

SomnoMed Limited

SOM AU / SOM.AX

Market Cap US\$116.4m <small>A\$130.8m</small>	Avg Daily Turnover US\$0.08m <small>A\$0.08m</small>	Free Float 87.62% <small>44.24 m shares</small>
--	--	---

Current	A\$2.52
Target	A\$2.97
Up/dow nside	17.8%

COMPANY NOTE

STOCK RATING

ADD
HOLD
REDUCE

Morgans Analyst(s)

Analyst

Scott POWER

T +61 7 3334 4884
E scott.power@morgans.com.au

Share price info

Share price perf. (%)	1M	3M	12M
Absolute	22%	49%	105%
Major shareholders	% held		
TDM Asset Management	8.1		
Australian Ethical Investments Ltd	5.6		

Sleeping easy

SOM is a designer and manufacturer of a premium range of oral appliances for the treatment of sleep related breathing disorders such as sleep apnoea and sleep bruxism. SOM is a global leader in COAT (Continuous Open Airway Therapy) products and has recently embarked on a rapid expansion of its sales business in Europe and the US while increasing its product offerings. We initiate with an ADD recommendation and a DCF valuation and price target of A\$2.97.

A play on the dollar

With more than 90% of SOM's sales originating from Europe and the US, SOM is leveraged to currency movements. Past sales have been hampered by an increasing AUD but the declining AUD will benefit SOM, investors should see higher average prices paid (in A\$) flow through the revenue figures.

US market penetration

Although different countries adopt COAT™ technology at varying rates, it appears that once established, the share of patients has usually settled around a 50/50 COAT to CPAP in mature and fully reimbursed markets. Where we see significant opportunity is in the US where COAT is in relative infancy at only 5% market penetration. Being SOM's largest addressable market and currently holding around 50% of sales in the US COAT market, the fragmentation of the US market will provide significant upside to sales.

The US market is predicted to grow from 180,000-200,000 patients fitted with custom made oral appliances in 2013 to over 1 million patients in 2020. The quadrupling of the addressable market and the potential for a taking a bigger piece of the pie provides significant upside.

Investment View - ADD

We initiate with an ADD recommendation and a price target and valuation of A\$2.97 which provides 17.8% upside to the current share price. SOM has had huge success over the last year in entering new and growing existing markets and we expect SOM to continue expanding its European footprint and expanding the US distribution and service networks through a beefed up medical sales team.

12 month price performance



Figure 1: Financial Summary

	FY12A	FY13A	FY14A	FY15F	FY16F
Revenue	15.2	18.5	25.9	32.3	38.8
Revenue growth		21%	40%	25%	20%
EBITDA	0.8	0.7	0.9	3.5	6.0
EBITDA growth		-13%	31%	283%	69%
NPAT	0.4	0.5	0.4	2.8	5.3
NPAT growth		25%	-21%	641%	86%
EPS (c)	0.8	1.0	0.8	5.8	10.7
PE Ratio (x)	260.9	209.0	271.2	36.6	19.6
DPS (c)	0.0	0.0	0.0	0.0	0.0
Yield	0.0%	0.0%	0.0%	0.0%	0.0%
EV/EBITDA	120.5	138.2	113.0	26.7	14.8

SOURCE: MORGANS, COMPANY REPORTS

Sleeping Easy

1. COMPANY OVERVIEW

SomnoMed Limited (SOM) is a designer and manufacturer of a premium range of oral appliances for the treatment of sleep related breathing disorders such as sleep apnoea and sleep bruxism. SOM listed on the ASX in July 2004, headquartered in Sydney. SOM has a growing presence in three key markets being Asia-Pacific, North America and Europe through product positioning with dentists, sleep specialists and third party agents. To date, 190,000 patients have used one of SOM's products.

Figure 2: SomnoDent G2



2. INVESTMENT VIEW

We initiate coverage with an ADD recommendation. We have valued SOM as A\$2.97 using a DCF methodology. Our price target has been set at the same level.

