Date
01 November 2017

Theme
Company Update

WILSONS

Company
SomnoMed (SOM)

BUY: Scrappy 1Q – Europe the powerhouse supporting outlook and RSS investment

We maintain our BUY rating with a revised price target of $4.27 per share. US direct sales in 1Q18 were underwhelming but the European business is really firing, with several jurisdictional investments starting to pay off. There is still some unresolved tension between what SomnoMed is trying to achieve in its conventional medical device business, versus its newer RSS (sleep centre) business in the US market. Our view remains positive. A level of transitory disruption was probably inevitable, and should be diluted into immateriality as the scale of RSS grows. No changes to our forecasts, which were set just below guidance, following FY17 results.

Key points

Patchy 1Q18 trading but sticking with our earnings forecasts. SomnoMed reported 1Q18 revenue of $13m (+18.8% on pcp) which was weaker than forecast. US trading was soft (-6% v pcp) reflecting several factors: renewed channel conflict, severe weather disruption and a drop in licensee activity levels. Channel conflict had abated in 4Q17 so its re-emergence suggests an ongoing phenomenon, attending every new regional RSS opening. As the RSS network expands in scale, these transitory disruptions should become less problematic. The European business is still in strong growth, although the geographical complexion of that growth is changing. The traditional Holland/Nordic market power remains in force, but increasingly, favourable French/Belgium reimbursement coverage is supporting large and sustainable share gains at ResMed/Narval's expense. We are maintaining our FY18e forecast of $75m revenue and $3.9m EBITDA. Our EBITDA forecast remain a little below company guidance ($5m), with a more conservative outlook for RSS revenue ramp-up.

Cash flow weakness reversing in following quarters. The combination of direct start-up cash costs and working capital investment to support RSS was a drag on operating and free cash flow in 1Q. With several of the initial RSS cohort now trending into positive cash flow, and the conventional device business generating $6.5m in operating EBITDA this year, we are comfortable that SomnoMed is adequately capitalised to deliver the RSS business as forecast.

Valuation. Price target of $4.27/sh is DCF-derived and breaks down to $3.50/sh for conventional medical device business and $0.77/sh for RSS (risked). Continued execution and de-risking of RSS cash flows could support an un-risked target price of up to $5.62 per share.

Risks and catalysts

Important risks and catalysts are listed on p.5 of this report.

Recommendation	BUY
12-mth target price (AUD)	**$4.27**
Share price @ 11-Oct-17 (AUD)	$3.75
Forecast 12-mth capital return	13.9%
Forecast 12-mth dividend yield	0.0%
12-mth total shareholder return	**13.9%**

Market cap	$220m
Enterprise value	$209m
Shares on issue	59m
Sold short	0.0%
ASX 300 weight	n/a
Median turnover/day	$0.1m

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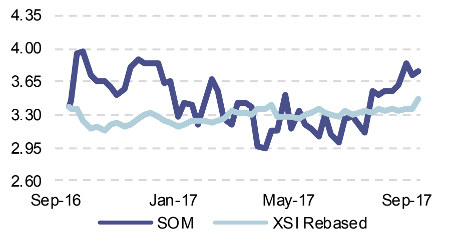
12-mth price performance ($)



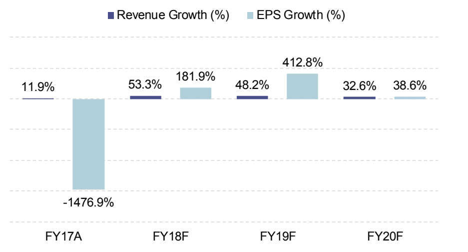
	1-mth	6-mth	12-mth
Abs return (%)	5.0	10.3	10.6
Rel return (%)	2.3	6.6	8.6

