

3<sup>rd</sup> February 2010

## AUSTRALIAN EQUITY RESEARCH

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# SOMNOMED LIMITED

### Summary

Somnomed (SOM) is a medical device maker, focusing on the production of oral appliances that aim to treat sleep disorders such as obstructive sleep apnea and sleep bruxism. Hanumans believe at current prices an investment in SOM offers a compelling risk reward prospect. This report provides an update as to the progress SOM is making in achieving its financial and operational goals including:

- The December quarterly cash flow report
- Launch of new product line to treat Sleep Bruxism
- Strategic partnerships in the US
- Development of production and distribution capabilities
- Favorable regulatory trends in Europe

SOM is an outstanding investment opportunity. Hanumans believe the stock is a BUY and we have a valuation of \$2.

SOM has;

- leadership in a niche market
- a MASSIVE addressable market
- is profitable with a net cash balance sheet
- favorable regulatory and medical best practice trends
- management who own the stock and are shareholder focused
- very high barriers to entry

At \$1 SOM has a fully diluted market capitalization of just ~\$39m. The company has no debt and at December had \$3.3m in cash. SOM is now profitable at the EBITDA and NPAT level and we forecast will make in excess of \$700K EBITDA this year and can make \$4m+ EBITDA in FY12. We do not feel the current share prices captures either a) the organic growth potential SOM has ahead or b) the strategic importance of a company like SOM to a large obstructive sleep apnea player like Resmed (ASX:RMD).

### Recommendation

Industry	Healthcare
12 month rating	Spec Buy
12 month price target	\$2.00
Forecast price appreciation	103%
Price (SOM)	\$0.97

### Trading Data (AUD)

52 wk range	\$0.32 - \$1.14
Market cap	\$37m
Shares	38m
Cash/Liquids	\$3.5m
Debt	Nil
Enterprise value	\$33.5m

### Historical Share Price (A\$)



Source: Paritech Pulse

## December Quarterly – Unit Sales up 67%, Revenue up 57%

The December Quarterly was very encouraging. Unit sales grew from 4,082 in the September quarter to 5,058. This represents growth of 24% quarter on quarter and growth of 67% for the December half 2009 relative to the December half 2008. Revenue growth did not match unit sales growth, largely due to the A\$ strengthening. Unit sales for the first half were 9,140 and revenue for the first half was \$5m. This puts SOM ahead of their full financial year guidance of unit sales of 18,000 and revenue guidance of A\$10m. SOM also reported an EBITDA profit of \$250,000 for the first half and pre tax profit of \$100,000. The current cash balance is \$3.3m after \$400,000 was spent on production facilities in the quarter.

## New Product to Treat Sleep Bruxism

Bruxism is a condition in which you grind, gnash or clench your teeth. If you have bruxism, you may unconsciously clench your teeth together during the day or grind them at night, which is called sleep bruxism. Sleep Bruxism (SB) can be frequent and severe enough to lead to jaw disorders, headaches, damaged teeth and other problems. SB is the most common sleep disorder with about 8% of the population having the condition. The global market is worth US\$200-300m and is growing at 8-12% p.a. The market is currently highly fragmented with patients serviced by oral devices individually made by dental technicians.

SOM believe they can capture 10% of this global market in a few years with the introduction of their SomBrux product. The product is custom made and uses SOM's SMH BFlex material. SOM believe they are well placed to roll this product out via their network of 2,000 dental practitioners globally. The Australian roll out commences in February with the US and Europe to follow in June.

Should we take the lower end of the current wholesale market forecast of US\$200m and grow it by 8% for 5 years then the SB oral device market will be US\$294m in 5 years. Taking 10% of this generates a US\$29m revenue opportunity or, at 65% gross margin, a US\$19m or A\$22m gross profit opportunity. All with very little incremental spend as this product utilizes the current distribution and production capability.

<b>SomBrux Market Potential</b>		
	<b>Base Case</b>	<b>Bull Case</b>
Market Today (US\$m)	200	300
Growth p.a.	8%	12%
Market in 5 years (US\$m)	294	529
Market Share	10%	15%
Revenue Opportunity (US\$m)	29	79
Gross Margin	65%	70%
Gross Margin Opportunity (US\$m)	19	56
Long term A\$ forecast	\$ 0.85	\$ 0.85
A\$ Gross Margin Opportunity (\$m)	22	65

## **Strategic Partnership in the US**

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In November SOM announced a couple of strategic partnerships with Watermark Medical and SleepQuest in the US and Canada. Watermark sell sleep testing equipment that people can use in their home. SleepQuest have a number of sleep centers on the West Coast of the US. SOM has entered strategic partnerships so that these companies will be able to offer the Somnomed MAS if the sleep physician believes Oral Appliance Treatment (OAT) is appropriate. SOM will benefit from these arrangements by increasing the awareness of OAT in the medical community and will help SOM expand their medical, as opposed to dental, network. By way of example, SOM have trained Watermark's 23 business development managers in who SOM is and their product set. SOM's product and dental network is also integrated into the software Watermark's software making it easier for GP's to refer patients to the SOM network of dentists. These partnerships promise to help grow unit sales in SOM's largest market.

