Date
18 August 2016

Theme
Financial results

Company

WILSONS

Nanosonics (NAN)

A little extra wind in their sails

Nanosonics reported its debut full-year profit in FY16, with its US business providing a stable growth platform for management to start exercising a range of new growth options. FY17 is shaping up as a year to develop the Trophon story more aggressively in Europe, and to bring new product R&D into focus. Revenue and underlying earnings run-rates heading into FY17 leave us confident about upside to our forecasts. While Nanosonics screens as expensive on some dimensions, the catalyst profile over the next 12 months may include: sustained US performance; strengthened fundamentals in Europe; potential partnering arrangements for accessing the Japanese and other ultrasound markets; new products from R&D activities; and candidacy for S&P/ASX 200 index. We reiterate our BUY rating. Price target maintained at $3.25 per share.

Key points

FY16 NPAT of $0.1m with authentic 2H profit setting the scene for FY17 earnings growth. Nanosonics reported a $3.4m 2H profit and $7.2m in operating cash flow. Management indicated that the 2H is a sound reflection of current demand patterns which sets up the forecast period well in terms of both earnings growth and free cash flow.

Geographic summary. US sales grew 121% to $39m, ANZ up 10% to $2.5m whilst Europe was weak at $1.2m. Market development efforts continue in the UK, building a sales pipeline ahead of English guideline publication in coming months. Potential upside in the US from non-GE ultrasound OEMs purchasing Trophons for inclusion with their ultrasound system sales. Nanosonics plans to sell capital equipment to non-GE OEMs but manage the ongoing resupply of consumables and services. Incremental positive.

Forecasts. Our FY17 and FY18 sales forecasts are up +2-3%; offset by an increase in operating expenses. Management guided to 15-20% opex growth in FY17 (W:16%), leaving our FY17e EBITDA forecast unchanged. Higher D&A expenses had a small negative effect on NPAT and EPS estimates (down 2-5%).

Price target maintained at $3.25 per share, BUY rating. Price target represents a 17% premium to DCF, which is based on the US, European and ANZ markets only. The reflects upside to DCF in recognition of growth options in new territories (notably Japan) and new product development R&D pushing into adjacent disinfection settings.

Risks and catalysts

Catalysts: a) quarterly revenue, cash flow and installed base reporting; b) potential partnering in new markets; c) release of guidelines favouring adoption in UK; **Risks**: a) slower-than-forecast sales growth; b) slow business development in Europe; d) manufacturing and regulatory risks.

Recommendation	BUY
12-mth target price (AUD)	**$3.25**
Share price @ 17-Aug-16 (AUD)	$2.80
Forecast 12-mth capital return	16.1%
Forecast 12-mth dividend yield	0.0%
12-mth total shareholder return	**16.1%**

Market cap	$829m
Enterprise value	$778m
Shares on issue	296m
Sold short	3.2%
ASX 300 weight	0.0%
Median turnover/day	$1.2m

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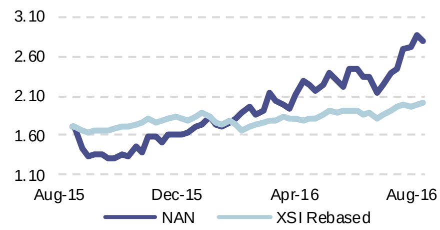
12-mth price performance ($)



	1-mth	6-mth	12-mth
Abs return (%)	19.1	42.1	63.7
Rel return (%)	15.3	23.8	46.0

Earnings forecasts

Year-end June (AUD)	FY15A	FY16A	FY17F	FY18F	FY19F
NPAT rep ($m)	-5.5	0.1	8.1	17.4	33.6
NPAT norm ($m)	-5.5	0.1	8.1	17.4	33.6
Consensus NPAT ($m)			10.8	21.0	37.7
EPS norm (cps)	-2.0	0.0	2.7	5.9	11.4
EPS growth (%)	-105.4	102.2	6120.4	114.7	93.7
P/E norm (x)	-137.1	6369.6	102.4	47.7	24.6
EV/EBITDA (x)	-164.5	808.1	88.7	43.2	22.8
FCF yield (%)	-0.3	0.4	0.7	2.0	3.9
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