2.1 Key strengths ▶

- **Increasing confidence in efficacy of COAT** – Because of the comfort and unobtrusiveness of COAT, there is a high level of compliance which has been a growing issue for physicians, patients and insurers in regards to the CPAP system. The higher compliance rate and lower cost will help COAT increase market share.
- **US market well below established COAT market penetration** – Newly established markets for CPAP (Continued Open Airway Therapy) have been found to settle around the 50/50 COAT to CPAP once established and fully reimbursed. COAT market penetration in the US is currently only around the 5% mark, and we believe there is significant upside potential in this market in the range of 20% penetration by 2020. With about 50% of the market is being supplied by dental laboratories and individual technicians, SOM currently accounts for 11% of the COAT market in the US.
- **Potential for growth** – SOM are increasing their focus on the US market, deploying more sales reps to market the product lines. In Europe, SOM have been rapidly expanding their reach in the last year – entering 9

new countries with another 6 planned by 2015. Currently, SOM have over 4,500 aligned dentists which are educated and trained in the fitting of SomnoDent. The Euro segment grew sales by 40% in FY14, with high uptake in the new markets. Across all segments, SOM achieved full year unit sales of 43,438 units and a growth of 21% over the prior year.

- **Higher compliance rate** – Various studies have reported that compliance rates for COAT systems are over 80% (based on self-reported compliance numbers) while CPAP rates are at or below 50% at 2 years. The higher compliance rate will drive insurers and patients to the more comfortable treatment option of COAT.

2.2 Key risks ▶

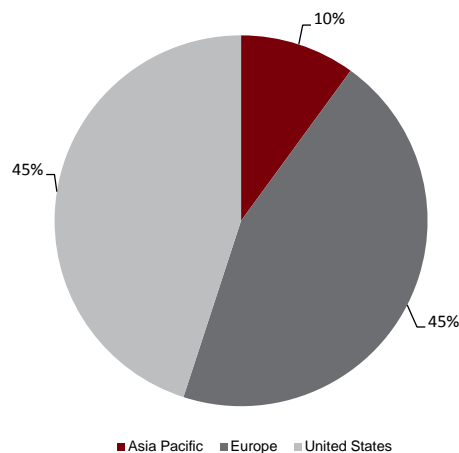
- **FX risks** – Rate impacts exists with around 90% of SOM's revenue coming from outside of Australia (Europe comprising ~45% and North America ~45%). Currently, we hold the view that this as a positive as we believe the Australian dollar will weaken over the next one to two years against the USD, increasing AUD revenue.
- **Expansion risks** – Given SOM's intention to further expand their European markets as well as increase its US footprint, additional funding either through debt/equity markets may be required. This is a small risk as SOM has managed to expand into these new markets over the last few years.
- **Substitution risks** – Alternative products exist in the sleep apnoea and bruxism arena such as CPAP, Herbst devices (cottage industry dentists) and nasal alternatives. The costs of the most viable alternative (CPAP) are much higher than COAT devices and are more obtrusive so we would expect to see a higher growth rate of COAT versus CPAP, especially in the US as confidence increases in these systems.
- **Reimbursement risks** – There are reimbursement risks associated with all medical therapies whereby insurance companies/government partially or fully subsidise the patients for the use of the product. Insurers are increasingly reimbursing COAT at various rates but often struggle to lock in a price for the dental service component.

2.3 Growth outlook ▶

SOM is focussed on:

- Growing its sales team in North America;
- Expanding its European footprint; and
- Improving the product lines and complementary products.