## **Production and Distribution Capabilities**

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SOM have increased their network of dental practitioners who are able to fit the SomnoDent device. The number of dental practices now stands at 2,000 globally with 1,500 of these in the US. SOM is well on its way to increasing the number of practices in the dental network to 2,300 by year end. Progressively efforts will turn to increasing the efficiency (i.e. number of devices fitted by each practice) of the network rather than its size. It is worthwhile to note that dentists pay to become a member of the SOM network. This payment of between A\$2,500 and A\$3,900 includes their education in fitting the device and their first 3 treatments. The fact dentists are willing to pay for their education is illustrative of the regard in which they hold the SOM product set.

On the production side of the business, management believes they can continue to increase gross profit margins. Gross profit margins currently stand at 63% up from the low 40's 3 years ago. Gross profit margins in excess of 70% are believed to be achievable. The \$400,000 of capex spent in the December quarter was spent in order to achieve this goal. If gross margins can go from current levels to 70% there is an extra \$700K EBITDA opportunity at current revenue levels. Achieving 70% GP margins would approximately double current earnings.

## **Favorable Regulatory Trends in Europe**

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Sweden has been an excellent market for SOM. This is because the government there has embraced Oral Appliance Treatments (OAT) ahead of CPAP as the first line treatment for obstructive sleep apnea. SOM commenced operations in Sweden in November 2008 and believe they currently have 10-15% market share. Sweden is worth mentioning because there is the potential for another Sweden success story in Holland. The Dutch government, as of January 2010, has included OAT's in the Medicare rebate for patients with and AHI (apnea-hypopnea index) of > 5 per hour. The AHI measures the number of interruptions a sleep apnea patient experience per hour. 5 is an extremely low level with more than 30 interruptions considered severe. Due to the reimbursement, and a low AHI hurdle, the Netherlands could be a very big market for SOM. France is another market in Europe that last year included OAT's on their Medicare reimbursement list. SOM is planning to enter France late in CY10.

## Valuation and Recommendation

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Looking in to the future, management has given the market guidance on where they think unit sales can go by FY12. Namely, they are targeting 36,000 units by FY12 from 18,000 this financial year. As stated, this 18,000 is now looking conservative given SOM grew unit sales at 24% qoq in December. Taking this unit sales forecast and making some assumptions around cost growth and holding GP margins around current levels it is clear to see how SOM could be making \$4m EBITDA in FY12. Given tax losses, our forecasts place SOM on a FY12 PE of less than 10x at current prices.

<b>SOM Valuation - Base Case</b>				
	<b>FY09</b>	<b>FY10</b>	<b>FY11</b>	<b>FY12</b>
Unit Sales	12,254	18,000	25,000	36,000
Unit Sales Growth		5,746	7,000	11,000
Unit % Growth		46.9%	38.9%	44.0%
Ave Unit Price	\$ 628.37	\$ 560.00	\$ 576.80	\$ 594.10
Price Growth			3%	3%
Revenue (\$m)	7.7	10.1	14.4	21.4
EBITDA Margin %		4%	10%	20%
<b>EBITDA</b>		<b>0.4</b>	<b>1.4</b>	<b>4.3</b>
Depreciation		0.3	0.3	0.3
<b>EBIT</b>		<b>0.1</b>	<b>1.1</b>	<b>4.0</b>
Interest		0.1	0.1	0.1
<b>OPBT</b>		<b>0.2</b>	<b>1.2</b>	<b>4.1</b>
Tax				
<b>NPAT</b>		<b>0.2</b>	<b>1.2</b>	<b>4.1</b>

If SOM achieves forecast sales trends then our Discounted Cash Flow analysis suggests the stock is worth \$2 per share using conservative discount rates. SOM is a unique company given its global dominance of a niche market with very high barriers to entry and rational and shareholder focused management. There is outstanding long-term value in SOM. **BUY.**

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## Ratings

BUY – anticipated stock return is greater than 10%

SELL – anticipated stock return is less than -10%

HOLD – anticipated stock return is between -10% and +10%

SPECULATIVE – high risk with stock price likely to fluctuate by 50% or more

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