

## BUY: US channel conflicts abating in Q4

We maintain a BUY rating and 12-month price target of \$4.50 per share. SomnoMed's Q3 update was a mixed bag with stellar European performance offset by continued caution from US customers, some of whom feel threatened by the company's own direct-to-consumer push (rolling out RSS sleep centres). The RSS network will reach five centres next month, is being pushed harder and costing ~\$1m more than forecast in FY17. SomnoMed revised down its EBITDA guidance to accommodate. Seeing the initial RSS portfolio break even at the clinic level will be a potent catalyst in helping the stock achieve our price target and 40% TSR.

### Key points

**3Q17 trading update.** Core medical device unit sales were 14,931 (up 6.7% on pcp) but 7% below our forecast of 16,000 principally on account of US sales weakness. SomnoMed's RSS sleep centre openings is still being seen as an incursion on local market share by some of its traditional customer base. We estimate that US volume was down ~6% on pcp, which is a larger impact than we had modelled. Anecdotally, US growth in April is back to trend, with some of the disenfranchised customer base having returned to ordering. European trading conditions remained strong – sales up 26% on pcp – with new French reimbursement support beginning to show in the results (France grew 40% off a low base). The sustained 20% growth in mature markets (Sweden, Netherlands) implies more market share won at the expense of CPAP therapy.

**RSS scale-up the major component of guidance cut.** SomnoMed has revised its FY17e EBITDA guidance to a loss of \$1.5m (previously \$0). Our interpretation is an additional ~\$1m being invested in the RSS initiative (presumably head count) which is ahead of schedule, opening its fifth centre in May. We estimate that the shortfall in US device sales in 2H accounts for a ~\$0.5m impact from lower sales revenue. Our new FY17e forecasts are at the new guidance for FY17, down ~\$1m in FY18 (higher RSS start-up costs), but largely unchanged in FY19, which is the break-out year for group earnings.

**Valuation.** Price target maintained at \$4.50 per share notwithstanding the near-term downgrades of ~\$1m per annum for both FY17 and FY18. Formal DCF valuation is \$4.23 per share or ~4.5% lower than last time. Taking RSS out of our model yields a price target of ~\$3.25 per share for traditional device business. Initial RSS centres reaching profitability could be a powerful catalyst for SomnoMed's stock to trend closer towards our price target and 40% TSR.

### Risks and catalysts

**Catalysts:** a) quarterly volumes; b) US managed care progress; c) margin improvement; d) RSS centre rollout. **Risks:** a) execution on US strategy; b) competition; c) average sales price erosion; d) RSS rollout 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)	0.6	0.2	-2.9	3.6	11.4
NPAT norm (\$m)	0.6	0.2	-2.7	3.6	11.4
Consensus NPAT (\$m)			-1.1	5.0	12.2
EPS norm (cps)	1.2	0.3	-4.9	6.3	19.9
EPS growth (%)	-55.3	-73.3	-1619.4	229.2	217.1
P/E norm (x)	268.3	1005.5	-66.2	51.2	16.2
EV/EBITDA (x)	198.2	116.9	-115.9	27.5	9.1
FCF yield (%)	-0.8	0.1	-3.1	-0.9	2.9
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, Wilsons estimates, S&P Capital IQ

### Wilsons Equity Research

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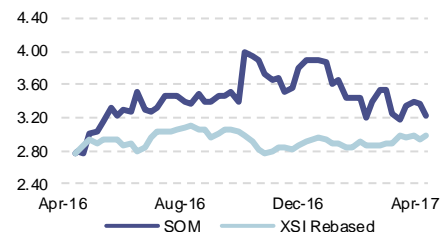
Recommendation	BUY
12-mth target price (AUD)	\$4.50
Share price @ 26-Apr-17 (AUD)	\$3.22
Forecast 12-mth capital return	39.8%
Forecast 12-mth dividend yield	0.0%
<b>12-mth total shareholder return</b>	<b>39.8%</b>

Market cap	\$185m
Enterprise value	\$172m
Shares on issue	57m
Sold short	0.0%
ASX 300 weight	n/a
Median turnover/day	\$0.0m

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### 12-mth price performance (\$)



	1-mth	6-mth	12-mth
Abs return (%)	0.3	-18.5	15.9
Rel return (%)	-1.5	-20.5	8.9

Key changes				
		24-Feb	After	Var %
NPAT:	FY17F	-1.4	-2.7	N/A
norm	FY18F	4.6	3.6	-21.4%
(\$m)	FY19F	11.5	11.4	-0.8%
EPS:	FY17F	-2.5	-4.9	N/A
norm	FY18F	8.0	6.3	-21.4%
(cps)	FY19F	20.1	19.9	-0.8%
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
<b>DCF methodology</b>		
WACC (%)	12.0	
Terminal growth assumption (%)	3.5	
PV of forecast FCFs (\$m)	57.5	
PV of terminal value (\$m)	173.2	
Enterprise value (\$m)	230.7	
Net debt (cash) (\$m)	-12.6	
Equity value (\$m)	243.3	