Key changes

		24-Jul	After	Var %
NPAT:	**FY17F**	8.5	8.1	-4.9%
norm	**FY18F**	17.8	17.4	-2.3%
($m)	**FY19F**	34.1	33.6	-1.4%
EPS:	**FY17F**	2.9	2.7	-4.9%
norm	**FY18F**	6.0	5.9	-2.3%
(cps)	**FY19F**	11.5	11.4	-1.4%
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:		3.25	3.25	0.0%
Rating:		**BUY**	**BUY**	

Price target

	Valuation	Price target
WACC (%)	12	
Terminal growth (%)	0	
NPV forecast FCF (A$m)	218	
NPV perpetuity (A$m)	554	
Net debt/(cash) (A$m)	52	
DCF valuation (A$m)	824	
Growth options (A$m)	0.0	
NAN valuation (A$m)	824.5	

DCF valuation ($/sh)	**2.79**
Price target ($/sh)	**3.25**

Interims ($m)

Half-year (AUD)	Dec 15 1HA	Jun 16 2HA	Dec 16 1HE	Jun 17 2HE
Sales revenue	15.6	27.2	27.2	33.0
EBITDA	-3.0	3.9	3.7	5.1
EBIT	-3.5	3.1	2.9	4.2
Net profit	**-3.2**	**3.4**	**3.3**	**4.7**
Norm EPS	**-1.1**	**1.2**	**1.1**	**1.6**
EBIT/sales (%)	-22.5	11.6	10.5	12.9
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	-47.5	-50.4	-63.7
Net debt/equity (%)	<0	<0	<0
Net debt/EV (%)	**<0**	**<0**	**<0**
Current ratio (x)	7.7	6.9	7.3
Interest cover (x)	0.7	<0	<0
Adj cash int cover (x)	**<0**	**<0**	**<0**
Debt/cash flow (x)	0.0	0.2	0.1
Net debt (cash)/share ($)	<0	<0	<0
NTA/share ($)	0.2	0.2	0.3
Book value/share ($)	0.2	0.2	0.3
Payout ratio (%)	0	0	0
Adj payout ratio (%)	14	0	0

EPS reconciliation ($m)

	FY16A Rep	FY16A Norm	FY17F Rep	FY17F Norm
Sales revenue	43	43	60	60
EBIT	-0.4	-0.4	7.1	7.1
Net profit	**0.1**	**0.1**	**8.1**	**8.1**
Notional earn	0.0	0.0	0.0	0.0
Pref/conv div	0.0	0.0	0.0	0.0
Profit for EPS	**0.1**	**0.1**	**8.1**	**8.1**
Diluted shrs (m)	287	287	296	296
Diluted EPS (c)	**0.0**	**0.0**	**2.7**	**2.7**

Returns

	FY16A	FY17F	FY18F	FY19F
ROE (%)	0	13	24	39
ROIC (%)	-6	42	70	111
Incremental ROE	31	79	73	119
Incremental ROIC	408	68	140	273

Key assumptions

Year-end June (AUD)	FY13A	FY14A	FY15A	FY16A	FY17F	FY18F	FY19F	FY20F
Revenue growth (%)	21.1	44.3	3.4	92.6	40.6	22.4	29.9	23.9
EBIT growth (%)	6.7	-56.0	105.5	-93.8	-2,080.0	129.0	98.3	45.6
NPAT growth (%)	23.3	-54.8	109.6	-102.3	6,315.0	114.7	93.7	7.3
EPS growth (%)	**10.7**	**-56.4**	**105.4**	**-102.2**	**6,120.4**	**114.7**	**93.7**	**7.3**
EBIT/sales (%)	-43.0	-13.1	-26.1	-0.8	11.8	22.1	33.7	39.7
Tax rate (%)	-0.6	1.2	0.1	7.4	0.0	0.0	0.0	25.6
ROA (%)	**-19.0**	**-8.4**	**-9.6**	**-0.5**	**7.8**	**15.4**	**27.8**	**38.3**
ROE (%)	**-26.6**	**-12.7**	**-12.2**	**0.2**	**10.8**	**19.6**	**34.5**	**35.0**

