FORSYTH BARR

F&P Healthcare

UNDERPERFORM

Unmasking ResMed's 2Q20 Result

Recent data points continue to support market share gains for ResMed (RMD) in the Homecare segment, likely at the expense of F&P Healthcare (FPH). This has been helped by a steady flow of new products. Our (and market) forecasts incorporate a re-acceleration in Homecare growth from FY21. 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 2Q20:** Another standout quarter — with market share gains evident.
- **Online data:** Trends support meaningful market share gain for RMD over recent quarters (and weeks), at the expense of both FPH and Phillips.
- **New products:** 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 2Q20 — strong quarter across the board

RMD reported a 2Q20 result ahead of consensus, with the key highlight another standout quarter for masks. Market share gains were evident globally for RMD in masks with +16% constant currency (CC) growth, well ahead of estimated industry growth ("high single digits"). Devices saw +8% CC growth, modestly ahead of industry growth. Rounding out a strong result — gross margins were up +60bp, driven 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	EV/EBITDA	PEG
FPH	UNDERPERFORM	NZ$13.4	NZ$23.30	85.5%	45.8x	29.8x	3.3x
RMD	n/a	A$36.0	A$25.05	91.7%	37.0x	25.4x	3.1x

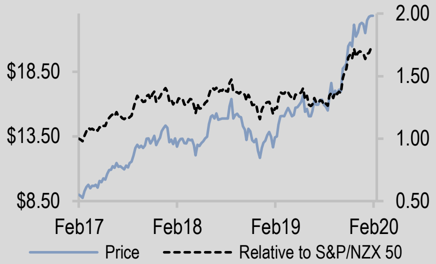
Source: Forsyth Barr analysis, Eikon

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$22.85
Target price	NZ$16.50
Risk rating	Medium
Issued shares	572.8m
Market cap	NZ$13,088m
Avg daily turnover	596.5k (NZ$10,314k)

Share Price Performance



Financials: Jan/	19A	20E	21E	22E
NPAT* (NZ$m)	209.2	265.5	304.0	350.1
EPS* (NZc)	36.5	46.2	52.6	60.2
EPS growth* (%)	9.5	26.4	13.9	14.6
DPS (NZc)	23.3	29.5	34.0	39.0
Imputation (%)	100	100	100	100

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	39.6	32.5	27.9	24.5
EV/EBIT	44.6	37.4	31.8	27.5
PE	n/a	49.5	43.5	37.9
Price / NTA	n/a	n/a	n/a	n/a
Cash div yld (%)	1.0	1.3	1.5	1.7
Gross div yld (%)	1.4	1.8	2.1	2.4

*Historic/forecast numbers based on normalised profits

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Fisher & Paykel Healthcare Corporation (FPH)

Priced as at 31 Jan 2020 (NZ$)	**22.85**

12-month target price (NZ$)*	**16.50**
Expected share price return	-27.8%
Net dividend yield	1.5%
Estimated 12-month return	-26.3%

Spot valuations (NZ$)	
1. DCF	16.57
2.Compco	14.75
3. n/a	n/a

Key WACC assumptions	
Risk free rate	2.00%
Equity beta	0.77
WACC	7.3%
Terminal growth	2.0%

DCF valuation summary (NZ$m)	
Total firm value	9,665
(Net debt)/cash	0
Less: Capitalised operating leases	-
Value of equity	9,665

Profit and Loss Account (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Sales revenue	981	1,070	1,202	1,359	1,539
Normalised EBITDA	**309**	**329**	**402**	**468**	**534**
Depreciation and amortisation	(45)	(42)	(53)	(57)	(58)
Normalised EBIT	**270**	**293**	**349**	**411**	**476**
Net interest	(2)	1	(2)	(1)	(3)
Associate income	-	-	-	-	-
Tax	(78)	(82)	(92)	(106)	(123)
Minority interests	-	-	-	-	-
Normalised NPAT	**190**	**209**	**266**	**304**	**350**
Abnormals/other	-	-	-	-	-
Reported NPAT	**190**	**209**	**266**	**304**	**350**
Normalised EPS (cps)	33.4	36.5	46.2	52.6	60.2
DPS (cps)	21.3	23.3	29.5	34.0	39.0

