

BUY: Free options on new product R&D

We maintain our BUY rating on Nanosonics and price target of \$3.34 per share. Investors should take advantage of this share price weakness following Nanosonics' 1H18 revenue miss. FY18 is an intense investment year with management pursuing growth options in Europe and several new product R&D campaigns. At the same time, Nanosonics continues to diversify market access – making it easier for clinics to obtain Trophon – but in some cases (rental, service contracts) at the expense of upfront capital revenue. Foregoing short-term capital revenue to increase the installed base could hardly be better news for shareholders. Consumables utilisation remains consistent across the installed base (~16,000 devices, globally). Shareholders should get a major pay-off from that annuity profit base growing at double-digit rates.

Key points

1H18 result snapshot. Nanosonics reported 1H18 EBITDA of \$3.7m which was broadly in line with our \$4.0m estimate, given a miss on revenue (\$30m reported versus \$37m). Revenue missed on account of: a) \$3-4m stocking order in pcp that didn't repeat; b) \$1.8m impact from GEHC inventory management; c) the mix between Nanosonics' direct sales and those by GEHC/other indirect resellers (1,700 units placed was ahead of the 1,600 in our model but different ASPs); and d) introduction of a "rental model". The US installed base (IB) grew by 1,700 Trophon units (+13% vs F17 update) to ~14,100 (US market ~35% penetrated). Ex-US IB grew 12% vs F17 to >16,000 units. We assess that most of the ex-US IB growth was in the UK (+86% v pcp) where management expects 75-100% growth this year under the Managed Equipment Services (MES) business model.

Outlook. Management guided 2H18 USA IB growth as similar to 1H18, which agreed with our model. FY18 operating expense guidance of \$48m implies at least a doubling of R&D expense for 2H. We cut our FY18e NPAT forecast by ~\$5m reflecting lower sales and an increase in R&D expense. FY19-20e forecasts maintained. FY18 was always positioned as an investment year, exercising growth options in Europe and in R&D pipeline.

New product R&D. Management talked openly about the 2nd Generation Trophon becoming available. Trophon-2 perpetuates the franchise in several ways including: a) resetting the price point higher; b) driving further market penetration with new functionality (possibly electronic medical record integration); and c) as a catalyst for a product replenishment cycle from within the existing IB, seeking upgrades. Management held back on the two further product ideas in their R&D pipeline for competitive and IP protection reasons. The new platforms should launch over FY19-20 and leverage the existing Nanosonics sales teams in infection control. In the past, product development candidates have included high level disinfection (HLD) solutions for transoesophageal echocardiogram probes and endoscopes. Both cases would represent market opportunities at least on par with Trophon.

Valuation. Our primary Nanosonics valuation is a DCF which values the international Trophon business at \$2.84 per share (and includes Trophon-2). We add a nominal \$0.50/sh to recognise new HLD platforms becoming available over the next 12-24 months.

Risks and catalysts

Risks: a) slower-than-forecast sales growth; b) slow business development in Europe; c) manufacturing and regulatory risks; d) investment limiting profit growth. **Catalysts:** a) revenue, cash flow and installed base reporting; b) potential partnering in new markets; c) new product launches.

Recommendation	BUY
12-mth target price (AUD)	\$3.34
Share price @ 23-Feb-18 (AUD)	\$2.62
Forecast 12-mth capital return	27.5%
Forecast 12-mth dividend yield	0.0%
12-mth total shareholder return	27.5%

Market cap	\$784m
Enterprise value	\$719m
Shares on issue	299m
Sold short	8.1%
ASX 300 weight	0.0%
Median turnover/day	\$2.0m

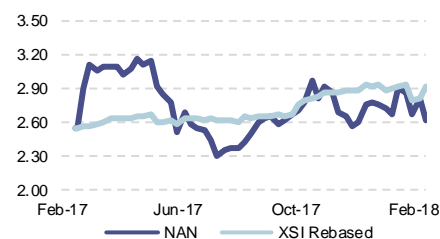
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12-mth price performance (\$)

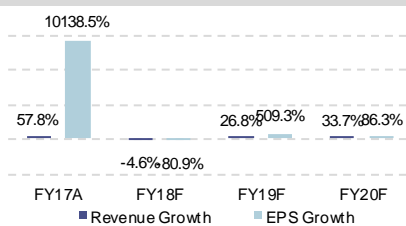


	1-mth	6-mth	12-mth
Abs return (%)	-9.7	4.8	2.7
Rel return (%)	-9.4	-5.4	-11.5

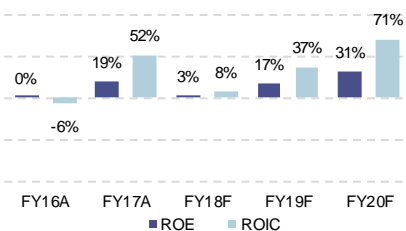
Key changes

		03-Oct	After	Var %
NPAT:	FY18F	7.7	2.6	-65.8%
norm	FY19F	16.1	16.1	0.0%
(\$m)	FY20F	30.0	30.0	-0.1%
EPS:	FY18F	2.6	0.9	-65.8%
norm	FY19F	5.4	5.4	0.0%
(cps)	FY20F	10.1	10.1	-0.1%
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:		3.34	3.34	0.1%
Rating:		BUY	BUY	