Figure 3: Sales Revenue by Geography



SOURCES: COMPANY REPORTS

3. INDUSTRY OVERVIEW

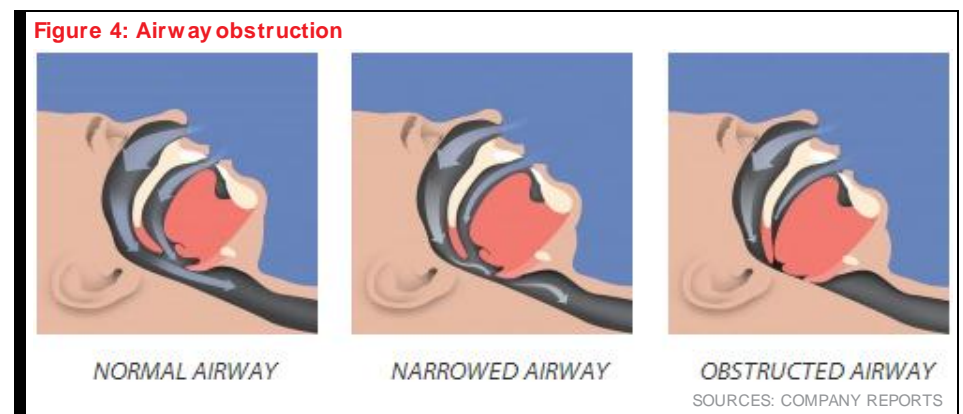
3.1 What is Obstructive Sleep Apnoea (OSA)?

Obstructive Sleep Apnoea (OSA) is a serious and lifelong medical condition where the incidence increases as we get older. OSA is a condition that can affect your sleep, health and quality of life. The condition is characterised by cessation of breathing or pauses in breathing due to the blockage or obstruction of the airways during sleep. It has been linked to hypertension, diabetes, heart disease, work and driving related accidents and stroke.

Obstructive Sleep Apnoea (OSA) is the most common type of sleep apnoea; around 84% of people with sleep apnoea are diagnosed with the disease. Studies suggest that about 100 million people worldwide are suspected to have obstructive sleep apnoea, of which more than 80% remain undiagnosed. Sleep apnoea is a relatively new market in the medical field, gaining momentum at a fast pace, especially in developed geographies. The demand for sleep apnoea devices is expected to increase at a faster pace, owing to gradually increasing awareness among both patients and the medical fraternity.

3.2 What causes OSA?

During sleep, muscles relax, including those that control the tongue and throat. The soft tissue at the back of throat can sag, narrowing and constricting the airway.



3.3 Market Growth

The global sleep apnoea market was valued at \$7.96bn in 2011 and is expected to reach \$19.72bn by 2017 representing a 14% compound annual growth rate (CAGR). North America was the largest market, followed by Europe and Asia. The Asian region's contribution (~13.5%) to the global sleep apnoea device market is expected to increase in the coming years among care givers and patients as the region shifts from curative medicine to wellness and prevention.

3.4 Products

Worn during sleep, continuous open airway therapy (COAT) is a first line therapeutic treatment option for people with mild to moderate OSA and consists of devices that have two components which fit over the upper and lower teeth. SOM's products are oral Mandibular Advancement Devices (MAD) which treats OSA by stabilizing and / or moving the lower jaw slightly forward. This optimal position of the jaw prevents the patient's airway from collapsing during sleep. The biggest advantage of the COAT devices is the high compliance rate due to the unobtrusive nature of the product.

SOM have six main productlines:

- **Fusion** – A combination flagship device that blends the best of a modular system, extended forward titration and SMH BFlex soft inner lining. Expected to be the sales volume leader.
- **G2**– Features easy and a most accurate calibration system of removable modular parts that is metal-free and easy to wear, clean and adjust.
- **Flex** – Made with unique SMH BFlex material, the SomnoDent Flex has a soft inner liner which maintains superior retention and offers premium patient comfort
- **Classic** – The original innovation in custom made oral devices, the SomnoDent Classic uses medical grade stainless steel ball clasps to enhance retention
- **Herbst Advanced** – A superior version of the industry standard with a unique titration mechanism

Figure 1: SOM product lines



3.5 Alternative Products

Alternative treatments for the condition include breathing devices such as Continuous Positive Airway Pressure (CPAP) to keep the airway open during sleep or surgery to expand the airway. CPAP is a medical device used to treat patients during sleep and currently commands around 70% of the market. The user wears a face mask connected to a compressor that blows air into the airway at pressures high enough to overcome obstructions and stimulate normal breathing. The airway pressure delivered into the upper airway is continuous during both inspiration and expiration. In addition to the CPAP devices, the industry also includes the accessories like facial interfaces and humidifiers. Prices ranges (before reimbursement) for most CPAP machines are A\$1,000-\$2,500 and supplies (mask, tubes and filters) run between A\$300-\$800.a.