Valuation Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EV/EBITDA (x)	42.2	39.6	32.5	27.9	24.5
EV/EBIT (x)	48.4	44.6	37.4	31.8	27.5
PE (x)	68.5	62.6	49.5	43.5	37.9
Price/NTA (x)	>100x	>100x	>100x	>100x	>100x
Free cash flow yield (%)	1.3	1.0	0.8	2.1	2.1
Net dividend yield (%)	0.9	1.0	1.3	1.5	1.7
Gross dividend yield (%)	1.3	1.4	1.8	2.1	2.4

Capital Structure	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Interest cover EBIT (x)	>100x	n/a	>100x	>100x	>100x
Interest cover EBITDA (x)	>100x	n/a	>100x	>100x	>100x
Net debt/ND+E (%)	-7.0	-6.3	-1.1	-9.6	-14.1
Net debt/EBITDA (x)	n/a	n/a	n/a	n/a	n/a

Growth Rates	**2018A**	**2019A**	**2020A**	**2021A**	**2022A**
Revenue (%)	9.7	9.1	12.3	13.1	13.2
EBITDA (%)	12.8	6.4	22.0	16.5	14.1
EBIT (%)	12.4	8.5	19.2	17.9	15.7
Normalised NPAT (%)	12.4	10.0	26.9	14.5	15.2
Normalised EPS (%)	11.7	9.5	26.4	13.9	14.6
Ordinary DPS (%)	9.0	9.4	26.9	15.3	14.7

Key Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Return on assets (%)	26.3	24.2	24.8	28.1	30.2
Return on equity (%)	25.0	22.9	25.9	26.4	26.9
Return on funds employed (%)	28.0	26.8	27.5	29.5	32.2
EBITDA margin (%)	31.5	30.8	33.4	34.4	34.7
EBIT margin (%)	27.5	27.3	29.0	30.2	30.9
Capex to sales (%)	8.5	11.7	14.5	4.7	7.1
Capex to depreciation (%)	238	366	385	130	221
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	64	64	64	65	65

Cash Flow (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EBITDA	**309**	**329**	**402**	**468**	**534**
Working capital change	9	7	(25)	(24)	(28)
Interest & tax paid	(71)	(83)	(93)	(107)	(126)
Other	-	-	-	-	-
Operating cash flow	**248**	**253**	**283**	**337**	**381**
Capital expenditure	(83)	(126)	(174)	(63)	(110)
(Acquisitions)/divestments	-	-	-	-	-
Other	(100)	-	-	-	-
Funding available/(required)	**65**	**128**	**109**	**273**	**271**
Dividends paid	(103)	(115)	(152)	(184)	(212)
Equity raised/(returned)	2	2	-	-	-
(Increase)/decrease in net debt	**(36)**	**15**	**(43)**	**90**	**59**

Operating Performance	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Sales revenue (NZ$m)					
Hospital	572	642	757	873	1,004
Growth (%)	14	12	18	15	15
Homecare	398	421	440	481	530
Growth (%)	4	6	4	9	10
Core products - total	**970**	**1,064**	**1,197**	**1,354**	**1,535**
Distributed products	11	7	5	5	5
Total sales	**981**	**1,070**	**1,202**	**1,359**	**1,539**
Cost breakdown and margins					
Gross profit (NZ$m)	650	716	801	911	1,033
Gross margin (%)	66	67	67	67	67
R & D costs (NZ$m)	(95)	(100)	(114)	(125)	(139)
SG&A costs (NZ$m)	(246)	(286)	(285)	(318)	(360)
Key line items to call out					
R&D tax credit (incl. as offset to ta	n/a	n/a	14	15	17
Litigation costs within SG&A	(16)	(23)	(1)	-	-
Currency					
NZDUSD spot rate	0.71	0.68	0.63	0.63	0.63
NZDEUR spot rate	0.61	0.59	0.58	0.58	0.58
USD hedging - % cover			90	80	40
USD hedging - average rate			0.67	0.66	0.66

Balance Sheet (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Working capital	159	159	184	209	236
Fixed assets	476	601	730	745	805
Intangibles	50	62	62	62	62
Right of use asset	-	-	-	-	-
Other assets	95	109	141	141	141
Total funds employed	**780**	**931**	**1,117**	**1,156**	**1,244**
Net debt/(cash)	(50)	(54)	(11)	(101)	(160)
Lease liability	-	-	-	-	-
Other liabilities	69	72	104	104	104
Shareholder's funds	761	913	1,025	1,153	1,300
Minority interests	-	-	-	-	-
Total funding sources	**780**	**931**	**1,117**	**1,156**	**1,244**

