



BUY

HOLD

SELL

## ACTION &amp; RECOMMENDATION

The next 12 months for this stock are interesting because the company is working more closely than ever with managed care groups in the US market. Managed care customers are the future of how SomnoMed's oral appliance device might win broader adoption and payer support in the US. There are pilot programs starting this year that could help define that model for its US business. The first half saw a break-even result driven by continued gains in Europe and a stabilising environment in the US. We have lifted our price target to \$1.75 but revise to a HOLD rating following c.50% outperformance over the past year. SomnoMed is a small company but it is developing into a fine medical device manufacturer, with a large growth opportunity to explore.

## 1HFY14 result

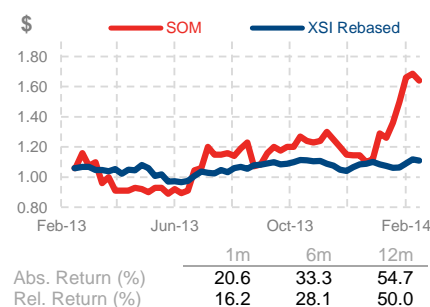
## What's Changed

- 1HFY14 was a break-even period characterised by solid growth in Europe and a stabilising US environment** – SomnoMed sold 20,455 oral appliance devices in 1HFY14 (+19%). Sales of \$12.6m were in line, and EBITDA of \$0.6m was as expected, reflecting continued investment in US medical market development.
- Guidance maintained** – the company still expects to sell more than 43,000 devices this fiscal year, which probably reflects a conservative outlook for the US. European growth is expected to remain ≥40%. The guidance also includes a contribution from the new mid-priced "Herbst" device, which was introduced for US Medicare beneficiaries.
- Outlook** – we made a small (900 device) upgrade to our FY14 forecast, bringing the estimate in line with guidance. Unforeseen increases in tax expense have reduced near-term NPAT forecasts – but these changes are not material to the investment view. SomnoMed still has c.\$17m in accumulated losses to offset its future tax burden.
- Price target lifted to \$1.75 per share** – our DCF valuation remains unchanged at \$1.50 per share but we have set the target higher than that because the sense coming from 1HFY14 commentary is that an incremental uplift in volumes (from the US medical initiative) may materialise earlier than expected – possibly in Q4. We have revised the rating to a HOLD (previously Buy). Our conviction view remains that the US market will increase utilisation of oral appliances for the treatment of obstructive sleep apnoea and SomnoMed will maintain a leadership position in that market.
- Catalysts** – stronger-than-expected US growth, acquisitions.
- Risks** – execution, competitive factors, reimbursement outcomes.

|                                  |               |
|----------------------------------|---------------|
| <b>12m Target Price (AUD)</b>    | <b>\$1.75</b> |
| Share Price @ 28-Feb-14 (AUD)    | \$1.64        |
| Fcst 12m Capital Return          | 6.5%          |
| Fcst 12m Dividend Yield          | 0.0%          |
| <b>12m Total S'holder Return</b> | <b>6.5%</b>   |

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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)   | FY12A                          | FY13A              | FY14E                   | FY15E | FY16E |
|-----------------------|--------------------------------|--------------------|-------------------------|-------|-------|
| NPAT Rep (\$m)        | 0.7                            | 0.7                | 0.3                     | 2.0   | 3.8   |
| NPAT Norm (\$m)       | 0.8                            | 0.7                | 0.3                     | 2.0   | 3.8   |
| Consensus NPAT (\$m)  |                                |                    | 0.9                     | 3.0   | 4.5   |
| EPS Norm (cps)        | 1.4                            | 1.5                | 0.6                     | 4.7   | 8.7   |
| EPS Growth (%)        | -25                            | 7                  | -60                     | 695   | 84    |
| P/E Norm (x)          | 117.3                          | 109.7              | 275.6                   | 34.7  | 18.8  |
| EV / EBITDA (x)       | 84.2                           | 103.9              | 47.5                    | 20.5  | 13.9  |
| FCF Yield (%)         | 0.1                            | 0.5                | -0.5                    | 2.1   | 4.4   |
| 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     |
| <b>Mkt Cap: \$73m</b> | <b>Enterprise Value: \$77m</b> | <b>Shares: 45m</b> | <b>Sold Short: 0.0%</b> |       |       |

