

Organic goodness

Organic growth in FY16 has established a platform for diversification in the USA, where SomnoMed will embark on its SCA sleep centre initiative early next year. The project adds a roll-out dimension to the story and a means of targeting lapsed sleep apnoea patients directly. In Europe, organic growth supported clear leverage in FY16, with that region producing about two-thirds of segmental EBITDA. We were encouraged by SomnoMed's commitment to new product development and expect management to remain active on the business development front this year, pushing further into key territories such as France and Korea. Confident guidance was provided for FY17. We have adjusted our FY17 forecast for SomnoMed's more aggressive start-up expenditure guidance relating to SCA. We maintain our target price at \$4.50 implying significant upside. BUY.

Key points

FY16 result. SomnoMed had pre-announced both its sales volumes (c.59K) and revenue of \$44m (+28% v pcp). Sustained direct sales growth in the US and European businesses was the highlight for the year: +27% and +21%, respectively. Device level gross margins were also up 60bps to 68.6% reflecting FX translation benefit to average selling prices. Underlying EBITDA of \$2.1m was also in line with guidance (\$1.5m reported basis post SCA start-up costs).

Expansion of European profitability. Europe achieved a notable 85% lift in segment level earnings to \$3.0m. Underlying EBITDA was in line with guidance at \$2.1m and \$1.5m at the reported level, after one-off costs associated with establishing SCA and other initiatives.

Guidance and forecasts. SomnoMed is guiding its core medical device business at >70K devices in FY17, >\$54m in revenue and \$4m EBITDA. Five SCA clinic openings are expected to treat >1,000 patients (2H), collect c.\$2m revenue and record an EBITDA loss of ~\$4m. The higher than expected start-up costs are now captured in our revised forecast of \$0.2m FY17e reported EBITDA (Wilson's slightly ahead of core business guidance at \$4.2m EBITDA).

Price target maintained at \$4.50 per share, BUY rating. Valuation basis is DCF with an explicit risk-adjustment for SCA-derived free cash flows. Un-risked, our combined valuation of SomnoMed's Core SomnoDent and SCA businesses is ~\$7.00 per share. Risk-adjusted, our valuation and price target are set at \$4.50 per share (unchanged).

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) average sales price erosion; d) SCA roll-out difficulties; e) working capital and liquidity pressure; f) adverse reimbursement outcomes.

Earnings forecasts					
Year-end June (AUD)	FY15A	FY16A	FY17F	FY18F	FY19F
NPAT rep (\$m)	0.5	0.1	-0.7	5.4	12.1
NPAT norm (\$m)	0.5	0.1	-0.7	5.4	12.1
Consensus NPAT (\$m)			5.0	6.7	9.6
EPS norm (cps)	1.2	0.2	-1.4	10.7	23.6
EPS growth (%)	30.5	-87.4	-1036.5	856.1	121.9
P/E norm (x)	277.1	2193.0	-234.2	31.0	14.0
EV/EBITDA (x)	160.8	128.6	1240.3	21.6	9.7
FCF yield (%)	-0.8	0.1	-2.4	1.8	4.6
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, Wilson's estimates, S&P Capital IQ

Wilson's Research

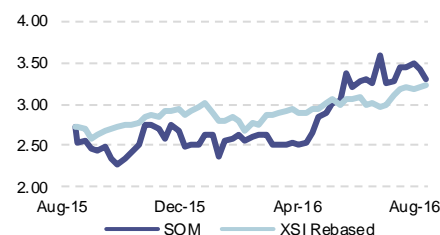
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Recommendation	BUY
12-mth target price (AUD)	\$4.50
Share price @ 18-Aug-16 (AUD)	\$3.30
Forecast 12-mth capital return	36.4%
Forecast 12-mth dividend yield	0.0%
12-mth total shareholder return	36.4%
Market cap	\$187m
Enterprise value	\$190m
Shares on issue	57m
Sold short	0.0%
ASX 300 weight	n/a
Median turnover/day	\$0.1m

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12-mth price performance (\$)