Profit and loss ($m)

Year-end June (AUD)	FY13A	FY14A	FY15A	FY16A	FY17F	FY18F	FY19F	FY20F
Sales revenue	14.9	21.5	22.2	42.8	60.2	73.6	95.7	118.5
EBITDA	-5.4	-1.8	-4.7	1.0	8.8	18.0	34.1	48.9
Depn & amort	1.0	1.0	1.1	1.3	1.7	1.7	1.8	1.9
EBIT	**-6.4**	**-2.8**	**-5.8**	**-0.4**	**7.1**	**16.3**	**32.3**	**47.0**
Net interest expense	-0.7	-0.2	-0.3	-0.5	-1.0	-1.1	-1.3	-1.4
Tax	0.0	0.0	0.0	0.0	0.0	0.0	0.0	12.4
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**	**8.1**	**17.4**	**33.6**	**36.1**
Abns/exts/signif	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Reported net profit	**-5.8**	**-2.6**	**-5.5**	**0.1**	**8.1**	**17.4**	**33.6**	**36.1**

Cash flow ($m)

Year-end June (AUD)	FY13A	FY14A	FY15A	FY16A	FY17F	FY18F	FY19F	FY20F
EBITDA	-5.4	-1.8	-4.7	1.0	8.8	18.0	34.1	48.9
Interest & tax	1.1	0.0	0.3	0.0	1.0	1.1	1.3	-11.0
Working cap/other	-0.2	-0.7	2.0	2.3	-3.8	-2.7	-2.8	-5.3
Operating cash flow	**-4.5**	**-2.6**	**-2.4**	**3.2**	**6.0**	**16.4**	**32.6**	**32.6**
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**	**6.0**	**16.4**	**32.6**	**32.6**
Dividends paid	0.0	0.0	0.0	0.4	0.0	0.0	-23.5	-25.2
Growth capex	-1.4	-0.5	-2.3	-1.1	-3.0	-3.1	-3.2	-3.2
Invest/disposals	0.0	0.0	0.0	-0.2	0.0	0.0	0.0	0.0
Other inv flows	0.0	-0.2	0.6	-2.6	0.0	0.0	0.0	0.0
Cash flow pre-financing	**-5.9**	**-3.3**	**-4.1**	**-0.2**	**2.9**	**13.3**	**5.9**	**4.2**
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	0.0	0.0	0.0	0.0
Funded by cash	5.3	2.7	-23.9	-3.6	-2.9	-13.3	-5.9	-4.2

Balance sheet summary ($m)

Year-end June (AUD)	FY13A	FY14A	FY15A	FY16A	FY17F	FY18F	FY19F	FY20F
Cash	24.1	21.2	45.7	48.8	51.8	65.1	71.0	75.2
Current receivables	4.2	5.7	3.9	7.7	12.3	16.5	19.7	24.2
Current inventories	2.9	4.2	6.2	6.9	8.7	9.3	10.0	13.0
Net PPE	1.8	1.8	3.6	3.3	4.7	6.1	7.4	8.8
Investments	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Intangibles/capitalised	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.6	0.6	1.0	1.4	1.4	1.4	1.5	1.5
Total assets	**33.7**	**33.5**	**60.4**	**68.2**	**78.8**	**98.4**	**109.7**	**122.7**
Current payables	3.0	3.0	2.7	4.6	7.0	9.0	10.0	12.0
Total debt	7.6	8.1	0.0	1.3	1.3	1.3	1.3	1.3
Other liabilities	1.4	2.0	12.9	5.5	5.7	5.9	6.1	6.4
Total liabilities	**11.9**	**13.1**	**15.7**	**11.5**	**14.1**	**16.3**	**17.5**	**19.7**
Minorities/convertibles	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Shareholder equity	**21.7**	**20.4**	**44.7**	**56.7**	**64.7**	**82.1**	**92.2**	**103.0**
Total funds employed	**29.3**	**28.5**	**44.7**	**58.0**	**66.1**	**83.5**	**93.5**	**104.3**