Figure 2: CPAP users have comparatively low compliance rates



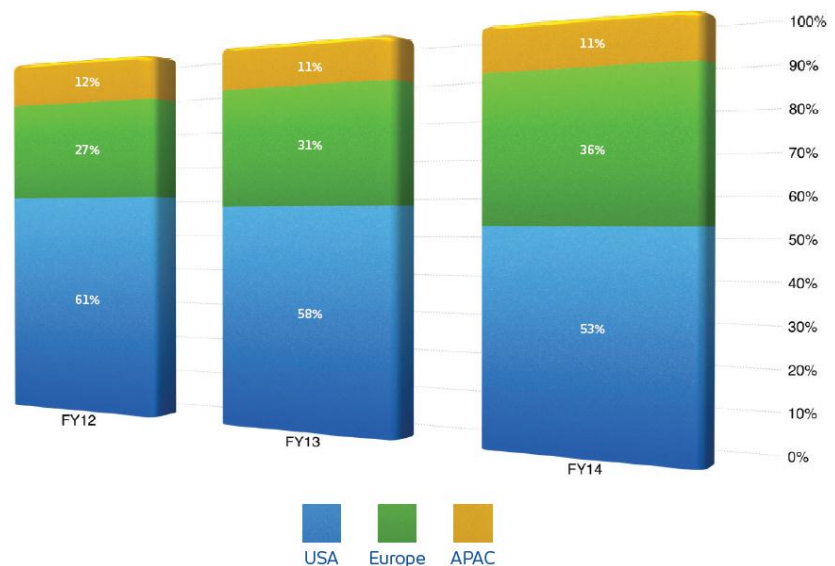
SOURCES: MORGANS

4. FINANCIAL SUMMARY

4.1 FY14 results show strong growth

- Revenue was up 39.5% to A\$25.9m – driven by new markets and increasing market share. Contributing at a faster rate are the new European markets, increasing the European contribution to 36% of revenues from 31% on pcp. If we review revenue growth since 2009, we note a compound growth rate of 36% in units sold and 39% in A\$ revenue.
- EBITDA grew by 26.5% to A\$1.05m after expensing investments made during the year in the build-up of the US medical departments, acquisitions of European businesses and costs associated with the entry into new markets in Europe and Asia.
- Product gross margin was 67% despite being affected by additional production and service costs.
- NPAT decreased to A\$0.214m from A\$0.704m representing a 70% decline on pcp. This was predominately due to costs associated with recent corporate activity, expenses incurred opening new markets in Europe, and a reduced deferred tax adjustment rather than a reflection of business activity.
- SOM had \$2.9m of cash reserves as at 30 June 2014. SOM has since raised \$7m through a placement and currently has cash reserves over \$9m. There was no debt.
- Net operating cash flow was (\$0.8m) in FY14 compared with \$0.6m in the previous year and reflects continued investment in new products and geographies.

Figure 3: Shares of units sold by global region



SOURCES: COMPANY REPORTS

4.2 Outlook for FY15

After investing ~A\$2m in FY14 to increase SOM's medical sales force in the US, the medical division is on track to break even in FY15. New European market entrants are also expected to breakeven by 2H15. Gross margin is expected to be maintained in the high sixty percent range due to economies of scale and stable corporate overheads. Unit sales are expected to grow by 26.5% to 55,000 units due to increasing product demand and awareness, a widening product line and geographical expansion while revenue is expected to grow by 25% to A\$32.5m.

