

# Nanosonics Limited

NAN : ASX : A\$0.90

**BUY 1**

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**Target: A\$0.95 1**

## COMPANY STATISTICS:

Share price	\$0.90
Valuation	\$0.95
12-month range	\$0.74-\$0.96
Market capitalisation	\$238M
Issued shares	264M
Options (various)	3.8M
Cash (30/06/14)	\$21.2M
Debt (30/06/13)	nil

## MAJOR SHAREHOLDERS

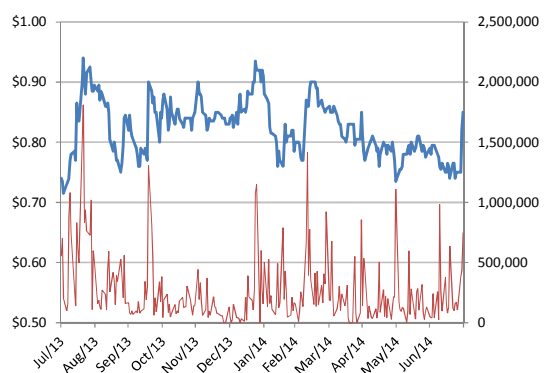
Allan Gray	11.9%
Bernard Stang	11.0%
Maurie Stang	10.9%
Kinetic Investments	7.3%

## EARNINGS SUMMARY

YE 30 June	FY13A	FY14E	FY15E
Sales (\$M)	14.9	21.5	34.0
Other income (\$M)	2.6	2.1	2.2
Net profit (\$M)	(5.7)	(0.7)	4.4
EPS (cps)	(2.2)	(0.3)	1.7
Op cash burn (\$M)	(20.8)	(23.6)	(32.1)
Net cash burn (\$M)	(5.9)	(2.1)	1.9
Net cash (\$M)	24.1	22.0	23.9

Source: Canaccord Genuity estimates

## SHARE PRICE PERFORMANCE



## COMPANY DESCRIPTION:

NAN is developing and commercialising products for low-temperature sterilisation based on its patented nanonebulant technology. Its first product, the Trophon EPR, is for sterilising ultrasound probes and has been launched in several markets including Australia, NZ, Europe and the US where it is marketed by GE Healthcare.

Lifesciences - Biotechnology

## Positive Feedback From Key US Site

### Investment Perspective

We visited the prestigious Johns Hopkins Hospital in Baltimore, USA, which purchased 25 trophon units in Q3 2012. Johns Hopkins Medicine now has 38 trophon units and expects to increase this number as it is adopted by other departments within the hospital and by other community hospitals and healthcare facilities within the group. Radiology Technical Manager of Ultrasound, Robert DeJong, outlined how the trophon has improved the hospitals ability to ensure ultrasound probes are properly high-level disinfected between patients. This has had a positive impact in terms of ensuring the hospital meets internal and external standards required for compliance essential for best practice and for maintaining funding. In addition, adoption of the trophon has resulted in improved staff satisfaction and cost savings from avoiding additional labour costs and the reduction of ultrasound probe repairs and replacements. This direct feedback from a highly respected customer who has used the trophon for 2 years further validates the multiple benefits that the trophon provides.

### Key Points

The experience in adopting the trophon at Johns Hopkins over the last 2 years has been very positive with Robert DeJong describing the product as "a Godsend". The reasons he gave for this included:

**Disinfection with Cidex labour intensive:-** and prone to non-adherence compared with point-of-care, fully automated 7-minute trophon process.

**Simplifies meeting accreditation standards:-** particularly for the Joint Commission responsible for hospitals accreditation required for funding.

**Reduces costs:-** by eliminating need to employ additional personnel and reducing ultrasound probe repairs or replacements.

**Improves staff satisfaction:-** by providing an easy solution to meet professional standards and reducing the need to take corrective action.

**Getting more widely adopted:-** with trophon being used by more department using, other facilities within the group and for surface probes.

**Maintain BUY recommendation and price target of \$0.95,** based on a discounted cash flow valuation of trophon in the major medical markets.