Earnings forecasts					
Year-end June (AUD)	**FY16A**	**FY17A**	**FY18F**	**FY19F**	**FY20F**
NPAT rep ($m)	0.2	-3.3	2.1	10.7	14.8
NPAT norm ($m)	0.2	-2.4	2.1	10.7	14.8
Consensus NPAT ($m)			0.1	12.2	15.4
EPS norm (cps)	0.3	-4.4	3.6	18.5	25.6
EPS growth (%)	-73.3	-1476.9	181.9	412.8	38.6
P/E norm (x)	1171.1	-85.1	103.9	20.3	14.6
EV/EBITDA (x)	141.4	-122.9	53.7	11.5	8.3
FCF yield (%)	0.1	-2.3	-1.1	2.3	4.6
DPS (cps)	0.0	0.0	0.0	0.0	0.0
Dividend yield (%)	0.0	0.0	0.0	0.0	0.0
Franking (%)	0	0	0	0	0

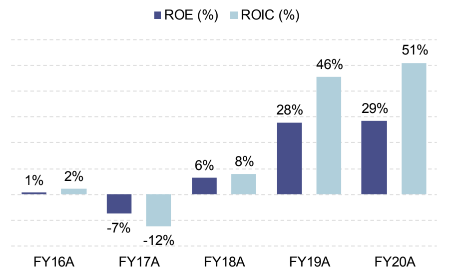
Source: Company data, Wilsons estimates, S&P Capital IQ

Key changes				
		28-Aug	**After**	**Var %**
NPAT:	**FY18F**	2.1	2.1	0.0%
norm	**FY19F**	10.7	10.7	0.0%
($m)	**FY20F**	14.8	14.8	0.0%
EPS:	**FY18F**	3.6	3.6	0.0%
norm	**FY19F**	18.5	18.5	0.0%
(cps)	**FY20F**	25.6	25.6	0.0%
DPS:	**FY18F**	0.0	0.0	0.0%
(cps)	**FY19F**	0.0	0.0	0.0%
	FY20F	0.0	0.0	0.0%
Price target:		4.27	4.27	0.0%
Rating:		**BUY**	**BUY**	

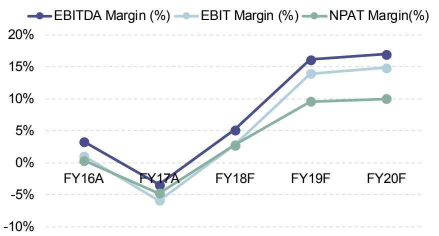
Growth rates



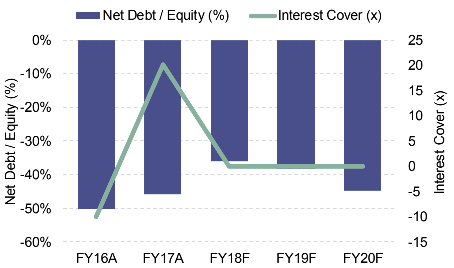
Returns



Margin trends



Solvency



Interims ($m)

	1H17A	2H17A	1H18E	2H18E
Sales revenue	23.8	25.5	33.2	42.4
EBITDA	0.4	-2.1	0.1	3.8
EBIT	-0.2	-2.8	-0.7	2.8
Net profit	**-0.3**	**-2.0**	**0.0**	**2.1**
Norm EPS	**-0.7**	**-3.7**	**0.0**	**3.6**
EBIT/sales (%)	-0.7	-10.8	-2.1	6.7
Dividend (c)	0.0	0.0	0.0	0.0
Franking (%)	0.0	0.0	0.0	0.0

Key assumptions

	FY13A	FY14A	FY15A	FY16A	FY17A	FY18F	FY19F	FY20F
Revenue growth (%)	21.3	40.1	33.0	28.0	11.9	53.3	48.2	32.6
EBIT growth (%)	-39.1	35.0	-45.7	90.2	-747.2	-172.8	633.5	41.1
NPAT growth (%)	-9.0	-9.2	-4.8	-72.4	-1,534.2	-186.9	421.0	38.6
EPS growth (%)	**-2.5**	**75.4**	**-55.3**	**-73.3**	**-1,476.9**	**-181.9**	**412.8**	**38.6**
EBIT/sales (%)	1.8	1.7	0.7	1.0	-5.9	2.8	14.0	14.9
Tax rate (%)	-93.3	3.4	44.8	85.0	-14.3	27.0	27.0	27.0
ROA (%)	**2.0**	**2.3**	**0.9**	**1.1**	**-7.0**	**4.3**	**24.1**	**28.5**
ROE (%)	6.3	5.1	2.8	0.5	-7.3	5.4	21.1	24.2
SomnoMed EBITDA ($m)	0.8	1.1	0.9	1.5	2.7	6.5	9.6	11.2
RSS EBITDA ($m)					-4.1	-2.6	8.5	14.0