Figure 4: FY15 outlook

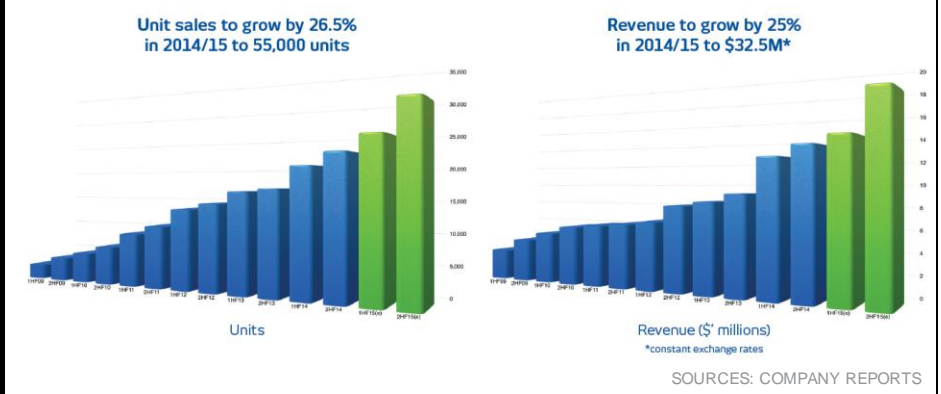


Figure 5: Target markets

Established Markets Entry 2004 - 2008	Emerging Markets Entry 2009 - 2013	New Markets Entry 2014 - 2015
Asia-Pacific	Asia-Pacific	Asia-Pacific
Australia	New Zealand (2009) Japan (2009) Singapore (2010)* Malaysia (2010)* Indonesia (2010)* Korea (2010)* Israel (2010)*	Korea (2014)
North America	North America	North America
USA Canada		
Europe	Europe	Europe
Sweden* Germany* Holland* Italy* Switzerland*	Holland (2012) France (2013) Sweden (2013) Germany (2013) Austria (2013) Norway (2013) Belgium (2013) Luxembourg (2013) Russia (2013) Denmark (2013)	Finland (2014) United Kingdom (2014) Republic of Ireland (2014) Spain (2014) Portugal (2014) Italy (2014)