	1-mth	6-mth	12-mth
Abs return (%)	-0.9	27.0	21.0
Rel return (%)	-4.1	11.1	2.7

Key changes				
		24-Jul	After	Var %
NPAT:	FY17F	1.1	-0.7	<-99%
norm	FY18F	5.5	5.4	-1.0%
(\$m)	FY19F	12.1	12.1	0.0%
EPS:	FY17F	2.3	-1.4	<-99%
norm	FY18F	10.8	10.7	-1.0%
(cps)	FY19F	23.6	23.6	0.0%
DPS:	FY17F	0.0	0.0	0.0%
(cps)	FY18F	0.0	0.0	0.0%
	FY19F	0.0	0.0	0.0%
Price target:		4.50	4.50	0.0%
Rating:		BUY	BUY	

Price target

	Valuation	Price target
WACC (%)	12.1	
Terminal growth (%)	3.4	
NPV forecast FCF (A\$m)	102.2	
NPV perpetuity (A\$m)	278.5	
Net debt/(cash) (A\$m)	17.6	
DCF valuation (A\$m)	398.3	

DCF valuation (A\$/sh)	6.97
Price target (A\$/sh)	4.50

Interims (\$m)

Half-year (AUD)	Dec 15	Jun 16	Dec 16	Jun 17
	1HA	2HA	1HE	2HE
Sales revenue	21.3	22.8	25.5	30.3
EBITDA	0.7	0.8	0.1	0.1
EBIT	0.2	0.2	-0.5	-0.4
Net profit	0.2	-0.1	-0.5	-0.1
Norm EPS	0.3	-0.2	-1.1	-0.3
EBIT/sales (%)	1.1	1.0	-2.1	-1.3
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)	FY16A	FY17F	FY18F
Net debt	-17.6	-12.9	-16.2
Net debt/equity (%)	<0	<0	<0
Net debt/EV (%)	<0	<0	<0
Current ratio (x)	5.3	5.1	4.8
Interest cover (x)	<0	◆	◆
Adj cash int cover (x)	<0		
Debt/cash flow (x)	0.0	0.0	0.0
Net debt (cash)/share (\$)	<0	<0	<0
NTA/share (\$)	0.6	0.5	0.6
Book value/share (\$)	0.7	0.6	0.7
Payout ratio (%)	0	0	0
Adj payout ratio (%)	0	0	0

EPS reconciliation (\$m)

	FY16A		FY17F	
	Rep	Norm	Rep	Norm
Sales revenue	44	44	56	56
EBIT	0.5	0.5	-0.9	-0.9
Net profit	0.1	0.1	-0.7	-0.7
Notional earn	0.0	0.0	0.0	0.0
Pref/conv div	0.0	0.0	0.0	0.0
Profit for EPS	0.1	0.1	-0.7	-0.7
Diluted shrs (m)	45	45	49	49
Diluted EPS (c)	0.1	0.2	-1.4	-1.4

Returns

	FY16A	FY17F	FY18F	FY19F
ROE (%)	0	-2	16	29
ROIC (%)	2	-4	27	55
Incremental ROE	-5	-15	275	101
Incremental ROIC	-2	-35	200	219

Key assumptions

Year-end June (AUD)	FY13A	FY14A	FY15A	FY16A	FY17F	FY18F	FY19F	FY20F
Revenue growth (%)	21.3	40.1	33.0	28.0	26.6	43.6	46.2	40.7
EBIT growth (%)	-52.1	-14.9	152.7	-17.1	-305.2	-902.9	141.1	103.8
NPAT growth (%)	-7.2	-69.5	148.3	-87.4	-1,136.2	-877.6	123.2	92.3
EPS growth (%)	-0.6	-41.1	30.5	-87.5	-1,036.5	-856.1	121.9	91.9
EBIT/sales (%)	1.4	0.8	1.6	1.0	-1.7	9.4	15.5	22.4
Tax rate (%)	-123.7	-6.7	23.5	86.3	-42.7	27.0	27.0	27.0
ROA (%)	1.6	1.1	2.0	1.1	-2.2	14.6	29.8	54.5
ROE (%)	6.4	1.7	2.5	0.2	-2.0	13.2	24.6	41.6

