Institutional Research & Dealing

stock research

RECOMMENDATION: SPECULATIVE BUY

Stock Code: NAN
Last Sale: $0.48
Market Cap (fd): $125.1m
Risk Level: High

Nanosonics Ltd

Initiation of coverage

29 August 2012

John Hester

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EVENT

- FY12 Results release

KEY HIGHLIGHTS

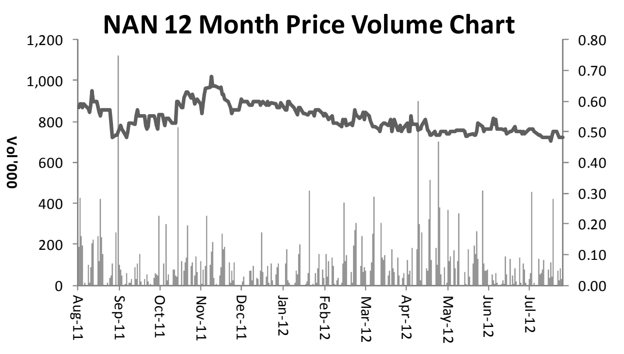
- NAN reported total sales of $12.3m and a net loss after tax of $4.6m. Gross cash outflow from operations was $5.0m. Closing cash was $30.0m. Gross debt, in the form of a convertible note, was $7.0m
- FY12 was the first full year of commercial activity for NAN. Importantly all markets remain substantially under developed and hence the potential for future sales growth is as strong as ever. In the US, NAN has partnered with GE Healthcare and revenues continue to build, albeit more slowly than first anticipated. Over recent months the sales force incentives program has been re-aligned and it is hoped this will create a more positive selling environment. We remain optimistic that the partnership with GE Healthcare will ultimately lead to lucrative US sales. GE Healthcare is a dominant provider of medical imaging equipment in the US market.
- Outside of the US much work needs to be done to develop markets and this is a process that will take a number of years. The ex US market is at least as large as the market in the US. NAN has a distributor model in these markets but is yet to appoint its own personnel to lead the sales process. We expect a longer sales lead time in Europe vs the US.

SELECT EQUITIES RECOMMENDATION

- We initiate with a long term buy recommendation based on our view that the Trophon is an innovative device. It may gradually increase its presence in a market that is in need of a replacement to the current solvent based disinfection methods that remain common place around the world.
- The market continues to price the stock for aggressive growth. In FY12 the company embarked on a steep learning curve about doing business outside of Australia. Over the course of the next 2 to 3 years we expect revenues will follow these first steps. Key risk is the appointment of sales personnel for the US and Europe to support GE Healthcare and others in selling the product.

Year end June	2011	2012	2013f	2014f
NPAT (Normalised) ($m)	-11.2	-4.6	-4.4	1.8
EBITDA	-12.0	-4.9	-4.3	2.0
EBIT	-12.9	-5.9	-5.4	0.7
EPS (cps)	-4.9	-2.0	-1.7	0.7
EPS growth	0.3	-0.6	-0.2	-1.4
DPS (cps)	0.0	0.0	0.0	0.0
Yield	0%	0%	0%	0%
PER (x)	-9.8	-24.3	-28.7	68.5
P/FCF	-10.7	-17.6	-35.6	46.4
EV/EBITDA	na	na	na	51.2
Shares on issue (m)				260.7
Avg Daily volume (m)				0.1
Diluted Market Cap ($m)				125.1
Excess capital ($m)				-22.3
Enterprise Value ($m)				102.8

Source: Company Reports and Select Equities Research



Source: IRESS

Summary

Table 1: FY12 result summary

Item ($m)	Actual FY11	Actual FY12	%Chg
Sales	2.2	12.3	*447.4%*
EBITDA	(12.0)	(4.9)	*-58.7%*
EBIT	(12.9)	(5.9)	*-54.7%*
Reported NPAT	(11.2)	(4.6)	*-58.5%*
Normalised NPAT	(11.2)	(4.6)	*-58.5%*
Reported EPS	(4.9)	(2.0)	*-59.8%*
DPS	-	-	*nm*

Source: Company Reports

Net cash from operating activities was -$5.0m (FY11 -$9.0m).
Gross margin was 61% (FY11 56%).
Operating costs increased by 4.9%.

Outlook for revenue growth

Over the course of FY13 we expect NAN will continue to build the sales momentum established over the course of FY12. Notwithstanding the last 12 months has seen the company go through a significant learning curve as it transitions from specialised R&D to include global sales and distribution.