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

ResMed 2Q20 — read through for FPH

In this edition of *Unmasking ResMed's Result*, we look at the 2Q20 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

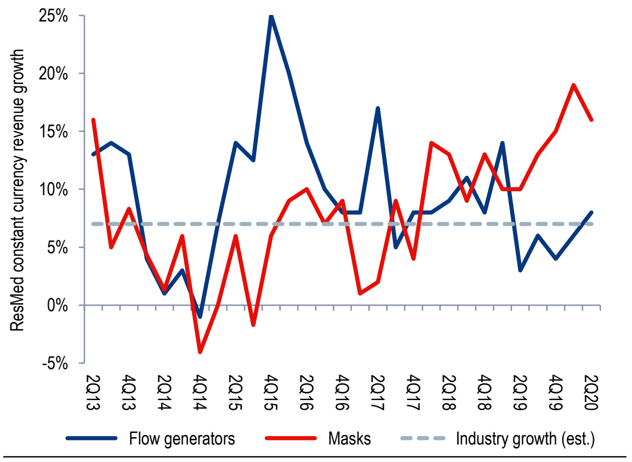
- **Recent competitor data points:** Quarterly results show a strong result from RMD (+11% growth in its sleep business) and solid growth from Phillips. This aligns with our view that FPH continues to lose market share, with RMD in the strongest position at the moment in the key masks category.
- **Online data:** While acknowledging limitations of extrapolation (online purchases are only a small part of the market) — nonetheless, trends support meaningful market share gain for RMD over recent quarters, at the expense of both FPH and Phillips.
- **New products:** Homecare dealers are spoilt 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

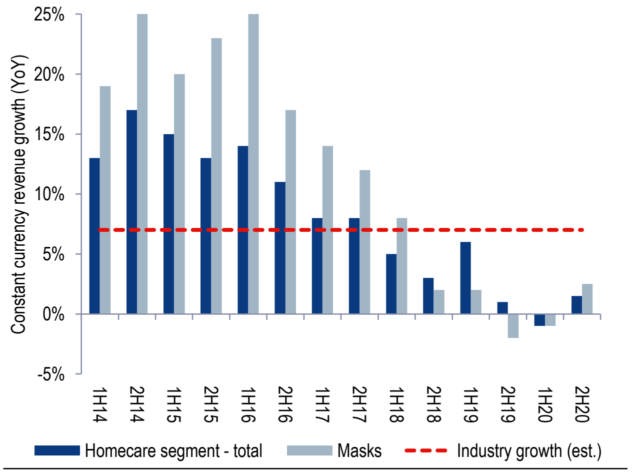
- **ResMed 2Q20 (refer Figure 2):**
  - Masks: Another quarter of clear market share gain, with global growth of +16% in constant currency in 2Q20 (+19% Americas; +11% Rest of World) vs estimated industry growth of +8–10%. Key drivers are: market share gains, improved adherence and better resupply rates.
  - Flow generators: +8% growth (+9% Americas; +6% Rest of World), a modest acceleration and ahead of estimated industry growth of +4–6%.
  - Gross margins: +60bp margin expansion, reflecting favourable product mix (i.e. the benefit of a strong mask performance).
- **Phillips 4Q19:** Shows a slowdown in its Sleep & Respiratory Care segment, with "flat sales" vs the recent trajectory of "mid single-digits", however, Phillips referenced that the core Sleep business (key part of relevance to FPH) has "strong momentum".

Figure 2. ResMed quarterly constant currency revenue growth



Source: Forsyth Barr analysis, ResMed company reports

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



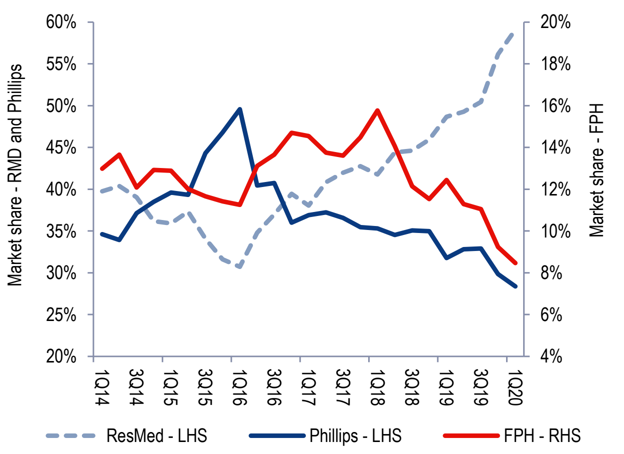
Source: Forsyth Barr analysis, Company reports

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, one key driver of mask selection.

