



# Southern Cross Equities

**Biotechnology research**

**Location:** Melbourne

**Business:** A supplier of equipment to test for sleep and nervous system disorders.

**Share Price (Australian Stock Exchange CMP):** 34 cents

**Market Cap. of tradeable shares:** \$47.6m

**Twelve Month Range (c):** 45 - 21

**No. of shares tradeable:** 140m

**Average weekly volume:** 0.36m

**Average weekly value:** \$0.14m

**% below 12 month high:** 24.4%

**Main players:** David Burton (Executive Chairman and 64% shareholder), Andrew Smith (Chief Operating Officer), David Lawson (Chief Financial Officer)

**Main strength:** A niche position in the high growth market for sleep diagnostic equipment.

**Main risk:** A failure of any of Compumedics' new products to gain market traction.

**Last note:** This is an introductory note. We are commencing coverage.

**Analyst disclosure:** Stuart Roberts holds 3,700 shares in Compumedics as at the date of this report.

An introductory note on

## Compumedics

(CMP - \$0.34)

### Speculative Buy

(for knowledgeable professional investors)

Tuesday, 9 December 2003

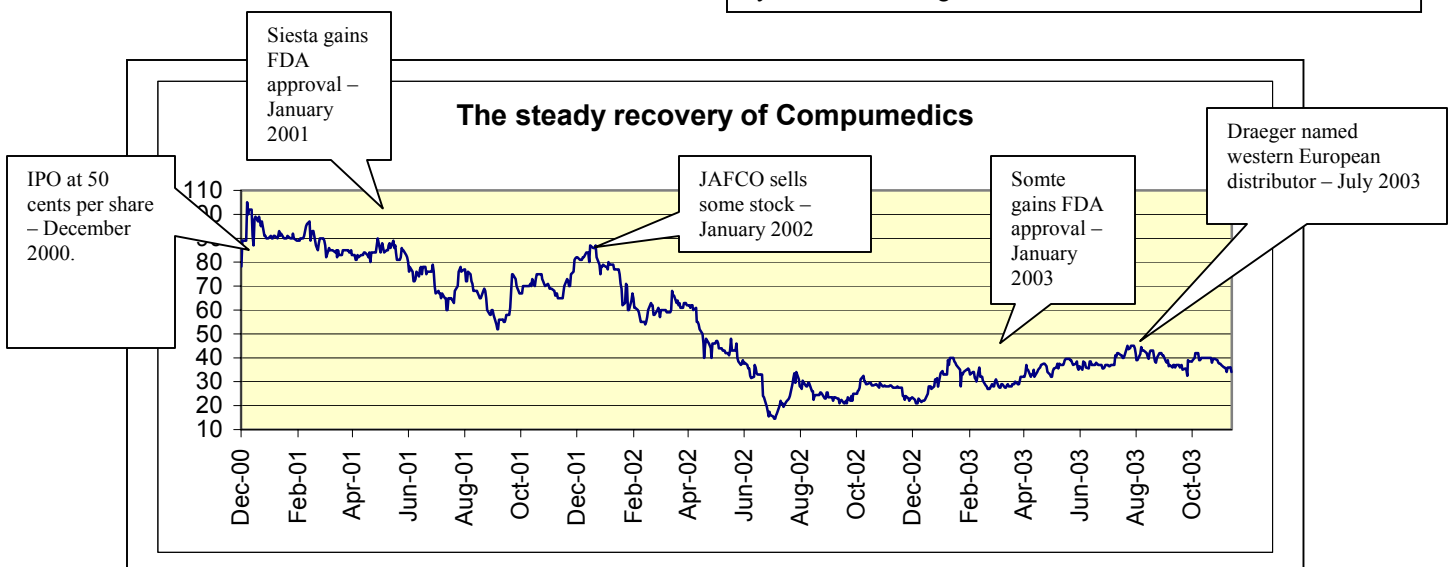
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## Compumedics – a spec. buy up to the sleeping point