Financial ratios

	FY13A	FY14A	FY15A	FY16A	FY17A	FY18F	FY19F	FY20F
PE (x)	244.9	139.6	312.5	1,171.1	-85.1	103.9	20.3	14.6
EV/EBITDA (x)	251.4	198.7	239.8	141.4	-122.9	53.7	11.5	8.3
Dividend yield (%)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
FCF yield (%)	0.2	-0.2	-0.6	0.1	-2.3	-1.1	2.3	4.6

Profit and loss ($m)

	FY13A	FY14A	FY15A	FY16A	FY17A	FY18F	FY19F	FY20F
Sales revenue	18.5	25.9	34.4	44.1	49.3	75.6	112.0	148.5
EBITDA	0.8	1.1	0.9	1.5	-1.7	3.9	18.1	25.2
Depn & amort	0.5	0.6	0.6	1.0	1.2	1.8	2.5	3.2
EBIT	**0.3**	**0.4**	**0.2**	**0.5**	**-2.9**	**2.1**	**15.6**	**22.1**
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	0.4	0.6	4.2	6.0
Minorities/pref divs	0.1	-0.2	0.1	0.1	-0.8	-0.5	0.7	1.3
Equity accounted NPAT	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net profit (pre-sig items)	**0.7**	**0.6**	**0.1**	**0.0**	**-2.4**	**2.1**	**10.7**	**14.8**
Abns/exts/signif	-0.1	-0.2	0.5	0.2	-1.0	0.0	0.0	0.0
Reported net profit	**0.6**	**0.4**	**0.6**	**0.2**	**-3.3**	**2.1**	**10.7**	**14.8**

Cash flow ($m)

	FY13A	FY14A	FY15A	FY16A	FY17A	FY18F	FY19F	FY20F
EBITDA	0.8	1.1	0.9	1.5	-1.7	3.9	18.1	25.2
Interest & tax	0.0	-0.5	0.1	-0.2	-1.2	-0.6	-4.2	-6.0
Working cap/other	-0.3	-1.3	-1.2	0.9	0.2	-2.3	-5.2	-5.5
Operating cash flow	**0.6**	**-0.8**	**-0.2**	**2.1**	**-2.7**	**1.0**	**8.7**	**13.8**
Maintenance capex	-0.2	0.3	-1.2	-1.9	-2.4	-3.5	-3.6	-3.8
Free cash flow	**0.4**	**-0.5**	**-1.4**	**0.2**	**-5.1**	**-2.5**	**5.1**	**10.1**
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	-0.3	0.0	0.0	0.0
Other inv flows	-0.1	-0.4	-0.3	-0.4	-0.1	0.0	0.0	0.0
Cash flow pre-financing	**-0.2**	**-1.2**	**-1.9**	**-1.5**	**-5.5**	**-2.5**	**5.1**	**10.1**
Funded by equity	0.5	0.0	7.3	10.7	2.4	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	3.1	2.5	-5.1	-10.1

Balance sheet summary ($m)

	FY13A	FY14A	FY15A	FY16A	FY17A	FY18F	FY19F	FY20F
Cash	4.2	2.9	8.3	16.7	14.2	11.7	16.8	26.9
Current receivables	4.4	5.5	7.2	9.4	10.2	12.8	19.2	25.9
Current inventories	0.9	1.0	1.3	1.8	1.9	3.0	4.5	6.1
Net PPE	1.2	1.3	2.1	3.8	4.5	5.7	6.3	6.4
Intangibles/capitalised	5.3	8.5	8.9	10.2	10.4	11.0	11.6	12.2
Total assets	**16.1**	**19.1**	**27.8**	**42.0**	**41.2**	**44.2**	**58.4**	**77.4**
Current payables	3.5	3.3	3.9	6.9	8.0	9.2	11.7	14.3
Total debt	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total liabilities	**4.5**	**6.6**	**6.2**	**8.8**	**10.3**	**11.7**	**14.4**	**17.4**
Shareholder equity	**11.6**	**12.6**	**21.5**	**33.2**	**31.0**	**32.5**	**43.9**	**60.1**
Total funds employed	**11.6**	**12.6**	**21.5**	**33.2**	**31.0**	**32.5**	**43.9**	**60.1**

