

F&P Healthcare

FY20 Result — Tailwinds Flowing

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UNDERPERFORM

F&P Healthcare (FPH) delivered a strong FY20 result, with momentum continuing into 1Q21; while this was anticipated, the magnitude of the positive momentum from COVID-19 outpaced our expectations. COVID-19 benefits reflect its technology being a front-line therapy for COVID-19 patients and a likely faster adoption curve for its high flow nasal cannula (HFNC) oxygen therapy, helped by the unique set of circumstances which has seen accelerated clinician exposure. FPH is a high quality growth company, benefitting from material tailwinds; however, valuation multiples are elevated against any benchmark. The share price lift through 2020 (+51%; market cap +NZ\$6.5bn) is also out of step with our scenarios around the magnitude of potential COVID-19 tailwinds. We see better value for risk elsewhere, although acknowledge momentum remains firmly on its side, and it is difficult to foresee a catalyst for a de-rating in the short-term (COVID-19 vaccine aside).

NZX Code	FPH	Financials: Mar/	20A	21E	22E	23E	Valuation (x)	20A	21E	22E	23E
Share price	NZ\$33.50	NPAT* (NZ\$m)	287.3	352.8	371.1	431.4	EV/EBITDA	43.6	35.7	33.7	29.4
Target price	NZ\$22.50	EPS* (NZc)	50.0	61.3	64.2	74.3	EV/EBIT	50.6	40.5	38.5	33.1
Risk rating	Medium	EPS growth* (%)	37.0	22.5	4.7	15.7	PE	67.0	54.7	52.2	45.1
Issued shares	574.2m	DPS (NZc)	27.5	35.0	38.5	44.6	Price / NTA	n/a	n/a	n/a	n/a
Market cap	NZ\$19,235m	Imputation (%)	100	100	100	100	Cash div yld (%)	0.8	1.0	1.1	1.3
Avg daily turnover	766.1k (NZ\$18,245k)	*Based on normalised profits					Gross div yld (%)	1.1	1.5	1.6	1.8

- **Earnings revisions:** FY21 revenue +4.5%, NPAT +9%. Medium-term +1-2% and +4-6% respectively.

FY20 unsurprisingly strong, albeit headline growth flattered by one-offs

We already knew FY20 was a strong year, and this was confirmed with FPH reporting FY20 NPAT of NZ\$287m, up +37% and modestly ahead of expectations and recent guidance. Adjusting for one-off factors (FX, ceasing of litigation spend and R&D/tax benefits) we derive underlying NPAT growth of +13%, which includes the benefit of COVID-19 related sales in 4Q20.

Tailwinds continue into FY21 — FPH's assumption set for guidance appears conservative

FPH made it clear it doesn't plan to predict the path of COVID-19, however, provided FY21 guidance (revenue ~NZ\$1.48bn; NPAT NZ \$325–340m) based on a set of assumptions, including that respiratory hospitalisations peak in 1Q21. There is a reasonable margin of error, particularly forecasting the duration of COVID-19 tailwinds; nonetheless, we view FPH's assumption set as conservative. Our revised FY21 forecasts (revenue NZ\$1.51bn; NPAT NZ\$353m) assumes a peak in 2Q21, while demand remains elevated in 3Q21 and slows meaningfully thereafter (also as it begins to cycle stronger comparatives). We don't assume a return to 'normal' until FY22.

Where to thereafter? There remain many unanswerable questions; our key change is to lift HFNC expectations

The path beyond COVID-19 isn't much clearer, with FPH (unsurprisingly) unable to answer a number of critical questions particularly around behaviour and adoption. Visibility is also low for a number of key variables. Taking this aside, the key change we make is to lift our base case around HFNC. This reflects (1) a higher target market (lifted to 50m patients per annum, vs our prior expectations of 40m and FPH longstanding guidance of 30m); and (2) a lift in the speed of adoption (by c. two years). COVID-19 has presented a unique set of circumstances which has seen a step-change in clinician exposure to HFNC, which may help to lower a key barrier to changing clinical practice; inertia. This boosts our DCF valuation by ~+15% in isolation. With no precedent, we expect the extent of the benefit (and accordingly pace of adoption) will remain a key area for debate.