| Key Changes             | 28-Oct                           | After       | Var %        |
|-------------------------|----------------------------------|-------------|--------------|
| <b>NPAT: FY14</b>       | 0.9                              | 0.3         | -72.9%       |
| <b>Norm FY15</b>        | 3.0                              | 2.0         | -32.6%       |
| <b>(\$m) FY16</b>       | 4.5                              | 3.8         | -15.8%       |
| <b>EPS: FY14</b>        | 2.2                              | 0.6         | -72.9%       |
| <b>Norm FY15</b>        | 7.0                              | 4.7         | -32.6%       |
| <b>(cps) FY16</b>       | 10.3                             | 8.7         | -15.8%       |
| <b>DPS: FY14</b>        | 0.0                              | 0.0         | 0.0%         |
| <b>(cps) FY15</b>       | 0.0                              | 0.0         | 0.0%         |
| <b>FY16</b>             | 0.0                              | 0.0         | 0.0%         |
| <b>Price Target:</b>    | <b>1.50</b>                      | <b>1.75</b> | <b>16.7%</b> |
| <b>Rec:</b>             | <b>BUY</b>                       | <b>HOLD</b> |              |
| <b>ASX 300 wgt: n/a</b> | <b>Median T'over/Day: \$0.0m</b> |             |              |

## Wilson HTM Equities Research – SomnoMed Limited

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#### PRICE TARGET

|                          | Valuation | Price Target |
|--------------------------|-----------|--------------|
| WACC (%)                 |           | 14           |
| Terminal growth (%)      |           | 3.1          |
| NPV Forecast FCF         |           | 32.8         |
| NPV Perpetuity (A\$M)    |           | 30.5         |
| Net Debt / (Cash) (A\$M) |           | 4.2          |
| Valuation (A\$M)         |           | 67.5         |

|                        |      |
|------------------------|------|
| DCF valuation (\$/shr) | 1.50 |
| Price target (\$/sh)   | 1.75 |

#### INTERIMS (\$m)

| Half Yr (AUD)     | Dec 12     | Jun 13     | Dec 13     | Jun 14     |
|-------------------|------------|------------|------------|------------|
|                   | 1HA        | 2HA        | 1HA        | 2HE        |
| Sales             | 9.0        | 9.5        | 12.6       | 13.1       |
| EBITDA            | 0.6        | 0.2        | 0.6        | 1.0        |
| EBIT              | 0.4        | -0.1       | 0.4        | 0.7        |
| <b>Net Profit</b> | <b>0.3</b> | <b>0.4</b> | <b>0.0</b> | <b>0.2</b> |
| <b>Norm. EPS</b>  | <b>0.5</b> | <b>1.0</b> | <b>0.0</b> | <b>0.6</b> |
| EBIT/Sales        | 3.9        | -1.2       | 2.8        | 5.2        |
| 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)             | FY13A        | FY14E        | FY15E        |
|---------------------------------|--------------|--------------|--------------|
| Net Debt                        | -4.2         | -3.9         | -5.2         |
| Net Debt / Equity (%)           | <0           | <0           | <0           |
| <b>Net Debt / EV (%)</b>        | <b>&lt;0</b> | <b>&lt;0</b> | <b>&lt;0</b> |
| Current Ratio (x)               | 3.7          | 3.4          | 3.4          |
| Interest Cover (x)              | <0           | <0           | <0           |
| <b>Adj. Cash Int. Cover (x)</b> | <b>1.2</b>   | <b>&lt;0</b> | <b>&lt;0</b> |
| Debt / CashFlow (x)             | 0.0          | 0.0          | 0.0          |
| Net Debt (cash) / share         | <0           | <0           | <0           |
| NTA / share (\$)                | 0.2          | 0.2          | 0.2          |
| Book Value / share (\$)         | 0.3          | 0.3          | 0.3          |
| Payout Ratio (%)                | 0            | 0            | 0            |
| Adj. Payout Ratio (%)           | 0            | 0            | 0            |