SomnoMed Limited

Investment thesis

We maintain our BUY rating with a revised price target of $4.27 per share. US direct sales in 1Q18 were underwhelming but the European business is really firing, with several jurisdictional investments starting to pay off. There is still some unresolved tension between what SomnoMed is trying to achieve in its conventional medical device business, versus its newer RSS (sleep centre) business in the US market. Our view remains positive. A level of transitory disruption was probably inevitable, and should be diluted into immateriality as the scale of RSS grows. No changes to our forecasts, which were set just below guidance, following FY17 results.

Outlook

We see two factors driving the stock over the next few years and supporting our BUY call.

First, the conventional medical device business appears to have reached a leverage point in terms of its operating margin. Notably, conventional operating EBITDA grew by 60% in FY17 and the company's financial guidance flags another 60% growth, this year. That outlook feels well supported by underlying volume and sales growth, particularly within the European business. Our modelling over FY18-20 has capped the conventional medical device EBITDA margin in the mid-teens, anticipating that SomnoMed will continue to make measured investments in itself to sustain and grow its R&D, international manufacturing capacity, supply chain efficiency, regulatory and marketing infrastructure.

Secondly, the market starts extrapolating early success to value RSS properly. On a stand-alone DCF basis, we value the conventional medical device business at approximately $3.50 per share. By difference, the market is yet to attribute much value to RSS and that is the major factor controlling valuation development over the next 12 months.

Valuation

Our DCF model for SomnoMed takes free cash flows from both the conventional medical device and RSS businesses but treats them differently from the risk perspective. The conventional medical device business is comparatively well established in terms of its revenue growth track record and underlying margin structure – so its free cash flows are discounted using a "naked" WACC of 10.7% pa.

RSS is still in its formative stages and is as yet unproven – so we risk-adjust its cash flows using a subjective probability of success ~50%. With that adjustment made, our DCF valuation of SomnoMed is $4.27 per share. Setting the RSS component to "un-risked" status would support a valuation of $5.62 per share.

1Q18… our notes

Financials

SomnoMed reported 1Q18 revenue of $13m (+18.8% on pcp) which was weaker than the 25% growth we were forecasting. Q1 is always seasonally weak, and generally speaks for 18-20% of full year, in terms of SomnoMed's conventional medical device business. We are maintaining our FY18e forecast of $75m revenue and $3.9m EBITDA. Our expectations remain a little below guidance, given our more conservative outlook for RSS revenue ramp-up and the associated start-up/opening costs as the network establishes itself. The RSS network is now at 10 centres with another 7-9 planned over the balance of FY18. Recalling SomnoMed's financial guidance and our forecast positioning over FY18-20e.

Table 1: FY18 guidance and forecast vs FY17

	FY17A	FY18 (guidance)	FY18E	FY19E	FY20E
SomnoMed Core					
Revenue	47.7	55.0	56.7	68.1	79.8
Underlying EBITDA	6.5	10.5	10.5	14.1	16.2
- operating margin	*13.6%*	*19.1%*	*18.5%*	*20.8%*	*20.4%*
Corporate expenses	(4.1)	(4.0)	(4.0)	(4.5)	(5.0)
EBITDA*	2.4	6.5	6.5	9.6	11.2
- EBITDA margin	*5.0%*	*11.8%*	*11.5%*	*14.2%*	*14.1%*
RSS					
Revenue	1.6	20-25	18.9	43.9	68.8
EBITDA*	(4.1)	(1.5)	(2.6)	8.0	14.0
Group					
Revenue	49.3	75-80	75.6	112.0	148.5
EBITDA*	(1.7)	5.0	3.9	17.6	25.2

Source: Wilsons' estimates, company data

Cash flow and balance sheet. Operating cash outflow in 1Q18 was $3.8m, $2.4m of which relates to direct start-up costs within RSS (operating costs of the seven centres opened in FY17 + the establishment costs for three centres opened 1Q18). There is an obvious working capital drag playing out in the operating cash results this year, reflecting the fact that third party payers (Medicare, private health insurers) tend to pay on 80-100 day terms. SomnoMed closed the period with $9.7m cash.

