

F&P Healthcare

UNDERPERFORM

Unmasking ResMed's 1Q20 Result

ResMed's (RMD) 1Q20 result saw a standout quarter for masks with further evidence of market share gains, likely at the expense of F&P Healthcare (FPH). The key question from here — is one new mask from FPH enough to change this dynamic and support a re-acceleration in Homecare growth, as incorporated in our forecasts. We view this as an area of downside risk, given a highly competitive market rife with new products, and an incumbent (RMD) with strong momentum and products that are resonating well in market.

Key take-outs

- **RMD 1Q20:** Standout quarter for masks, with an acceleration in growth, supporting gross margin expansion.
- **New products:** Homecare dealers are spoilt for choice with a highly competitive landscape — the past 12 months has seen four new masks from RMD, one from Phillips and one from FPH.
- **Competitive bidding (CB):** Industry anecdotes suggest downside risk to mask prices from CB 2021. Circa 5% of FPH revenue is exposed to CB.

RMD 1Q20 — strong quarter; new products supporting mask growth

RMD reported a 1Q20 result ahead of consensus, with the key highlight being a standout quarter for masks. Market share gains were evident globally for RMD in masks with +19% constant currency (CC) growth. An array of new products has tipped the scales in its favour, with clear positive momentum in recent quarters. Devices saw +6% CC growth, broadly in line with industry growth.

Rounding out a strong result — gross margins were up +120bp (+70bp organic, topped up by acquisitions) helped by strength in the high margin mask category.

Our read through for FPH

- **Industry insights:** Competitor commentary supports an attractive industry backdrop (growth of c. +6–8%), with sleep apnea underdiagnosed globally.
- **Masks:** Our FPH forecasts are for market share losses in FY20. Recent results from competitors provide nothing to change this view. We assume new products are successful in changing this trajectory from FY21; albeit this is reliant on a favourable industry response in what is currently a competitive landscape of well-regarded products. One new mask has been launched and we expect to see at least one more in the next 6 months.
- **Flow generators:** RMD and Phillips remain the dominant players in this segment. We see nothing to change this view; particularly given FPH's strategy is to focus almost entirely on masks.

Figure 1. FPH and RMD metrics

	Rating	Market Cap (bn)	Price	12-mth Chg	12 month forward PE	12 month forward EV/EBITDA	PEG
FPH	UNDERPERFORM	NZ\$10.9	NZ\$18.93	42.5%	40.3x	25.6x	2.9x
RMD	n/a	A\$29.7	A\$20.65	50.3%	31.6x	21.7x	2.5x

Source: Forsyth Barr analysis, Eikon

Investment View

FPH is a high quality company with an attractive outlook supported by a long runway of organic growth opportunities, particularly in the Hospital segment where clinical evidence continues to build. However, valuation metrics are elevated even when adjusting for growth, relative to global peers, which leaves little room for error. UNDERPERFORM.

NZX Code	FPH
Share price	NZ\$18.93
Target price	NZ\$16.00
Risk rating	Medium
Issued shares	572.8m
Market cap	NZ\$10,843m
Average daily turnover	602.4k (NZ\$9,027k)

Share Price Performance



Financials: March	19A	20E	21E	22E
NPAT* (NZ\$m)	209.2	262.0	300.2	345.5
EPS* (NZc)	36.5	45.5	51.9	59.4
EPS growth* (%)	9.5	24.7	14.0	14.5
DPS (NZc)	23.3	29.0	34.0	39.0
Imputation (%)	100	100	100	100

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	32.8	27.2	23.4	20.5
EV/EBIT	36.9	31.4	26.5	23.0
PE	n/a	41.6	36.5	31.8
Price / NTA	n/a	n/a	n/a	n/a
Cash dividend yield (%)	1.2	1.5	1.8	2.1
Gross dividend yield (%)	1.7	2.1	2.5	2.9

*Historic and forecast numbers based on underlying profits

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Fisher & Paykel Healthcare Corporation (FPH) priced as at 25 Oct 2019: NZ\$18.93

