



BUY

HOLD

SELL

ACTION & RECOMMENDATION

SomnoMed has provided its Q2 update and continues to execute well, reporting new sales records in its major markets. Unit sales grew 22% in Q2 to 13,575 devices (2H guidance was maintained at 30,000). The operating profit guidance was low-ended, but was consistent with the previous outlook of \$2-4m EBITDA. Product launches and the cost of entering and building new markets will weigh on the 1H profit, which we expect to be announced on 18 February. These footprint-extending activities enhance the company's strategic value in compelling ways. We have revised our PT to \$3.06 but kept the rating at a HOLD. The 2H guidance does look ambitious, so there may be better-value entry points over the next six months.

2QFY15 – undeniable strategic value in the sleep market

What's Changed

- **13,575 unit sales in Q2 and maintains 2H volume guidance** – Q2 volumes were slightly below our forecast (WHTMe: 13,800) but up 22% on pcp. SomnoMed still expects to sell 30,000 devices in 2H, which is what we have forecast.
- **Records broken in all regions** – USA unit sales grew >30% against a softish (~10%) comp; Europe also impressive with 19% sales growth, cycling a very steep (+55%) comparable period. A new record for Europe was set in Q2, despite five new markets being opened in the period.
- **Revenue and earnings guidance** – SomnoMed expects ~\$32.5m revenue in FY15, which compares well with our forecast of \$32.7m (unchanged). The company also updated its earnings guidance, with EBITDA expected to be towards the low end of the \$2-4m range previously specified. We have reduced our EBITDA forecasts by ~\$2m per annum over the FY15-17e forecast period to account for additional SG&A investments in product launches and new market initiations.
- **Valuation** – we have upgraded our DCF in two ways: a) reducing the discount rate by 100 bps to 12% (appropriate given progress and proximity to genuine profit growth); and b) increased our long-term margin assumptions. Previous estimates were probably too conservative when set alongside mature, international medical device groups.
- **Price target** – new price target of \$3.06. HOLD maintained.

Risks & Catalysts

- **Catalysts:** US managed care groups implementing SomnoDent in their treatment models for sleep apnoea, continuing global volume growth, further acquisitions and capacity expansion. **Risks:** Execution on US medical strategy, competitive factors, adverse reimbursement outcomes, capacity to finance and supply growth.

12m Target Price (AUD)	\$3.06
Share Price @ 28-Jan-15 (AUD)	\$2.90
Fcst 12m Capital Return	5.6%
Fcst 12m Dividend Yield	0.0%
12m Total S'holder Return	5.6%

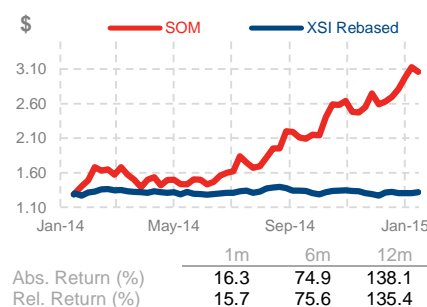
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12m Share Price Performance



WHTM Return Re-Investment Matrix

Return	High	Cash Generator	Champion
	Low	Challenged	Potential
		Low	High
		Re-Investment	

WHTM Risk Assessment

	Low	Med	High	Spec
Share Price Risk				
Business Risk				

Year-End June (AUD)	FY13A	FY14A	FY15E	FY16E	FY17E
NPAT Rep (\$m)	0.7	0.2	0.2	3.2	6.3
NPAT Norm (\$m)	0.7	0.2	0.2	3.2	6.3
Consensus NPAT (\$m)			2.5	5.0	8.5
EPS Norm (cps)	1.6	0.5	0.5	6.6	13.2
EPS Growth (%)	-2	-68	6	1163	99
P/E Norm (x)	184.4	584.0	553.3	43.8	22.0
EV/EBITDA (x)	202.2	178.5	75.3	30.3	19.4
FCF Yield (%)	0.3	-0.3	-1.0	-0.1	3.6
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, WHTM estimates, S&P Capital IQ