Nanosonics Limited – FY16 results

Table 1: NAN FY16 results vs pcp and Wilsons' estimates, FY17-FY18 outlook

Earnings summary								
Y/E: 30 Jun		FY15a	FY16a	%chg	WHTMe	%var	FY17e	FY18e
Net revenue	**$m**	**22.2**	**42.8**	**93%**	**42.8**	**0%**	**58.3**	**72.1**
USA	$m	17.7	39.0	121%	38.3	2%	53.2	65.6
EU, ROW	$m	2.3	1.2	-47%	2.3	-48%	2.7	4.1
ANZ	$m	2.3	2.5	10%	2.2	14%	2.4	2.5
Gross Profit	$m	15.3	32.2	110%	30.0	7%	39.9	49.4
Margin	*%*	*68.9%*	*75.2%*		*70.1%*		*68.5%*	*68.5%*
Operating Expenses	$m	20.0	31.2	56%	28.8	8%	31.2	31.4
EBITDA	**$m**	**(4.7)**	**1.0**	**nm**	**1.2**	**-21%**	**8.8**	**18.0**
Margin	*%*		*2.2%*		*2.8%*		*15.0%*	*25.0%*
D&A	$m	1.1	1.3	22%	1.0	**34%**	1.7	1.7
EBIT	$m	(5.8)	(0.4)	94%	0.2	nm	7.1	16.3
Margin	*%*							
Net interest expense (benefit)	$m	(0.3)	(0.5)	50%	(0.8)	-38%	(0.9)	(1.1)
Tax expense (benefit)	$m	(0.0)	0.0	0%	0.0	0%	-	-
NPAT (normalised)	**$m**	**(5.5)**	**0.1**	**nm**	**0.9**	**nm**	**8.0**	**17.4**
NPAT (reported)	$m	(5.5)	0.1	nm	0.9	nm	8.0	17.4
EPS (normalised)	**cps**	**(2.0)**	**0.04**	**nm**	**0.32**	**nm**	**2.7**	**5.9**
DPS	**cps**	**-**	**-**	**-**	**-**	**-**	**-**	**-**

Source: Nanosonics, Wilsons

Results highlights

INCOME STATEMENT

Strong US sales in 2H. Nanosonics had pre-announced $27.2m in 2H sales (cf. $15.7m in 1H) with two consecutive quarters of 1,000+ Trophon placements and steady consumables utilisation. Gross margin benefited from switching more of their US business to a direct marketing model, and from a higher contribution of consumables in the US sales mix. On a full-year basis, currency translation assisted revenue by ~$4m. On a constant currency basis, revenue growth was 73%.

