Edison investment research

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Mediwatch

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	PE (x)	Yield (%)
10/06	2.65	(0.95)	(0.99)	0.0	N/A	N/A
10/07	5.68	0.08	0.06	0.0	N/A	N/A
10/08e	9.10	0.50	0.40	0.0	15.3	N/A
10/09e	10.00	0.80	0.63	0.0	9.7	N/A

Note: *PBT and EPS are normalised, excluding goodwill amortisation and exceptional items; 18-month trading period to October 2006.

Investment summary: Understandable, but...

In the context of the more challenging trading climate and the need to adjust our estimates to lower levels, the City's reaction to the Mediwatch interims is understandable. However, the group is again profitable and looks set to lift earnings appreciably over the medium term. The rating does not reflect this potential.

Profitable first half

The interim announcement shows Mediwatch to be profitable for the second successive half year. As expected, increased sales and marketing costs associated with the planned growth in the underlying business were not fully absorbed, leading to lower profits than those earned in the second half of last year. However, the group has clearly turned the corner and should continue profitably into the future.

Continued investment in the future

The investment behind the modest profits shortfall demonstrates management's determination to invest in future growth. Mediwatch has recently entered into an agreement with Bostwick Laboratories enabling the group to offer molecular and pathology tests alongside its constantly developing diagnostic equipment portfolio. This extends its unique one-stop shop for hospitals, clinics and surgeries.

Secure finances

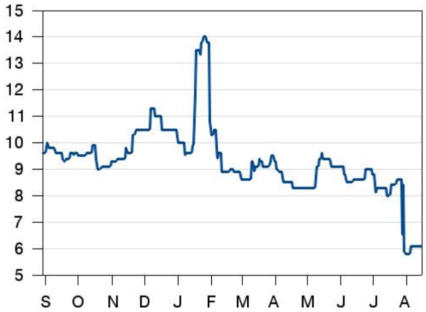
The group negotiated a £1.2m facility with its bankers earlier this year. Group net borrowings at April 2008 were under half that level and look likely to remain at around these levels in the foreseeable future. There seem ample funds for immediate needs.

Valuation: Re-rating potential

The current rating of the shares reflects nervousness about the global economic situation, a weak AIM market and the modest profits reduction. If the group can deliver on ambitious internal targets, the typical ratings in the high teens for medical equipment manufacturers suggest scope for an upward re-rating.

Price 6.12p
Market Cap £8m

Share price graph



Share details

Code	MDW
Listing	AIM
Sector	Healthcare Equipment
Shares in issue	130m

Price

	High	Low
52 week	14p	6p

Balance Sheet as at 30 April 2008

Debt/Equity (%)	11
NAV per share (p)	3.2
Net borrowings (£m)	0.46

Business

Mediwatch develops and distributes specialist equipment for the early detection of urological disorders. Following a major acquisition, there is a major presence in the US.

Valuation

	2007	2008e	2009e
P/E relative	N/A	139%	96%
P/CF	N/A	12.5	9.9
EV/Sales	1.5	0.9	0.8
ROE	2%	11%	14%

Revenues by geography

UK	Europe	US	Other
14%	19%	56%	11%

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Mediwatch is a research client of Edison Investment Research Limited

Investment summary: Understandable, but...

Company description: Detection of urological disorders

Mediwatch designs, manufactures and distributes specialist medical equipment for the diagnosis of urological disorders. The group was transformed in 2007 by the acquisition of the Urodynamics division of Medtronic, which helped to establish critical mass and build a meaningful presence in the US. Mediwatch now has sales teams based in the US and the UK, plus a comprehensive agency network to manage sales in the rest of the world.

Valuation

The share price is currently at less than half the level following the announcement of takeover negotiations in early 2008. This reflects a combination of disappointment that the proposed deal did not proceed, the general weakness of share prices across the AIM market and the fact that earlier profit estimates may prove optimistic. Equipment development companies are always difficult to evaluate because of the interaction of competing technologies and the indeterminate establishment timetable. Given the ratings in the high teens for established sector businesses, there is scope for a re-rating if our estimates for the year to October 2009 can be delivered.

Sensitivities

The key sensitivities continue to relate to the integration and development of the two businesses. Last year saw major growth in revenues: both the US sales team and the global agency network require careful management. Moreover, the planned sharp rises in revenues over the next two to three years will require the establishment of robust working capital controls to ensure effective management of group resources. There is some sensitivity to the underlying level of economic activity, as seen during the first half of the current year. However, group products are designed to facilitate diagnostic procedures at relatively low cost by less technically skilled operators. Cost pressures on medical authorities should ensure consistently increasing demand for group products.

Financials

- The profits breakthrough established in the second half of 2006/07 has been sustained into the current year. Revenues for the second half may fall short of expectations and as a consequence we have downgraded our pre-tax profit targets.
- Fears about rising working capital have, so far, not been borne out by events. Our estimate of net borrowings of £0.6m at October 2008 should prove adequate.

Exhibit 1: Estimate changes

Note: Figures in £m except per share data

	EPS			PBT			EBITDA		
	Old	New	% chg.	Old	New	% chg.	Old	New	% chg.
2007	(0.10)	(0.10)	N/A	(0.13)	(0.13)	N/A	(0.04)	(0.04)	N/A
2008e	0.63	0.40	(37)	0.80	0.50	(37)	0.98	0.64	(35)
2009e	1.34	0.63	(53)	1.70	0.80	(53)	1.84	0.94	(49)

Source: Company announcements/Edison Research estimates

Continuing profitable

The fundamental message accompanying the interim results announcement is that the move into profit, which was achieved in the second half of 2006/07, has been sustained into the current year. Trading conditions have become tougher and the timetable for the establishment of a key new product in the US has been delayed. The net result is that second half revenue and profits will fall short of earlier expectations, but management continues to invest in the ongoing development of the group, reinforcing the medium-term potential.