Key Changes	17-Oct	After	Var %
NPAT: FY15	2.1	0.2	N/A
Norm FY16	4.6	3.2	-30.4%
(\$m) FY17	7.6	6.3	-17.1%
EPS: FY15	4.4	0.5	N/A
Norm FY16	9.5	6.6	-30.5%
(cps) FY17	15.8	13.2	-16.5%
DPS: FY15	0.0	0.0	0.0%
(cps) FY16	0.0	0.0	0.0%
FY17	0.0	0.0	0.0%
Price Target:	2.73	3.06	12.4%
Rec:	HOLD	HOLD	

Mkt Cap: \$147m Enterprise Value: \$150m Shares: 51m Sold Short: 0.0 ASX 300 Wgt: n/a Median T'over/Day: \$0.1m



PRICE TARGET

	Valuation	Price Target
WACC (%)	12	
Terminal growth (%)	3	
NPV Forecast FCF	54	
NPV Perpetuity (A\$M)	89	
Net Debt / (Cash) (A\$M)	8	
DCF Valuation (A\$M)	152	

Price target (A\$/sh) **3.06**

INTERIMS (\$m)

Half-yr (AUD)	Dec 13	Jun 14	Dec 14	Jun 15
	1HA	2HA	1HE	2HE
Sales	12.6	13.3	14.4	18.3
EBITDA	0.6	0.2	-0.3	2.3
EBIT	0.4	-0.1	-0.7	2.0
Net Profit	0.0	0.2	-1.2	1.4
Norm. EPS	0.0	0.5	-2.6	2.9
EBIT/Sales	2.8	-1.0	-4.7	10.8
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)	FY14A	FY15E	FY16E
Net Debt	-2.9	-8.2	-7.8
Net Debt / Equity (%)	<0	<0	<0
Net Debt / EV (%)	<0	<0	<0
Current Ratio (x)	4.0	4.0	3.9
Interest Cover (x)	<0	<0	<0
Adj. Cash Int. Cover (x)	>99	7.2	<0
Debt / CashFlow (x)	0.0	0.0	0.0
Net Debt (cash) / share (\$)	<0	<0	<0
NTA / share (\$)	0.2	0.3	0.3
Book Value / share (\$)	0.3	0.4	0.5
Payout Ratio (%)	0	0	0
Adj. Payout Ratio (%)	0	0	0

EPS RECONCILIATION (\$m)

	FY14A		FY15E	
	Rep.	Norm	Rep.	Norm
Sales	26	26	33	33
EBIT	0.2	0.2	1.3	1.3
Net Profit	0.2	0.2	0.2	0.2
Notional Earn.	0.0	0.0	0.0	0.0
Pref./Conv. Div.	0.0	0.0	0.0	0.0
Profit for EPS	0.2	0.2	0.2	0.2
Diluted	43	43	47	47
Diluted EPS (c)	0.5	0.5	0.5	0.5

RETURNS

	FY14A	FY15E	FY16E	FY17E
ROE (%)	1.8	1.5	14.8	24.2
ROIC (%)	1.9	8.5	21.8	30.4
Incremental ROE	-29.2	0.7	56.2	66.4
Incremental ROIC	-0.3	35.2	72.5	77.1

KEY ASSUMPTIONS

Year-end June (AUD)	FY10A	FY11A	FY12A	FY13A	FY14A	FY15E	FY16E	FY17E
Revenue Growth (%)	38.5	15.1	23.6	21.3	40.1	26.2	23.8	19.5
EBIT Growth (%)	-103.9	720.1	-15.5	-55.4	-3.2	460.2	223.4	65.0
NPAT Growth (%)	-148.3	-4.9	-4.7	-7.2	-69.5	14.1	1,194.3	99.4
EPS Growth (%)	-146.3	-13.1	-11.8	-2.0	-68.4	5.5	1,162.6	99.4
EBIT / Sales (%)	0.7	5.1	3.5	1.3	0.9	4.0	10.3	14.3
Tax Rate (%)	-586.9	-10.7	-18.8	-123.7	-6.7	81.8	25.7	9.6
ROA (%)	1.1	7.8	4.4	1.5	1.2	4.5	11.7	16.7
ROE (%)	17.0	13.5	8.7	6.4	1.7	1.3	12.8	21.8

PROFIT & LOSS (\$m)