Fisher & Paykel Healthcare Corporation (FPH)

Priced as at 29 Jun 2020 (NZ\$) **33.50**

12-month target price (NZ\$)*	22.50
Expected share price return	-32.8%
Net dividend yield	1.1%
Estimated 12-month return	-31.8%

Key WACC assumptions	
Risk free rate	2.00%
Equity beta	0.77
WACC	7.0%
Terminal growth	2.0%

Spot valuations (NZ\$)	
1. DCF	22.69
2. Compco	20.06
3. n/a	n/a

DCF valuation summary (NZ\$m)	
Total firm value	13,181
(Net debt)/cash	0
Less: Capitalised operating leases	(153)
Value of equity	13,028

Profit and Loss Account (NZ\$m)	2019A	2020A	2021E	2022E	2023E
Sales revenue	1,070.4	1,263.7	1,511.6	1,573.1	1,800.8
Normalised EBITDA	329.3	440.3	537.1	568.3	651.9
Depreciation and amortisation	(41.7)	(61.0)	(63.1)	(70.0)	(73.0)
Normalised EBIT	292.6	379.3	474.0	498.3	578.9
Net interest	0.8	(1.7)	(1.2)	(0.7)	0.0
Associate income	0	0	0	0	0
Tax	(82.0)	(83.2)	(120.1)	(126.5)	(147.5)
Minority interests	0	0	0	0	0
Normalised NPAT	209.2	287.3	352.8	371.1	431.4
Abnormals/other	0	0	0	0	0
Reported NPAT	209.2	287.3	352.8	371.1	431.4
Normalised EPS (cps)	36.5	50.0	61.3	64.2	74.3
DPS (cps)	23.3	27.5	35.0	38.5	44.6

Growth Rates	2019A	2020A	2021E	2022E	2023E
Revenue (%)	9.1	18.1	19.6	4.1	14.5
EBITDA (%)	6.4	33.7	22.0	5.8	14.7
EBIT (%)	8.5	29.6	25.0	5.1	16.2
Normalised NPAT (%)	10.0	37.3	22.8	5.2	16.2
Normalised EPS (%)	9.5	37.0	22.5	4.7	15.7
Ordinary DPS (%)	9.4	18.3	27.3	10.0	15.8

Cash Flow (NZ\$m)	2019A	2020A	2021E	2022E	2023E
EBITDA	329.3	440.3	537.1	568.3	651.9
Working capital change	6.7	(14.3)	(36.6)	(9.8)	(36.2)
Interest & tax paid	(82.7)	(95.9)	(121.3)	(127.2)	(147.5)
Other	0	0	0	0	0
Operating cash flow	253.3	330.1	379.3	431.3	468.3
Capital expenditure	(125.7)	(155.7)	(165.0)	(106.3)	(162.5)
(Acquisitions)/divestments	0	0	0	0	0
Other	0	(9.7)	(7.3)	(7.9)	(8.5)
Funding available/(required)	127.6	164.7	207.0	317.1	297.3
Dividends paid	(114.6)	(146.4)	(179.9)	(212.4)	(241.2)
Equity raised/(returned)	2.1	0	0	0	0
(Increase)/decrease in net debt	15.1	18.3	27.1	104.7	56.1

Balance Sheet (NZ\$m)	2019A	2020A	2021E	2022E	2023E
Working capital	159.0	203.6	240.2	250.0	286.2
Fixed assets	601.4	710.6	805.9	834.0	913.6
Intangibles	61.5	73.9	88.5	105.2	124.3
Right of use asset	0	24.7	26.6	28.6	30.8
Other assets	109.1	136.5	138.4	140.4	142.6
Total funds employed	931.0	1,149.3	1,299.5	1,358.2	1,497.5
Net debt/(cash)	(54.4)	(42.2)	(69.3)	(174.0)	(230.1)
Lease liability	0	33.6	36.2	38.9	41.9
Other liabilities	72.2	181.4	184.0	186.7	189.7
Shareholder's funds	913.2	976.5	1,148.7	1,306.7	1,496.1
Minority interests	0	0	0	0	0
Total funding sources	931.0	1,149.3	1,299.5	1,358.2	1,497.5