Regional observations

Scrappy 1Q demand in the USA. The regional result was cycling a difficult comparable period (20.5% growth in 1Q17 with 35% growth in Sep-16). Several unhelpful factors also coalesced during the quarter:

a) a reversion to the "channel conflict" effects that disrupted performance Q2-3 of FY17 (traditional customer base pushing back in a punitive way, objecting to the perceived competitive threat posed by RSS) – this phenomenon was largely absent in the pcp;

b) a drop-off in licensee sales (which represented 16.5% of sales in the pcp); and

c) severe weather events in three US states.

Taken together, unit sales were down 6% in the conventional US device business. While we were surprised to see channel conflict re-emerge, our view remains that this will ultimately moderate and its impact in this seasonally and structurally weak Q1 is probably exaggerated. Channel conflict does seem to emerge and then resolve in every new jurisdiction that SomnoMed opens an RSS centre. The experience thus far suggests that specific demand for SomnoDent ultimately drives purchasing behaviour. SomnoMed's ability to supply a high quality, FDA-approved medical device, at a price and with acceptable turnaround times remains an unmatched competitive advantage. Experience also suggests that much improved Q2 trading should follow. We usually see an influx of activity in the December quarter as health insurance beneficiaries seek treatments before their out-of-pocket deductibles "reset" in January.

Steady progress on the RSS campaign. SomnoMed did not report an explicit split for RSS revenue but the qualitative feedback remains positive, with respect to centre performance versus the "S3" centres in Texas, which formed the template for this business. As mentioned 10 RSS centres are now open and, as per management's commentary at the FY17 result in August, many of the initial cohort are break-even/profitable at the individual clinic level.

Reimbursement support from private payers varies with jurisdiction, as always – but we understand that RSS has had some good regional wins over 1Q18 in terms of coverage and pricing. The RSS network is still an early-stage venture and lessons are being learned to make subsequent centre openings run more smoothly. We would expect to see a more quantitative update on both centre and network performance when SomnoMed reports its 1H18 results in February.

European results remain both diversified and high growth. European sales grew 24% over a 19% growth comp, underlining the diversity from which this segment draws new volume. The key markets such as Holland and the Nordics remain in growth phase, presumably on account of SomnoMed's preferred status as a supplier to public health payers. For some time, SomnoMed has also been competing in a direct, head-to-head manner with CPAP in front-line therapy, winning incremental share from both ResMed and Phillips/Respironics.

In France, oral appliance therapy has been on a (more) equal footing with CPAP in mild/moderate patients since reimbursement changes came into effect in November 2016. We estimate that SomnoMed has grown its French operation to be annualising at 3,000+ device per annum, largely at the expense of Narval (a ResMed subsidiary), as SomnoDent takes market share from Narval CC. The French market is shaping up to be a key driver for SomnoMed, where we see a 7,000-10,000 device market potential if: a) underlying sleep apnoea patient growth remains in mid-single digits; and b) reimbursement continues to drive utilisation/mix change in a similar direction to that seen in Holland/Nordics over the past 5-10 years.

SomnoMed's European business remains the most important profit centre and source of group earnings leverage. Shareholders are benefiting from a series of foundation investments in European jurisdictions over the past 3-4 years, which are now coming to fruition.

SomnoMed (SOM)

Business description

SomnoMed Limited (SOM) develops, manufactures and sells oral appliance devices for the treatment of obstructive sleep apnoea (OSA). The company has developed a global infrastructure to address the OSA market, with the majority of its sales derived from the US and Europe. More recently SomnoMed has invested to create a network of treatment centres in the USA which trade as Renew Sleep Solutions (RSS). These centres employ social media and other advertising channels to reach lapsed, previously diagnosed patients as a direct-to-consumer channel for their SomnoDent devices.

Investment thesis

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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.$9.7m cash as at end-1Q18
- 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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Definitions at wilsonsadvisory.com.au/Disclosures.

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