DCF valuation (A\$/sh)	4.23
<b>Price target (A\$/sh)</b>	<b>4.50</b>

Interims (\$m)				
Half-year (AUD)	Dec 15	Jun 16	Dec 16	Jun 17
	1HA	2HA	1HE	2HE
Sales revenue	21.3	22.8	23.8	26.4
EBITDA	0.9	0.6	0.4	-1.9
EBIT	0.4	0.0	-0.2	-2.7
<b>Net profit</b>	<b>0.3</b>	<b>-0.2</b>	<b>-0.3</b>	<b>-2.3</b>
<b>Norm EPS</b>	<b>0.8</b>	<b>-0.4</b>	<b>-0.7</b>	<b>-4.1</b>
EBIT/sales (%)	2.1	0.0	-0.7	-10.2
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)	FY16A	FY17F	FY18F
Net debt	-16.7	-12.6	-10.9
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)	4.9	5.1	4.5
Interest cover (x)	<0	54.9	◆
<b>Adj cash int cover (x)</b>	<b>&lt;0</b>	<b>98.9</b>	
Debt/cash flow (x)	0.0	0.0	0.0
Net debt (cash)/share (\$)	<0	<0	<0
NTA/share (\$)	0.5	0.4	0.5
Book value/share (\$)	0.7	0.5	0.6
Payout ratio (%)	0	0	0
Adj payout ratio (%)	0	0	0

EPS reconciliation (\$m)				
	FY16A		FY17F	
	Rep	Norm	Rep	Norm
Sales revenue	44	44	50	50
EBIT	0.6	0.5	-3.1	-2.9
<b>Net profit</b>	<b>0.2</b>	<b>0.2</b>	<b>-2.9</b>	<b>-2.7</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>0.2</b>	<b>0.2</b>	<b>-2.9</b>	<b>-2.7</b>
Diluted shrs (m)	48	52	55	55
<b>Diluted EPS (c)</b>	<b>0.3</b>	<b>0.3</b>	<b>-5.3</b>	<b>-4.9</b>

Returns				
	FY16A	FY17F	FY18F	FY19F
ROE (%)	1	-8	11	29
ROIC (%)	2	-12	16	45
Incremental ROE	-4	-65	>999	102
Incremental ROIC	4	-103	167	144

Key assumptions								
Year-end June (AUD)	FY13A	FY14A	FY15A	FY16A	FY17F	FY18F	FY19F	FY20F
Revenue growth (%)	21.3	40.1	33.0	28.0	13.9	47.5	44.9	47.2
EBIT growth (%)	-39.1	35.0	-45.7	90.2	-731.7	-259.0	265.0	81.2
NPAT growth (%)	-9.0	-9.2	-4.8	-72.4	-1,730.1	-234.2	217.1	76.0
<b>EPS growth (%)</b>	<b>-2.5</b>	<b>75.4</b>	<b>-55.3</b>	<b>-73.3</b>	<b>-1,619.4</b>	<b>-229.2</b>	<b>217.1</b>	<b>76.0</b>
EBIT/sales (%)	1.8	1.7	0.7	1.0	-5.7	6.1	15.5	19.0
Tax rate (%)	-93.3	3.4	44.8	85.0	-22.4	27.0	27.0	27.0
<b>ROA (%)</b>	<b>2.0</b>	<b>2.3</b>	<b>0.9</b>	<b>1.1</b>	<b>-7.2</b>	<b>9.3</b>	<b>24.8</b>	<b>36.2</b>
ROE (%)	6.3	5.1	2.8	0.5	-8.4	9.4	21.1	29.5

SomnoMed EBITDA (\$m)	0.8	1.1	0.9	1.5	2.7	7.7	11.0	14.0
RSS EBITDA (\$m)	0.0	0.0	0.0	0.0	-4.2	-1.4	8.0	19.6