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

Valuation Ratios	2019A	2020A	2021E	2022E	2023E
EV/EBITDA (x)	58.3	43.6	35.7	33.7	29.4
EV/EBIT (x)	65.6	50.6	40.5	38.5	33.1
PE (x)	91.7	67.0	54.7	52.2	45.1
Price/NTA (x)	>100x	>100x	>100x	>100x	>100x
Free cash flow yield (%)	0.7	0.9	1.1	1.7	1.6
Net dividend yield (%)	0.7	0.8	1.0	1.1	1.3
Gross dividend yield (%)	1.0	1.1	1.5	1.6	1.8

Capital Structure	2019A	2020A	2021E	2022E	2023E
Interest cover EBIT (x)	n/a	>100x	>100x	>100x	n/a
Interest cover EBITDA (x)	n/a	>100x	>100x	>100x	n/a
Net debt/ND+E (%)	-6.3	-4.5	-6.4	-15.4	-18.2
Net debt/EBITDA (x)	n/a	n/a	n/a	n/a	n/a

Key Ratios	2019A	2020A	2021E	2022E	2023E
Return on assets (%)	24.2	26.0	28.8	29.1	30.8
Return on equity (%)	22.9	29.4	30.7	28.4	28.8
Return on funds employed (%)	26.8	33.0	35.2	33.6	36.0
EBITDA margin (%)	30.8	34.8	35.5	36.1	36.2
EBIT margin (%)	27.3	30.0	31.4	31.7	32.1
Capex to sales (%)	11.7	12.3	10.9	6.8	9.0
Capex to depreciation (%)	366	322	331	190	279
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	64	55	57	60	60

Operating Performance	2019A	2020A	2021E	2022E	2023E
Sales revenue (NZ\$m)					
Hospital	642	801	1,021	1,033	1,216
Growth (%)	12	25	27	1	18
Homecare	421	457	486	535	580
Growth (%)	6	9	6	10	8
Core products - total	1,064	1,259	1,507	1,568	1,796
Distributed products	7	5	5	5	5
Total sales	1,070	1,264	1,512	1,573	1,801

Cost breakdown and margins					
Gross profit (NZ\$m)	716	836	973	1,022	1,168
Gross margin (%)	67	66	64	65	65
R & D costs (NZ\$m)	(100)	(119)	(130)	(135)	(155)
SG&A costs (NZ\$m)	(286)	(277)	(306)	(319)	(362)
Key line items to call out					
R&D tax credit (incl. as offset to tax)	n/a	13	15	15	17
Litigation costs within SG&A	(23)	0	0	0	0

Currency					
NZDUSD spot rate	0.68	0.65	0.64	0.64	0.64
NZDEUR spot rate	0.59	0.58	0.56	0.56	0.56
USD hedging - % cover			85	60	45
USD hedging - average rate			0.65	0.65	0.64

FY20 result – key features

FPH reported a strong FY20 result, as expected, and modestly ahead of recent company guidance. NPAT was up +37% to NZ\$287m, a modest beat versus guidance (NZ\$275–280m) and our expectations.

Areas of interest

- **Headline growth flattered by some one-offs:** We derive underlying profit growth of c. +13% adjusting for one-offs during the period. This includes the boost in 4Q20 from COVID-19 related sales.
- **Margins:** FY20 saw some cost bite through gross margins, although SG&A leverage to the strong revenue momentum helped to offset this with FY20 EBIT margins reaching 30% (+268bp), in line with our expectations.
- **Balance sheet, cashflow and dividend:** FY20 gearing was -4.3% at the lower end of its gearing target (-5% to 5%). Operating cashflow was strong at +27% (albeit not as strong as profit growth). FPH declared a final dividend below our expectations, with a surprising decline in its payout ratio to 55%, taking the FY20 dividend to 27.5cps – a cash yield of 1%.