March year end

Forsyth Barr valuation					Valuation Ratios						
Valuation methodology					Blended DCF/Compco						
					2018A	2019A	2020E	2021E	2022E		
12-month target price (NZ\$)*					16.00	Spot valuations (NZ\$)					
Expected share price return	-15.5%	1. DCF	15.76		EV/EBITDA (x)	35.0	32.8	27.2	23.4	20.5	
Net dividend yield	1.7%	2. Compco	14.35		EV/EBIT (x)	40.1	36.9	31.4	26.5	23.0	
Estimated 12-month return	-13.8%	3. n/a	n/a		PE (x)	56.7	51.8	41.6	36.5	31.8	
Key WACC assumptions					DCF valuation summary (NZ\$m)						
Risk free rate	2.00%	Total firm value		9,107	Price/NTA (x)	>100x	>100x	>100x	>100x	>100x	
Equity beta	0.77	(Net debt)/cash		0	Free cash flow yield (%)	1.5	1.2	1.2	2.4	2.5	
WACC	7.5%	Value of equity		9,107	Net dividend yield (%)	1.1	1.2	1.5	1.8	2.1	
Terminal growth	2.0%	Shares (m)		573	Gross dividend yield (%)	1.6	1.7	2.1	2.5	2.9	
					Imputation (%)	100	100	100	100	100	
					Pay-out ratio (%)	64	64	64	65	66	
Profit and Loss Account (NZ\$m)					Capital Structure						
Sales revenue	2018A	2019A	2020E	2021E	2022E	Interest cover EBIT (x)	>100x	n/a	>100x	>100x	>100x
Normalised EBITDA	309	329	397	463	528	Interest cover EBITDA (x)	>100x	n/a	>100x	>100x	>100x
Depreciation and amortisation	(45)	(42)	(53)	(55)	(57)	Net debt/ND+E (%)	-7.0	-6.3	-3.6	-11.5	-15.5
Normalised EBIT	270	293	344	407	471	Net debt/EBITDA (x)	n/a	n/a	n/a	n/a	n/a
Net interest	(2)	1	(2)	(2)	(3)	Key Ratios					
Associate income	-	-	-	-	-	Return on assets (%)	26.3	24.2	25.0	28.3	30.4
Tax	(78)	(82)	(91)	(106)	(122)	Return on equity (%)	25.0	22.9	25.6	26.2	26.8
Minority interests	-	-	-	-	-	Return on funds employed (%)	28.0	26.8	27.4	29.9	32.5
Normalised NPAT	190	209	262	300	346	EBITDA margin (%)	31.5	30.8	33.3	34.3	34.5
Abnormals/other	-	-	-	-	-	EBIT margin (%)	27.5	27.3	28.8	30.2	30.8
Reported NPAT	190	209	262	300	346	Capex to sales (%)	8.5	11.7	12.6	4.9	7.1
Normalised EPS (cps)	33.4	36.5	45.5	51.9	59.4	Capex to depreciation (%)	238	366	332	141	223
DPS (cps)	21.3	23.3	29.0	34.0	39.0	Operating Performance					
					Sales revenue (NZ\$m)						
					Hospital						
					Growth (%)						
					Homecare						
					Growth (%)						
					Core products - total						
					Distributed products						
					Total sales						
					Hospital						
					Growth (%)						
					Homecare						
					Growth (%)						
					Cost breakdown and margins						
					Gross profit (NZ\$m)						
					Gross margin (%)						
					R & D costs (NZ\$m)						
					as % of revenue						
					SG&A costs (NZ\$m)						
					as % of revenue						
					Key line items to call out						
					R&D tax credit (incl. as offset to tax)						
					Litigation costs within SG&A						
					Currency rates						
					Spot rates						
					NZDUSD						
					NZDEUR						
					Effective rates						
					NZDUSD						
					NZDEUR						
					FX hedging						
					USD cover of expected exposure (%)						
					USD average rate of cover						
					EUR cover of expected exposure (%)						
					EUR average rate of cover						
Cash Flow (NZ\$m)					Balance Sheet (NZ\$m)						
EBITDA	2018A	2019A	2020E	2021E	2022E	Working capital	159	159	182	205	233
Working capital change	9	7	(23)	(24)	(27)	Fixed assets	476	601	706	726	785
Interest & tax paid	(71)	(83)	(93)	(107)	(125)	Intangibles	50	62	62	62	62
Other	-	-	-	-	-	Other assets	95	109	141	141	141
Operating cash flow	248	253	281	332	375	Total funds employed	780	931	1,090	1,134	1,221
Capital expenditure	(83)	(126)	(150)	(66)	(108)	Net debt/(cash)	(50)	(54)	(35)	(118)	(173)
(Acquisitions)/divestments	-	-	-	-	-	Other non current liabilities	69	72	104	104	104
Other	(100)	-	-	-	-	Shareholder's funds	761	913	1,022	1,148	1,290
Funding available/(required)	65	128	131	265	267	Minority interests	-	-	-	-	-
Dividends paid	(103)	(115)	(150)	(182)	(212)	Total funding sources	780	931	1,090	1,134	1,221
Equity raised/(returned)	2	2	-	-	-						
Increase/(decrease) in net debt	36	(15)	19	(83)	(55)						