#### EPS RECONCILIATION (\$m)

|                        | FY13A      |            | FY14E      |            |
|------------------------|------------|------------|------------|------------|
|                        | Rep.       | Norm.      | Rep.       | Norm.      |
| Sales Revenue          | 18         | 18         | 26         | 26         |
| EBIT                   | 0.2        | 0.2        | 1.0        | 1.0        |
| <b>Net Profit</b>      | <b>0.7</b> | <b>0.7</b> | <b>0.3</b> | <b>0.3</b> |
| Notional Earn.         | 0.0        | 0.0        | 0.0        | 0.0        |
| Pref./Conv. Div.       | 0.0        | 0.0        | 0.0        | 0.0        |
| <b>Profit for EPS</b>  | <b>0.7</b> | <b>0.7</b> | <b>0.3</b> | <b>0.3</b> |
| Diluted Shrs(m)        | 47         | 47         | 43         | 43         |
| <b>Diluted EPS (c)</b> | <b>1.5</b> | <b>1.5</b> | <b>0.6</b> | <b>0.6</b> |

#### RETURNS

|                  | FY13A | FY14E | FY15E | FY16E |
|------------------|-------|-------|-------|-------|
| ROE (%)          | 6.8   | 2.1   | 14.9  | 22.6  |
| ROIC (%)         | 2.6   | 9.0   | 23.5  | 33.6  |
| Incremental ROE  | -2.1  | -25.5 | 112.0 | 59.2  |
| Incremental ROIC | -8.1  | 35.2  | 128.4 | 151.8 |

#### KEY ASSUMPTIONS

| Year-end June (AUD)   | FY09A        | FY10A         | FY11A        | FY12A        | FY13A      | FY14E        | FY15E        | FY16E       |
|-----------------------|--------------|---------------|--------------|--------------|------------|--------------|--------------|-------------|
| Revenue Growth (%)    | 111.5        | 38.5          | 15.1         | 23.6         | 21.3       | 38.7         | 14.0         | 19.2        |
| EBIT Growth (%)       | -33.4        | -103.9        | 720.1        | -15.5        | -55.4      | 335.4        | 199.6        | 54.9        |
| NPAT Growth (%)       | -35.2        | -148.3        | -4.9         | -4.7         | -7.2       | -63.4        | 694.6        | 84.1        |
| <b>EPS Growth (%)</b> | <b>-50.2</b> | <b>-146.8</b> | <b>-11.6</b> | <b>-25.2</b> | <b>6.9</b> | <b>-60.2</b> | <b>694.6</b> | <b>84.1</b> |
| EBIT / Sales (%)      | -25.6        | 0.7           | 5.1          | 3.5          | 1.3        | 4.0          | 10.6         | 13.8        |
| Tax Rate (%)          | 0.9          | -586.9        | -10.7        | -18.8        | -123.7     | 75.9         | 35.0         | 22.6        |
| <b>ROA (%)</b>        | <b>-30.0</b> | <b>1.1</b>    | <b>7.8</b>   | <b>4.4</b>   | <b>1.5</b> | <b>5.6</b>   | <b>14.4</b>  | <b>18.3</b> |
| <b>ROE (%)</b>        | <b>-34.0</b> | <b>17.0</b>   | <b>13.5</b>  | <b>8.7</b>   | <b>6.4</b> | <b>2.2</b>   | <b>15.0</b>  | <b>21.6</b> |

#### PROFIT & LOSS (\$m)

| Year-end June (AUD)              | FY09A       | FY10A      | FY11A      | FY12A      | FY13A      | FY14E      | FY15E      | FY16E      |
|----------------------------------|-------------|------------|------------|------------|------------|------------|------------|------------|
| Sales Revenue                    | 7.7         | 10.7       | 12.3       | 15.2       | 18.5       | 25.6       | 29.2       | 34.9       |
| EBITDA                           | -1.7        | 0.2        | 0.8        | 0.9        | 0.7        | 1.6        | 3.8        | 5.5        |
| Depn & Amort                     | 0.3         | 0.2        | 0.2        | 0.4        | 0.5        | 0.6        | 0.7        | 0.7        |
| <b>EBIT</b>                      | <b>-2.0</b> | <b>0.0</b> | <b>0.6</b> | <b>0.5</b> | <b>0.2</b> | <b>1.0</b> | <b>3.1</b> | <b>4.8</b> |
| Net Interest Expense             | -0.2        | -0.1       | -0.1       | -0.1       | -0.1       | 0.0        | 0.0        | -0.1       |
| Tax                              | 0.0         | -0.7       | -0.1       | -0.1       | -0.4       | 0.8        | 1.1        | 1.1        |
| 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        |
| <b>Net Profit pre Sig. Items</b> | <b>-1.8</b> | <b>0.8</b> | <b>0.7</b> | <b>0.7</b> | <b>0.7</b> | <b>0.3</b> | <b>2.0</b> | <b>3.8</b> |
| Abn's / Ext's / Signif.          | 0.0         | 0.0        | 0.0        | 0.0        | 0.0        | 0.0        | 0.0        | 0.0        |
| <b>Reported Net Profit</b>       | <b>-1.8</b> | <b>0.8</b> | <b>0.7</b> | <b>0.7</b> | <b>0.7</b> | <b>0.3</b> | <b>2.0</b> | <b>3.8</b> |