Figure 1. FY20 result key snapshot (NZ\$m)

	FY19	FY20	% chg	Forsyth Barr
Sales revenue	1,070.4	1,263.7	18.1%	1,235.4
EBIT	292.6	379.3	29.6%	367.2
NPAT	209.2	287.3	37.3%	278.5
Underlying EPS (cps)	36.5	50.0	37.0%	48.4
DPS (cps)	23.25	27.50	18.3%	31.00

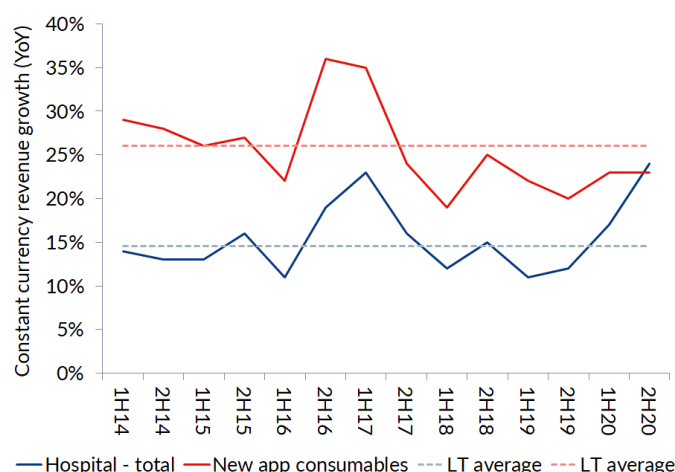
Source: Forsyth Barr analysis, Company reports

Figure 2. Profit growth excluding 'one-offs'

	FY19	FY20	Growth
NPAT as reported	209.2	287.3	37%
Tax and R&D grant changes	3.6	18.7	
Litigation (post tax)	(16.8)	0	
Total FX benefit (post tax)	4.9	22.3	
NPAT adjusted	217.5	246.3	13%

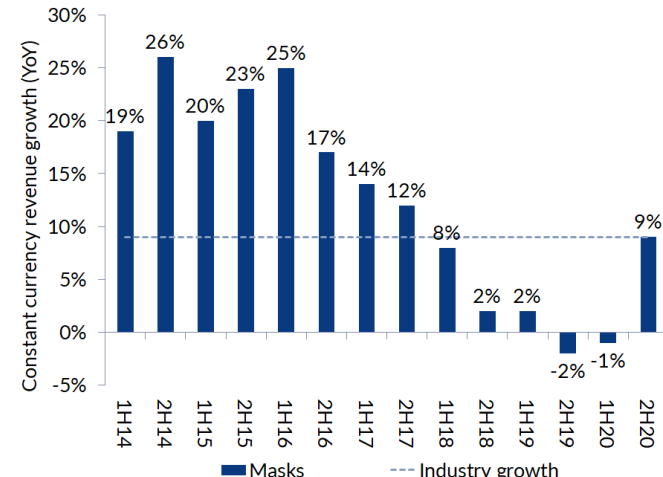
Source: Forsyth Barr analysis, Company reports

Figure 3. Strong finish for Hospital, particularly hardware



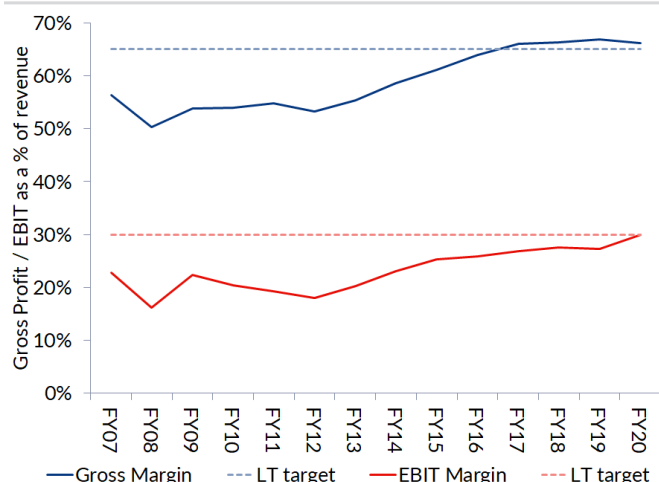
Source: Forsyth Barr analysis, Company reports