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	50.2	74.1	107.3	157.9
EBITDA	0.8	1.1	0.9	1.5	-1.5	6.3	19.0	33.6
Depn & amort	0.5	0.6	0.6	1.0	1.4	1.7	2.4	3.5
<b>EBIT</b>	<b>0.3</b>	<b>0.4</b>	<b>0.2</b>	<b>0.5</b>	<b>-2.9</b>	<b>4.5</b>	<b>16.6</b>	<b>30.1</b>
Net interest expense	-0.1	0.0	-0.1	0.0	-0.1	0.0	0.0	0.0
Tax	-0.4	0.0	0.2	0.4	0.6	1.2	4.5	8.1
Minorities/pref divs	0.1	-0.2	0.1	0.1	-0.7	-0.3	0.7	1.8
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>0.7</b>	<b>0.6</b>	<b>0.1</b>	<b>0.0</b>	<b>-2.7</b>	<b>3.6</b>	<b>11.4</b>	<b>20.1</b>
Abns/exts/signif	-0.1	-0.2	0.5	0.2	-0.3	0.0	0.0	0.0
<b>Reported net profit</b>	<b>0.6</b>	<b>0.4</b>	<b>0.6</b>	<b>0.2</b>	<b>-2.9</b>	<b>3.6</b>	<b>11.4</b>	<b>20.1</b>

Cash flow (\$m)								
Year-end June (AUD)	FY13A	FY14A	FY15A	FY16A	FY17F	FY18F	FY19F	FY20F
EBITDA	0.8	1.1	0.9	1.5	-1.5	6.3	19.0	33.6
Interest & tax	0.0	-0.5	0.1	-0.2	-1.1	-1.2	-4.5	-8.1
Working cap/other	-0.3	-1.3	-1.2	0.9	-0.5	-3.2	-5.5	-8.1
<b>Operating cash flow</b>	<b>0.6</b>	<b>-0.8</b>	<b>-0.2</b>	<b>2.1</b>	<b>-3.1</b>	<b>1.8</b>	<b>9.0</b>	<b>17.4</b>
Maintenance capex	-0.2	0.3	-1.2	-1.9	-2.6	-3.5	-3.6	-3.8
<b>Free cash flow</b>	<b>0.4</b>	<b>-0.5</b>	<b>-1.4</b>	<b>0.2</b>	<b>-5.7</b>	<b>-1.7</b>	<b>5.4</b>	<b>13.6</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	-0.5	-0.3	-0.2	-1.3	-0.5	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
<b>Cash flow pre-financing</b>	<b>-0.2</b>	<b>-1.2</b>	<b>-1.9</b>	<b>-1.5</b>	<b>-6.2</b>	<b>-1.7</b>	<b>5.4</b>	<b>13.6</b>
Funded by equity	0.5	0.0	7.3	10.7	1.1	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	5.1	1.7	-5.4	-13.6

Balance sheet summary (\$m)								
Year-end June (AUD)	FY13A	FY14A	FY15A	FY16A	FY17F	FY18F	FY19F	FY20F
Cash	4.2	2.9	8.3	16.7	12.6	10.9	16.3	29.8
Current receivables	4.4	5.5	7.2	9.4	8.0	12.2	18.4	27.2
Current inventories	0.9	1.0	1.3	1.8	2.1	3.3	4.9	7.3
Net PPE	1.2	1.3	2.1	3.8	4.5	5.8	6.5	6.2
Investments	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Intangibles/capitalised	5.3	8.5	8.9	10.2	10.8	11.4	12.0	12.6
Other	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Total assets</b>	<b>16.1</b>	<b>19.1</b>	<b>27.8</b>	<b>42.0</b>	<b>38.0</b>	<b>43.6</b>	<b>58.1</b>	<b>83.2</b>
Current payables	3.5	3.3	3.9	6.9	5.8	7.8	9.9	12.8
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	1.8	1.9	2.2	2.4	2.7
<b>Total liabilities</b>	<b>4.5</b>	<b>6.6</b>	<b>6.2</b>	<b>8.8</b>	<b>7.7</b>	<b>9.9</b>	<b>12.4</b>	<b>15.5</b>
Minorities/convertibles	0.6	0.2	0.2	-0.6	-0.6	-0.6	-0.6	-0.6
<b>Shareholder equity</b>	<b>11.6</b>	<b>12.6</b>	<b>21.5</b>	<b>33.2</b>	<b>30.3</b>	<b>33.6</b>	<b>45.7</b>	<b>67.7</b>
<b>Total funds employed</b>	<b>11.6</b>	<b>12.6</b>	<b>21.5</b>	<b>33.2</b>	<b>30.3</b>	<b>33.6</b>	<b>45.7</b>	<b>67.7</b>