#### CASHFLOW (\$m)

| Year-end June (AUD)            | FY09A       | FY10A       | FY11A       | FY12A       | FY13A       | FY14E       | FY15E      | FY16E      |
|--------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|------------|------------|
| EBITDA                         | -1.7        | 0.2         | 0.8         | 0.9         | 0.7         | 1.6         | 3.8        | 5.5        |
| Interest & Tax                 | 0.2         | 0.1         | 0.1         | 0.1         | 0.0         | -0.4        | -1.1       | -1.0       |
| Working Cap / Other            | 0.2         | 0.2         | -1.2        | -0.7        | -0.2        | -1.2        | -0.4       | -0.4       |
| <b>Operating Cash Flow</b>     | <b>-1.3</b> | <b>0.5</b>  | <b>-0.3</b> | <b>0.3</b>  | <b>0.6</b>  | <b>0.0</b>  | <b>2.3</b> | <b>4.1</b> |
| Maintenance Capex              | 0.0         | -0.5        | -0.3        | -0.2        | -0.2        | -0.4        | -0.7       | -0.9       |
| <b>Free Cash Flow</b>          | <b>-1.4</b> | <b>-0.1</b> | <b>-0.6</b> | <b>0.1</b>  | <b>0.4</b>  | <b>-0.4</b> | <b>1.6</b> | <b>3.2</b> |
| 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         | 0.0         | -0.1        | -0.3        | -0.5        | -0.3        | -0.3       | -0.3       |
| Other Inv. Flows               | 0.0         | 0.0         | 0.2         | -0.3        | -0.1        | 0.1         | 0.0        | 0.0        |
| <b>Cash Flow Pre Financing</b> | <b>-1.4</b> | <b>-0.1</b> | <b>-0.5</b> | <b>-0.5</b> | <b>-0.2</b> | <b>-0.5</b> | <b>1.3</b> | <b>2.9</b> |
| Funded by Equity               | 0.0         | 0.4         | 0.3         | 0.1         | 0.5         | 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                 | 1.4         | -0.4        | 0.2         | 0.3         | -0.3        | 0.5         | -1.3       | -2.9       |

#### BALANCE SHEET SUMMARY (\$m)

| Year-end June (AUD)         | FY09A      | FY10A      | FY11A      | FY12A       | FY13A       | FY14E       | FY15E       | FY16E       |
|-----------------------------|------------|------------|------------|-------------|-------------|-------------|-------------|-------------|
| Cash                        | 4.0        | 4.3        | 3.9        | 3.5         | 4.2         | 3.9         | 5.2         | 8.1         |
| Current Receivables         | 1.4        | 1.6        | 2.2        | 3.7         | 4.4         | 5.3         | 6.4         | 7.5         |
| Current Inventories         | 0.1        | 0.2        | 0.2        | 0.5         | 0.9         | 1.3         | 1.6         | 1.9         |
| Net PPE                     | 0.2        | 0.6        | 1.1        | 1.1         | 1.2         | 1.3         | 1.4         | 1.4         |
| Investments                 | 0.0        | 0.0        | 0.0        | 0.0         | 0.0         | 0.0         | 0.0         | 0.0         |
| Intangibles / Capitalised   | 0.3        | 1.0        | 1.2        | 2.7         | 5.3         | 6.6         | 7.0         | 7.4         |
| Other                       | 0.0        | 0.1        | 0.1        | 0.5         | 0.2         | 0.0         | 0.0         | 0.0         |
| <b>Total Assets</b>         | <b>6.0</b> | <b>7.8</b> | <b>8.7</b> | <b>12.0</b> | <b>16.1</b> | <b>18.5</b> | <b>21.5</b> | <b>26.3</b> |
| Current Payables            | 1.5        | 1.9        | 2.2        | 2.4         | 3.5         | 4.0         | 4.8         | 5.6         |
| Total Debt                  | 0.0        | 0.0        | 0.0        | 0.0         | 0.0         | 0.0         | 0.0         | 0.0         |
| Other Liabilities           | 0.2        | 0.3        | 0.3        | 0.4         | 1.0         | 1.8         | 2.0         | 2.2         |
| <b>Total Liabilities</b>    | <b>1.7</b> | <b>2.2</b> | <b>2.5</b> | <b>2.8</b>  | <b>4.5</b>  | <b>5.7</b>  | <b>6.7</b>  | <b>7.8</b>  |
| Minorities / Convertibles   | 0.0        | 0.0        | 0.0        | 0.5         | 0.6         | 1.1         | 1.1         | 1.1         |
| <b>Shareholder Equity</b>   | <b>4.3</b> | <b>5.7</b> | <b>6.2</b> | <b>9.2</b>  | <b>11.6</b> | <b>12.7</b> | <b>14.8</b> | <b>18.5</b> |
| <b>Total Funds Employed</b> | <b>4.3</b> | <b>5.7</b> | <b>6.2</b> | <b>9.2</b>  | <b>11.6</b> | <b>12.7</b> | <b>14.8</b> | <b>18.5</b> |