Figure 4. Return to industry growth for sleep apnea masks



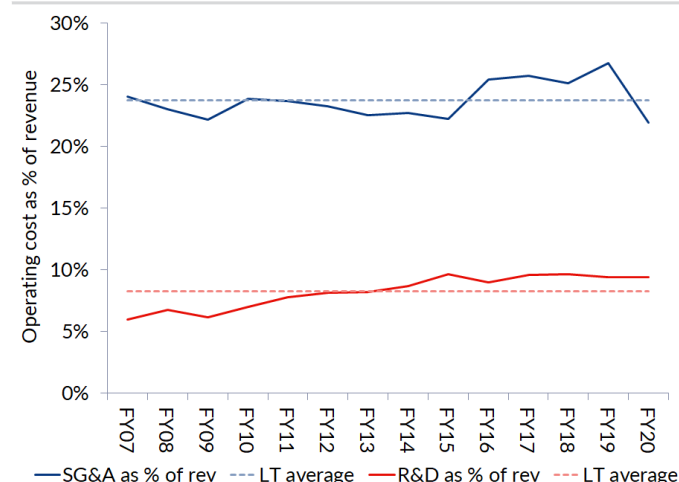
Source: Forsyth Barr analysis, Company reports

Figure 5. EBIT margin expansion despite cost bite in GM



Source: Forsyth Barr analysis, Company reports

Figure 6. Leverage to revenue growth, evident in SG&A



Source: Forsyth Barr analysis, Company reports

Where to from here?

FPH is a clear beneficiary of COVID-19, with material tailwinds continuing into 1Q21. Benefits can be simplified into (1) a strong spike in demand for its Hospital products, and (2) a unique (and likely once in a generation) opportunity for clinicians to be exposed to high flow nasal cannula (HFNC) oxygen therapy in a more accelerated pace, which may help to bring forward the adoption curve for the technology. However, FPH's share price has increased ~+51% since pre COVID-19 and market cap by +NZ\$6.5bn which appears out of step with any magnitude of scenarios around the upside.

FY21 – quantifying the short-term spike in demand

Company commentary/guidance: FPH provided FY21 guidance for revenue of NZ\$1.48bn and NPAT of NZ\$325–340m, based on some key assumptions including that "respiratory hospitalisations peak in Q1 due to COVID-19 and return to normal by the beginning of H2". The company has seen a stellar start to FY21, with significant growth in its Hospital segment (no doubt boosted by COVID-19 demand) with hardware growth >300% and consumables >33% YoY. Homecare is more modest, with growth currently tracking below our full year run-rate.

Our view: There is no doubt COVID-19 will provide a material tailwind for FY21, however, there remains a reasonable margin of error in the extent and duration of this benefit. Based on the current COVID-19 status globally, we view the assumption set used as a basis for FPH guidance as conservative. Our revised FY21 forecasts assume a 'peak' in 2Q21, while levels remain elevated in 3Q21 and slow meaningfully thereafter. We don't assume a return to 'normal' until FY22.

Where to thereafter?

There are still a number of unanswered questions, including:

- What happens to hardware demand post COVID-19? Given a typical product life of 10 years+, what level of revenue will hardware revert to?
- What level of the current uplift in HFNC patient numbers is COVID-19 patients? Can this be fully converted to 'non COVID-19' demand post the pandemic?
- How does adoption change for HFNC? COVID-19 has provided a unique opportunity for hands on experience with this 'new' technology. The key barrier to changing clinical practice is inertia to change. COVID-19 may prove to be an enduring catalyst to higher adoption rates, however, the extent of the uplift remains a key area for debate.
- What are the implications of the material investment in capacity (capex, people and opex)? FPH is currently materially scaling up, despite providing guidance based on an assumption set where hospitalisations have reached their peak. There is potential for a period of 'excess capacity'.

Our view: The key change we make to our longer-term forecasts is to HFNC expectations, namely (1) a lift in the target market for HFNC – FPH has lifted its view to 50m patients per annum (up from 30m prior; and ahead of our prior expectations of 40m), (2) a lift in the speed of adoption by c. two years (30% penetration reached by FY26E vs FY28E prior). We have also lowered our dividend payout ratio expectations as FPH made it clear that growth (and re-investment) is the clear priority.

