest customers to roll out dedicated sleep dentistry clinics as a new channel in the US market.

SomnoMed has announced plans to introduce a "direct to patient" channel to accelerate growth within its US business. Sleep Centres America (SCA) is a new US subsidiary that plans to roll out a network of treatment centres that specialise in treating sleep apnoea patients with SomnoMed's oral appliances. The SCA operating model has been licensed from a company called Simple Sleep Services LLC (S3), based in Texas, which has grown rapidly over the past 2-3 years to become SomnoMed's largest US customer.

The new business primarily targets the "lapsed" sleep apnoea patient – patients who have been previously diagnosed, have since failed or rejected the standard of care (positive airway pressure, or PAP) and remain untreated. S3 markets oral appliance therapy directly to these patients via radio advertising and social media. Its services include the fitting of SomnoMed's oral appliances, associated dental treatments, facilitation of sleep testing and lodging/processing reimbursement claims.

There is a large pool of latent demand from "lapsed" patients who have failed other therapies and remain untreated.

Lapsed patients comprise a large segment of the diagnosed sleep apnoea market. Underlying growth in the US sleep apnoea market usually tracks at ~6% per annum, fed by greater awareness of the disease and improved access to sleep diagnostics. We estimate that 3m new patients were diagnosed in the USA last year and prescribed a PAP machine. Compliance with PAP therapy is typically 50% or less after six months, meaning that the industry creates a large pool of untreated patients every year, which is cumulative. Following failure on PAP therapy, a patient's options are essentially limited to surgery. In recent years the work of SomnoMed and other medical device manufacturers has lifted the profile of oral appliance therapy as a suitable treatment option with improved validation on both safety, efficacy and compliance. The SCA model is SomnoMed's first attempt to target this lapsed patient pool in a systematic way.

Under the SCA initiative, SomnoMed has the rights to build, own and operate S3 centres everywhere in the world outside of Texas. Within Texas, S3 will remain independent and free to expand its network, which continues to prescribe SomnoMed's devices on an exclusive basis. SomnoMed owns an 84% controlling interest in SCA. Minority interests in SCA are held by S3 and its founders.

The S3 centres in Texas, on which SCA clinics will be based, ramp rapidly to profitability and generate good operating margins.

Centre economics under S3 operating model look attractive. SomnoMed has shared information relating to S3's existing two centres in Dallas and Fort Worth. We understand that the Dallas centre reached 1,500 devices (annualised) in its second full year and is still growing well. SCA aims to operate at least 5 centres by the end of FY17 and 15 centres by the end of FY18. The company has also provided initial estimates of 3-year financial performance for individual centres.

Table 1: Indicative SCA treatment centre economics over first four years

	Yr1	Yr2	Yr3
Patients (devices)	450	1,250	1,650
Revenue (A$m)	1.3	3.2	4.0
EBITDA (A$m)	-	0.8	1.2
EBITDA margin		*25.0%*	*30.0%*

Source: SomnoMed

WHTM view

SomnoMed's "direct" medical channel remains a differentiating feature of the company's US business.

High degree of complementarity with existing business. SomnoMed's primary sales channel today is via a direct marketing model targeting sleep physicians, health insurers and managed care organisations (MCOs). This channel is a differentiating attribute for SomnoMed; the result of 4-5 years' work, primarily via education processes, which have positioned oral appliance therapy as a favourable alternative to CPAP.

Despite the work that SomnoMed has done to simplify medical referrals, "direct" medical diagnosis and oral appliance treatment still has its complications and involves a high proportion of newly or recently diagnosed sleep apnoea patients. The SCA channel appears to be more straightforward, with a majority of target patients already diagnosed but seeking treatment when prompted towards the oral appliance alternative. In this sense, we do not see that SCA's business will be competitive with SomnoMed's direct channel. Nor should it impact the clinical practice of sleep physicians already being serviced by SomnoMed's direct channel. In some cases, the SCA network may offer a neat solution to how SomnoMed provides its managed care customers with pre-qualified dental capabilities.

SCA targets volume outside the direct channel, but may work synergistically with SomnoMed's managed care efforts.

Managed care customers should be attracted to means of keeping their patients' diagnosis and treatment pathways as closed, or "in-network" as possible. Therefore, we see the SCA initiative as complimentary and simplifying to the direct channel.

Investment thesis could play out in half the time. Our investment thesis on SomnoMed is that oral appliance therapy can at least triple its share of the US sleep apnoea market, and that SomnoMed could defend its leadership position over that period and triple its US business. Currently, we assess that oral appliances represent ~5-7% of the market, but see penetration rising to ~15% of a larger market, recalling that the underlying market is growing at 6%. In essence – our pre-SCA forecasts had SomnoMed tripling its US business over the next 5-6 years. The SCA initiative could halve the time for this to occur.