* Forsyth Barr target prices reflect valuation rolled forward at cost of equity less the next 12-months dividend

ResMed 1Q20 — read through for FPH

In our 16th edition of *Unmasking ResMed's Result*, we look at the 1Q20 ResMed (RMD) result release with a focus on any insight or implications we see for FPH. Given the limited market data available for FPH's two core divisions, Homecare and Hospital, we use RMD's quarterly releases to look for insight into the Obstructive Sleep Apnea (OSA) market for FPH's Homecare division. Homecare/OSA makes up ~40% of FPH revenue.

Key take-outs

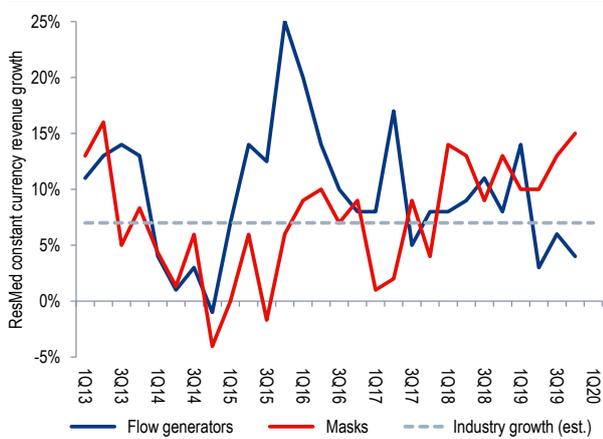
- **Recent competitor data points:** Quarterly results show a strong result from ResMed (+11% growth in its sleep business) and solid growth from Phillips. This aligns with our view that FPH is currently losing market share.
- **New products:** Homecare dealers are spoiled for choice with a suite of new products over the past 12 months, with RMD particularly active (and successful). FPH is now looking to play catch up to drive a rebound in growth in its sleep segment.
- **Competitive bidding (CB):** Industry anecdotes suggest downside risk for mask prices as part of CB 2021 which impacts ~25% of US customers.

Industry data in more detail

Recent OSA sales growth insights

- **ResMed 1Q20 (refer Figure 2):**
 - Masks: Clear evidence of market share gains, with a strong acceleration in global growth to +19% in constant currency in 1Q20 (+19% Americas; +19% Rest of World) vs estimated industry growth of +8–10% Key drivers are: market share gains, improved adherence and better resupply rates.
 - Flow generators: +6% growth (+8% Americas; +4% Rest of World) at the upper end of estimated industry growth of +4–6%.
 - Gross margins: +70bp organic margin expansion (+120bp including acquisitions to 59.5%), helped by favourable product mix.
- **Phillips 3Q19:**
 - "Mid-single digit" growth in OSA portfolio, with strong demand for new masks.
 - Margins: A material margin decline in Connected Care segment (includes the OSA business) driven by a range of issues which largely appear company specific, not helped by various manufacturing changes to combat increasing headwinds from tariffs (on China).