Year-end June (AUD)	FY10A	FY11A	FY12A	FY13A	FY14A	FY15E	FY16E	FY17E
Sales Revenue	10.7	12.3	15.2	18.5	25.9	32.7	40.4	48.3
EBITDA	0.2	0.8	0.9	0.7	0.8	2.0	5.0	7.8
Deprn & Amort	0.2	0.2	0.4	0.5	0.6	0.7	0.8	0.9
EBIT	0.0	0.6	0.5	0.2	0.2	1.3	4.2	6.9
Net Interest Expense	-0.1	-0.1	-0.1	-0.1	0.0	-0.1	-0.1	-0.1
Tax	-0.7	-0.1	-0.1	-0.4	0.0	1.1	1.1	0.7
Minorities / pref divs	0.0	0.0	0.0	0.0	0.0	0.0	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	0.8	0.7	0.7	0.7	0.2	0.2	3.2	6.3
Abn's / Ext's / Signif.	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Reported Net Profit	0.8	0.7	0.7	0.7	0.2	0.2	3.2	6.3

CASH FLOW (\$m)

Year-end June (AUD)	FY10A	FY11A	FY12A	FY13A	FY14A	FY15E	FY16E	FY17E
EBITDA	0.2	0.8	0.9	0.7	0.8	2.0	5.0	7.8
Interest & Tax	0.1	0.1	0.1	0.0	-0.5	-1.0	-1.0	-0.6
Working Cap / Other	0.2	-1.2	-0.7	-0.2	-1.1	-0.4	-0.6	-0.7
Operating Cash Flow	0.5	-0.3	0.3	0.6	-0.8	0.5	3.3	6.5
Maintenance Capex	-0.5	-0.3	-0.2	-0.2	0.3	-2.0	-3.5	-1.2
Free Cash Flow	-0.1	-0.6	0.1	0.4	-0.5	-1.4	-0.2	5.3
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	0.0	-0.1	-0.3	-0.5	-0.3	-0.3	-0.3	-0.3
Other Inv. Flows	0.0	0.2	-0.3	-0.1	-0.4	0.0	0.0	0.0
Cash Flow Pre Financing	-0.1	-0.5	-0.5	-0.2	-1.2	-1.7	-0.4	5.0
Funded by Equity	0.4	0.3	0.1	0.5	0.0	7.0	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	-0.4	0.2	0.3	-0.3	1.2	-5.3	0.4	-5.0

BALANCE SHEET SUMMARY (\$m)

Year-end June (AUD)	FY10A	FY11A	FY12A	FY13A	FY14A	FY15E	FY16E	FY17E
Cash	4.3	3.9	3.5	4.2	2.9	8.2	7.8	12.8
Current Receivables	1.6	2.2	3.7	4.4	5.5	7.4	9.0	10.7
Current Inventories	0.2	0.2	0.5	0.9	1.0	1.8	2.2	2.7
Net PPE	0.6	1.1	1.1	1.2	1.3	2.3	4.5	4.7
Investments	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Intangibles / Capitalised	1.0	1.2	2.7	5.3	8.5	9.1	9.8	10.3
Other	0.1	0.1	0.5	0.2	0.0	0.0	0.0	0.0
Total Assets	7.8	8.7	12.0	16.1	19.1	28.8	33.3	41.2
Current Payables	1.9	2.2	2.4	3.5	3.3	5.5	6.7	8.1
Total Debt	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other Liabilities	0.3	0.3	0.4	1.0	3.2	3.4	3.6	3.9
Total Liabilities	2.2	2.5	2.8	4.5	6.6	9.0	10.4	11.9
Minorities / Convertibles	0.0	0.0	0.5	0.6	0.2	0.2	0.2	0.2
Shareholder Equity	5.7	6.2	9.2	11.6	12.6	19.8	23.0	29.3
Total Funds Employed	5.7	6.2	9.2	11.6	12.6	19.8	23.0	29.3