The Melbourne-based Compumedics has a strategic position in the high growth market for sleep diagnostic equipment. We believe it is now growing its top and bottom line thanks to a change in its distribution strategy and an expansion beyond sleep into the general area of central nervous system disorders. While the company is still dealing with some working capital and inventory issues, and Compumedics stock has disappointed in the past due to missed earnings targets, the changes within the business suggest that the growth now being experienced is on a significantly more solid basis. Compumedics rates a **Speculative Buy for Knowledgeable Professional Investors**, with a target price of 93 cents per share. While Compumedics has grown revenue in excess of 25% p.a. for the past four years earnings have been absent. Results through this financial year need to, and should, point to earnings growth finally getting into sync with revenue growth.



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## **Compumedics – a spec. buy up to the sleeping point\***

One gets a sense reading the latest Annual Report of the Melbourne-based Compumedics that one is dealing with a fairly ambitious company. In the year to June 2003 this supplier of equipment for the diagnosis of sleep and central nervous system disorders as well as brain research tools recorded \$32m in revenue (62% up on the previous year). Turn to page 5 of the 2003 Annual Report and the company proclaims that its 'medium term objective' is to see revenues at \$100m. Compumedics has been, to date, a fast growth company at the top line. In the five years since 1998 revenue growth has been 35% p.a., putting Compumedics on track to achieve its medium term objective in around 2007. In this note we argue that Compumedics current stock price heavily undervalues the company's prospects for revenue growth and increased profitability in the lucrative markets in which it is becoming a global player. 2003/2004 is the company's 'credibility year', proving or indicating that it can successfully build shareholder value.

### **Clinical sleep diagnostics - not a sleepy business for Compumedics**

The current Executive Chairman, the electronics engineer David Burton, founded Compumedics in 1987 to make sleep diagnostic equipment. This remains the company's core business, with 2003 revenues in the order of \$17.5m, selling into what Compumedics estimates is a A\$250m a year market. As the business success of Resmed, a Sydney-based company that makes equipment to rectify sleep disordered breathing, has demonstrated to Australian investors over the last four years, sleep diagnosis is in the process of becoming big business. It is now believed that in the western world perhaps one in eight people suffer from sleep apnea or a sleep disorder of some kind, a situation that severely impacts on the patient's quality of life due both to continual tiredness as well as the cardiovascular and central nervous system complications that can arise as a result. With awareness of sleep disorders rising in the population, more and more people are looking to undergo diagnostic testing. There are, however, not enough beds in these clinics – one goes in for a night to be observed by a professional in the process of sleeping or attempting to sleep - to keep up with the patient flows. It takes weeks to get an appointment. However as new clinics are opening in response to the demand, those clinics in turn need the kind of diagnostic tools Compumedics supplies.

Compumedics currently sells five products in the sleep diagnostics area. The main product is the E-Series 'physiological amplifier', which gathers data about the patient's sleep status by detecting various electrical impulses in the patient's body via numerous wires attached to the body. Compumedics also supplies the world's first wireless sleep diagnostic system, called Siesta, and a product called Somté (FDA approval gained in January 2003) that gathers both respiratory and cardiac data. A software platform to work with the data gathered, called ProFusion PSG, also has a strong following. Compumedics seems to be doing well in terms of building its global presence. In Japan it sells through Teijin, a sleep disorder player that is Japan's largest supplier of CPAP machines. And in Europe Compumedics was able to announce in May 2003 a deal with a German medical instrument supplier called Draeger, which became Compumedics' distributor in much of western Europe. Compumedics grew its US and

*Perhaps one in eight people suffer from sleep apnea or a sleep disorder of some kind*

European business by 50% and 45% respectively in 2002/2003 while its Japanese business doubled, but with the company only having a 7% market share there is plenty of room to grow. We expect the brisk growth pace of Compumedics sleep diagnostic business will continue in 2004. For one thing, Compumedics has flagged that it may be able to gain 15% of the US sleep diagnostic market during that year. That would mean \$18m or \$19m in sales in that market as against the \$15m recorded in 2003. In Japan it hopes to do twice the amount of business in the six months to December 2003 than it did in the

\* J.P. Morgan Jr (1867-1943) once advised a friend who was complaining that the state of his stock portfolio was preventing him from sleeping at night to 'sell down to the sleeping point'.