**FINANCIAL SUMMARY****Financial Performance**

Year End	June	2012A	2013A	2014E	2015E	2016E	2017E	2018E	2019E	2020E	2021E	2022E
Operating Revenue	\$M	12.3	14.9	21.5	34.0	47.9	70.9	98.2	117.1	130.0	152.5	158.7
Interest Revenue	\$M	0.6	1.2	0.9	1.0	1.5	2.3	3.3	4.2	5.2	6.1	6.7
Gov't Grants	\$M	0.2	1.5	1.5	1.1	1.1	1.1	1.1	1.2	1.2	1.2	1.2
<b>Total Revenue</b>	<b>\$M</b>	<b>13.0</b>	<b>17.6</b>	<b>23.9</b>	<b>36.1</b>	<b>50.5</b>	<b>74.3</b>	<b>102.6</b>	<b>122.5</b>	<b>136.4</b>	<b>159.8</b>	<b>166.7</b>
Operating Expenses	\$M	-17.5	-21.7	-23.6	-30.7	-35.3	-42.0	-49.0	-54.6	-58.1	-65.0	-66.3
<b>EBITDA</b>	<b>\$M</b>	<b>-4.4</b>	<b>-4.1</b>	<b>0.4</b>	<b>5.4</b>	<b>15.2</b>	<b>32.3</b>	<b>53.6</b>	<b>67.9</b>	<b>78.3</b>	<b>94.8</b>	<b>100.4</b>
Depreciation & Amortisation	\$M	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Amortisation of Intangibles	\$M	-0.9	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
<b>EBIT</b>	<b>\$M</b>	<b>-5.3</b>	<b>-5.2</b>	<b>-0.7</b>	<b>4.4</b>	<b>14.2</b>	<b>31.3</b>	<b>52.6</b>	<b>66.9</b>	<b>77.3</b>	<b>93.8</b>	<b>99.3</b>
Interest Expense	\$M	0.0	-0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Tax Expense	\$M	0.6	0.0	0.0	0.0	0.0	0.0	-11.7	-19.7	-22.8	-27.8	-29.4
<b>Profit After Tax</b>	<b>\$M</b>	<b>-4.7</b>	<b>-5.7</b>	<b>-0.7</b>	<b>4.4</b>	<b>14.2</b>	<b>31.3</b>	<b>40.9</b>	<b>47.2</b>	<b>54.4</b>	<b>66.0</b>	<b>69.9</b>
<b>Per Share</b>												
EPS	cps	-1.9	-2.2	-0.3	1.7	5.4	11.9	15.6	18.0	20.8	25.2	26.7
Cash Backing	cps	11.3	9.2	8.4	9.1	13.6	24.6	39.2	56.2	76.0	100.2	125.8

**Cash Flow**

Year End	June	2012A	2013A	2014E	2015E	2016E	2017E	2018E	2019E	2020E	2021E	2022E
Receipts	\$M	10.9	14.0	21.5	34.0	47.9	70.9	98.2	117.1	130.0	152.5	158.7
Suppliers & Employers	\$M	-17.2	-21.1	-24.6	-31.7	-36.3	-43.0	-50.1	-55.6	-59.1	-66.0	-67.4
Interest Received	\$M	0.6	1.1	0.9	1.0	1.5	2.3	3.3	4.2	5.2	6.1	6.7
Tax Paid	\$M	0.6	1.5	1.5	0.0	0.0	0.0	-11.7	-19.7	-22.8	-27.8	-29.4
<b>Cash From Operations</b>	<b>\$M</b>	<b>-5.0</b>	<b>-4.5</b>	<b>-0.7</b>	<b>3.3</b>	<b>13.1</b>	<b>30.2</b>	<b>39.8</b>	<b>46.0</b>	<b>53.2</b>	<b>64.8</b>	<b>68.7</b>
<b>Cash From Investing</b>	<b>\$M</b>	<b>-0.8</b>	<b>-1.4</b>	<b>-1.4</b>	<b>-1.4</b>	<b>-1.4</b>	<b>-1.4</b>	<b>-1.4</b>	<b>-1.4</b>	<b>-1.4</b>	<b>-1.4</b>	<b>-1.4</b>
<b>Cash From Financing</b>	<b>\$M</b>	<b>22.8</b>	<b>0.5</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>
Opening Cash Balance	\$M	12.4	29.3	24.1	22.0	23.9	35.6	64.4	102.8	147.4	199.2	262.6
Net Incr / (Decr) In Cash	\$M	17.0	-5.2	-2.1	1.9	11.7	28.8	38.4	44.6	51.8	63.4	67.3
<b>Closing Cash Balance</b>	<b>\$M</b>	<b>29.3</b>	<b>24.1</b>	<b>22.0</b>	<b>23.9</b>	<b>35.6</b>	<b>64.4</b>	<b>102.8</b>	<b>147.4</b>	<b>199.2</b>	<b>262.6</b>	<b>329.9</b>