The fundamental issue is that NAN is a small Australian company with key markets outside of Australia. NAN has shown itself to be highly competent at selling in the domestic market with many of the country's top hospital and gynaecology clinics buying the Trophon. However, establishing a similar proximity of relationship with offshore buyers has, not surprisingly, not gone as smoothly as we had hoped.

Despite hurdles in offshore markets the domestic experience continues to provide reassurance that the product is a winner. The medical community is traditionally reluctant to change its methods, particularly where cheaper options are available and these habits take time to change.

Revenues outside of North America and Australasia (i.e. predominantly European sales) in FY12 amounted to $414K or the equivalent of ~75 devices. This is significantly lower than expectations given that wholesalers had been in place and the product was launched in November 2011.

There can be no doubt that NAN needs to its own personnel to lead sales in Europe and the US. The selection of the right personnel is, therefore, a key risk as the company builds its presence in these markets over the next 4 to 5 years. In this respect the appointment of Non Executive Director Mr. Michael Kavanagh (Senior VP Global Marketing Cohclear Ltd) is potentially an advantage.

His more than 8 years experience with Cochlear and prior to that with a major pharmaceutical company may bring a list of key contacts, particularly with major distributors and sales persons. Notwithstanding NAN has a long way to go in developing all of these markets including in the US.

As a result of these observations we have lowered our expectation for sales growth in Europe at least in the short term.

Within the US we estimate that approximately 1,500 Trophon's were sold in the year including a portion of the 4Q12 sales required to bring GE up to its minimum order quantity for the fiscal year. It is likely GE will hold these additional units in stock until sold and accordingly 1Q13 sales are likely to show minimal growth vs pcp. This is unlikely to be reflected in 1Q13 cash flows as NAN will collect more than $3.0m in receivables from 30 June 2012.

The second year of the contract with GE Healthcare includes the same minimum order quantity as year 1 i.e. 1,500 units.

We estimate total unit sales in FY12 across all geographies were ~1,600 and the install base is approximately 2,000 units worldwide. We further estimates breakeven unit sales is approximately 2,500 units. Breakeven point is of course dependent upon selling costs amongst other things and we expect NAN will substantially ramp up selling expenses with additional headcount over the course of FY13 in order to drive top line growth.

Cash and working capital

Following the recent $15m placement and $7.5m capital injection by GE Healthcare the company finished the year with $30m in cash. Working capital increased by $2.3m to net $3.0m (being receivables + inventory – creditors). Days sales in receivables should stabilise at 45 days over the longer term, hence working capital will increase but only relative to sales activity.

Cash burn has now dropped below $1m per quarter (4Q12 -$647K). Looking forward cash flow may be lumpy particularly because the timing of large orders is difficult to forecast. Despite this, expenses below the manufacturing line are relatively fixed, however, it remains to be seen how these change once additional sales headcount is added.

While equity holders are always concerned about cash burn, the stock is priced for growth and consequently we expect the careful use of cash reserves to grow revenues. At this point in the company's life cycle it is more important to see top line growth rather than the preservation of capital, particularly as the major development spend on the Trophon is now in the past.

We noted that CEO Ron Weinberger completed the earnings call from Chicago, where we understand he is currently spending more than 4 weeks on the ground to consolidate the emerging NAN sales force. The NAN sales team will effectively be product specialists for the Trophon. They will support the GE Healthcare sales force and assist key opinion leaders in their assessment of the Trophon. Our view continues to be that the virtues of Trophon make it a compelling proposition for buyers, subject of course to budget constraints. The Trophon retails for ~US$12,000. NAN sells each device of ~A$6,000.

NAN has capacity to manufacture up to 6,000 units under its present facilities in Sydney. Based on current projections it may be some years before manufacturing capacity becomes an issue.

Valuation

The market continues to value the stock for aggressive sales growth over the next few years. As the domestic experience over the last couple of years has shown the basis for this confidence is justified with a good take up rate in private clinics.

Our valuation is based on a DCF model and this includes aggressive growth in the outer years. The DCF model suggest the price can double rather triple in the short to medium term.

NAN currently has just the one product but further products of the same nature are in the pipeline and these may add further value. There is no time frame at this point for new products.

By way of reminder the Trophon is used widely in private practice as well as in some public hospitals. It is the only system approved for transducer reprocessing by Qld Health. The device is used in more than 600 sites across Australia and more than 300 sites in the US – hence still very early days in the US.