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previous corresponding period.

**Brains and nerves – the ‘newer’ markets in which Compumedics has begun to establish its presence.**

When diagnosing disorders of the central nervous system such as schizophrenia or depression, neurophysiologists need to conduct studies such as EEGs, that is, electroencephalographies which ‘map’ the way in which neurons are firing in the brain, and EMGs, or electromyographies, which track the electrical impulses in the muscles. This is a much larger market to be playing in than sleep, with perhaps A\$890m a year being spent worldwide in this area. Only in the last couple of years, however, has Compumedics sought to be a player. In 2003 it only did \$0.9m a year in neuro diagnostics revenue but with the formation of a U.S. unit called Compumedics Neuroscience in 2003 it will strongly position new products into this market such as Safiro, an ‘ambulatory EEG system’ (i.e. one can walk around while wired up) and Comperio, an EMG system, alongside the E-Series products and Siesta product which neuro specialists already make use of.

Probably only A\$70m annually gets spent by the army of researchers worldwide doing basic research into brain function. 14% of that market, however, is served by Compumedics, which is significant because academic researchers tend to be good opinion leaders when it comes to equipment choice in a field. And with brain function, a fast growing field in academia due to the ‘new frontier’ quality of academic work in the central nervous system, we also expect some decent growth from this business. Consequently we see the \$9.7m spent on products such as SynAmps, a fairly powerful amplifier system, NuAmps, an EEG amplifier, and ESI, an Electric Source Imaging tool for gathering EEG and other brain elements of brain data, as probably lower margin but valuable products given the flow-on effects for the rest of the business.

*With the business now at \$33m it appears to be nearing the ‘spill’ point where extra revenue makes it down to the bottom line*

**The financials**

In 2002/2003 Compumedics’ \$32.1m in adjusted revenues allowed for a \$2.1m EBITDA, which represented only a 6.5% EBITDA margin. If one allows all R&D to be expensed then in the 2003 year EBITDA was actually \$1.9m in the red. Not a very attractive company on the surface of things. However Compumedics argues that it’s currently in margin improvement mode. Gross margins in 2002 were 62% but they fell to only 56% in 2003 for three reasons. Part of this was foreign exchange – the Australian dollar was buying just 56 American cents at the start of 2002/2003 but 67 American

cents by the end of the year, which was deleterious for a big exporter like Compumedics and cost around two percentage points in gross margin. However the other two reasons, each of which accounted for another two percentage points, were a one-off change in revenue recognition policy, and the cost of setting up new premises in the Australia and the US. Consequently Compumedics would argue that margins are set to rise in 2004. With the business now at \$32m, it appears to be perhaps only two or three years away from the ‘spill’ point where most extra revenue makes it down to the bottom line, and David Lawson has worked hard at boosting efficiencies through the business, helped by the recently hired Chief Operating Officer, Andrew Smith. Compumedics has some issues in terms of working capital – at June 2003 it still had debtor days of 96 days, although it had been 131 a year previous – and the company has flagged that this plus inventory will be on the agenda for improvement in 2004. At least Compumedics’ balance sheet can cope with whatever shocks are required. As at June 2003 Compumedics was more or less debt free, \$5.4m in cash offsetting the \$5.2m in debt on the balance sheet. With no intangibles being carried on the balance sheet (these were written off in 2003) there were net assets per share of \$11.7m, or 8.3 cents per share.

