

18 January, 2010

Nanosonics Ltd (NAN)

Buy

Big On Demand

Upgrade Based Revised Forecasts

In December 2009, NAN raised \$12M at \$0.55 per share to support product rollout, production capacity expansion and new product development. The key driver for this raising was positive feedback the company has received for its Trophon® ultrasound probe sterilizer from distributors and potential customers which supports our view that the demand for this product is likely to be robust.

Following further discussions with management, we have revised our forecast projections for the production and sales of Trophon® and of the associated consumables. As a result of these revisions, we have upgraded our 12-month price target to \$1.00 (previously \$0.80) and retain our Buy recommendation.

Key Changes To Forecast Projections

The key changes that we have made to our forecast projections are:

- Increased the final market penetration in a number of key markets;
- Revised the ramp-up curves for sales following market launch;
- Increased the number of sterilisations per machine (consumables);
- Matched sales to reflect revised ramp-up in production capacity.

The net result of these changes is that they have decreased our near-term forecast sales revenue but have had a positive impact on our longer-term sales projections.

The company has indicated that it intends to invest up to \$8M from the raising in the development two new products categories:

- Steriliser for single-lumen endoscopes;
- Hospital-bed disinfection based on the Xonar platform.

In addition to hospital beds, the Xonar platform can be used to decontaminate rooms & surfaces or laboratory equipment such as incubators. We have not included any contribution from any new products in our forecasts or valuation.

In our view, the commercial opportunity from Trophon® alone provides investors with significant potential upside to make NAN an attractive speculative investment. We believe the company is likely to develop further products that, at this stage, provide investors with options for further upside over that anticipated from Trophon®.

YE 30 June	2009	2010	2011	2012
Operating Revenue \$M	0.3	5.9	39.5	67.2
Grants and Interest \$M	1.3	0.4	0.8	2.2
Total Revenue \$M	1.7	6.2	40.3	69.4
Net Profit \$M	-8.8	-5.3	15.0	30.3
Cash Balance \$M	13.9	20.5	35.6	65.9
Operating Cash Burn \$M	-10.8	-11.6	-25.2	-36.1
Net Cash Burn \$M	-10.5	-5.3	15.0	30.3

Investment Summary

Share Price \$ps	\$0.65
Target Price (12 month) \$ps	\$1.00
Health Care	
www.nanosonics.com.au	
Issued Capital M	218M
Market Cap \$M	\$142M
Net Cash \$M	\$21M
Analyst Name	Matthijs Smith

Changes to Forecasts

Recommendation was	Buy
Price Target was \$ps	\$0.80

Share Price Chart



Year Hi-Lo \$ps	\$0.68 - \$0.19		
Avg Monthly Vol (M)	0.5		
Performance %	1 m	3 m	12 m
Absolute	14.0%	34.0%	124.1%
Rel Top 200	9.2%	32.2%	84.8%

Shareholders

	%
Stang, Bernie	14.0%
Stang, Maurie	14.0%
Kritzler, Steven	11.0%
Kinetic Investment Partners	5.1%

Company Activities

NAN is an Australian company focused on developing and commercialising a portfolio of novel disinfection and sterilisation products utilising its proprietary technology platform.



Promising Future Supports Additional Investment

Company raised \$12M in December 2009

In December 2009, NAN raised \$12M through a placement at \$0.55 per share. The funds were raised to support the sales growth of the company's ultrasound probe sterilisation unit, the Trophon®, and to invest in development of the next products based on NAN's proprietary sterilisation technology. Specifically, the funds are to support:

- **Trophon® rollout:** inventory, marketing and distribution management;
- **Production capacity expansion:** relocation to new site with 10,000 units pa capacity;
- **New products:** single-lumen endoscope steriliser and hospital bed disinfection.

Investment in product roll-out and new product development

We view the investment into generating sales revenue from its first product and leveraging its technology platform to generate the next products as a real positive for the company. The management of NAN has historically been financially prudent, and thus we believe they have only raised this additional capital to realise the opportunities available to the company.