Profit and loss (\$m)

Year-end June (AUD)	FY13A	FY14A	FY15A	FY16A	FY17F	FY18F	FY19F	FY20F
Sales revenue	18.5	25.9	34.4	44.1	55.8	80.1	117.2	164.9
EBITDA	0.8	0.8	1.2	1.5	0.2	8.8	19.6	38.6
Depn & amort	0.5	0.6	0.6	1.0	1.1	1.3	1.5	1.7
EBIT	0.3	0.2	0.6	0.5	-0.9	7.5	18.1	36.9
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	0.4	0.4	2.0	4.9	10.0
Minorities/pref divs	0.0	0.0	0.0	0.0	-0.6	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	0.1	-0.7	5.4	12.1	23.2
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	0.1	-0.7	5.4	12.1	23.2

Cash flow (\$m)

Year-end June (AUD)	FY13A	FY14A	FY15A	FY16A	FY17F	FY18F	FY19F	FY20F
EBITDA	0.8	0.8	1.2	1.5	0.2	8.8	19.6	38.6
Interest & tax	0.0	-0.5	0.1	-0.3	-0.1	-2.0	-4.9	-10.0
Working cap/other	-0.2	-1.1	-1.5	0.9	-0.6	0.6	-1.9	-1.8
Operating cash flow	0.6	-0.8	-0.2	2.1	-0.5	7.3	12.9	26.8
Maintenance capex	-0.2	0.3	-1.2	-1.9	-3.9	-4.1	-4.2	-4.4
Free cash flow	0.4	-0.5	-1.4	0.2	-4.5	3.3	8.7	22.4
Dividends paid	0.0	0.0	0.0	0.0	0.0	0.0	-5.5	-16.5
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	-0.4	0.0	0.0	0.0	0.0
Cash flow pre-financing	-0.2	-1.2	-1.9	-1.5	-4.7	3.3	3.2	6.0
Funded by equity	0.5	0.0	7.3	10.7	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	-9.2	4.7	-3.3	-3.2	-6.0

Balance sheet summary (\$m)

Year-end June (AUD)	FY13A	FY14A	FY15A	FY16A	FY17F	FY18F	FY19F	FY20F
Cash	4.2	2.9	8.3	17.6	12.9	16.2	19.4	25.4
Current receivables	4.4	5.5	7.2	7.8	8.0	9.3	12.6	14.4
Current inventories	0.9	1.0	1.3	1.7	2.2	2.5	2.8	3.2
Net PPE	1.2	1.3	2.1	3.6	5.9	8.0	10.0	12.1
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	9.7	10.6	11.2	11.9	12.6
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	40.4	39.5	47.2	56.8	67.8
Current payables	3.5	3.3	3.9	6.1	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	1.7	1.8	2.1	2.3	2.6
Total liabilities	4.5	6.6	6.2	7.7	7.8	10.1	11.9	12.4
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	32.7	31.6	37.1	44.9	55.4
Total funds employed	11.6	12.6	21.5	32.7	31.6	37.1	44.9	55.4