**Valuing Compumedics**

Compumedics medium term sales target of \$100m p.a. derives in part from the company’s estimate that its new manufacturing facilities, at Abbotsford in Melbourne’s eastern suburbs and at El Paso in Texas, have been set up to

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handle that level of business. As an early stage approach to modeling Compumedics we constructed a simple DCF model (see Table 1 below). We modeled Compumedics as boosting sales 15% a year for the next ten years, which would raise revenue above \$100m in 2012. We allowed 60% gross margins, and the company's non-R&D cost base to rise 15% a year between 2004 and 2006 and 5% thereafter. For R&D we kept this at a constant 12% of sales, which is where the company has stated that it expects R&D expenditure to be looking forward. With 2% p.a. growth in perpetuity factored into our terminal value, and a 10% discount rate, Compumedics could be valued at \$2.51 per share. Take this as an optimistic case valuation. For a base case valuation, using a 25% discount rate, we came up with a 93 cents per share valuation. These valuations naturally assume that the Compumedics team can 'do it' this time, as they indicated they would at the November 2003 Annual General Meeting.

At the current share price Compumedics is discounting even our base case valuation by a significant margin. We would suggest a two-fold reason for this. Firstly, it's only been relatively recently that Compumedics has enjoyed some top-line scale. When it went public in 2000 the company was only expected to do \$19m in sales for the 2000/2001 year, which didn't put the stock on many 'radar screens'. More recently, the market has been watching Compumedics to see if the kind of growth it now seems to be experiencing is 'real'. We expect that the half-year result for the period to December 2003 may prove a catalyst to push the stock in the direction of at least our base case valuation.

**Buy up to the sleeping point**

Investing in Compumedics is not without risk. The company has been listed since December 2000 and has disappointed investors due to missed earnings targets mainly due to problems over distribution. On the other hand the large and growing markets into which the company is selling products, and the pipeline of new products Compumedics is introducing, has yet to be fully accounted for in the current share price. Compumedics stock is a **Speculative Buy for Knowledgeable Professional Investors, with a target share price of 93 cents** based on our base case valuation of the Compumedics business.

|                  | 2003a | 2004e | 2005e |
|------------------|-------|-------|-------|
| Revenue          | 32.1  | 36.9  | 42.4  |
| EBITDA*          | -1.9  | 2.6   | 3.0   |
| NPAT**           | -0.7  | 1.8   | 2.1   |
| EPS              | -0.5  | 1.3   | 1.5   |
| DPS              | 0     | 0     | 0     |
| PER              | N/A   | 25.9  | 22.5  |
| EV/ EBITDA       | N/A   | 18.1  | 15.7  |
| Return on equity | N/A   | 15.7% | 18.1% |

\* 2003 figure reflects notional full expensing of R&D

\*\* 2003 figure adjusts for intangible write-offs

**Appendix I – A Compumedics timeline**

**21 December 2000** – Compumedics stock closes its first day of trading at 78.2 cents, as against the 50 cents at which the company raised \$15m.

**4 January 2001** – Compumedics stock jumps 13% to 98 cents on news that the Siesta product has received market clearance from the FDA.

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## Southern Cross Equities

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Tuesday, December 09, 2003

Speculative Buy at 34 cents

**10 September 2001** – Compumedics stock has steadily declined to 68 cents. The company announces net profit for 2000/2001 of \$1.97m, ahead of forecast, on \$18.3m in revenue.

**14 January 2002** – JAFCO, the venture capitalist, advises that it has reduced its holding from 5.9% to 5.5%, providing an explanation for the share price weakness that had seen the stock drop from 87 cents on 4 January to 79 cents that afternoon.

**14 February 2002** – Compumedics stock has kept declining and is now 60 cents. The company announces net profit for the six months to December 2001 of \$0.3m, down 52%, in spite of a 32% rise in revenue to \$9m.

**29 April 2002** – Compumedics announces the acquisition of the Neuroscan neurological instrument business of El Paso in Texas. Compumedics rises a cent to 61 cents.

**27 July 2002** – Compumedics rises from 16.5 cents to 20 cents on news that a letter of intent has been signed with Draeger Medical in Germany.

**6 September 2002** – Compumedics stock has gained half a cent to 24.5 cents. The 2001/2002 result is a loss of \$1.9m on sales of \$19.7m.

**28 January 2003** – Compumedics stock has recovered to 39 cents, from 22 cents the last time it traded. The company announces that Somte has gained FDA approval.