**Balance Sheet**

Year End	June	2012A	2013A	2014E	2015E	2016E	2017E	2018E	2019E	2020E	2021E	2022E
Cash & Cash Equivalents	\$M	29.3	24.1	22.0	23.9	35.6	64.4	102.8	147.4	199.2	262.6	329.9
<b>Current Assets</b>	<b>\$M</b>	<b>35.0</b>	<b>31.7</b>	<b>29.6</b>	<b>31.5</b>	<b>43.2</b>	<b>72.0</b>	<b>110.4</b>	<b>155.0</b>	<b>206.8</b>	<b>270.2</b>	<b>337.5</b>
<b>Non-Current Assets</b>	<b>\$M</b>	<b>1.7</b>	<b>2.0</b>	<b>1.8</b>	<b>1.8</b>	<b>1.8</b>	<b>1.8</b>	<b>1.8</b>	<b>1.8</b>	<b>1.8</b>	<b>1.8</b>	<b>1.8</b>
<b>TOTAL ASSETS</b>	<b>\$M</b>	<b>36.7</b>	<b>33.7</b>	<b>31.4</b>	<b>33.4</b>	<b>45.1</b>	<b>73.8</b>	<b>112.2</b>	<b>156.8</b>	<b>208.7</b>	<b>272.0</b>	<b>339.3</b>
Current Debt	\$M	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Current Liabilities</b>	<b>\$M</b>	<b>3.5</b>	<b>4.2</b>	<b>3.8</b>	<b>3.8</b>	<b>3.8</b>	<b>3.8</b>	<b>3.8</b>	<b>3.8</b>	<b>3.8</b>	<b>3.8</b>	<b>3.8</b>
Non-Current Debt	\$M	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Non-Current Liabilities</b>	<b>\$M</b>	<b>7.2</b>	<b>7.7</b>	<b>7.7</b>	<b>7.7</b>	<b>7.7</b>	<b>7.7</b>	<b>7.7</b>	<b>7.7</b>	<b>7.7</b>	<b>7.7</b>	<b>7.7</b>
<b>TOTAL LIABILITIES</b>	<b>\$M</b>	<b>10.7</b>	<b>11.9</b>	<b>11.5</b>	<b>11.5</b>	<b>11.5</b>	<b>11.5</b>	<b>11.5</b>	<b>11.5</b>	<b>11.5</b>	<b>11.5</b>	<b>11.5</b>
Equity	\$M	75.7	77.1	76.0	73.6	71.1	68.6	66.0	63.5	60.9	58.3	55.6
Accumulated Profits / (Losses)	\$M	-49.7	-55.4	-56.1	-51.7	-37.5	-6.3	34.6	81.8	136.2	202.2	272.1
<b>TOTAL EQUITY</b>	<b>\$M</b>	<b>26.0</b>	<b>21.7</b>	<b>19.9</b>	<b>21.8</b>	<b>33.5</b>	<b>62.3</b>	<b>100.7</b>	<b>145.3</b>	<b>197.1</b>	<b>260.5</b>	<b>327.8</b>