In our view, the demand for the Trophon® is likely to be very strong. We see the key challenge for the company is being able to generate the capacity to meet that demand while maintaining strict quality control.

Robust Demand

One of the key reasons that we like NAN is that we have always expected the demand for their Trophon® product was likely to be strong due to:

- **Unique product:** only low-temperature, point-of-care steriliser on the market;
- **Material user benefits:** improved efficiencies result in favourable cost-benefit ratio for users;
- **Recommended guidelines:** new guidelines in many markets support adoption of Trophon®.

Strong demand for Trophon® product

Having completed its controlled, limited product launch last year, the company is getting very positive feedback regarding the product which is translating into demand. At its AGM in November, NAN announced it had an in-principle agreement with an Australian company for an initial installation of 200 Trophon units. This is expected to commence during 1Q-CY10.

The company has received strong indications of demand from potential customers around the world following recent attendance at the World Federation for Ultrasound in Medicine and Biology (WFUMB) in Sydney and the Medica 2009 trade fair in Germany.

Driven by changes in regulatory guidelines

One of the underlying demand-drivers for the Trophon® unit is changes being made in many markets to the recommended guidelines for how ultrasound probes should be treated between patients. These changes are banning some of the existing treatments (such as glutaldehyde) or, in some cases, specifically recommending hydrogen peroxide-based systems. We believe that the Trophon® is the only hydrogen peroxide-based, point-of-care system that is available and we are not aware of any other products that are currently under development.

Competitor's product has been banned by the FDA

The US company Steris Corp (NYSE:STE, MCap US\$1.6bn) does have low-temperature sterilisation systems, including some which are based on hydrogen peroxide, on the market. However, these systems are too large or too expensive (US\$80,000+) to be used in a point-of-care setting and consequently cannot provide the workflow and capital benefits of the Trophon®. Furthermore, one of Steris's low temperature sterilisation products, the SYSTEM 1, has recently been banned by the FDA as the result of a dispute between the regulator and the company on various modifications made. This may provide a further opportunity for NAN in the US market.

Expecting US approval by 3Q

The Trophon® has already been approved in Australia, Canada and Europe. An application for approval has been filed in the US and we are expecting a decision on that application around 3Q-CY10. The company also plans to file for approval in Japan later this year.

The company has yet to appoint a US distributor. However we believe that there has been considerable interest not only from potential distributors but also from the original equipment manufactures (OEMs) of ultrasound probes who are interested in offering a sale package that would bundle their ultrasound probes with the Trophon®. As the OEMs have well-established distribution channels and sales forces, this has the potential to generate very high volume demand for the Trophon® unit.

In summary, we continue to believe that demand for the Trophon® unit will be very strong and has the potential to generate significant sales revenue for the company over the next few years. Furthermore, based on data from Steris, we have increased our assumption regarding the number of cycles for each machine up to 960 per year (5/day) (previously 480 per year). This has a significant impact on the future annuity stream generated from consumables and has been one of the key drivers for increasing our 12-month price target from \$0.80 to \$1.00.

Building Supply

Investing in expanding internal production capacity

At the end of last year, NAN had the capacity to manufacture 2,000 Trophon® units per year on a single shift (165/month). The company has identified an outsource site with the potential to increase capacity by a further 6,000 units per year. Furthermore, many of the components that go into the Trophon® have the potential be put together externally as sub-assemblies providing a future route for capacity expansion by using outsource manufacturers.

The funds raised in the December 2009 capital raising will allow the company to relocate to a new site which is expected to have a manufacturing capacity of 10,000 units per year. However, at this stage, the company is still evaluating potential new sites and thus this capacity is not likely to come on line until 3Q or 4Q CY10.

In the interim, the company has two options available to increase capacity:

- **Multiple shifts:** potentially could increase internal production to 4,000 – 5,000 units pa:
- **Outsource site:** interim use of an external site with final assembly at existing site.

We believe the company is actively looking at both options in order to expand its near-term production capacity to meet the current demand coming from the Australian and European markets and the likely demand once the product is approved in the US. However, while there is a clear need to expand capacity, the company is equally aware that it is critical for the company to maintain its high level of quality control over every unit that is shipped.