**26 February 2003** – In Japan a Shinkansen bullet train with 800 passengers on board runs at 270 km/h in spite of the driver being asleep for eight minutes. Eventually the train is stopped by automatic control. It is subsequently revealed that the driver suffers sleep apnea. Compumedics considers the incident to be a significant market driver for its sleep diagnostic business in Japan.

**5 July 2003** – Draeger Medical is named western European distributor for Compumedics. The stock rises half a cent to 35.5 cents.

**2 September 2003** – Compumedics stock is 40.5 cents. The 2002/2003 result is a loss of \$0.7m before write off of intangibles, on sales of \$32m.

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**Table 1: Early stage DCF valuation of Compumedics**

| Year                             | 2003                       | 2004   | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012  | 2013  | 2014  | Growth                              |
|----------------------------------|----------------------------|--------|------|------|------|------|------|------|------|-------|-------|-------|-------------------------------------|
| Discount rate                    | 10% optimistic<br>25% base |        |      |      |      |      |      |      |      |       |       |       |                                     |
| Revenue (\$m)                    | 32.1                       | 36.9   | 42.4 | 48.8 | 56.1 | 64.5 | 74.1 | 85.3 | 98.1 | 112.8 | 129.7 |       | 15%                                 |
| Cost of sales (\$m)              | 14.2                       | 14.7   | 17.0 | 19.5 | 22.4 | 25.8 | 29.7 | 34.1 | 39.2 | 45.1  | 51.9  |       |                                     |
| Gross profit (\$m)               | 17.9                       | 22.1   | 25.4 | 29.3 | 33.6 | 38.7 | 44.5 | 51.2 | 58.8 | 67.7  | 77.8  |       |                                     |
| Operating expenses (\$m)         | 13.1                       | 15.1   | 17.3 | 19.9 | 20.9 | 22.0 | 23.1 | 24.2 | 25.4 | 26.7  | 28.0  |       | 15% for 2004-2006,<br>5% thereafter |
| R&D (\$m)                        | 6.7                        | 4.4    | 5.1  | 5.9  | 6.7  | 7.7  | 8.9  | 10.2 | 11.8 | 13.5  | 15.6  |       |                                     |
| EBITDA (\$m)                     | -1.9                       | 2.6    | 3.0  | 3.5  | 6.0  | 9.0  | 12.5 | 16.7 | 21.6 | 27.4  | 34.2  |       |                                     |
| Tax (\$m)                        | 0.0                        | 0.8    | 0.9  | 1.0  | 1.8  | 2.7  | 3.8  | 5.0  | 6.5  | 8.2   | 10.3  |       |                                     |
| Surplus after tax (\$m)          | -1.9                       | 1.8    | 2.1  | 2.4  | 4.2  | 6.3  | 8.8  | 11.7 | 15.1 | 19.2  | 24.0  | 24.0  | 2%                                  |
| <b>Optimistic case DCF (\$m)</b> |                            | 1.8    | 1.9  | 2.0  | 3.2  | 4.3  | 5.4  | 6.6  | 7.8  | 9.0   | 10.2  | 299.4 |                                     |
| NPV (\$m)                        |                            | 351.5  |      |      |      |      |      |      |      |       |       |       |                                     |
| NPV per share                    |                            | \$2.51 |      |      |      |      |      |      |      |       |       |       |                                     |
| <b>Base case DCF (\$m)</b>       |                            | 1.8    | 1.7  | 1.6  | 2.1  | 2.6  | 2.9  | 3.1  | 3.2  | 3.2   | 3.2   | 104.1 |                                     |
| NPV (\$m)                        |                            | 129.5  |      |      |      |      |      |      |      |       |       |       |                                     |
| NPV per share (\$m)              |                            | \$0.93 |      |      |      |      |      |      |      |       |       |       |                                     |

*Director:* David O'Halloran

*Analyst:* Stuart Roberts



**Southern Cross Equities**

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*Speculative Buy at 34 cents*

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***Disclosure of interest***

Southern Cross Equities Ltd and its associates hold 1,594,825 shares in Compumedics as at the date of this report. This position is subject to change without notice.

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