SomnoMed Limited – FY16 results

Table 1: SOM FY16 results vs pcg and Wilsons' estimates, FY17-FY18 outlook

Earnings summary								
YE: 30 Jun		FY15a	FY16a	%chg	Wilsons	%var	FY17e	FY18e
Device sales	units	51,355	58,983	15%	59,746	-1%	71,663	88,148
Sales revenue	\$m	34.4	44.1	28%	44.3	-1%	55.8	80.1
MAS		28.9	37.3	29%	38.0	-2%	46.6	53.5
Managed care, other		5.5	6.8	23%	6.0	13%	6.9	7.9
SCA		-	-	-	-	-	2.3	18.7
Gross Profit	\$m	19.5	25.3	30%	26.0	-3%	34.6	49.7
Margin	%	56.6%	57.5%		58.7%		60.0%	60.0%
Operating Expenses	\$m	18.3	23.9	30%	24.6	-3%	34.4	40.9
EBITDA	\$m	1.2	1.5	25%	1.4	5%	0.2	8.8
Margin	%	3.4%	3.3%		3.2%		0.3%	11.0%
D&A	\$m	1.2	1.0	-14%	0.8	21%	1.1	1.3
EBIT	\$m	0.6	0.5	-17%	0.6	-18%	(0.9)	7.5
Margin	%	1.6%	1.0%		1.3%		-1.7%	9.4%
Net interest expense (benefit)	\$m	(0.1)	(0.0)	0%	0.0	0%	-	-
Tax expense (benefit)	\$m	0.2	0.4	nm	0.2	nm	0.4	2.0
NPAT (normalised)	\$m	0.5	0.4	-32%	0.4	-10%	(0.7)	5.4
NPAT (reported)	\$m	0.5	0.4	-32%	0.4	-10%	(0.7)	5.4
EPS (normalised)	cps	1.2	0.3	-73%	0.3	-7%	(1.4)	10.7
DPS	cps	-	-	-	-	-	-	-

Source: SomnoMed, Wilsons

Results highlights

Direct sales model proving yet again to be the way it's done in USA. SomnoMed had pre-announced both its sales volume (c.59K) and revenue of \$44m. The year-on-year decline in licensee sales has been well covered in previous research (down 47% to ~3K devices). Direct US sales growth was 27%, European unit sales growth was 21% and Asia Pacific grew at 8%. Device level gross margins were up 60bps to 68.6% reflecting FX translation benefit to average selling prices. Group level gross margin also improved, notwithstanding a higher level of managed care and other revenues, on which SomnoMed does not yet collect margin.

Expansion of European profitability. Europe achieved a notable 85% lift in segment level earnings to \$3.0m. Underlying EBITDA was in line with guidance at \$2.1m and \$1.5m at the reported level, after one-off costs associated with establishing SCA and other initiatives.