SomnoMed Limited – Q2FY15 update

TABLE 1: Q2 RESULTS AND FULL-YEAR EXPECTATIONS

	FY13	1QFY14	2QFY14	3QFY14	4QFY14	FY14	1QFY15	2QFY15	3QFY15E	4QFY15E	FY15E	FY16E	FY17E
Unit Sales	35,841	9,309	11,146	11,010	11,973	43,438	11,200	13,575	14,225	15,775	54,775	65,165	74,939
- pcp growth	16.0%	13.1%	23.6%	28.3%	19.6%	21.2%	20.3%	21.8%	29.2%	31.8%	26.1%	19.0%	15.0%
Sales revenue (A\$m)	18.5	5.7	6.9	6.5	6.8	25.9	6.8	8.0	8.3	9.6	32.7	40.4	48.3
COGS (A\$m)	6.2	1.9	2.6	2.1	2.5	9.1	2.2	2.6	2.7	3.2	10.8	13.3	15.9
Gross profit (A\$m)	12.3	3.8	4.3	4.4	4.3	16.8	4.6	5.4	5.6	6.4	21.9	27.1	32.4
- gross margin	66.4%	67.0%	62.9%	67.0%	63.2%	64.9%	67.0%	67.0%	67.0%	67.0%	67.0%	67.0%	67.0%
Opex (A\$m)	11.5					16.0					19.9	22.1	24.6
EBITDA (A\$m)	0.7		0.6		0.2	0.8	-	0.3		2.3	2.0	5.0	7.8
Net income HY (A\$m)	0.7		0.0		0.2	0.2	-	1.2		1.4	0.2	3.2	6.3
EPS (cps)	1.6		0.0		0.5	0.5	-	2.6		2.9	0.5	6.6	13.2

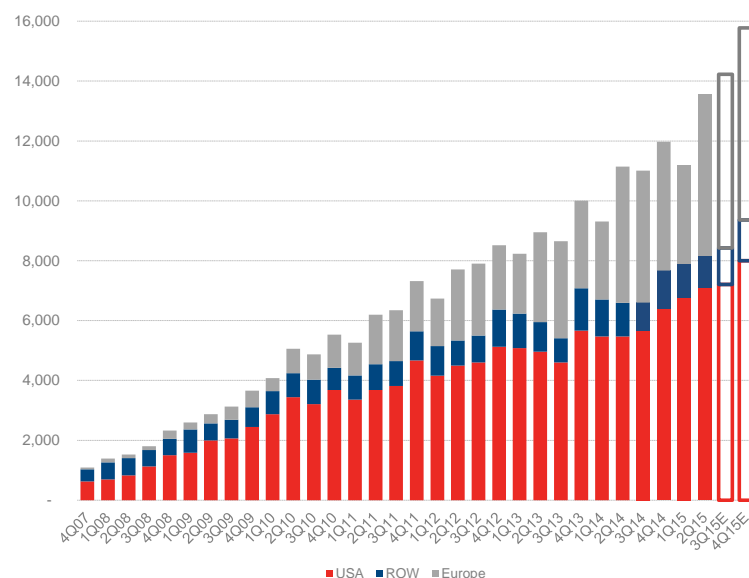
Source: SomnoMed, WHTM Research

GUIDANCE AND CHANGES TO FORECASTS

SomnoMed made modifications to its FY15 guidance, described below:

- **Volumes** – SomnoMed maintained its 2H sales guidance at 30,000 devices, despite there having been a small shortfall in 1H (225 devices or less than 1%). We thought the volumes in Q1 impressive, with both the US and European segments setting new records.

FIGURE 1: QUARTERLY UNIT SALES BY REGION, FY08-15E



Growth acceleration in USA

European performance in Q2 was actually a record – beating the previous record (Q2/14) by 19%

Source: WHTM Research

- **Revenue** – SomnoMed expects revenue of ~\$32.5m full year, which compares well with our forecast of \$32.7m. Sales of \$14.8m in 1H had a currency tailwind of ~1%. The 2H stands to see a 12% tailwind for US sales at spot (AUD/USD ~0.8), but this could be offset by the Euro, which is ~5% weaker against the AUD than in the pcp. Overall impact ~4-6% favourable for SomnoMed.
- **EBITDA** – guiding FY15 at the lower end of the \$2m to \$4m range, which was set last year. We have taken ~\$2m away from our EBITDA forecasts over the FY15-17e forecast period to reflect increased expenditure in SG&A (market start-up costs, marketing, product launches).
- **Strategic value** – while extending their footprint may reduce near-term earnings, it builds the strategic value of the company.