**Valuation**

Risk Free Rate	%	4.60%
Market Premium	%	5.50%
Beta	x	1.1
Discount Rate	%	10.7%
Forecast Period	years	12
12-Month Price Target	\$	\$0.95
Current Price	\$	\$0.83
Return	%	14%

SOURCES: Company reports, Canaccord Genuity estimates

## Johns Hopkins Medicine

Johns Hopkins Medicine is one of the most prestigious medical groups in the United States. It comprises six community hospitals and 38 primary and specialty medical practices. We visited the flagship Johns Hopkins Hospital in Baltimore where we met with Robert DeJong, the Radiology Technical Manager, Ultrasound.

Rob was responsible for introducing the trophon into Johns Hopkins in 2012 when they initially purchased 25 units. They currently have 38 units and are likely to be purchasing additional units.

Some key facts about Johns Hopkins Medicine include:

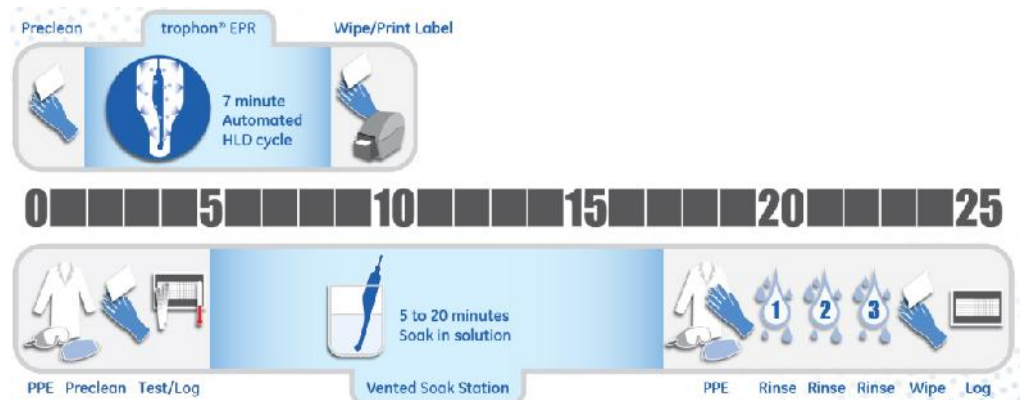
- Johns Hopkins Hospital is the only hospital in the US to be ranked #1 for 25 consecutive years;
- Johns Hopkins Hospital has 1,059 patient beds and another 1,618 beds are available in the other five community hospitals;
- Each year Johns Hopkins Medicine handles over 120,000 inpatient admissions and 350,000 emergency visits;
- Its primary and specialty care practices handle over 850,000 patient visits each year;
- Johns Hopkins scientists receive over \$450M in annual federal funding and 19 scientists from its School of Medicine have been awarded the Nobel Prize.

## Key Take-Aways

### 1. Manual disinfection process with Cidex complex and unreliable

Disinfection using trophon is a 7-minute, automated cycle conducted at the point of care which allows the sonographer to continue with other tasks such as completing a patient consultation. By comparison, disinfection using Cidex is a 25-30min manual process that has to be conducted in a dedicated room with negative pressure and ventilation. A comparison of the two processes is shown schematically below.

Figure 1. Comparison of disinfection process with tropon EPR vs Cidex



SOURCE: Company presentation – 14 August 2014

At the Johns Hopkins, the high level of direct staff involvement required for the Cidex sterilisation often resulted in this process being conducted incorrectly.

For example, the number of gowns and protective equipment used was often significantly less than would be required for the number of disinfections logged, indicating the sonographers were compromising their safety by taking shortcuts.

Similarly, the time the probe needs to be soaked in Cidex is a function of temperature and the activity of the Cidex solution. These times were often exceeded, sometimes as long as overnight, due to the sonographer conducting other tasks or forgetting about the probe being disinfected. These longer soaking times:

- could lead to damage to the probe due to the corrosive nature of Cidex;
- require corresponding increases in rinsing which were often not conducted.