Risks

Execution risks:

- **People risks**. SomnoMed needs to hire well in composing the corporate team that then takes responsibility for SCA, which is essentially a start-up. We note that the S3 founders have joined the board of SCA in a non-executive capacity and will consult for at least three years. Although S3 and its founders took no consideration for the licence granted to SomnoMed, their 16% interest in what SCA achieves beyond Texas provides an incentive.
- **Site selection**. SomnoMed is yet to disclose where it plans to place its first SCA clinics but selection criteria may include:

  a. <u>Demographics (age)</u> – prevalence of sleep apnoea rises with age so the USA's older states (Florida, Mid-West) may be attractive places to start.

  b. <u>Insurance and payer mix (Medicare v privately insured patients)</u> – although most Medicare carriers and private payers reimburse for oral appliance therapy, there is a lot of regional differences in coverage. S3's initial success in Texas was based on only "average" reimbursement outcomes. Better payment rates exist in California and other states.

  c. <u>Relationships with insurers and or managed care organisations (MCOs)</u> – in some areas SCA may contemplate negotiating a discounted "in network" payment rate for members of local health plans. The trade-off between lower pricing and rapid access to start-up patient volume (and clinic break-even) must be assessed case by case.

  d. <u>Access to pre-qualified dentists</u> – SCA centres will employ dentists with the appropriate training in sleep dentistry. SomnoMed has trained thousands of US dentists, whose geographical distribution may inform site selection.

Regulatory and clinical risks appear low. In most US states, SCA clinics will need to be associated with a registered dentist. As in Australia, US dentists maintain their own professional indemnity insurances, so the exposure to medical-style claims (malpractice, negligence) is low.

Risk of replication and competition. The clinic model contemplated by SCA has limited competitive advantages and may be replicable at relatively low cost (SomnoMed estimates just $200K per centre). Other parties may seek to copy the SCA model and compete with a broader range of non-SomnoMed oral appliances that are approved for the US market. SomnoMed is the only operator with the requisite manufacturing capacity, but competitive interference should be expected if the SCA network proves to be as successful as forecast.

Manufacturing, supply and logistics. A successful SCA network will bring manufacturing capacity constraints forward by several years, compared with our previous forecasts. We estimate that SomnoMed's Manila facility could produce up to 120,000 devices per annum (~50% capacity in FY16). The business could approach operational limits on a run-rate basis as soon as mid-FY19, necessitating another site.

Working capital. Conceptually, we expect SCA to be quite a good operating cash business, given that much of the revenue should be collected at the point of care and the patient is the party that waits for reimbursement from Medicare or health insurance. We assess that the recent capital raising provides an adequate buffer, although increased activity levels and managed care involvement with their broader US business could put more pressure on accounts receivable and liquidity.

Outlook

Changes to forecasts

FY16 guidance downgrade on licensee channel weakness and one-off costs associated with SCA project. SomnoMed has revised its FY16 EBITDA guidance in two ways. The company's original guidance was for $3.0m EBITDA:

- **Adjustment to $2.0m to $2.4m on an underlying basis** – largely on a lower sales volume unit outlook, linked to known weakness in the US licensee business. Recall that Q3 results were lower than expected with a sharper drop-off in US licensee business. The profile and relative importance of the US licensee business has diminished very swiftly over the nine months since SomnoMed set its FY16 volume guidance at 62,000 devices, which included ~4,000 devices to be sold in that channel. We estimate that the drop-off in licensee business may be ~2,250 devices over the FY16 year, relative to initial expectations. Revenue guidance should be exceeded reflecting favourable FX and higher managed care revenue. The latter does not yet contribute any earnings – hence the gap in EBITDA.
- **Further adjustment to $1.4m to $1.6m on a reported basis** – reflecting one-off costs relating to the SCA transaction (legal, travel, recruitment, etc).

SCA could at least triple the earnings outlook compared to previous forecasts. Centre start-up costs should actually depress earnings in FY17 but drive materially higher profitability in future years. SomnoMed's traditional US business stands to benefit from the incremental sales and gross profits derived from SomnoDent devices sold to the SCA network. Separately, we model SCA clinic profitability in line with company guidance, with individual centres reaching approximately 30% EBITDA margins in their third year after opening.