Continued investments in building "footprint" increases SOM's appeal as a potential M&A target

None of the major CPAP manufacturers (ResMed, Respironics or F&P Healthcare) have recorded much success in entering the oral appliance markets for sleep apnoea treatment. That market is becoming significant now



VALUATION

We set target prices for SomnoMed with reference to a discounted cash flow (DCF) model. The stock has traded at a healthy premium to DCF recently, which we think reflects: a) positive outlook for top-line growth, particularly in the US; b) the outlook for profitability and earnings growth; c) the low AUS/USD; and d) SomnoMed's potential strategic value as a target for M&A. Two modifications to our DCF valuation are appropriate:

- Lower the discount rate to reflect lower commercial risk** – we typically apply discount rates of 14-18% to value life science companies at the more speculative end of our coverage. Over the four years we have covered SomnoMed, our discount rate has been lowered from 14% to 13% as the company has developed sales momentum and mapped out its “medical strategy” in the US market. A further 100 bps reduction to 12% is probably appropriate now, given the company's continued progress, which is likely to launch the business into genuine profitability and growth over the next 3-5 years.
- Reviewed our assumptions about long term profitability** – SomnoMed has expressed a desire to grow its EBITDA margin to ~20% over the next few years. Our long-run forecasting has assumed “mature” EBITDA margins of ~24%, which may prove to be too low. Our long-term gross margin assumption is 67%, which is similar to current levels. This may improve if SomnoMed can incorporate more automation into its device manufacturing and distribution network.

Our initial forecasts of long-term profitability may have been too low, considering the outlook for high and improving gross margins

We selected a group of international medical device companies to assess profitability and valuation multiples (PER, EV/EBITDA).

TABLE 2: PROFITABILITY AMONG INTERNATIONAL MEDICAL DEVICE COS

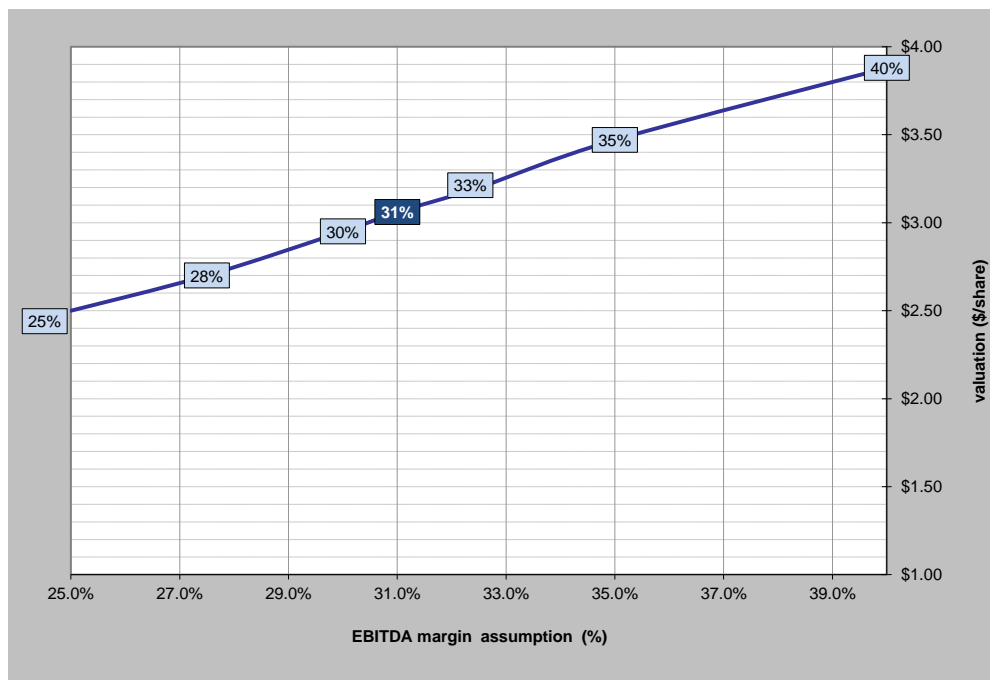
Company	Ticker	Mkt Cap (US\$m)	EBITDA margin	PER	EV/EBITDA
SomnoMed	SOM:AU	157	15.6%	38.7x	30.3x
ResMed Inc	RMD:US	9,366	30.3%	27.0x	19.0x
Medtronic	MDT:US	74,010	34.3%	19.7x	12.0x
F&P Healthcare	FPH:AU	3,968	29.0%	26.6x	15.7x
Cochlear	COH:AU	5,809	26.7%	30.2x	19.8x
Zimmer	ZMH:US	19,826	38.7%	18.6x	9.7x
Stryker	SYK:US	35,013	26.9%	19.6x	12.6x
St Jude	STJ:US	18,867	31.1%	16.4x	12.1x
Johnson & Johnson	JNJ:US	266,237	32.6%	17.5x	11.5x
Edwards Lifesciences	EW:US	13,921	23.8%	32.7x	17.2x
Covidien	COV:US	48,500	28.1%	26.3x	16.7x
CareFusion	CFN:US	12,213	23.9%	29.8x	11.3x
C. R. Bard	BCR:US	13,345	26.8%	38.4x	13.2x
Boston Scientific	BSX:US	19,844	23.8%	51.3x	12.3x
Becton Dickinson	BDX:US	27,750	26.8%	22.5x	12.5x
Abbott Laboratories	ABT:US	66,480	30.8%	19.1x	11.8x
Averages			28.9%	26.4x	13.8x