Ultimately, the manual, multi-step and non-point of care nature of the Cidex disinfection process meant the correct process was often compromised. This was one of the reasons that Rob DeJong described the availability of the trophon as “a Godsend”.

## **2. trophon simplifies meeting compliance requirements for accreditation**

The automated nature of disinfection using the trophon means there is less scope for human error which, in turn, means auditing compliance to disinfection procedures to meet regulatory requirements is much simpler.

The US Joint Commission (J-Co) is an independent, not-for-profit organisation that accredits more than 20,000 US healthcare providers. Accreditation by J-Co is usually a requirement for hospitals and clinics to secure public and private funding.

In a recent newsletter (Issue 2, Quick Safety, May 2014), J-Co highlighted that inadequate processes for high-level disinfection of medical equipment was one of the top five areas where healthcare facilities were found to be non-compliant. Typically, non-compliant facilities are issued with violation notices and have a defined period to take corrective action. If they fail to do so, it can result in restrictions to their funding and negative publicity. For hospital administrators, meeting J-Co’s standards and maintaining accreditation is absolutely top of mind.

Rob DeJong said that, since adopting trophon, he regularly receives calls from other healthcare facilities wanting to put in place high-level disinfection procedures for ultrasound probes in order for those facilities to meet J-Co’s standards.

## **3. trophon saves on labour costs**

Prior to adopting the trophon, Johns Hopkins Hospital was considering appointing a staff member that was fully responsible for ensuring the correct disinfection of ultrasound probes. This was prompted by the difficulty experienced with staff adhering to the proper Cidex disinfection process and the impact it had on internal compliance, external compliance and, consequently, on staff satisfaction.

These comments on the labour requirement for Cidex disinfection reinforce similar comments that were made by Dr Carolyn Burns at the Brigham and Women’s Hospital during our site visit last year. Dr Burns pointed out that the time spent by her sonography staff conducting disinfection effectively required her to have an extra sonographer on

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staff. In this case, adopting the trophon resulted in saving at least one sonographer salary plus freed up the dedicated disinfection room to be used for patient consultations that effectively provided additional revenue opportunities.

#### **4. trophon improves internal compliance and staff satisfaction**

One of the big impacts the trophon has had on the workplace, according to Rob DeJong, was the improvement on staff satisfaction. First, his sonography staff were aware that they were not consistently adhering to the correct disinfection protocol which resulted in professional dissatisfaction by his staff.

Furthermore, within the hospital, the Infection Control Department would conduct random inspections 2-3 times per month. Often these would identify procedure violations which would have to be followed up directly with individual staff members. Rob DeJong said that since adopting the trophon, the levels of staff satisfaction and staff morale have improved significantly because there is no longer the need to regularly reprimand staff for not disinfecting their probes properly or for not using the protective equipment.

#### **5. trophon dramatically reduces probe repair and replacement costs**

Cidex is highly corrosive. When probes are regularly exposed to Cidex or when they are soaked in it for long periods of time, it can corrode the plastic. In particular, it can lead to the lifting of the protective membrane covering the transducer and introduce air bubbles that significantly reduce image quality.

In the Department where Rob DeJong worked, they previously had around 10 intracavity ultrasound probes. Prior to adopting the trophon, the Department would have to repair or replace 3-4 of these probes each year. Repairs would typically cost \$3K-\$5K, even under a service contract, while replacements were typically around \$15K.

Since adopting the trophon in 2012, Rob DeJong's department has not had to repair or replace a single probe.

#### **6. trophon use within hospital sites is expanding**

The use of the trophon within Johns Hopkins Medicine has expanded since it was first adopted in 2012.

Within the hospital, other departments, such as Urology and Emergency, have started using the trophon. For example, the Emergency Department often needs to conduct rapid examinations of new patients in situations where there may be a lot of blood or open wounds which results in a high risk of cross-patient infections.

The Emergency Department and other departments, including Obstetrics and Gynaecology, have also started using the trophon to disinfect surface probes between patients. If this practice is adopted at other sites, it could result in an increase in the number of cycles per machine and hence the consumables revenue for NAN.