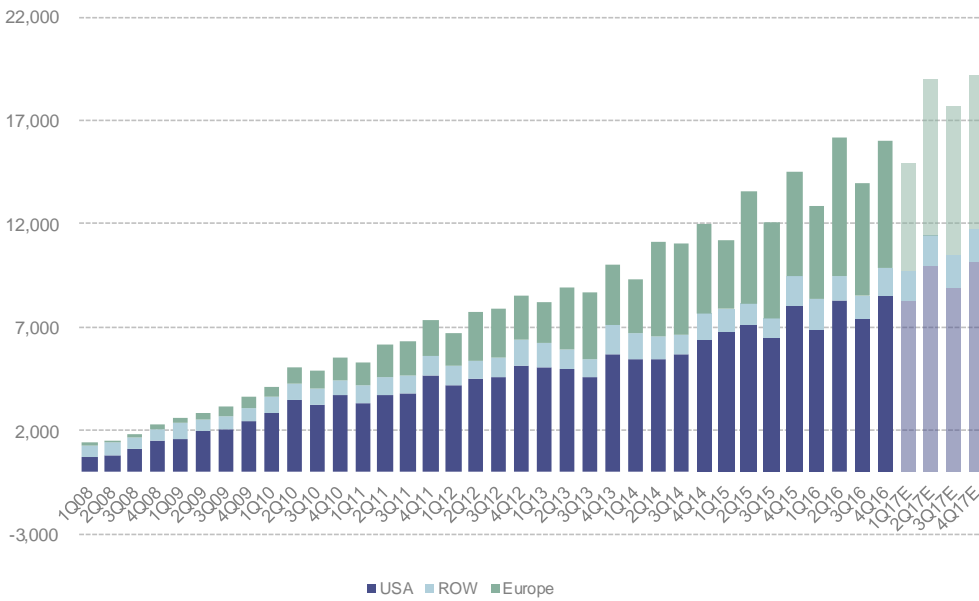
Table 2: Segmental earnings summary

Earnings summary								
		FY15a	FY16a	%chg	Wilsons	%var	FY17e	FY18e
Sales revenue	\$m	34.4	44.1	28%	44.3	-1%	55.8	80.1
North America		14.5	19.6	35%	20.6	-5%	27.8	48.2
Europe		16.5	20.6	25%	19.9	4%	23.7	27.3
Asia Pac		3.4	3.9	13%	3.8	2%	4.3	4.7
Segmental EBITDA	\$m	3.5	4.4	28%	4.3	3%	6.8	11.6
North America		1.3	1.2	-6%	1.5	-21%	3.0	7.1
Europe		1.6	3.0	85%	2.5	20%	3.5	4.0
Asia Pac		0.6	0.2	-60%	0.3	-24%	0.3	0.5
Unallocated costs, adjustments		2.6	2.3	-11%	2.2	5%	2.6	2.8
Core EBITDA	\$m	0.9	2.1	141%	2.1	0%	4.2	8.8
Margin	%	2.5%	4.8%		4.7%		7.4%	11.0%
SCA start-up costs, other expense		-	0.6				4.0	-
Reported EBITDA	\$m	0.9	1.5	70%	1.4	5%	0.2	8.8

Source: SomnoMed, Wilsons



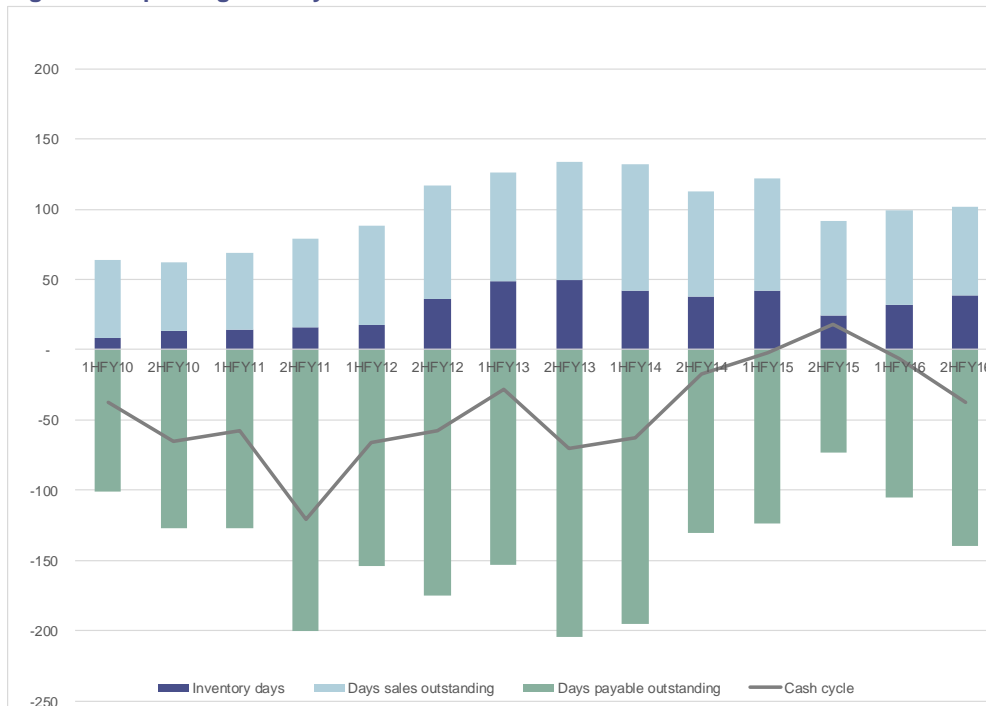
Figure 1: Quarterly net sales FY08-16 and FY17e forecasts by geography



Source: Wilsons

Operating cash flow and working capital profile in good order. Full-year operating cash flow was \$2.1m (-\$0.2m in FY15). SomnoMed has maintained a good track record of inventory management and receivables collection over the years, and operates its business on an efficient cash cycle. Following a successful capital raising in 2HFY16, SomnoMed closed the year with \$17.6m cash and no debt.