The Balance – Forecast Sales

Expect sales will be initially limited by supply rather than demand

With our expectation of strong demand for the Trophon®, we believe that in the near term, sales will primarily be supply constrained rather than demand-limited.

Taking into account our estimated ramp-up of production, we have reduced our forecast near term sales to match this production. However, we have increased our market share estimates to reflect the positive feedback the company has received in terms of demand for the Trophon®.

We have used an end-user price of A\$10,000 per unit which includes a 50% distributor margin and a 25% COGS providing NAN with a 25% gross margin on each unit sold.

Table 1: Forecast Sales For Trophon Units And Consumables

	2010E	2011E	2012E	2013E
Trophon Unit Sales (#)	1,038	4,346	8,441	12,081
Wholesale Revenue from Units (\$M)	5.2	21.7	42.2	60.4
Revenue from Consumables (\$M)	1.3	6.3	16.0	29.9
Total Revenue From Trophon (\$M)	6.5	28.0	58.2	90.3

SOURCE: *Shaws Estimate*

New Products In The Pipeline

A significant proportion of the newly raised cash was to support the development of new products. NAN's technology platform has a number of different applications and many of the systems that have been used in the Trophon® can be incorporated into other products in either a modified or unmodified form. There are two key product areas the company is initially looking to focus on:

1. **Single lumen endoscope steriliser:** these are endoscopes, such a laparoscopes and colposcopes, that are used for a variety of internal examinations and surgical procedures. These endoscopes have a lumen (a hollow internal channel), into which the sterilant needs to be pumped. NAN's management estimates it will take around 24-30 months to develop a pre-production prototype for this product and a further 12 months for scale-up and regulatory approval. We believe this device would address a potential market of \$200M-\$300M.
2. **Bed disinfection unit:** this device would be used to treat hospital beds between patients. Hospital-acquired infections are increasing rapidly and have a major impact on both hospital costs and patients outcomes. NAN's management believe they could development a pre-production prototype of such a device by 2H CY11 and the regulatory requirements for a bed disinfection unit would be less onerous than for other pieces of medical equipment. We would expect there to be a significant market for such a device if it were effective and easy to use.

We have not included any contribution from these new potential products in our valuation or price target. At this stage, we believe the nearer term cash flows from the Trophon® more than adequately support our investment recommendation. However, we believe this investment in new products is important from a strategic perspective, especially given the opportunities the company has to leverage its underlying technology platform.

Long term forecasts robust with sales growth from both units and consumables

Company investing in developing two new products over the next 2-3 years

New products could provide additional value above our current valuation.

FINANCIAL PERFORMANCE

Year End	June	2008 (Act)	2009 (Act)	2010 (Est)	2011 (Est)	2012 (Est)	2013 (Est)	2014 (Est)	2015 (Est)	2016 (Est)	2017 (Est)
Operating Revenue	\$M	0.0	0.3	6.5	28.0	58.2	90.3	104.2	106.0	94.0	84.8
Interest Revenue	\$M	1.9	1.2	1.1	1.6	2.6	4.4	6.6	9.0	11.4	13.7
Gov't Grants	\$M	1.1	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total Revenue	\$M	3.1	1.7	7.6	29.6	60.8	94.7	110.8	115.1	105.5	98.5
Operating Expenses	\$M	-9.4	-10.0	-11.7	-21.5	-34.4	-47.2	-51.3	-51.2	-45.1	-40.8
EBITDA	\$M	-6.4	-8.3	-4.1	8.1	26.4	47.5	59.5	63.9	60.4	57.8
Depreciation & Amortisation	\$M	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Amortisation of Intangibles	\$M	-0.8	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4
EBIT	\$M	-7.1	-8.8	-4.5	7.7	26.0	47.1	59.1	63.5	60.0	57.3
Interest Expense	\$M	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Tax Expense	\$M	0.0	0.0	0.0	0.0	0.0	-12.9	-17.7	-19.0	-18.0	-17.2
Profit After Tax	\$M	-7.2	-8.8	-4.5	7.7	26.0	34.2	41.4	44.4	42.0	40.1
Per Share											
EPS	cps	-3.7	-4.5	-2.2	3.7	12.5	16.4	19.8	21.3	20.1	19.2
Cash Backing	cps	12.4	7.1	9.3	12.8	24.7	40.4	59.3	79.7	98.9	117.3