Other hospitals within Johns Hopkins Medicine network, including Bayview Medical Center and Howard County General Hospital, have adopted the trophon. As Johns Hopkins Medicine includes a total of six community hospitals, and 38 primary and specialty care practices, there is still scope for additional sites to come on stream.

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## Investment Risks

The opportunity with NAN is to invest in a fully-funded company that is in the early stages of growing sales in a unique and commercially attractive product. Given the company's current market capitalisation of \$130M, if this is successful, investors have the potential to make significant capital gains. However, the road to riches is never without risk and the key risks that we see facing NAN are:

**Poor sales support from GE:** - this is a very different product from those that GE has previously sold. As with any distributor relationship, it may not get the sales traction that we are expecting. This could arise from inappropriate sales incentives within GE, lack of familiarity with the necessary sales process for the products, or simply lack of attention as GE focuses on sales of its other product during tough market conditions.

**Manufacturing hiccups:** the company has already had to make a number of post-launch improvements and had its production disrupted by issues with supplied components. These disruptions could occur again and, if they did, would have an impact on sales. We also do not dismiss manufacturing issues arising from scale-up production or relocation to a new facility which could also impact on sales or product quality.

We believe having Resmed's ex-Head of Manufacturing, Gerard Putt, who has been through the scale-up production of high-end devices should limit this risk. We have already seen the impact of his expertise on manufacturing efficiency.

**Customer push-back:** with an increasing focus on healthcare budgets, NAN may experience some resistance from potential customers unwilling or unable to make the purchase. NAN may be forced to explore other sales models (for instance provide the instrument and make money on higher price consumables) which could disenfranchise existing customers. However, we believe the tangible commercial benefits and the sales traction to date indicate that this can be managed with the correct sales strategy.

**European malaise:** despite being the first market to gain approval, sales in Europe have been minimal. We have modelled a slow ramp up in sales in Europe but the combination of economic uncertainty in the region with a fragmented market and different requirements in different countries may mean sales continue to be slow.

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## Appendix: Company Announcements

Date	Event
07-Aug-14	trophon approved in Japan with commercial sales expected to start 2H FY2015
19-May-14	trophon-EPR included in new guidelines from American Institute of Ultrasound in Medicine
28-Mar-14	Nanosonics signs strategic partnership with Miele for distribution of trophon EPR in Germany
31-Oct-13	Awarded Janssen 2013 Industry Excellence Award
23-Oct-13	Michael Kavanagh commences as CEO and President
10-Oct-13	Australian study highlights risk of cross-infection from ultrasound probes following conventional disinfection
30-Aug-13	South Korean regulator approved trophon
28-Aug-13	Michael Kavanagh appointed as CEO, Ron Weinberger in charge of product development & commercialisation
14 Aug-13	GE commits to additional investment in sales and marketing of Nanosonics's trophon
17-Apr-13	Signs Toshiba up as non-exclusive distributor of the trophon in the UK
09-Apr-13	Provides update that 458 ultrasound probes are certified by OEM's for disinfection using a trophon
22 Mar-13	California-based Scripps Health network installs 21 trophons as part of initial roll out through its 29 sites
12-Oct-12	Wins Emerging Exporter at 2012 Premier's NSW Export Awards
30-Jul-12	Michael Kavanagh, Senior VP of global marketing for Cochlear, joins the Board as a Non-Executive Director
25-Jun-12	GE Healthcare's healthymagination Fund invests \$7.5M into NAN via a convertible note
04-May-12	Raises \$15.5M at \$0.53 per share via institutional placement that included \$10.6M from Allan Gray
14-Oct-11	Will increase manufacturing capacity by 50% to 6000 Trophon units per annum
19-Dec-11	Ron Weinberger to take up the role of CEO after acting as interim CEO since May 2011
07-Jul-11	GE Healthcare launches Trophon ultrasound probe steriliser into the US market
16-May-11	Exclusive distribution contract for North America and Canada with GE Healthcare
16-May-11	CEO David Radford resigns and Ron Weinberger, currently Executive Director, becomes interim CEO
13-Apr-11	Appoints McGregor Grant as CFO and Gerard Putt, ex-Resmed, as Head of Manufacturing
28-Feb-11	FDA approves Trophon ultrasound probe steriliser for sale in the US
16-Dec-10	Russian distributor, AVA Medical, commits to 200 Trophon units during 2011
21-Sep-10	Initial agreement with GE Healthcare for distribution of Trophon ultrasound probe steriliser in US and Canada
20-Sep-10	Australian distributor included as Queensland Specialty Product Provider for supply of the Trophon EPR
29-Jun-10	Has recommenced production following successful in-field testing of the updated Trophon units