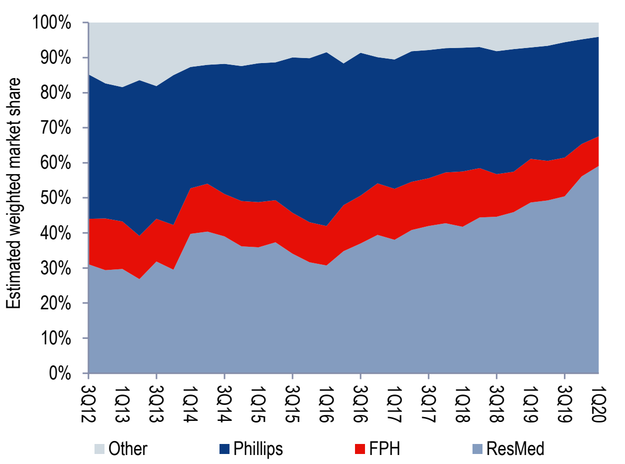
Trends support clear market share gain for RMD over recent quarters, at the expense of both FPH and Phillips.

Figure 4. Weighted average market share trends



Source: Forsyth Barr analysis, CPAP.com

Figure 5. Weighted average market share by manufacturer

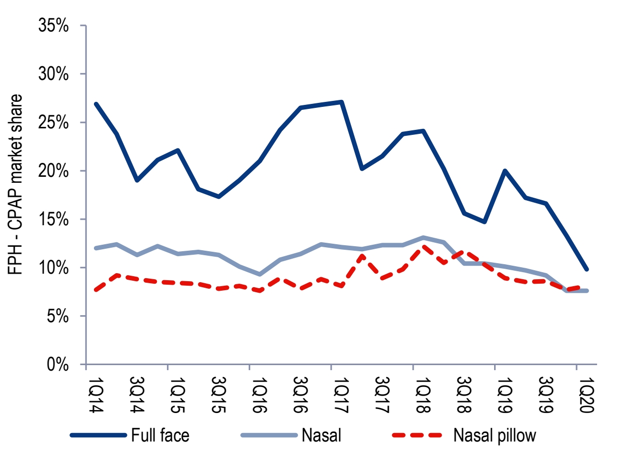


Source: Forsyth Barr analysis, CPAP.com

Mask category breakdown

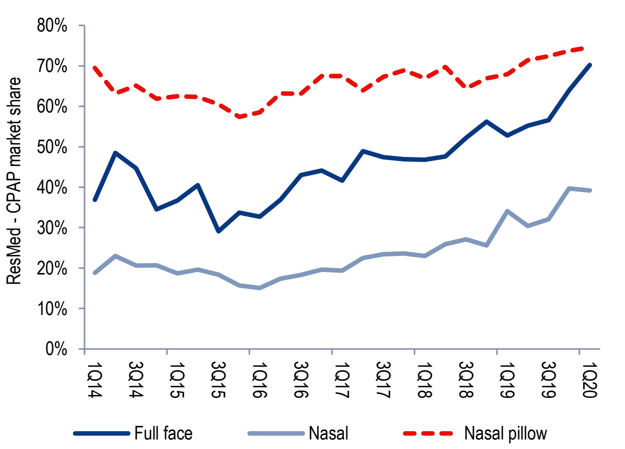
- **Nasal masks:** The largest, most competitive segment, with an estimated c. 40% share of the mask market. Phillips is the clear market leader, albeit RMD has been taking incremental share, particularly in recent quarters. FPH market share has weakened over recent quarters, tracking at c. 8% (vs 12–13% in CY 2017/18).
- **Full-face:** The smallest category, albeit has gained share in the past few years and now makes up ~33% of the market. Historically FPH has had the most success in full-face masks, although a hiatus of new products has seen its share steadily fall in recent quarters to 10% (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 ~75%). FPH's recent launch (Brevida) started well in the online data, albeit its market share has trended lower in recent quarters, with overall category share now c. 8% vs. a range of 8–12% over the past 5yrs.