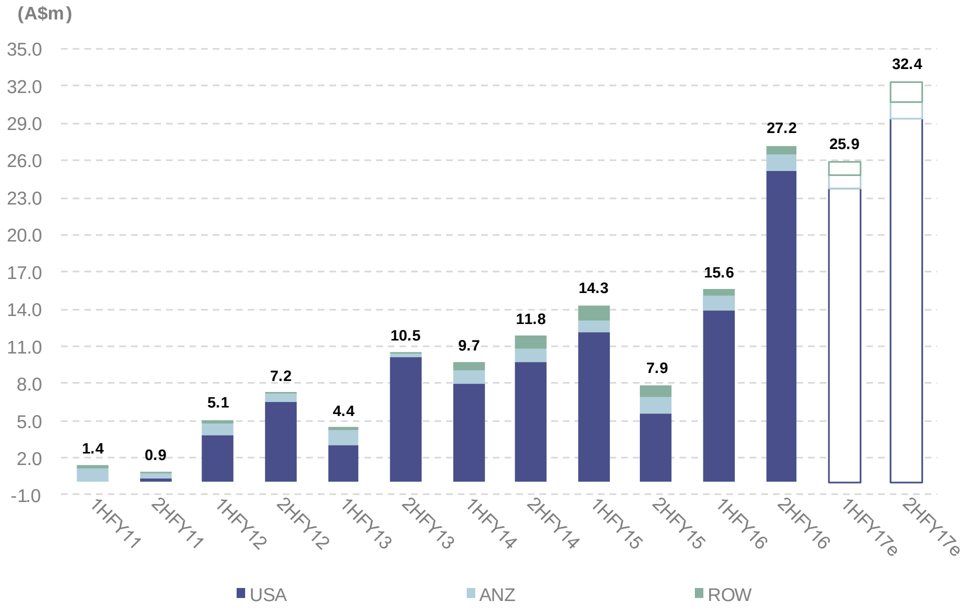
Installed base growth in the US driving sales and gross margin. Nanosonics grew its US Trophon placements by 74% over the year, activities spit between their own direct sales and GE Healthcare's (GEHC) renewed commitment to the Trophon platform. We assess that GEHC probably cleared any residual Trophon inventories in the Q4 and expect that sales are now a true reflection of organic, clinic-level demand. Good early momentum has been established over the first year of US direct sales. At the end of the 2H the US installed base stood at over 8,700 Trophons, driving annuity-styled revenues from service contracts and consumables sales. The company is targeting a US installed base of 40,000 Trophons or more. Utilisation appears to be quite stable and undiluted by the rapid influx of new installations. We estimate approximately 3.3 cycles per Trophon per day contributed to the result. US sales of A$38.3m were 117% ahead of pcp. Over FY16, the mix between capital and consumables sales was approximately 60:40.

Potential upside from sales to non-GE original equipment manufacturers (OEMs). Other ultrasound manufacturers may access Trophons for inclusion with their ultrasound system sales. Nanosonics plans to sell the Trophon capital equipment to non-GE OEMs at a price point below their direct sales price and then manage the ongoing resupply of consumables and services.

Ex-US market development ongoing. European sales were lower than expected. Market development efforts continue in the UK, building a sales pipeline ahead of English guideline publication in coming months. There are 25 Trusts in the UK already purchasing equipment, with 9 of them placing repeat orders. In Wales, all seven Health Boards have now adopted Trophon. The first shipment to Scotland is planned for next week, following the publication of supportive guidelines and interactions with all 14 Scottish Health Boards.

ANZ sales were up 10%. Management estimates 70-75% penetration in New Zealand and 60-65% penetration in Australia.