Figure 7. Earnings revisions

NZ\$m	FY20A		FY21E		FY22E			FY23E		
	Actual	Old	New	% chg	Old	New	% chg	Old	New	% chg
Total revenue	1,263.7	1,444.7	1,511.6	4.5%	1,566.7	1,573.1	0.4%	1,784.5	1,800.8	0.9%
Normalised Profit	287.3	324.7	352.8	8.6%	355.5	371.1	4.4%	406.1	431.4	6.2%
Normalised EPS (cps)	50.0	56.2	61.3	9.1%	61.2	64.2	5.0%	69.5	74.3	6.9%
Dividend per share (cps)	27.5	36.0	35.0	-2.8%	39.5	38.5	-2.5%	44.8	44.6	-0.4%
NZDUSD - spot	0.65	0.62	0.64	2.8%	0.63	0.64	1.8%	0.63	0.64	0.9%

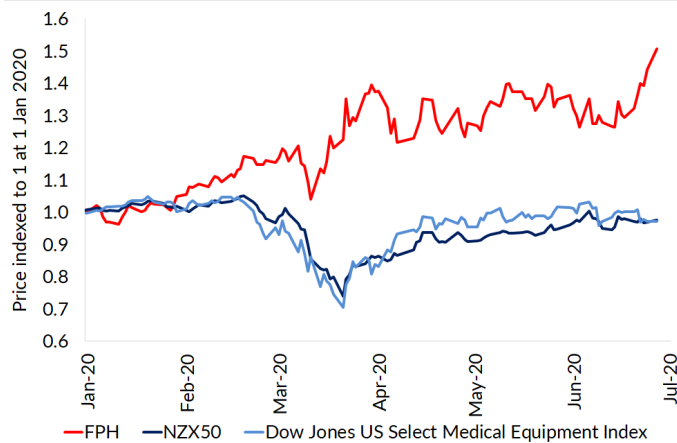
Source: Forsyth Barr analysis

Our view; UNDERPERFORM

As discussed above, FPH is seeing material tailwinds from COVID-19. There is no doubt the company is well positioned, with products in high demand (and vital for critical patients), ample runway remaining for longer-term growth and a strong balance sheet.

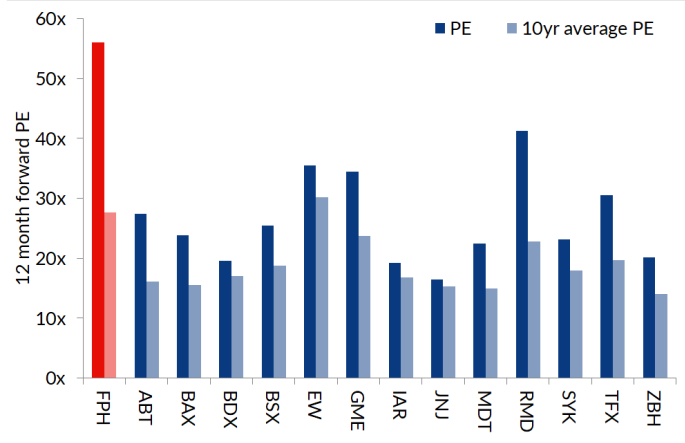
However, FPH was already one of the most expensive global medical device companies (growth-adjusted and absolute) leading into COVID-19 and has outperformed to date in 2020 (share price +51%; market cap +NZ\$6.5bn). Its current PE of ~55x is 2x its 10-year average and compares to global peers at ~26x (1.4x the 10-year average). While it is difficult to foresee a catalyst for a de-rating, particularly given near-term earnings momentum, we see better value for risk elsewhere. Retain UNDERPERFORM; target price lifted to NZ\$22.50.

Figure 8. Price performance vs NZ market and global peers



Source: Forsyth Barr analysis, Bloomberg

Figure 9. Sector multiples versus 10 year average



Source: Forsyth Barr analysis, Bloomberg

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. The company is also benefitting from COVID-19 related demand, with some of its products recommended as a front-line therapy. However, FPH is one of the most expensive global medical device companies (growth-adjusted and absolute). While it is difficult to foresee a catalyst for a de-rating, particularly given near-term earnings momentum, we see better value for risk elsewhere. **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. 75% 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 (ageing population, global focus on lowering healthcare costs and improving diagnosis rates).