Table 2: Group level earnings revisions incorporating SCA impact

Earnings revisions (post SCA)		FY16e	FY17e	FY18e	FY19e	FY20e
Sales revenue - Before	$m	44.3	51.0	59.0	65.6	75.3
Sales revenue - After	**$m**	**44.3**	**53.4**	**76.1**	**113.8**	**161.8**
- Change	*%*	*0%*	*5%*	*29%*	*73%*	*115%*
EBITDA - Before	$m	3.0	4.8	6.7	8.0	11.0
EBITDA - After	**$m**	**1.4**	**1.8**	**8.9**	**20.0**	**43.0**
- Change	*%*	*-53%*	*-63%*	*33%*	*150%*	*291%*
NPAT (normalised) - Before	$m	1.6	3.1	4.4	5.4	7.5
NPAT (normalised) - After	**$m**	**0.4**	**1.1**	**5.5**	**12.3**	**26.4**
- Change	*%*	*-75%*	*-65%*	*25%*	*128%*	*252%*
EPS (normalised) - Before	cps	3.7	6.9	10.0	11.0	12.0
EPS (normalised) - After	**cps**	**0.9**	**2.2**	**10.8**	**24.1**	**51.6**
- Change	*%*	*-76%*	*-68%*	*8%*	*119%*	*330%*

Source: WHTM Research

Isolating the impacts of SCA for clear impact analysis. In the table below we have set out our previous forecasts for SomnoMed (the "traditional" business) alongside specific revenue and earnings contributions from the SCA initiative.

Key assumptions:

- **Roll-out schedule** – consistent with company guidance we assume 5 SCA clinics are opened in FY17 and a further 10 in FY18. We then assume an additional 10 centres in FY19 but then cap the network at 25. In each case we model clinic ramp-up and EBITDA development over three years, consistent with Table 1. For each centre's fourth year we model an additional 20% growth in volume, with an incremental uplift in EBITDA margin from 30% to 33%.
- **Unit sales growth lifted** – previously we modelled aggregate, medium-term unit growth rates of ~15% to 16% (higher in US, lower in APAC) which may prove conservative. The SCA initiative lifts group level unit growth above 25% in a sustainable way, driven by the mechanics of the centre roll-out.
- **Revenue** – we model US$2,000 per treatment at SCA centres, which includes the device and all patient services. SomnoMed will likely recognise revenue for device sales to SCA, but these will be eliminated at the group level.
- **Gross profit and EBITDA** – incremental gross profit and EBITDA from devices sold to SCA patients will likely be reported in SomnoMed's segment. SCA's earnings line, as presented below, excludes the device margin but includes corporate costs.
- **Accretive in FY18 and the dominant source of earnings thereafter** – investors will verify that by FY19 in our new forecast, the aggregate contribution of SCA earnings exceeds the earnings from SomnoMed's traditional business. We forecast that the venture will lose ~A$2.9m in its first year and be profitable in year two.

Table 3: Detailed forecasts illustrating the contributions from SCA against the "traditional" SomnoMed business

INCOME STATEMENT FORECASTS	FY14a	FY15a	FY16e	FY17e	FY18e	FY19e	FY20e
DEVICE FORECASTS	**43,438**	**51,355**	**59,746**	**72,166**	**88,731**	**112,452**	**140,610**
SomnoMed	43,438	51,355	59,746	71,311	82,386	94,397	108,175
SCA	-	-	-	855	6,345	18,055	32,435
- aggregate growth	*21%*	*18%*	*16%*	*21%*	*23%*	*27%*	*25%*
NET REVENUE	**25.9**	**34.4**	**44.3**	**53.4**	**76.1**	**113.8**	**161.8**
SomnoMed	25.9	34.4	44.3	51.0	59.0	65.6	75.3
SCA	-	-	-	2.3	17.1	48.1	86.5
- aggregate growth	*40%*	*33%*	*29%*	*20%*	*43%*	*49%*	*42%*
EBITDA	**0.8**	**1.2**	**1.4**	**1.8**	**8.9**	**20.0**	**43.0**
SomnoMed	0.8	1.2	1.4	4.4	6.7	8.0	11.0
Incremental device sales to SCA	-	-	-	0.2	1.7	4.8	8.6
SCA	-	-	-	(2.9)	0.5	7.2	23.3
- growth	*9%*	*43%*	*18%*	*27%*	*403%*	*124%*	*115%*
UNDERLYING EBITDA MARGIN	3%	3%	3%	3%	12%	18%	27%
EBIT	**0.2**	**0.6**	**0.6**	**0.9**	**7.6**	**18.4**	**41.3**
-growth	*n/a*	*10%*	*1%*	*56%*	*776%*	*142%*	*124%*
- margin	*1%*	*2%*	*1%*	*2%*	*10%*	*16%*	*26%*
Net interest	0.0	0.1	-	-	-	-	-
PBT	**0.2**	**0.7**	**0.6**	**0.9**	**7.6**	**18.4**	**41.3**
Tax	(0.0)	0.2	0.2	0.2	2.1	5.0	11.2
Reported NPAT	**0.2**	**0.5**	**0.4**	**1.1**	**5.5**	**12.3**	**26.4**
- Minorities	-	-	-	(0.5)	0.1	1.1	3.7
Normalised EPS (cps)	**0.9**	**1.2**	**0.9**	**2.2**	**10.8**	**24.1**	**51.6**
-growth	*n/a*	*33%*	*-25%*	*147%*	*386%*	*123%*	*114%*