Source: IRESS



**APPENDIX: IMPORTANT DISCLOSURES**

**Analyst Certification:**

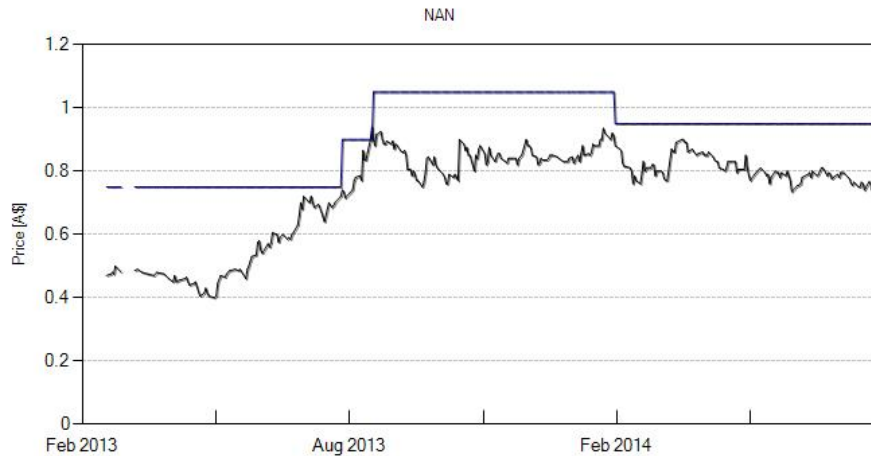
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**Site Visit:**

An analyst has visited Nanosonics Limited's material operations in Sydney and Boston. No payment or reimbursement was received from the issuer for the related travel costs.

**Price Chart:\***



Date	Analyst	Rating	Target Price	Date	Analyst	Rating	Target Price
1) 10/10/2012	Smith	Buy	0.90	4) 08/21/2013	Smith	Buy	1.05
2) 02/07/2013	Smith	Buy	0.75	5) 01/31/2014	Smith	Buy	0.95
3) 07/31/2013	Smith	Buy	0.90				

\*Price charts assume event 1 indicates initiation of coverage or the beginning of the measurement period.

**Distribution of Ratings:  
Global Stock Ratings  
(as of 3 July 2014)**

Rating	Coverage Universe		IB Clients	
	#	%	#	%
Buy	602	61.2%	38.2%	
Speculative Buy	49	5.0%	55.1%	
Hold	290	29.5%	13.1%	
Sell	41	4.2%	7.3%	
	984	100.0%		

\*Total includes stocks that are Under Review

**Canaccord Genuity Ratings System:**

**BUY:** The stock is expected to generate risk-adjusted returns of over 10% during the next 12 months.  
**HOLD:** The stock is expected to generate risk-adjusted returns of 0-10% during the next 12 months.

**SELL:** The stock is expected to generate negative risk-adjusted returns during the next 12 months.

**NOT RATED:** Canaccord Genuity does not provide research coverage of the relevant issuer.

"Risk-adjusted return" refers to the expected return in relation to the amount of risk associated with the designated investment or the relevant issuer.

**Risk Qualifier:**

**SPECULATIVE:** Stocks bear significantly higher risk that typically cannot be valued by normal fundamental criteria. Investments in the stock may result in material loss.

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Company	Disclosure
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