*Third party agent

SOURCES: COMPANY REPORTS

5. BOARD AND SHAREHOLDER BASE

5.1 Board

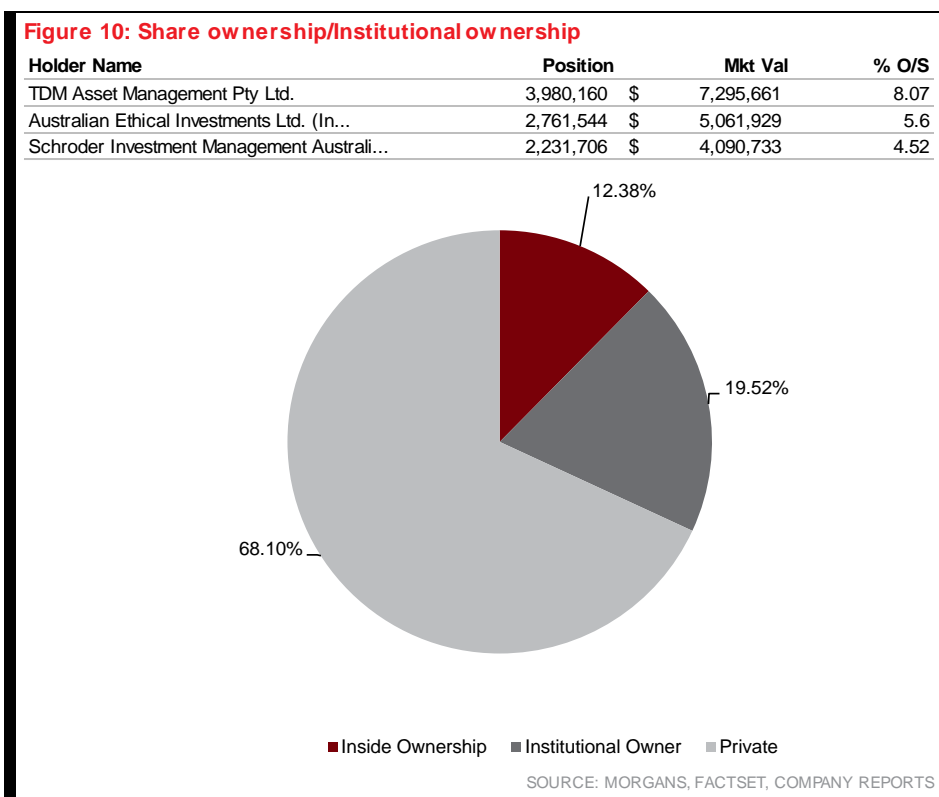
Figure 6: BOARD OF DIRECTORS

Name, Role	Description
Dr. Peter Neustadt – Executive Chairman and CEO, SomnoMed, Ltd.	Dr. Neustadt is a management consultant and entrepreneur with more than thirty years' experience in building and improving public companies within the hospitality, media, property and finance sectors. He has previously worked for the global management consulting firm, McKinsey & Company and was an executive board member of Kerry Packer's Consolidated Press Holdings (CPH).
Dr. Neustadt served on a number of public and private company boards including Cypress Lakes Group Limited, The Golden Door, CEL Limited, Network TEN, Advance Bank Limited, Trafalgar and Manboom Limited.	
Mr. Neil Verdal-Austin – Chief Financial Officer	Mr. Verdal-Austin has more than twenty years' experience as CFO for various medical distribution and manufacturing companies where medical devices and making a difference in people's lives, have become his passion. His experience includes systems development and implementation, business acquisitions, strategic planning, reporting and operations management. Prior to his current role at SomnoMed, Neil worked at Lifehealthcare, the largest Australian healthcare distributor of medical products and devices.
Before Lifehealthcare, he was CFO and a key stakeholder at the Orthomedics Group, a large medical distributor in South Africa. During that appointment, he was a key figure in the leadership team and instrumental in all commercial aspects of that business, its processes, acquisitions, financial performance and operational excellence. Neil completed his studies at the University of Cape Town, South Africa and is a Chartered Accountant (Australia).	
Terence A Flitcroft – Company Secretary	Mr. Flitcroft has been a Director of the company from 1995 until May 2003. He is a Chartered Accountant with broad commercial and financial experience and has acted as a director and company secretary for a number of private and public companies.
Lee Ausburn – Non-Executive Director, M.Pharm., B.Pharm., Dip.Hosp.Pharm. (University of Sydney)	Terry provides company secretarial and accounting services to the Company on a contract basis. He is a Director of Winchester Associates Pty Limited, a licensed investment advisor. Lee has had a long career in the health industry, beginning as a pharmacist before joining Merck and Co. Inc., a global pharmaceutical company. During this period, she progressed through a range of roles, beginning in marketing before becoming responsible for reimbursement and pricing of Merck products in Australia.
She is a non-executive director of Australian Pharmaceutical Industries (API) Ltd, which distributes pharmaceuticals to pharmacies across Australia. API also has retail pharmacy operations through Priceline stores.	
Robert Scherini – Non-Executive Director	Rob is a past Managing Director for Johnson & Johnson Medical Australia/NZ and has held senior management positions both locally and internationally. He was posted for a number of years in J&J international headquarter in Brussels before returning to Australia where he was directly responsible for J&J's medical device business in the APAC region. He has a strong track record of growing businesses and brings to the Board a wealth of experience in Sales & Marketing, Business Development, Finance, Operations and Supply, Legal, Human Resources and Information Technology.
Rob has a bachelor degree in Business and is a Certified Practising Accountant (CPA). He was a Member of the Board of the Medical Technology Association of Australia (MTAA) for nine years. He has been a strong advocate of Human Resources Strategy and was recognised as Best HR Champion at the 2004 Australian HR Awards. In 2007 was awarded a Rotary International Fellowship for his assistance to the community.	