Table 2: Summary of DCF valuation

Firm Value	
Total PV of Explicit Free Cashflow	61.3
Total PV of Continuing Year	152.7
Enterprise Value	214.0
Less Net Debt	-22.3
Equity Value	236.3
Number of Shares (thousands)	260.7
Equity Value Per Share	$0.91
Dividends prior to valuation base date yet to be received	$0.00
Net cashflow valuation per share incl cum dividends	$0.91
Franking Credits per share (valued at 20¢ in the $)	$0.06
Total Value Per Share	$0.96

Source: Select Equities Research

Business Description

- NAN is a manufacturer and distributor of the Trophon, based in Sydney Australia. The company developed the IP and commenced commercialisation of the device in 2011.
- Trophon is a medical device which uses atomised hydrogen peroxide to disinfect intracavity ultrasound probes used in medical imaging practices. It complies with Australian Standards for high level disinfection and has numerous advantages for use over competing products. The device is also approved for use in the US and Europe.
- As at August 2012 the Trophon is installed in more than 900 sites around the world. More than 133,000 ultrasound devices are sold around the world each year.
- Within the USA, it is estimated there are more than ~160,000 sites with ultrasound devices. Of these, it is estimated that up to 40% could accommodate a Trophon device. These figures imply between 50,000 – 60,000 potential sites.
- It is expected that in normal use the Trophon will have a life cycle of 4 years. Longer term we expect annual demand in the US will peak between 10K to 15K units per annum. We expect ROW sales would at least mimic the US market in size. These sales levels are well beyond the figures in our DCF model and growth of these dimensions would see the stock price well in excess of our target price.
- NAN has partnered with GE Healthcare in the US. GE has exclusive distribution rights in the US and non exclusive rights in Europe. NAN has numerous other distributors in other markets.
- NAN sells the Trophon for ~A$6K. Retail price is ~$12K. The company also derives a substantial revenue stream from the sale of consumables (hydrogen peroxide) and services contracts.
- The Trophon has regulatory approval in the USA, Canada, EU, Aust, NZ
- Other industry bodies have also confirmed the efficacy of the technology including the US Centre for Disease Control which issued the following statement in 2008:

➢ A vaginal probe and all endocavitary probes require routine probe disinfection between examinations
➢ Glutaraldehyde may shorten the life of the transducer and might have toxic effects on the gametes and embryos (IVF)
➢ 70% alcohol or soaking for 2 minutes in 500 ppm chlorine -has not been validated. High-level disinfection with a product (e.g., hydrogen peroxide) that is not toxic to staff, patients, probes, and retrieved cells should be used until the effectiveness of alternative procedures against microbes of importance at the cavitary site is demonstrated by well-designed experimental scientific studies

Risk Factors

- The Trophon is the only point of care system for ultrasound devices in the market today as far as we are aware. Other systems use hydrogen peroxide for disinfection, however these are significantly higher capital expenditure devices and are not point of care. We expect that a direct competitor to the Trophon will emerge over time.
- NAN continues to await the grant of patents in most key markets, hence it may be susceptible to challenges on these patents.

Code	**NAN**
Last sale 29/08/2012	**$ 0.48**
# shares (m)	260.7
Market Cap ($m)	125.1
Net Debt	-22.3
Enterprise value	102.8
Index	All Ords
Target price	0.96

Year end June	**2011**	**2012**	**2013f**	**2014f**
Financial Performance ($m)				
Sales Revenue	2.2	12.3	16.9	26.9
EBITDA	-12.0	-4.9	-4.3	2.0
Depreciation	-1.0	-0.9	-1.1	-1.3
EBITA	**-12.9**	**-5.9**	**-5.4**	**0.7**
Amortisation	0.0	0.0	0.0	0.0
EBIT	**-12.9**	**-5.9**	**-5.4**	**0.7**
Net Interest Expense	-1.1	-0.6	-1.1	-1.1
Pre-Tax Profit	**-11.9**	**-5.3**	**-4.4**	**1.8**
Tax	-0.7	-0.6	0.0	0.0
OEI	0.0	0.0	0.0	0.0
NPAT	**-11.2**	**-4.6**	**-4.4**	**1.8**
Net Abnormals	0.0	0.0	0.0	0.0
NPAT Reported	**-11.2**	**-4.6**	**-4.4**	**1.8**
Normalised Earnings	**-11.2**	**-4.6**	**-4.4**	**1.8**
Margins on Operating Revenue				
EBITDA	*-532%*	*-40%*	*-26%*	*8%*
EBIT	*-576%*	*-48%*	*-32%*	*3%*
NPAT	*-497%*	*-38%*	*-26%*	*7%*
Growth				
Revenue	194%	447%	38%	59%
EBITDA	*46.1%*	*-58.7%*	*-12.3%*	*-147.2%*
NPAT	*36.7%*	*-58.5%*	*-6.1%*	*-141.9%*
Earnings and valuation ratios at current price of $0.48				
Reported EPS	-4.9	-2.0	-1.7	0.7
Normalised EPS	-4.9	-2.0	-1.7	0.7
Normalised Growth	27%	-60%	-16%	-142%
Ordinary DPS	0	0	0	0
PE Ratio	-9.8	-24.3	-28.7	68.5
EV/EBITDA	na	na	na	51.2
Price/FCF	-10.7	-17.6	-35.6	46.4
Price/BV	7.7	4.8	5.8	5.3
Yield (%)	0%	0%	0%	0%
Interest cover	na	na	na	na
Gearing	na	na	na	na
ROE	-78%	-18%	-20%	8%
ROA	-77%	-16%	-17%	2%
Earnings and valuation ratios at current price of $0.96				
P/E ratio	-21	-52	-62	147
EV/EBITDA	-9	-21	-25	51