Figure 2. ResMed quarterly constant currency revenue growth



Source: Forsyth Barr analysis, ResMed company reports

Figure 3. FPH constant currency revenue growth (OSA masks)



Source: Forsyth Barr analysis, Company reports

Online data

Relevant industry data is scarce, albeit CPAP.com publishes sales data for self-pay consumers. While this is a very small segment of the US market (we estimate <3%) it can provide a gauge of consumer preference, which is one key driver of mask selection.

- **Nasal masks:** The largest, most competitive segment, with an estimated c. 45% share of the mask market. Phillips is the clear market leader, albeit RMD has been taking incremental share, particularly in recent quarters. FPH market share has weakened over recent quarters, tracking at c. 9% (vs 12–13% in CY 2017/18).
- **Full-face:** The smallest category, albeit has gained share in the past few years and now makes up ~27% of the market. Historically FPH has had the most success in full-face masks, although a hiatus of new products has seen its share fall to 16% (vs. a 1Q17 peak of 27%). RMD has been the key beneficiary, helped by new products.
- **Nasal pillows:** RMD is the clear market leader and continues to take share (now ~72%). FPH's recent launch (Brevida) started well in the online data, albeit shows no evidence of acceleration with FPH's nasal pillow share broadly unchanged at c. 9% (8–12% range) over the past 5yrs.

Competitive bidding

US public health insurer, CMS, has opened Round 2021 of Competitive Bidding (CB) — the process for homecare dealers to supply and replenish a range of medical devices and drive reimbursement levels. Dealers will dictate the outcome, but we see nothing to change our view that average selling prices for manufacturers will remain under pressure near-term. Market feedback suggests the key area of risk is downside for masks.

Change in process this round; education key

The key change this round of CB is the introduction of 'lead product pricing' — meaning the OSA mask price is set based on a historic ratio to the lead item: flow generators.

Risks appear downside skewed for masks

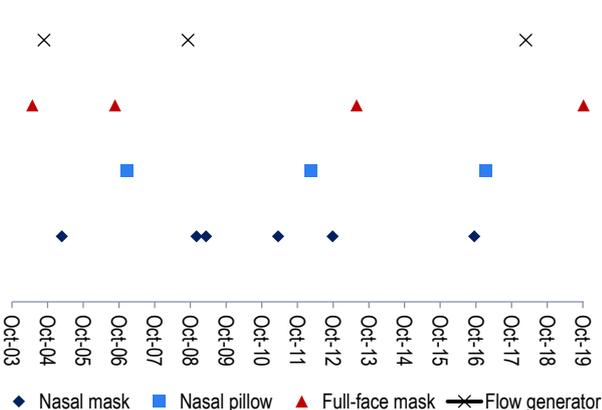
Industry feedback suggests overall reimbursement is likely to be broadly stable, albeit the mix is expected to shift in favour of flow generators which may create some downside risk to mask prices. We estimate FPH's revenue exposed to CB is c. 5%.

New product landscape

Ongoing success and growth in OSA masks is typically reliant on regular new product launches. Anecdotal feedback and data points suggest both Phillips and RMD have delivered a step forward in their mask offerings over the past couple of years, with RMD in particular enjoying material market share gains in recent quarters.