## Outlook

**Table 1: Earnings forecast detail FY15-20e**

	FY15	1HFY 16	2HFY 16	FY16	1HFY 17e	2HFY 17e	FY17e	1HFY 18e	2HFY 18e	FY18e	FY19e	FY20e
<b>Medical device unit sales</b>	<b>51,355</b>	28,997	29,986	<b>58,983</b>	33,309	33,181	<b>66,490</b>	39,953	43,489	<b>83,442</b>	<b>103,542</b>	<b>129,997</b>
SomnoMed	51,355	28,997	29,986	58,983	33,309	32,381	65,690	37,453	39,189	76,642	87,542	98,497
RSS	-	-	-	-	-	800	800	2,500	4,300	6,800	16,000	31,500
<b>Group revenue (\$m)</b>	<b>34.4</b>	21.3	22.8	<b>44.1</b>	23.7	26.6	<b>50.3</b>	34.2	41.6	<b>75.9</b>	<b>111.6</b>	<b>166.3</b>
SomnoMed	34.4	21.3	22.8	44.1	23.7	24.5	48.2	27.7	30.3	58.0	69.5	83.4
RSS	-	-	-	-	-	2.1	2.1	6.6	11.3	17.9	42.1	82.9
<b>Gross profit (\$m)</b>	<b>19.5</b>	12.3	13.1	<b>25.3</b>	13.7	16.0	<b>29.7</b>	22.2	27.7	<b>49.8</b>	<b>78.1</b>	<b>122.5</b>
SomnoMed	19.5	12.3	13.1	25.3	13.7	14.1	27.8	16.2	17.5	33.7	40.3	48.0
RSS	-	-	-	-	-	1.9	1.9	5.9	10.2	16.1	37.8	74.5
<b>EBITDA (\$m)</b>	<b>0.9</b>	0.9	0.6	<b>1.5</b>	0.4	(1.9)	<b>(1.5)</b>	2.2	4.1	<b>6.3</b>	<b>19.0</b>	<b>33.6</b>
SomnoMed	0.9	0.9	0.6	1.5	1.4	1.3	2.7	3.8	3.9	7.7	11.0	14.0
RSS	-	-	-	-	(1.0)	(3.2)	(4.2)	(1.6)	0.2	(1.4)	8.0	19.6
Depreciation and amortisation	0.6	0.5	0.6	1.0	0.6	0.8	1.4	0.8	0.9	1.7	2.4	3.5
<b>EBIT (\$m)</b>	<b>0.2</b>	0.4	0.0	<b>0.5</b>	(0.2)	(2.7)	<b>(2.9)</b>	1.4	3.2	<b>4.5</b>	<b>16.6</b>	<b>30.1</b>
Net interest	0.1	0.0	0.0	0.0	(0.1)	-	(0.1)	-	-	-	-	-
Tax	0.2	0.1	0.3	0.4	0.4	0.2	0.6	0.4	0.9	1.2	4.5	8.1
Minorities	0.1	0.0	0.1	0.1	(0.2)	(0.5)	(0.7)	(0.3)	(0.0)	(0.3)	0.7	1.8
<b>NPAT (\$m)</b>	<b>0.6</b>	0.2	(0.0)	<b>0.2</b>	(0.6)	(2.3)	<b>(2.9)</b>	1.3	2.3	<b>3.6</b>	<b>11.4</b>	<b>20.1</b>

Source: Wilsons' estimates

## Valuation

Price target maintained at \$4.50 per share notwithstanding the near-term downgrades of ~\$1m per annum for both FY17 and FY18. Formal DCF valuation is \$4.23 per share or ~4.5% lower than last time. We have maintained the premium price target, noting that the investment thesis pivots on SomnoMed delivering RSS earnings without significant impairment of its conventional medical device market share.

Taking RSS out of our valuation yields a price target of ~\$3.25 per share, implying that the market is applying a steep discounting the potential impact from RSS. Seeing the first few RSS centres reach profitability could be powerful catalysts for the stock to trend closer to our price target.

**Table 2: DCF summary**

<b>DCF Assumptions</b>			
Effective WACC	12.0%	Explicit forecast period (years)	10
Risk-free rate	4.5%	Terminal growth rate	3.5%
Risk premium	6.0%	Tax rate	25%
Implied equity beta	1.25		
<b>Valuation</b>			
PV of future cash flows (\$m)	57.5		
PV of terminal value (\$m)	173.2		
Enterprise value (\$m)	230.7		
Less net debt (cash) (\$m)	(12.6)	Basic diluted shares (m)	57.4
<b>Equity value (\$m)</b>	<b>243.3</b>	<b>DCF value per share (\$/share)</b>	<b>4.23</b>
		<b>Risked price target (\$/share)</b>	<b>4.50</b>

Source: Wilsons



# 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.\$13.9m cash as at end-3QFY17
- No significant debt

## Board

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

## Management

- Derek Smith (Global CEO)
- Neil Verdal-Austin (CFO)
- Kien T. Nguyen (President, North America)
- James R. Evanger (CEO – Renew Sleep Solutions)
- Dr Jagdeep Bijwadia (Chief Medical Officer)

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