SOURCES: COMPANY REPORTS

5.2 Substantial shareholders

As can be seen from Figure 10, insiders own 12.4% with CEO Peter Neustadt owning 7% of outstanding shares. There are a number of major institutional shareholders on the register as Figure 10 shows.



6. VALUATION AND RECOMMENDATION

6.1 Valuation

We have valued SOM at A\$2.97 using a DCF valuation methodology. To derive our DCF of A\$2.97 we have assumed a weighted average cost of capital of 12.5%, long term EBITDA growth rate of 28% until 2024 and a terminal growth of 8 times. Other assumptions are: SomnoDent unit sale price of A\$596, COGS margin of 35% and operating costs increase of 10% YoY. For more detail, refer to table 1 below.

Table 1: Key Drivers

Drivers	FY12A	FY13A	FY14A	FY15F	FY16F
SomnoDent					
Av sold p.a.			43400	54250	65100
Ave \$ per unit			596	596	596
SomnoDent revenue \$Am			26	32	39
Total Revenue A\$m			26	32	39

SOURCES: MORGANS, COMPANY REPORTS

6.2 Forecasts and Sensitivities

The key assumptions driving our forecasts are contained in Table 1. Our model is most sensitive to a change in the long term growth rate; a 1% increase/decrease impacts our DCF valuation by \$0.14/(\$0.14) respectively. Our COGS rate is currently set at 35% of revenue based on an evaluation of FY12-14 gross margins which ranged from 32%-35%. The sensitivity to a 1% increase/decrease impacts our valuation by \$0.16/(\$0.16) respectively.

QUEENSLAND

BRISBANE - HEAD OFFICE	(07) 3334 4888
BRISBANE - EDWARD STREET	(07) 3121 5677
BRISBANE - TYNAN PARTNERS	(07) 3152 0600
BUNDABERG	(07) 4153 1050
CAIRNS	(07) 4222 0555
CALOUNDRA	(07) 5491 5422
EMERALD	(07) 4988 2777
GLADSTONE	(07) 4972 8000
GOLD COAST	(07) 5581 5777
IPSWICH/SPRINGFIELD	(07) 3202 3995
KEDRON	(07) 3350 9000
MACKAY	(07) 4957 3033
MILTON	(07) 3114 8600
MT GRAVATT/CAPALABA	(07) 3245 5466
NOOSA	(07) 5449 9511
REDCLIFFE	(07) 3897 3999
ROCKHAMPTON	(07) 4922 5855
SPRING HILL	(07) 3833 9333
SUNSHINE COAST	(07) 5479 2757
TOOWOOMBA	(07) 4639 1277
TOWNSVILLE	(07) 4725 5787
YEPPON	(07) 4939 3021

NEW SOUTH WALES

SYDNEY	(02) 8215 5055
ARMIDALE	(02) 6770 3300
BALLINA	(02) 6686 4144
BALMAIN	(02) 8755 3333
CHATSWOOD	(02) 8116 1700
COFFS HARBOUR	(02) 6651 5700
GOSFORD	(02) 4325 0884
HURSTVILLE	(02) 9570 5755
MERIMBULA	(02) 6495 2869
NEUTRAL BAY	(02) 8969 7500
NEWCASTLE	(02) 4926 4044
NEWPORT	(02) 9998 4200

DISCLAIMER

The information contained in this report is provided to you by Morgans Financial Limited as general advice only, and is made without consideration of an individual's relevant personal circumstances. Morgans Financial Limited ABN 49 010 669 726, its related bodies corporate, directors and officers, employees, authorised representatives and agents ("Morgans") do not accept any liability for any loss or damage arising from or in connection with any action taken or not taken on the basis of information contained in this report, or for any errors or omissions contained within. It is recommended that any persons who wish to act upon this report consult with their Morgans investment adviser before doing so. Those acting upon such information without advice do so entirely at their own risk.