CASH FLOW

Year End	June	2008 (Act)	2009 (Act)	2010 (Est)	2011 (Est)	2012 (Est)	2013 (Est)	2014 (Est)	2015 (Est)	2016 (Est)	2017 (Est)
Receipts	\$M	1.4	0.1	6.5	28.0	58.2	90.3	104.2	106.0	94.0	84.8
Suppliers & Employers	\$M	-10.2	-10.8	-12.1	-21.9	-34.8	-47.6	-51.7	-51.6	-45.5	-41.2
Interest Received	\$M	1.7	1.6	1.1	1.6	2.6	4.4	6.6	9.0	11.4	13.7
Tax Paid	\$M	0.0	0.0	0.0	0.0	0.0	-12.9	-17.7	-19.0	-18.0	-17.2
Cash From Operations	\$M	-7.1	-9.1	-4.5	7.7	26.0	34.2	41.4	44.4	42.0	40.1
Cash From Investing	\$M	-0.4	-1.4	-1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Cash From Financing	\$M	-0.2	0.2	12.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Opening Cash Balance	\$M	31.9	24.2	13.9	20.3	28.1	54.1	88.2	129.6	174.0	216.0
Net Incr / (Decr) In Cash	\$M	-7.7	-10.3	6.5	7.7	26.0	34.2	41.4	44.4	42.0	40.1
Closing Cash Balance	\$M	24.2	13.9	20.3	28.1	54.1	88.2	129.6	174.0	216.0	256.1

BALANCE SHEET

Year End	June	2008 (Act)	2009 (Act)	2010 (Est)	2011 (Est)	2012 (Est)	2013 (Est)	2014 (Est)	2015 (Est)	2016 (Est)	2017 (Est)
Cash & Cash Equivalents	\$M	24.2	13.9	20.3	28.1	54.1	88.2	129.6	174.0	216.0	256.1
Current Assets	\$M	24.6	15.4	21.9	29.6	55.6	89.8	131.1	175.6	217.6	257.7
Non-Current Assets	\$M	1.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.1
TOTAL ASSETS	\$M	25.6	17.6	24.0	31.7	57.7	91.8	133.2	177.6	219.6	259.8
Current Debt	\$M	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Current Liabilities	\$M	1.1	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Non-Current Debt	\$M	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Non-Current Liabilities	\$M	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
TOTAL LIABILITIES	\$M	1.07	1.27	1.27	1.27	1.27	1.27	1.27	1.27	1.27	1.27
Equity	\$M	41.9	42.2	54.2	54.2	54.2	54.2	54.2	54.2	54.2	54.2
Accumulated Profits / (Losses)	\$M	-17.3	-25.9	-30.5	-22.7	3.3	37.4	78.8	123.2	165.2	205.3
TOTAL EQUITY	\$M	24.6	16.3	23.8	31.5	57.5	91.7	133.0	177.5	219.4	259.6

VALUATION

Risk Free Rate	%	5.60%
Market Premium	%	5.50%
Beta	x	1.80
Discount Rate	%	13.9%
Forecast Period	years	14
12-Month Price Target	\$	\$1.00
Current Price	\$	\$0.65
Return	%	55%

Company Directors

Maurie Stang
David Radford
Ron Weinberger
David Fisher
David Slack

Chairman
Chief Executive Officer
Executive Director
Non-Executive Director
Non-Executive Director

Company Activities

Nanosonics Limited (NAN) is an Australian company focused on developing and commercialising a portfolio of novel disinfection and sterilisation products utilising its proprietary technology platform.

Information for Company Activities is sourced from Huntley Investment Information Pty Ltd.

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