Interim Results	**1H11**	**2H11**	**1H12**	**2H12**
Revenues	1.4	0.9	5.1	7.2
EBIT	(5.2)	(7.8)	(3.3)	(2.6)

Substantial Shareholders	# shares	%
Maurie Stang	28.5	10.9%
Bernie Stang	28.3	10.9%
Steve Kritzler	22.8	8.7%
Allan Gray Australia Pty Ltd	20.0	7.7%

	2011	**2012**	**2013f**	**2014f**
Financial Position ($m)				
Cash	12.4	29.3	24.9	27.5
Receivables	0.9	3.0	2.3	2.2
Inventories	1.6	2.4	2.6	2.9
Other	0.2	0.2	0.6	0.6
Current Assets	**15.1**	**35.0**	**30.5**	**33.2**
PPE	1.5	1.5	1.4	1.6
Intangibles	0.2	0.1	0.1	0.1
Other	0.1	0.1	0.5	0.6
Non-Current Assets	**1.8**	**1.6**	**1.9**	**2.2**
Payables	1.8	2.4	2.1	2.3
Interest bearing liabilities	0.0	0.0	0.0	0.0
Other	0.8	1.1	1.7	2.7
Current Liabilities	**2.5**	**3.5**	**3.8**	**5.0**
Interest bearing liabilities	0.0	7.0	7.0	7.0
Other	0.0	0.2	0.0	0.0
Non-Current Liabilities	**0.0**	**7.2**	**7.0**	**7.0**
Net Assets	**14.3**	**26.0**	**21.6**	**23.4**
Contributed equity	58.1	73.5	73.5	73.5
Retained Profits	-45.1	-49.7	-54.1	-52.2
Other	1.4	2.1	2.1	2.1
Total Equity	**14.4**	**26.0**	**21.6**	**23.4**
Cash Flow ($m)				
Gross cashflow	-10.7	-6.8	-3.6	3.1
Net Interest	1.0	0.6	1.1	1.1
Tax paid	0.0	0.6	0.0	0.0
Other	0.7	0.0	0.0	0.0
Net operating cash flows	**-9.0**	**-5.6**	**-2.5**	**4.2**
Payments for PPE	-1.2	-0.8	-1.0	-1.5
Payments for acquisitions	0.0	0.0	0.0	0.0
Other	0.0	0.8	-0.9	-0.1
Net investing cash flows	**-1.2**	**0.0**	**-1.9**	**-1.6**
Net share issues	1.4	15.5	0.0	0.0
Net borrowings	0.0	7.0	0.0	0.0
Dividends paid	0.0	0.0	0.0	0.0
Net financing cash flows	**1.4**	**22.5**	**0.0**	**0.0**
Change in cash held	**-8.8**	**16.9**	**-4.4**	**2.6**
Cash at beginning of period	21.1	12.4	29.3	24.9
Other	0.0	0.0	0.0	0.0
Cash at end of period	**12.4**	**29.3**	**24.9**	**27.5**
Free Cash Flow ($m)				
EBITDA	-12.0	-4.9	-4.3	2.0
Less: Net Interest	1.0	0.6	1.1	1.1
Less: Tax paid	0.0	-0.6	0.0	0.0
Less: Maintenance Capex	-1.2	-0.8	-1.0	-1.5
Less: Change in WC	0.2	-2.3	0.2	0.1
Less: Change in provisions	0.0	0.0	0.5	1.0
Free Cash Flow	**-11.9**	**-8.1**	**-3.5**	**2.7**
Trophon unit sales	612	1,600	2,000	2,600
Cumulative unit sales	400	2,000	4,000	6,600
Revenue estimates $m				
Unit sales	3.7	9.6	12.0	15.6
Consumables	1.3	1.8	4.3	10.5
Service & parts	0.2	0.9	0.6	0.8
Total Revenues	**5.2**	**12.3**	**16.9**	**26.9**

Source: Company Reports and Select Equities Research

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