## SomnoMed Limited – 1HFY14 results

TABLE 1: SOMNOMED'S 1HFY14 RESULT VERSUS PCP + FULL FY14 FORECAST

| SOM - 1HFY14 Results |        |        |        |        |      |        |        |        |    |
|----------------------|--------|--------|--------|--------|------|--------|--------|--------|----|
|                      | 1HFY13 | 1HFY14 | growth | WHTMe  | var  | FY13   | FY14e  | growth |    |
| Unit sales           | 17,251 | 20,455 | 19%    | 20,100 | 1.8% | 35,773 | 43,000 | 20%    |    |
| Sales                | 9.0    | 12.6   | 39%    | 11.5   | 9.2% | 18.5   | 25.6   | 39%    |    |
| Gross profit         | 6.0    | 8.1    | 36%    | 7.6    | 7%   | 12.3   | 16.9   | 38%    |    |
| Gross margin         | 66.1%  | 64.7%  |        | 66.0%  |      | 9.0    | 10.5   | 17%    |    |
| SG&A                 | 3.7    | 5.9    | 60%    | 5.4    | 8%   | 9.0    | 12.1   | 34%    |    |
| Corporate, R&D       | 1.6    | 1.6    | 0%     | 1.6    | 0%   | 2.5    | 3.0    | 22%    |    |
| EBITDA               | 0.6    | 0.6    | 10%    | 0.6    | 7.3% | 0.7    | 1.8    | 145%   |    |
| EBIT                 | 0.4    | 0.4    | 1%     | 0.3    | 19%  | 0.2    | 1.2    | 419%   |    |
| Tax                  | 0.1    | 0.4    | 176%   | 0.2    | 81%  | -      | 0.4    | 0.9    | nm |
| Core NPAT            | 0.3    | 0.0    | -97%   | 0.2    | nm   | 0.7    | 0.4    | -49%   |    |
| EPS                  | 0.45   | 0.0    | -100%  | 0.5    | nm   | 1.5    | 0.8    | -47%   |    |

Source: WHTM Research

### RESULT HIGHLIGHTS

**Breakeven on 1HFY14 after tax** – SomnoMed reported a break-even period (NPAT of \$8,600) which was lower than our forecast of c.\$200K. Unit sales and revenue data was already known from the December quarterly. Both were higher than initially forecast, but this was partially offset by a lower gross margin: 65% compared with 66% in the pcp and WHTMe. SomnoMed expects a blended gross margin of at least c.67% in the future. Gross profit of \$8.1m was 7% higher than our forecast of \$7.6m.

EBITDA of \$0.6m was in line with our forecast, notwithstanding higher SG&A expenses, which reflected continuing investments in the US medical initiatives (c.\$0.9m in 1H). The company reported a far greater tax expense relating to the royalty charge that SomnoMed's parent company charges its US subsidiary. Unforeseen taxes were also incurred by the Dutch entity. In aggregate these tax expenses were \$361K and nearly double what we were forecasting.