This report was prepared as private communication to clients of Morgans and is not intended for public circulation, publication or for use by any third party. The contents of this report may not be reproduced in whole or in part without the prior written consent of Morgans. While this report is based on information from sources which Morgans believes are reliable, its accuracy and completeness cannot be guaranteed. Any opinions expressed reflect Morgans judgement at this date and are subject to change. Morgans is under no obligation to provide revised assessments in the event of changed circumstances. This report does not constitute an offer or invitation to purchase any securities and should not be relied upon in connection with any contract or commitment whatsoever.

Although CIMB Securities (Australia) Ltd (ABN 84 002 768 701), its related bodies corporate, directors and officers, employees, authorised representatives and agents ("CIMB Securities Australia") may have been involved in the preparation of certain content for this Research Report, this Research Report constitutes general advice provided by Morgans to the recipient of this report under its Australian financial services licence and Morgans is solely responsible for the content of this report. CIMB Securities Australia do not accept any liability for any loss or damage arising from or in connection with any action taken or not taken on the basis of information contained in this report, or for any errors or omissions contained within.

DISCLOSURE OF INTEREST

Morgans and CIMB Securities Australia may from time to time hold an interest in any security referred to in this report and may, as principal or agent, sell such interests. Morgans or CIMB Securities Australia may previously have acted as manager or co-manager of a public offering of any such securities. Morgans' affiliates or CIMB Securities Australia affiliates may provide or have provided banking services or corporate finance to the companies referred to in the report. The knowledge of affiliates concerning such services may not be reflected in this report. Each of Morgans and CIMB Securities Australia advises that it may earn brokerage, commissions, fees or other benefits and advantages, direct or indirect, in connection with the making of a recommendation or a dealing by a client in these securities. Some or all of Morgans' Authorised Representatives may be remunerated wholly or partly by way of commission.

REGULATORY DISCLOSURES

The preparation of this report was funded by ASX in accordance with the ASX Equity Research Scheme. This report was generated by Morgans and not by ASX. ASX does not provide financial product advice. The views expressed in this report do not necessarily reflect the views of ASX. No responsibility or liability is accepted by ASX in relation to this report.

RECOMMENDATION STRUCTURE

For a full explanation of the recommendation structure, refer to our website at https://www.morgans.com.au/research_disclaimer.

If you no longer wish to receive Morgans' publications please advise your local Morgans office or write to Morgans, Reply Paid 202, Brisbane QLD 4001 and include your account details.

ORANGE	(02) 6361 9166
PORT MACQUARIE	(02) 6583 1735
SCONE	(02) 6544 3144
SYDNEY – LEVEL 7 CURRENCY HOUSE	(02) 8216 5111
SYDNEY – LEVEL 9	(02) 8215 5000
SYDNEY – HUNTER STREET	(02) 9125 1788
	(02) 9615 4500
SYDNEY – REYNOLDS EQUITIES	(02) 9373 4452
WOLLONGONG	(02) 4227 3022

ACT

CANBERRA	(02) 6232 4999
----------	----------------

VICTORIA

MELBOURNE	(03) 9947 4111
BRIGHTON	(03) 9519 3555
CAMBERWELL	(03) 9813 2945
CARLTON	(03) 9066 3200
FARRER HOUSE	(03) 8644 5488
GEELONG	(03) 5222 5128
RICHMOND	(03) 9916 4000
SOUTH YARRA	(03) 9098 8511
TRARALGON	(03) 5176 6055
WARRNAMBOOL	(03) 5559 1500

WESTERN AUSTRALIA

PERTH	(08) 6462 1999
-------	----------------

SOUTH AUSTRALIA

ADELAIDE	(08) 8464 5000
NORWOOD	(08) 8461 2800

NORTHERN TERRITORY

DARWIN	(08) 8981 9555
--------	----------------

TASMANIA

HOBART	(03) 6236 9000
--------	----------------