Figure 6. CPAP market share by mask category – FPH



Source: Forsyth Barr analysis, CPAP.com

Figure 7. CPAP market share by mask category – ResMed



Source: Forsyth Barr analysis, CPAP.com

Competitive bidding

Bids have been submitted for Round 2021 of Competitive Bidding (CB) — the process which sets reimbursement and supply levels for homecare dealers under key US public health insurer, CMS. Results are expected in August/September 2020. 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. There is also some suggestion the current CB process encourages homecare dealers to engage with manufacturers in a portfolio and business growth discussion, which could present some risk to FPH and benefit RMD.

We estimate FPH's overall revenue exposure to CB is c. 5%.

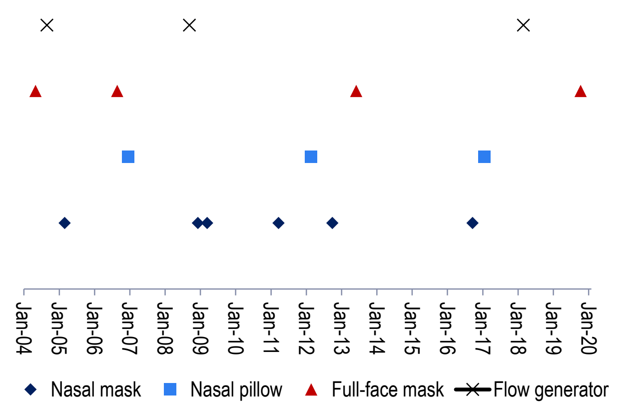
New product landscape

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.

RMD has launched four new masks over the last year, while FPH launched only one new mask (F&P Vitera — full face mask) in October 2019 after a longer than usual period without new masks. Another launch is expected from FPH in the near-term.

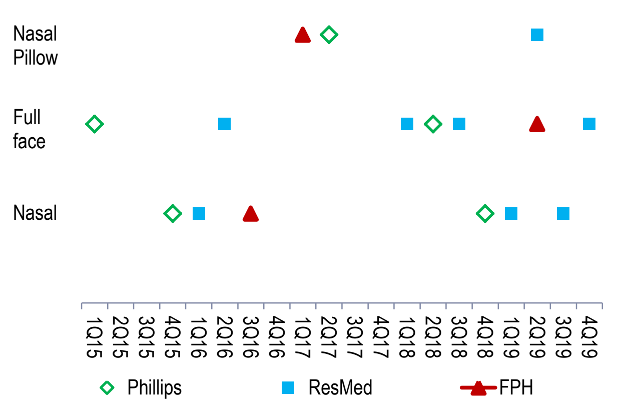
The key question — will this be enough to drive a return to attractive growth rates for FPH in the mask category? We are unconvinced, particularly given a highly competitive market. We will continue to monitor industry feedback and the online data over the near-term to help provide better insight.

Figure 8. FPH estimated product launch timing



Source: Forsyth Barr analysis, Company announcements

Figure 9. 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. However, valuation metrics are elevated versus history and global peers, even when adjusting for this growth profile. 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 supportive (global focus on lowering healthcare costs, ageing population and improving diagnosis rates).

Earnings and cash flow outlook

- **Near-term two speed growth path:** Hospital continues to deliver strong results, while Homecare is under pressure following a period of new product hiatus. Changing the latter trajectory is reliant on success with new products.
- **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 within this range near-term.