**Managed care the US focus, near term** – the pilot programs placing SomnoMed dentists in-house at managed care facilities are now expected to commence in April, having taken longer than expected to register dentists appropriately. For the first time, a US managed care group will offer a SomnoDent oral appliance as a first line treatment option in newly diagnosed obstructive sleep apnoea patients. The centre involved in the trial writes c.2,000 CPAP prescriptions per year. We expect the pilot will last 3-6 months and may provide good evidence for increasing utilisation of SomnoDent within this managed care group's network.

Over 1HFY14, we estimate that US unit sales increased around 10% to 11,080 devices, representing 54% of total unit sales. We are forecasting 11,400 devices in the second half or c.11% growth over a relatively weak pcp.

**Early benefits from medical initiative** – the company now expects to see modest incremental volumes flowing from its investments in recent years. This patient work has set about increasing awareness and the willingness among sleep physicians to prescribe an oral appliance for sleep apnoea patients. We thought the leading indicators of success would be from managed care companies and corporates – as was the case during the earliest days of continuous positive airway pressure (CPAP) therapy. We think SomnoMed is likely to work with an increasing number of managed care companies, given that its therapy is likely to achieve equivalent health outcomes for patients at substantially less cost, compared with CPAP.

*Higher tax expense the only significant difference between SomnoMed's 1H and WHTMe*

*Gross margins solid across the business, notwithstanding the introduction of lower price SKUs*

*US managed care pilots now commence April*

*10% volume growth in the US*

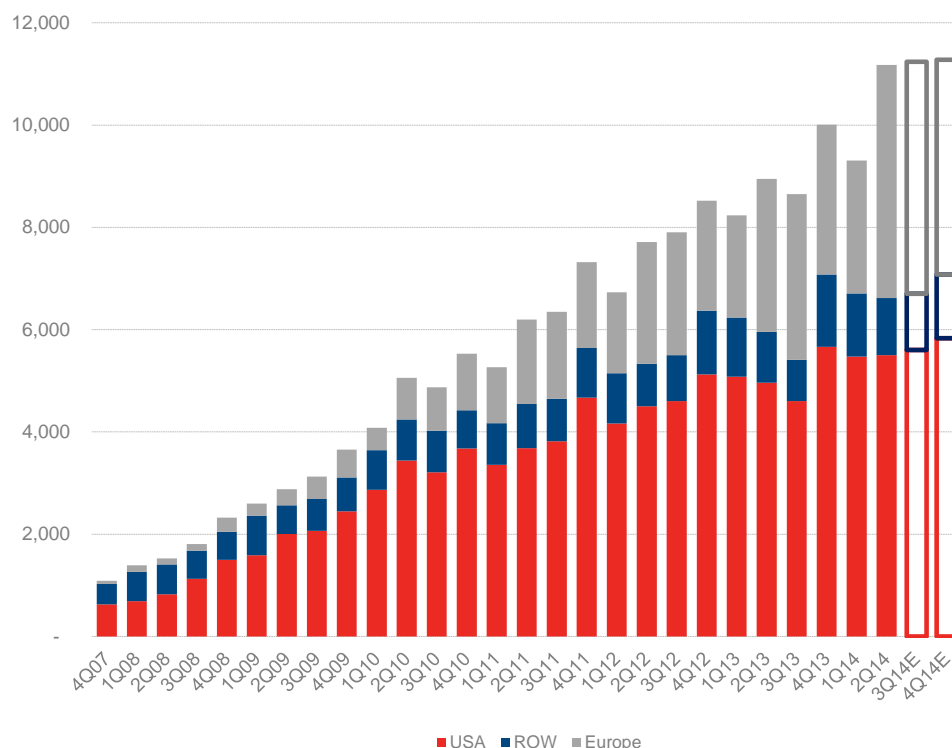


**Herbst appliance launched, another to come** – the SomnoDent Herbst was launched in the US market, targeting Medicare patients at a mid-price point. Herbst has an average selling price of c.US\$350 compared with the SomnoDent G2/Flex devices which are US\$500+. A follow-up Herbst “Plus” is planned for later this year to test a slightly higher price point. The key patented advance relates to ease of titration (the process by which the dentist/patient arrives at the optimal relative positioning of the top and bottom jaws to treat the sleep apnoea comfortably).