Source: WHTM Research

SomnoMed's mature cost structure is still years from developing – but our assumption (24% EBITDA margin) is certainly towards the low end when compared with larger medical device companies. Setting our assumption mid-range (31% EBITDA margin) increases our valuation to \$3.06 per share. We provide a sensitivity analysis over the page.



FIGURE 1: VALUATION SENSITIVITY TO LONG-RUN EBITDA ASSUMPTION



Lifting profitability assumptions supports increased DCF valuations

Our long-term assumption lifted from ~24% margin to ~31% margin

Source: WHTM Research

Applying sector multiples as valuation checks – we think SomnoMed’s stock can sustain multiples of at or above those of the more established names in medical devices. The sample we selected display average PER of 26.4x and 13.8x EV/EBITDA.

FIGURE 2: 12-MONTH ROLLING EV/EBITDA AND PER DATA FOR SOMNOMED



Source: WHTM Research

Price target up to \$3.06 per share but maintaining HOLD, waiting for a better entry point or new catalysts – we see the current market pricing as broadly fair for SomnoMed. Sustainable valuation gains from this point really depend on catalysts such as:

- SomnoMed surpassing the 2H volume guidance;
- Setting FY16 volume guidance above consensus (65-67K); and
- Cost control initiatives supporting strong EBITDA uplift over FY16-17.



RETURN RE-INVESTMENT MATRIX

Return	High	Cash Generator	Champion
	Low	Challenged	Potential
		Low	High
		Re-investment	

Returns: Lead product launched (SomnoDent) in all major markets. Enjoys the leadership position in this emerging category of treatments for obstructive sleep apnoea.

Re-investment: Opportunities grow the global market by fostering links between medical and dental aspects of sleep apnoea. Increase awareness of alternatives to CPAP.

RISK MEASURES

	Low	Med	High	Spec
Share Price Risk				
Business Risk				

Share price risk: SOM liquidity is relatively low, posing higher risks.

Business risk: Small company with limited resources addressing a global opportunity. Competition increasing could grow market; could take market. These risks are mitigated by having a well coordinated infrastructure for product manufacturing and supply.

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 arrangements. SomnoMed currently enjoys a leadership position in this market. We see SomnoMed's (RMD) recent entry into this market as validation of our investment thesis. We expect that the medically oriented diagnosis and referral channels for OSA will embrace oral appliances as an alternative for OSA patients who refuse treatment 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 increase to 35% or higher 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

- SOM had c.\$8.9M cash as at end-2QFY15

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 Verdall-Austin (CFO)
- Kien T. Nguyen (President, North America)
- Dr Jagdeep Bijwadia (Chief Medical Officer)

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Return Reinvestment Matrix and Risk Measures

Definitions at <http://www.wilsonhtm.com.au/Disclosures>

Recommendation Structure and Other Definitions

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