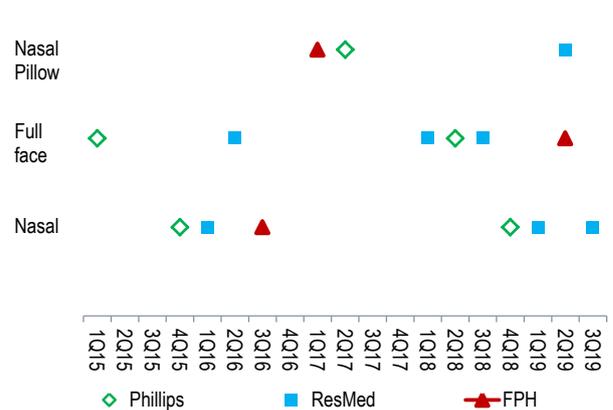
FPH has just ended a longer than usual period without new masks, with the recent launch of Vitera in the full face category. The key question — is one mask enough to change the current negative trajectory and return to attractive growth rates? We are unconvinced, particularly given a highly competitive market. Feedback from US dealers over the next quarter will be a key early indicator. We expect a further new mask in FY20 from FPH.

Figure 4. FPH estimated product launch timing



Source: Forsyth Barr analysis, Company announcements

Figure 5. Est. mask launch timing by category for key manufacturers



Source: Forsyth Barr analysis, Company announcements, Company websites

Investment summary

F&P Healthcare (FPH) has developed specialised expertise in heated humidification that forms the basis of its strong market position in the hospital and growing presence in homecare. It has progressively widened its addressable market through 'new' applications which is a key driver of an attractive, long-term, double-digit profit growth outlook. Valuation metrics are elevated even when adjusting for growth, relative to global peers, leaving little room for error. **UNDERPERFORM.**

Business quality

- **Track record:** FPH has created value through continued product innovation and progressively widening its addressable market with 'new' applications of its technology to serve more patient groups and provide more products per patient.
- **Strong market position:** FPH's business model is supported by a high portion of recurring revenue (>85%) and strong global market position (including c. 70% share in the invasive ventilation market; c. 15% in sleep apnea and growing presence in areas where FPH is working to change clinical practice).
- **Attractive industry backdrop:** FPH operates in markets with high barriers to entry and where adoption curves are long. Structural trends are also supportive (ageing population, global focus on lowering healthcare costs and improving diagnosis rates).

Earnings and cash flow outlook

- **Slower near-term constant currency revenue growth:** Increasingly reliant on the Hospital segment, with Homecare under pressure following a period of new product hiatus. Changing this trajectory is reliant on new products being successful.
- **Long-term growth thesis attractive:** FPH has a long runway of organic growth opportunities, particularly in the Hospital segment where clinical evidence continues to build for 'new' applications.

Financial structure

- **Balance sheet:** FPH's target gearing range of -5% to +5% ensures flexibility for events like product recalls or hedging opportunities. We expect it to remain in a net cash position near-term.

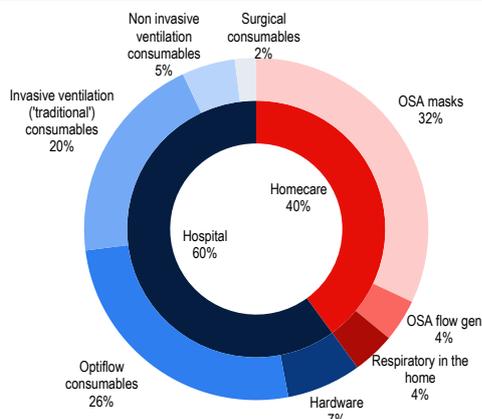
Risks factors

- **Change in technology or medical treatments:** May result in some products becoming obsolete or cause it to incur costs to implement new technologies. There is some risk mitigation given FPH's diversified offering.

Company description

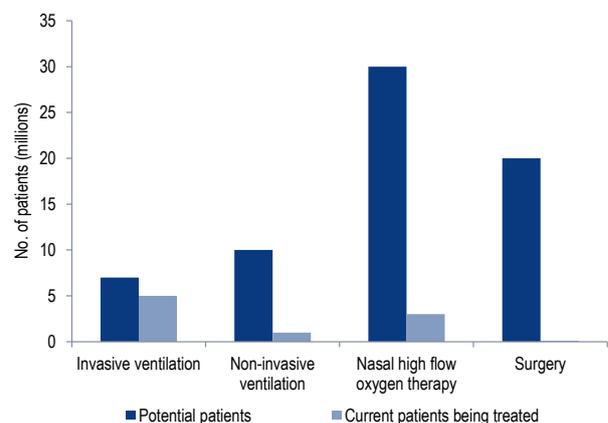
FPH designs, manufactures and markets heated humidifiers for use in respiratory care and humidified airflow generators for obstructive sleep apnea (OSA), along with associated single and multi-use accessories. FPH has a strong global market share in respiratory care following over 30 years in the market. The company leveraged its expertise in humidification products into the OSA market. It has a market share of 10%-15% and is the third player behind ResMed and Phillips Respironics. FPH has a range of over 2,700 products and accessories and sells its products globally.