*More mid-priced options to assist market share and sales*

**US recovery not complete yet, though positive signals in Jan-Feb** – notwithstanding the operational improvements over the past year, physical unit sales growth in the US market still looks modest in absolute terms. SomnoMed has maintained its FY14 guidance of 43,000 devices – an all-inclusive number (SomnoDent Classic, Flex, G2, Herbst). We understand that the momentum that came into play late in Q2 has continued into the first months of Q3. Qualitatively, on the conference call earlier this week, the company indicated growth rates of c.40% in Europe, c.20% in the US and c.12% elsewhere – which would get closer to 44,000 devices current guidance probably indicates some continuing conservatism with respect to the American market.

**FIGURE 1: WORK TO DO IN THE USA MARKET – ABSOLUTE SALES LOOK FLAT, PAST THREE QUARTERS**



*US unit sales growth modest in absolute terms*

*WHTM has lifted outlook to match FY14 guidance of 43,000 devices*

*Guidance likely reflects a conservative view on US in 2H*

Source: WHTM Research

**European outlook remains very positive** – European unit sales grew 47% in 1H to 7,159 devices. The restructuring and expansion of the market channels there have given SomnoMed a greater degree of freedom in optimising price and competitiveness – a common theme through Holland, Germany, Scandinavia and increasingly France. We are forecasting c.8,700 device sales in Europe for 2H (+42% on pcp).

*Europe remains a potent driver for SomnoMed*

**Rest of world mixed, potential upside from Korea, Japan** – we estimate c.9% volume growth ex-US/EU to 2,250 devices. Australia and New Zealand remain good markets for SomnoMed, growing c.14%. With SomnoMed having restructured the channel in South Korea last year, better sales commenced there in November.

*APAC a small part of the picture, but SomnoMed showing intent there*



## CHANGES TO FORECASTS, OUTLOOK

We have made some modest upgrades to unit sales in FY14 (c.900 devices) to reflect the successful launch of the Herbst and some additional sales into the managed care pilot in Q4. The extra revenue does not flow to earnings, as SomnoMed plans a higher promotional presence at international sleep medicine/dentistry conferences over the coming periods.

*Forecasts unchanged, save for non-material changes to SG&A and tax*

Our profit forecasts are less than last time because we have recognised higher tax expenses relating to the royalty charge that SomnoMed's parent company charges its US subsidiary and from the Dutch business. SomnoMed has c.\$17m in accumulated losses that it expects to offset future tax burden. These changes are not material to our investment view.

The company's financial position is adequate for now, closing the period with c.\$4m cash and no debt. Further expansion in manufacturing capacity is likely over the next three years, but this will not be expensive and can probably be financed in non-dilutive ways. In the meantime, growth in the gross profit is adequate to support the growth initiatives – none of which necessarily accelerate by throwing money at them.

## VALUATION. RECOMMENDATION, RISKS

We value SomnoMed using discounted cash flow and that remains unchanged from last time at \$1.50 per share. Importantly, our valuation is based on a forecast that does not recognise any incremental uplift in volumes (from the US medical initiative) until ~FY16. Following the latest result, there is a sense that this may materialise earlier than expected. The evidence will come in the form of US sales growth beating expectations, particularly in Q4 and into FY15.

*Price target lifted to \$1.75 per share*

We have revised our rating to HOLD, given the recent share price run and ~50% relative outperformance over the past 12 months. Our conviction view remains that SomnoMed is a high quality business that has completed some solid, patient work in building its infrastructure to supply its medical devices, globally.

*HOLD rating following 12 months' outperformance*

And further, we also hold the view that the US market will increase utilisation of oral appliances for the treatment of obstructive sleep apnoea. Treatment penetration in the US remains low (3-5%) but we think it is likely to improve over time as the evidence gaps close, and as sleep physicians become more confident in prescribing oral appliance therapy. The key question is whether US sleep physicians will accept the argument that despite a weaker impact on the hard measurements of sleep apnoea, overall treatment acceptance/compliance outweighs that, so the overall performance is non-inferior to CPAP.





## RETURN RE-INVESTMENT MATRIX

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

**Return:** 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 low, posing high 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-co-ordinated 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 ResMed'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.\$4M cash as at end-1HFY14. 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 Verdall-Austin (CFO)
- Kien T. Nguyen (President, North America)
- Dr Jagdeep Bijwadia (Chief Medical Officer)
- Stacey Gilbert, VP Managed Care

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#### Return Reinvestment Matrix and Risk Measures

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

#### Recommendation Structure and Other Definitions

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

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#### Disclosure of Interest. SomnoMed Ltd

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