Figure 1: Half-yearly net sales FY11-16 and FY17 forecasts by geography



Source: Wilsons

Table 2: Geographic sales summary FY11-16 and FY17e-FY20e

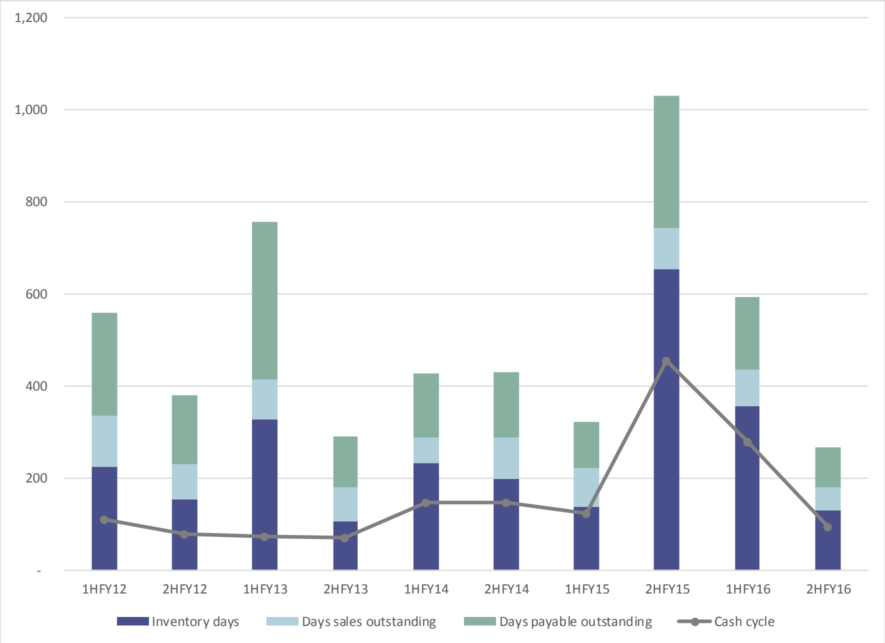
	FY11	FY12	FY13	FY14	FY15	FY16	FY17e	FY18e	FY19e	FY20e
USA sales ($m)	0.3	10.2	13.2	17.7	17.7	39.0	55.1	67.1	84.4	105.6
- growth%			*29%*	*34%*	*0%*	*121%*	*41%*	*22%*	*26%*	*25%*
ANZ sales ($m)	1.6	1.7	1.5	2.3	2.3	2.5	2.4	2.5	2.6	2.7
- growth%			*-9%*	*51%*	*1%*	*11%*	*-6%*	*4%*	*4%*	*4%*
ROW sales ($m)	0.3	0.4	0.2	1.6	2.3	1.2	2.7	4.1	8.6	10.2
- growth%			*-43%*	*558%*	*45%*	*-46%*	*122%*	*50%*	*113%*	*18%*
Total	**2.2**	**12.3**	**14.9**	**21.5**	**22.2**	**42.8**	**60.2**	**73.6**	**95.7**	**118.5**
- growth%			*21%*	*44%*	*3%*	*93%*	*41%*	*22%*	*30%*	*24%*

Source: Nanosonics, Wilsons

Operating expenditure up on R&D investment, SG&A. Increases in opex reflected the annualised cost of supporting the direct US business and a 50% increase in R&D investment to $7.3m. Management guided a 15-20% increase in aggregate opex in FY17 with similar objectives in mind: more R&D, market development activities in Europe, Japan and potentially Middle East. R&D objectives include next generation Trophon platform + natural extensions into other high level disinfection settings.

Operating cash flow and working capital profile tightening up. Full-year operating cash flow was $3.2m ($4.7m in Q4). Nanosonics also achieved steady improvement in its inventory capital management over the 2H as its US sales and marketing organisation became more efficient and could respond to normalised demand.

Figure 2: Improving cash cycle under US direct sales model



Source: Wilsons

Forecasts

We have made a number of small changes to our forecasting approach in re-setting FY17 and FY18 estimates. Our sales forecasts are up by ~2-3% but the benefit is offset by an increase in operating expenses. In FY17 we are forecasting a 16% increase in aggregate operating expense to ~$37.1m leaving EBITDA forecast unchanged. We have recognised higher D&A expenses with a small effect on NPAT and EPS.