Earnings and cashflow outlook

- **COVID-19:** FPH is benefitting, and will continue to benefit, from demand for its products as a result of COVID-19. In particular, nasal high flow oxygen therapy has been recommended as a front-line therapy by a growing number of public health authorities globally. Predicting the course and duration of new cases remains challenging, influenced by countries' corrective measures.
- **Attractive long-term growth runway; albeit with two speed growth path:** FPH has a long runway of organic growth opportunities, particularly in the Hospital segment where clinical evidence continues to build for 'new' applications. Penetration for the latter remains low relative to a large addressable market. While Hospital continues to deliver standout results, we expect a more modest outlook for Homecare, not helped by a highly competitive environment.

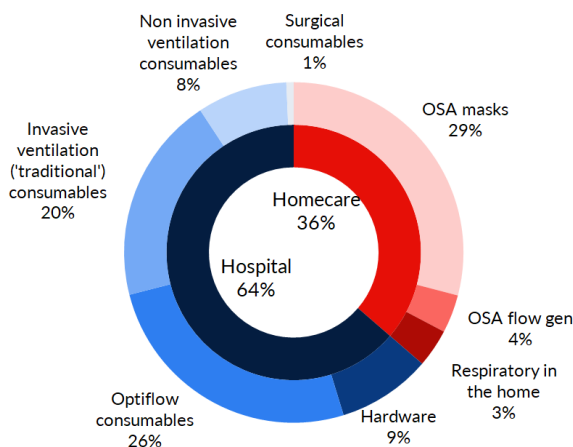
Financial structure

- **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.

Risk factors

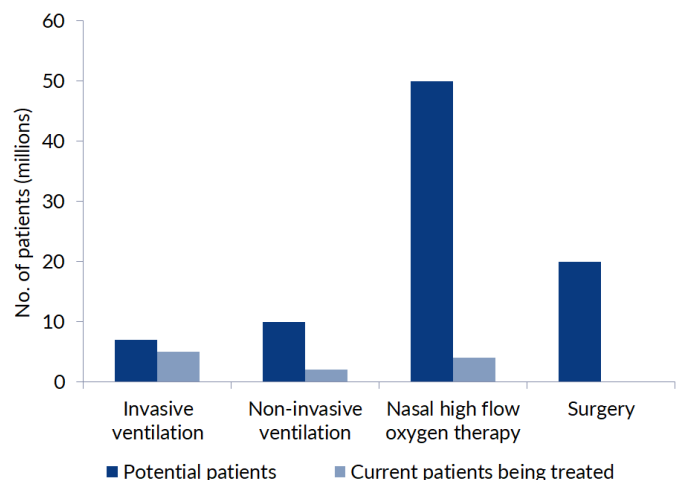
- **Change in technology or medical treatments:** May result in some products becoming obsolete or cause it to incur costs to implement new technologies. There is some risk mitigation given FPH's diversified offering.
- **Litigation or a need to defend its intellectual property:** This can be an expensive exercise.

Figure 10. Revenue breakdown by segment (est.)