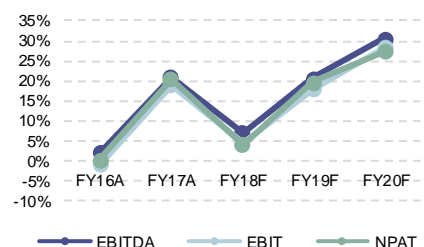
Growth rates



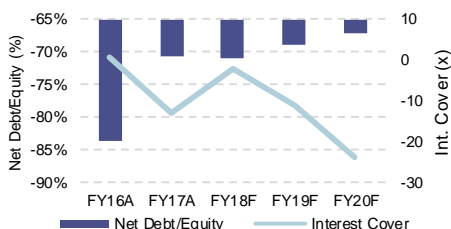
Returns



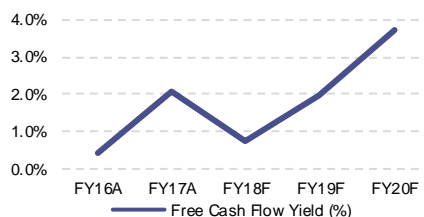
Margin trends



Solvency



Free cash flow yield



Interims (\$m)

	1H17A	2H17A	1H18E	2H18E
Sales revenue	0.0	67.5	30.0	34.4
EBITDA	10.5	3.7	3.7	0.8
EBIT	9.8	3.0	3.1	-0.2
Net profit	10.3	3.6	2.2	0.4
Norm EPS	3.4	1.2	0.7	0.1
EBIT/sales (%)		4.5	10.3	-0.6
Dividend (c)	0.0	0.0	0.0	0.0
Franking (%)	0.0	0.0	0.0	0.0
Payout ratio (%)	0.0	0.0	0.0	0.0
Adj payout (%)	0.0	0.0	0.0	0.0

Key assumptions

	FY13A	FY14A	FY15A	FY16A	FY17A	FY18F	FY19F	FY20F
Revenue growth (%)	21.1	44.3	3.4	92.6	57.8	-4.6	26.8	33.7
EBIT growth (%)	6.7	-56.0	105.5	-93.8	-3,683.8	-77.7	413.8	110.8
NPAT growth (%)	23.3	-54.8	109.6	-102.3	10,893.7	-80.9	509.3	86.3
EPS growth (%)	10.7	-56.4	102.7	-102.3	10,138.5	-80.9	509.3	86.3
EBIT/sales (%)	-43.0	-13.1	-26.1	-0.8	19.1	4.5	18.1	28.5
Tax rate (%)	-0.6	1.2	0.1	7.4	0.0	36.2	0.0	7.5
ROA (%)	-19.0	-8.4	-9.6	-0.4	12.6	2.7	13.2	26.8
ROE (%)	-26.6	-12.7	-12.2	0.2	15.4	2.8	16.8	30.6

Financial ratios

	FY13A	FY14A	FY15A	FY16A	FY17A	FY18F	FY19F	FY20F
PE (x)	-114.9	-263.5	-130.0	5,765.1	56.3	295.2	48.4	26.0
EV/EBITDA (x)	-134.1	-389.9	-152.0	747.0	50.9	159.8	42.5	21.5
Dividend yield (%)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
FCF yield (%)	-0.6	-0.3	-0.3	0.4	2.1	0.7	2.0	3.7
Payout ratio (%)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Adj payout (%)	0.0	0.0	0.0	0.0	0.0	0.0	88.6	86.9

Profit and loss (\$m)

	FY13A	FY14A	FY15A	FY16A	FY17A	FY18F	FY19F	FY20F
Sales revenue	14.9	21.5	22.2	42.8	67.5	64.4	81.6	109.2
EBITDA	-5.4	-1.8	-4.7	1.0	14.1	4.5	16.9	33.4
Deprn & amort	1.0	1.0	1.1	1.3	1.3	1.6	2.2	2.3
EBIT	-6.4	-2.8	-5.8	-0.4	12.9	2.9	14.8	31.1
Net interest expense	-0.7	-0.2	-0.3	-0.5	-1.0	-1.3	-1.3	-1.3
Tax	0.0	0.0	0.0	0.0	0.0	1.5	0.0	2.4
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)	-5.8	-2.6	-5.5	0.1	13.9	2.6	16.1	30.0
Abns/exts/signif	0.0	0.0	0.0	0.0	12.3	-1.5	0.0	0.0
Reported net profit	-5.8	-2.6	-5.5	0.1	26.2	1.1	16.1	30.0

Cash flow (\$m)