Source: WHTM Research

Valuation

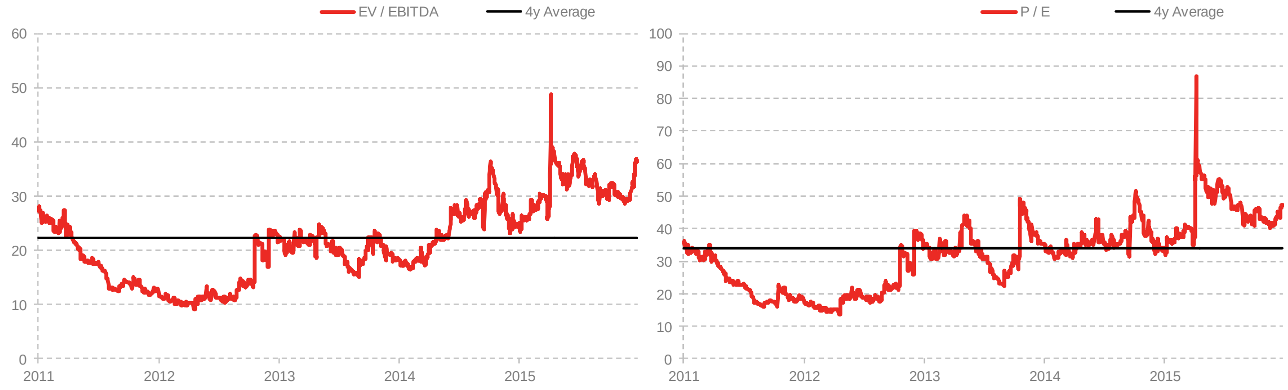
The DCF valuation implications of SCA are straightforward. Without any explicit adjustment for risk, the addition of SCA would lift the basic valuation from $3.05 per share to $7.54 per share. Risk adjustment is necessary however, and we have attenuated the SCA impact with an arbitrary discount, when setting our new price target at $4.50 per share. We see this risk discount unwinding over time and the price target rising as SomnoMed delivers key project milestones: SCA centre openings, progress reports detailing incremental sales and earnings.

Table 4: DCF valuation summary

DCF Parameters			
Discount rate	12.2%	Tax rate	25%
Risk-free rate	3.5%	Terminal growth rate	3.5%
Risk premium	7.0%	Forecast horizon	FY25
Equity beta	1.2		
DCF Valuation			
PV of future cash flows ($M)	110.9	Share count	57.1
PV of terminal value ($M)	300.6		
Value of operating assets ($M)	411.4	**DCF value per share ($)**	**7.51**
Less net debt (cash)	17.3	- risk discount (~40%)	
Equity value ($M)	**428.8**	**Price target/share ($)**	**4.50**

Source: WHTM Research

Figure 1: Five-year re-rating trend in earnings capitalisation multiples for SomnoMed



Source: Bloomberg, WHTM Research

SomnoMed Limited (SOM)

BUSINESS DESCRIPTION

SomnoMed Limited (SOM) develops, manufactures and sells oral appliance devices for the treatment of obstructive sleep apnoea (OSA), snoring and bruxism. 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

Our thesis on SomnoMed is that an increasing number of OSA patients will choose an oral appliance in preference to continuous positive air pressure (CPAP) devices given increasing awareness and improving reimbursement access. SomnoMed currently enjoys a leadership position in this market. We expect that the medically oriented diagnosis and referral channels for OSA will embrace oral appliances as an alternative for OSA patients who refuse or are otherwise not well treated with CPAP.

REVENUE DRIVERS

- Growth rates. In recent years the company has sustained consistent 20-30% unit sales growth pcp comps. We think this can be maintained as the company taps the medically diagnosed OSA referral channels
- 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
- Low level of 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 US is improving, but still needs to develop and broaden

BALANCE SHEET

- SomnoMed had c.$6.5M cash as at end-Q3FY16
- No debt

BOARD

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

MANAGEMENT

- Dr Peter Neustadt (Executive Chairman)
- Neil Verdal-Austin (CFO)
- Kien T. Nguyen (President, North America)
- Dr Jagdeep Bijwadia (Chief Medical Officer)

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Recommendation structure and other definitions

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