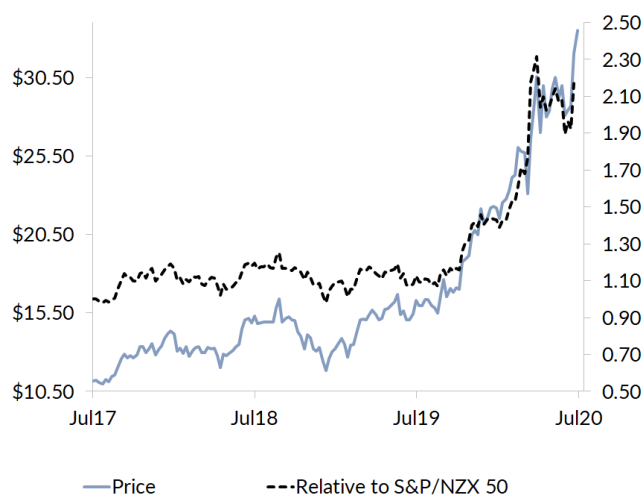


Source: Forsyth Barr analysis, Company reports

Figure 11. Global market penetration in Hospital/RAC segment



Source: Forsyth Barr analysis, Company reports

Figure 12. Price performance


Source: Forsyth Barr analysis

Figure 13. Substantial shareholders

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

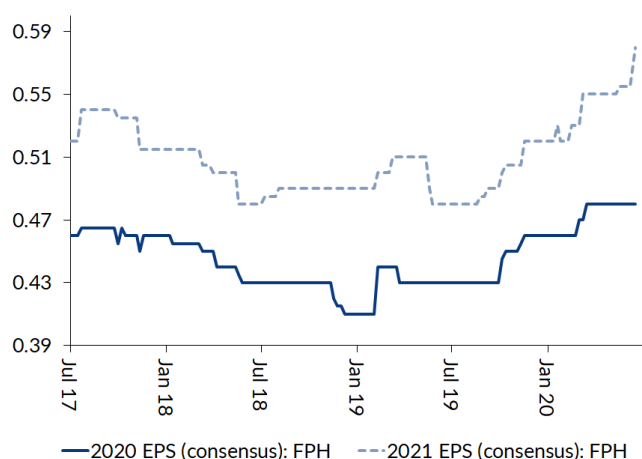
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 14. International valuation comparisons

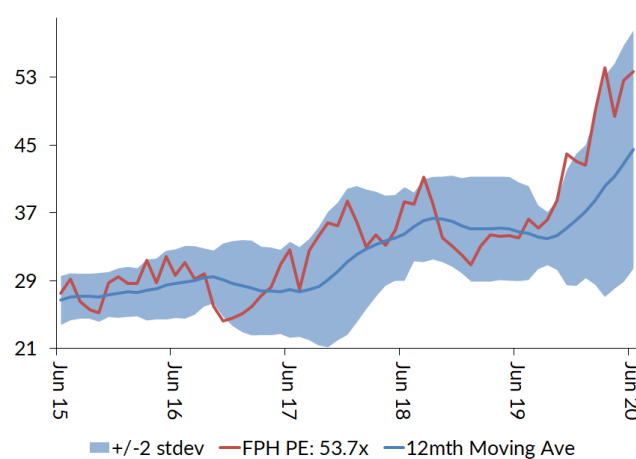
Company	Code	Price	Mkt Cap (m)	PE 2021E	PE 2022E	EV/EBITDA 2021E	EV/EBITDA 2022E	EV/EBIT 2021E	EV/EBIT 2022E	Cash Yld 2022E
(metrics re-weighted to reflect FPH's balance date - March)										
F&P Healthcare	FPH NZ	NZ\$33.50	NZ\$19,235	>50x	>50x	35.7x	33.8x	40.5x	38.5x	1.1%
RESMED INC	RMD US	US\$185.63	US\$26,855	41.3x	37.9x	28.4x	26.4x	32.7x	30.1x	0.9%
TELEFLEX INC	TFX US	US\$355.87	US\$16,521	33.1x	25.8x	26.1x	19.5x	28.0x	21.3x	0.4%
BOSTON SCIENTIFIC CORP	BSX US	US\$33.28	US\$47,547	31.2x	19.0x	22.4x	15.6x	27.8x	19.2x	0.0%
BECTON DICKINSON AND CO	BDX US	US\$233.57	US\$67,684	20.6x	17.7x	16.6x	14.7x	21.3x	18.8x	1.7%
Compco Average:				31.5x	25.1x	23.4x	19.1x	27.4x	22.4x	0.8%
FPH Relative:				n/a	n/a	53%	77%	48%	72%	51%

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 15. Consensus EPS momentum (NZ\$)


Source: Forsyth Barr analysis

Figure 16. One year forward PE (x)


Source: Forsyth Barr analysis

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OUTPERFORM	NEUTRAL	UNDERPERFORM
49.0%	35.3%	15.7%

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