	FY13A	FY14A	FY15A	FY16A	FY17A	FY18F	FY19F	FY20F
EBITDA	-5.4	-1.8	-4.7	1.0	14.1	4.5	16.9	33.4
Interest & tax	1.1	0.0	0.3	0.0	0.0	0.0	0.0	-2.4
Working cap/other	-0.2	-0.7	2.0	2.3	2.2	1.3	-1.5	-1.6
Operating cash flow	-4.5	-2.6	-2.4	3.2	16.4	5.8	15.4	29.3
Maintenance capex	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Free cash flow	-4.5	-2.6	-2.4	3.2	16.4	5.8	15.4	29.3
Dividends paid	0.0	0.0	0.0	0.0	0.0	0.0	-13.7	-25.5
Growth capex	-1.4	-0.5	-2.3	-1.1	-1.1	-2.3	-2.2	-2.5
Invest/disposals	0.0	0.0	0.0	-0.2	-0.2	0.0	0.0	0.0
Oth investing/finance flows	0.0	-0.2	0.6	-2.1	-0.1	-0.3	0.0	0.0
Cash flow pre-financing	-5.9	-3.3	-4.1	-0.2	15.1	3.2	-0.4	1.4
Funded by equity	0.5	0.3	28.0	0.1	0.0	0.0	0.0	0.0
Funded by debt	0.0	0.2	0.0	3.8	-0.4	-0.2	0.0	0.0
Funded by cash	5.3	2.7	-23.9	-3.6	-14.7	-3.0	0.4	-1.4

Balance sheet summary (\$m)

	FY13A	FY14A	FY15A	FY16A	FY17A	FY18F	FY19F	FY20F
Cash	24.1	21.2	45.7	48.8	63.0	65.9	65.5	66.8
Current receivables	4.2	5.7	3.9	7.7	8.9	8.8	10.9	14.6
Current inventories	2.9	4.2	6.2	6.9	7.7	9.5	13.0	15.0
Net PPE	1.8	1.8	3.6	3.3	3.5	4.6	4.7	4.9
Intangibles/capitalised	0.0	0.0	0.0	0.0	14.1	12.8	12.8	12.8
Total assets	33.7	33.5	60.4	68.2	99.3	103.4	108.7	116.0
Current payables	3.0	3.0	2.7	4.6	3.7	4.0	6.0	8.0
Total debt	7.6	8.1	0.0	1.3	1.4	1.2	1.2	1.2
Total liabilities	11.9	13.1	15.7	11.5	12.0	12.3	15.1	17.9
Shareholder equity	21.7	20.4	44.7	56.7	87.3	91.1	93.6	98.1
Total funds employed	29.3	28.5	44.7	58.0	88.6	92.3	94.7	99.2



Nanosonics (NAN)

Business description

Nanosonics Limited (NAN) develops, manufactures and markets equipment for the high level disinfection of ultrasound probes and other pieces of medical device hardware. Its products are underpinned by a "NanoNebulant" technology – very fine, nebulised droplets of concentrated hydrogen peroxide which kill microorganisms on surfaces. Its lead product, the Trophon EPR, is now available in most major markets for disinfecting obstetrics/gynaecologic probes.

Investment thesis

We maintain our BUY rating on Nanosonics and price target of \$3.34 per share. Investors should be taking advantage of this share price weakness following Nanosonics' 1H18 revenue miss. FY18 is an intense investment year with management pursuing growth options in Europe and several new product R&D campaigns. At the same time, Nanosonics continues to diversify market access – making it easier for clinics to obtain Trophon – but in some cases (rental, service contracts) at the expense of upfront capital revenue. Foregoing short-term capital revenue to increase the installed base could hardly be better news for shareholders. Consumables utilisation remains absolutely consistent across the installed base (~16,000 devices, globally). Shareholders should get a major pay-off from that annuity profit base growing at double-digit rates.

Revenue drivers

- Has an non-exclusive distribution arrangement with GEHC for the US and Canadian markets
- Network of third-party device distributors in Europe
- Revenue a function of both device sales (capital equipment) and consumables (cartridges of hydrogen peroxide and other products used with every disinfection cycle)

Margin drivers

- Gross margins: devices (c.60%); consumables (c.85%)
- Contract pricing may be variable
- Business development expenses expected in both Europe and USA business – building channels, increasing awareness, providing additional customer support

Key issues/catalysts

Upside risks:

- Faster-than-expected sales traction in USA and other markets
- Decision to scale-up manufacturing a leading indicator of demand
- New product development opportunities may include high-level disinfection units for transesophageal transducers, endoscopes or other device reprocessing applications

Risk to view

Downside risks:

- Lower sales growth
- Regulatory and/or clinical practice changes take a long time to change
- All device manufacturers face scale-up, quality control risks.

Balance sheet

- Nanosonics had c.\$61m net cash as at end-FY17

Board

- Mr Maurie Stang (Non-Exec. Chairman)
- Mr Michael Kavanagh (Managing Director)
- Mr Richard England (Non-Exec. Director)
- Dr David Fisher (Non-Exec. Director)
- Ms Marie McDonald (Non-Exec. Director)
- Mr Steven Sargent (Non-Exec. Director)

Management

- Mr Michael Kavanagh (CEO)
- Dr Ron Weinberger (President Technology Development)
- Dr Steven Farrugia (Senior VP, Design and Development)
- Mr McGregor Grant (CFO)
- Mr Gerard Putt (COO)

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Recommendation structure and other definitions

Definitions at wilsonsadvisory.com.au/Disclosures.

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