Table 3: Changes to forecasts

Earnings revisions			
Y/E: 30 Jun		**FY17e**	**FY18e**
Sales revenue - Before	$m	58.3	72.1
Sales revenue - After	**$m**	**60.2**	**73.6**
- Change	*%*	*3.2%*	*2.1%*
EBITDA - Before	$m	8.8	18.0
EBITDA - After	**$m**	**8.8**	**18.0**
- Change	*%*	*-0.3%*	*0.0%*
NPAT (normalised) - Before	$m	8.5	17.8
NPAT (normalised) - After	**$m**	**8.1**	**17.4**
- Change	*%*	*-4.9%*	*-2.5%*
EPS (normalised) - Before	cps	2.9	6.0
EPS (normalised) - After	**cps**	**2.7**	**5.9**
- Change	*%*	*-4.9%*	*-2.3%*
DPS - Before	cps	-	-
DPS - After	**cps**	**-**	**-**
- Change	*%*		

Source: Wilsons

Valuation. Recommendation. Risks.

We maintain our BUY rating with price target at $3.25 per share.

We value Nanosonics using a discounted cash flow methodology which gives explicit treatment to the US, European (UK, Germany, France) and ANZ markets. In the US, we forecast steady Trophon adoption, reaching a “saturation” installed base of 42,000 devices by the end of FY23. In Europe, we are modelling a maximum installed base less than 10,000 reflecting greater fragmentation and slower market adoption.

Table 4: DCF valuation summary

The Valuation			Inputs	
PV of FCFF ($m)		218.3	Forecast period	FY17-30
PV of Terminal Value ($m)		554.4	Risk-free rate	3.5%
Value of Operating Assets ($m)		772.7	Risk premium	7.0%
Net cash (debt) ($m)		51.8	Debt to Equity	nil
Equity Value ($m)		824.5	Implied beta	1.2
DCF valuation per share	**$**	**2.79**		
12 month price target	**$**	**3.25**	Discount rate	11.9%
Premium to DCF		*17%*	Tg	4.0%

Source: Wilsons

Upside from under-explored territories and new product development. As discussed above our DCF is limited to the countries in which Nanosonics is now selling. The company will continue to expand into other territories in coming years, which will obviously support further valuation extensions.

Price target set at a premium to DCF. Given that the company remains in the pre-earnings phase of development, we retain the use of a 12% discount rate as a de facto WACC in our DCF. Ultimately, this business should lower its cost of capital when the business model is proven – mature medical device companies typically having WACC closer to 8% pa. Re-valuing NAN at 8.5% WACC would imply a 12-month price target of $5.41 per share (again, only based on current marketed countries).

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

Our thesis on Nanosonics is that, in time, regulatory pressure will build within the radiology industry to provide greater safety and traceability. This should entail a shift away from the use of toxic, bulk liquid disinfection practices.

Revenue drivers

- Has a 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)

Balance sheet

- Nanosonics had c.$48.8m cash as at end-FY16.

Margin drivers

- Gross margins: devices (c.60-75%); consumables (c.80-90%)
- Contract pricing may be variable
- Business development expenses expected in both Europe and US business – building channels, increasing awareness, providing additional customer support

Board

- Mr Maurie Stang (Non-Exec. Chairman)
- Mr Michael Kavanagh (Managing Director)
- Dr Ron Weinberger (Executive Director)
- Mr Richard England (Non-Exec. Director)
- Dr David Fisher (Non-Exec. Director)
- Mr Steven Sargent (Non-Exec. Director)

Key issues/catalysts

Upside risks:

- Faster-than-expected sales traction in the US by GEHC and Nanosonics sales forces
- Decision to scale-up manufacturing a leading indicator of demand
- Partnering transactions on other projects – disinfection units for transesophageal transducers, other applications

Management

- Mr Michael Kavanagh (CEO, Executive Director)
- Mr McGregor Grant (CFO)
- Dr Ron Weinberger (President – Technology Development)
- Dr Steven Farrugia (Senior VP Design & Development)

Risk to view

Downside risks:

- Disappointment on quarterly sales development
- Regulatory and/or clinical practice changes take a long time to change
- All device manufacturers face scale-up, quality control risks
- Adverse pricing outcomes
- New technology competition

Contact details

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Disclaimers and disclosures

Recommendation structure and other definitions

Definitions at wilsonsadvisory.com.au/Disclosures.

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