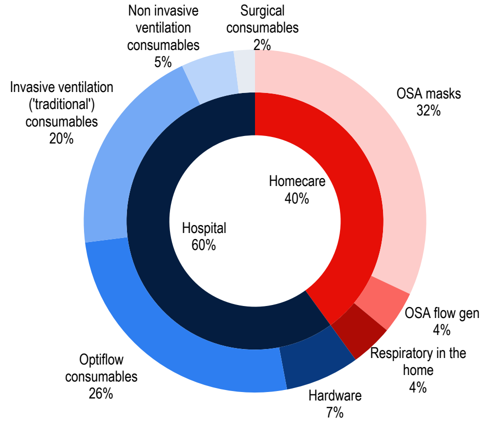
Risks factors

- **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

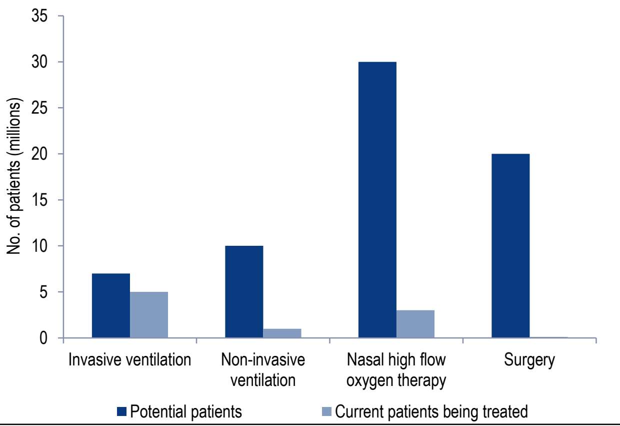
FPH designs, manufactures and markets heated humidifiers for use in respiratory care and humidified airflow generators for obstructive sleep apnea (OSA), along with associated single and multi-use accessories. FPH has a strong global market share in respiratory care following over 30 years in the market. 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 10. Revenue breakdown by segment (est.)



Source: Company reports, Forsyth Barr analysis

Figure 11. Global market penetration in RAC / Hospital segment



Source: Company reports, Forsyth Barr analysis

Figure 12. Substantial Shareholders

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

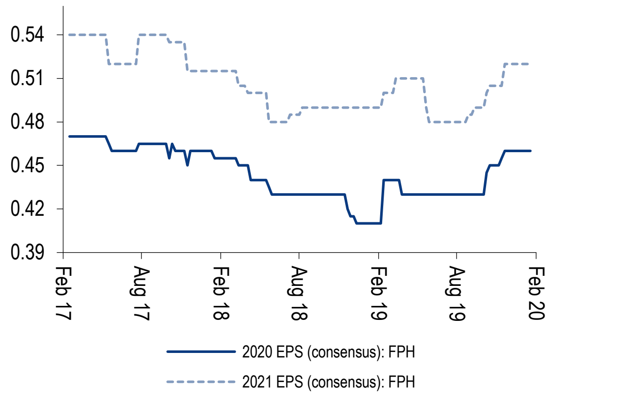
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 13. International Compcos

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
(metrics re-weighted to reflect FPH's balance date - March)			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E
F&P Healthcare	**FPH NZ**	**NZ$22.85**	**NZ$13,088**	**49.5x**	**43.5x**	**32.4x**	**27.9x**	**37.4x**	**31.7x**	**1.5%**
ResMed Inc	RMD US	US$164.10	US$23,595	45.1x	37.3x	28.6x	25.3x	34.7x	29.8x	1.0%
Teleflex Inc	TFX US	US$375.98	US$17,406	32.8x	28.5x	23.7x	21.0x	28.8x	25.7x	0.4%
Boston Scientific Corp	BSX US	US$43.41	US$60,506	33.0x	23.6x	25.5x	17.3x	38.8x	n/a	n/a
Becton Dickinson and Co	BDX US	US$280.69	US$76,069	46.2x	21.2x	20.1x	15.8x	36.9x	19.1x	1.3%
			Compco Average:	**39.3x**	**27.7x**	**24.5x**	**19.9x**	**34.8x**	**24.9x**	**0.9%**
EV = Current Market Cap + Actual Net Debt			**FPH Relative:**	**+26%**	**+57%**	**+33%**	**+40%**	**+7%**	**+28%**	**+64%**

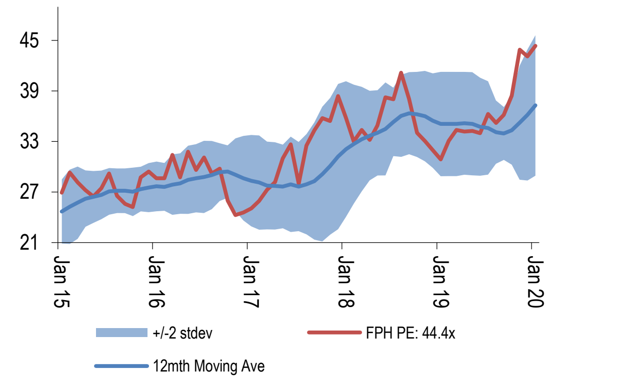
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (FPH) companies fiscal year end

Figure 14. Consensus EPS Momentum



Source: Forsyth Barr analysis, Bloomberg

Figure 15. 12 Month Forward PE



Source: Forsyth Barr analysis

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