Figure 6. Revenue breakdown by segment (est.)



Source: Company reports, Forsyth Barr analysis

Figure 7. Global market penetration in RAC / Hospital segment



Source: Company reports, Forsyth Barr analysis

Figure 8. Substantial Shareholders

Shareholder	Latest Holding
The Capital Group Companies	6.4%
The Vanguard Group	5.3%
BlackRock Investment Management	5.0%

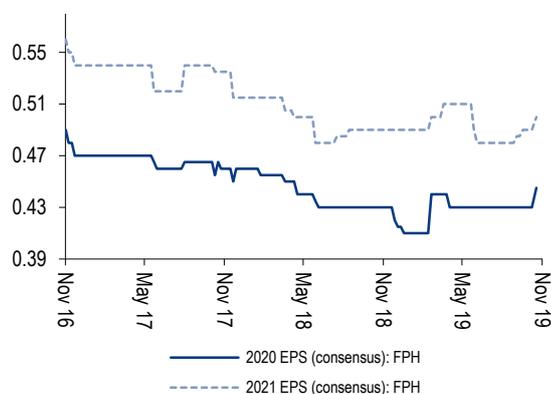
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 9. International Compco's

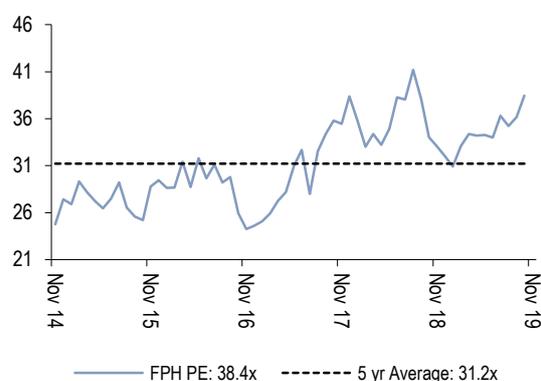
Company <i>(metrics re-weighted to reflect FPH's balance date - March)</i>	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
				2020E	2021E	2020E	2021E	2020E	2021E	
F&P Healthcare	FPH NZ	NZ\$18.93	NZ\$10,843	41.6x	36.5x	27.2x	23.3x	31.3x	26.5x	1.8%
ResMed Inc	RMD US	US\$127.61	US\$18,346	35.2x	29.2x	22.7x	20.1x	27.8x	24.1x	1.3%
Teleflex Inc	TFX US	US\$319.82	US\$14,793	28.0x	24.2x	18.9x	16.5x	24.9x	22.0x	0.4%
Boston Scientific Corp	BSX US	US\$40.32	US\$56,132	24.9x	21.8x	19.2x	17.1x	22.5x	19.5x	n/a
Becton Dickinson and Co	BDX US	US\$246.01	US\$66,382	20.1x	18.0x	15.1x	13.1x	18.6x	16.8x	1.5%
Compco Average:				27.0x	23.3x	19.0x	16.7x	23.4x	20.6x	1.1%
FPH Relative:				+54%	+56%	+43%	+40%	+34%	+28%	+66%

EV = Current Market Cap + Actual Net Debt

Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (FPH) companies fiscal year end

Figure 10. Consensus EPS Momentum


Source: Forsyth Barr analysis, Bloomberg

Figure 11. 12 Month Forward PE


Source: Forsyth Barr analysis

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