Figure 2: Improving cash cycle under US direct sales model



Source: Wilsons

Guidance and forecasts

Guidance. SomnoMed provided guidance for both its core business and the SCA clinics, the first of which should open in early calendar 2017. Core EBITDA is expected to nearly double on an underlying basis to \$4.0m. The start-up investment in starting SCA was ~\$1.1m more aggressive than we were modelling (\$4.0m EBITDA loss versus our estimate of \$2.9m).

Table 3: SomonMed's FY17 guidance versus Wilsons' estimates

FY17				
	Core	SCA	Group	Wilsons
Units/patients	>70,000	>1,000	>71,000	71,663
Revenue	>\$54m	\$2m	>\$56m	\$55.8m
EBITDA	4.0	(4.0)	\$0.0m	\$0.2m

Source: SomnoMed, Wilsons

Forecasts changes. Revenue estimates are increased reflecting higher managed care activity with no earnings passed through at this stage. We have also factored in the guided (higher) start-up costs for SCA which has reduced our reported EBITDA forecast to \$0.2m. Our forecast of ~\$4.2m underlying, core business EBITDA is unchanged. Minor changes to FY18 forecast.

Table 4: Changes to forecasts

Earnings revisions				
Y/E: 30 Jun			FY17e	FY18e
Sales revenue - Before	\$m		53.5	76.1
Sales revenue - After	\$m		55.8	80.1
- Change	%		4.3%	5.3%
EBITDA - Before	\$m		1.8	8.9
EBITDA - After	\$m		0.2	8.8
- Change	%		nm	-0.9%
NPAT (normalised) - Before	\$m		1.1	5.5
NPAT (normalised) - After	\$m		-0.7	5.4
- Change	%		nm	-1.6%
EPS (normalised) - Before	cps		2.3	10.8
EPS (normalised) - After	cps		-1.4	10.7
- Change	%		nm	-1.3%
DPS - Before	cps		0.0	0.0
DPS - After	cps		0.0	0.0
- Change	%			

Source: Wilsons



Valuation. Recommendation. Risks.

We maintain our BUY rating with price target at \$4.50 per share.

We value SomnoMed using a discounted cash flow methodology. We have chosen to risk-adjust our forecast SCA free cash flows to attenuate its impact on valuation. Without any explicit risk adjustment, the combined valuation of SomnoMed's core and SCA businesses is ~\$7.00 per share. Risk-adjusted, our valuation and price target are set at \$4.50 per share (unchanged). Valuation gains might come over the next 12-24 months as SCA's operational and earnings progress de-risks that component of the model.

Table 5: 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)	102.2	Share count	57.1
PV of terminal value (\$M)	278.5		
Value of operating assets (\$M)	380.6	DCF value per share (\$)	6.97
Less net debt (cash)	17.6	- risk discount (~40%)	
Equity value (\$M)	398.3	Price target/share (\$)	4.50

Source: Wilsons

Upside from faster SCA business development. SomnoMed's SCA guidance of 1,000 patients treated in 5 centres over the 2HFY17 is potentially conservative and implies long lead times to first sales in start-up centres. If the centres develop along a similar trajectory to the S3 centres in Texas, on which they are based, this could provide upside to the guidance and our forecasts.

Key risk this year in the SCA start-up phase. SomnoMed has hired an experienced sleep centre executive as President and CEO to run the SCA venture. 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.

SCA has obvious start-up risks associated with it, but we are satisfied that there is enough latent demand among "lapsed" sleep apnoea patients who have failed CPAP therapy and seek alternative treatments.

SomnoMed (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.\$17.6m cash as at end-FY16
- 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)
- Derek Smith (Global CEO-elect)
- Neil Verdal-Austin (CFO)
- Kien T. Nguyen (President, North America)
- James R. Evanger (CEO – Sleep Centres America)
- Dr Jagdeep Bijwadia (Chief Medical Officer)

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