Profitable during the first half

Exhibit 2: Three trading periods to April 2008

Note: Figures before exceptional items and goodwill amortisation

Six months to	April 2007 £m	October 2007 £m	April 2008 £m
Revenue			
-UK	0.397	0.380	0.841
-USA	1.090	2.072	1.777
-Europe	0.161	0.931	1.262
-Rest of the world	0.181	0.472	0.491
	1.829	3.855	4.371
Gross profit	0.645	1.882	2.057
Operating profit	(0.266)	0.374	0.293
Pre-tax profit	(0.271)	0.353	0.270
Gross margins	35.3%	48.8%	47.1%
Operating margins	(14.5%)	9.7%	6.7%

Source: Company announcements

The Mediwatch interim statement shows turnover ahead by 139% to £4.37m and a shift from operating losses of £0.27m to a profit of £0.29m, compared with the corresponding period last year. The fundamental factor was the acquisition of the former Urodynamics division of Medtronic, which was consolidated for the full period in the current year and for just two months in the six months to April 2007.

In relation to the second half of last year, revenues rose by 13.4%. There was a modest drop in gross margins, largely stemming from changes to the product mix and the increased number of agency sales. However, operating margins slipped back by three points from 9.7% to 6.7%, as the planned rise in the cost base outweighed the 9% rise in gross profits. This shortfall in revenues was largely anticipated in our March trading update, but hopes of a second half upturn now look unlikely to be fulfilled. Nevertheless, the clear message is that Mediwatch has turned the corner and should continue profitable into the future.

Pressure on margins

There was a disappointing performance in the US, where revenues slipped back by 14% relative to the second half of 2006/07. We sense that there may have been some short-term supply difficulties and the trading climate is reported to have been more challenging. In addition, the planned introduction of PSAwatch to the US market has been delayed, because securing ethical approval has taken longer than anticipated at the university hospital where the trial is being carried out as part the FDA approval process.

Dan Parker, who joined Mediwatch from Medtronic at the time of the acquisition to lead the North American sales effort, has unexpectedly decided to take early retirement for personal reasons. He has been replaced as VP Sales & Marketing, by a new executive who has some 20 years' experience in the life sciences and medical equipment sectors. The tougher trading conditions in the US have continued, but there are more positive signs since the appointment of the new executive. The newly extended sales team is now equipped with more effective demonstration equipment and we are hopeful of some recovery in revenues during the second half.

Elsewhere, revenues have grown impressively. The establishment of in-house assembly operations adjacent to the group head office in the UK has led to much more reliable supply-chain management and the UK and European sales teams have more than made up the North American revenue shortfall. This was especially so in the UK, where sales were more than doubled to £1.26m; sales into Europe rose by 36% and those into the rest of the world were also increased. Action had been taken during the second half of the previous year to strengthen the sales team, with several new appointments, while a number of new agents were signed up for sales into overseas markets.

Investment in future growth

These figures are naturally slightly disappointing, but management continues to invest in the future. As mentioned earlier this year, there has been a fundamental strengthening of the main board. The non-executive element of the board was restructured last year, followed in May 2008 by the appointment of Christian Rollins as Group Finance Director and Colm Croskery and Chief Operating Officer.

In addition, staff numbers are up by some 20% over the twelve months to April 2008, from 47 to 56 people. There has been a modest demand for more personnel to manage product assembly, but the majority of the new team members are involved in sales and marketing. These investments need to be made in advance of the generation of new revenues, and there is little doubt that the profits shortfall stemmed from the fact that the increased costs could not be fully absorbed in the short term. The strong UK performance should be sustained following a decision to handle sales directly, with a new motivated team appointed to replace the incumbent external agent.

Research and development remains fundamental to group strategy. Investment covers both improvements to existing products and the development of new products. Mediwatch claims a unique one-stop shop: it can supply medical professionals with a full range of urological diagnostic equipment from its own portfolio. The product mix within the systems varies to reflect the needs of the customer, but Bluetooth transmission is already available to link the results of each machine and to facilitate the filing of results, printing of diagnoses and the automatic letter-writing.

The recently signed distribution agreement with Bostwick Laboratories augments the group's product range adding specialist molecular and pathology testing for urological disorders. This strategic approach gives Mediwatch the real opportunity to provide a one-stop solution for urologists. We look to see further similar service agreements in the future, which can provide speedy access to certain key markets for the group's new partners, earn attractive gross margins and can be quickly earnings enhancing.

Management is responding to the deteriorating market conditions by maintaining strong control of overhead costs. The timing of the upgrading of equipment by clinics and surgeries can be delayed during an unhelpful trading climate, but there appears to be a clear underlying long-term upward trend in demand for the group product base running at around 8% per annum. Management is determined to continue raising its share of the available market by constantly honing and upgrading its equipment to meet the changing needs of its customers.

Financials

The likely shortfall in revenues means that we have reduced our profit estimates, simply by virtue of insufficient gross profit to finance the planned increase in the cost base. On the other hand, inventories appear under firm control, helped by the burgeoning in-house manufacturing operation, and year-end borrowings should still be close to our earlier expectations. On the basis of our revised profit expectations, we expect the group to be cash-generative over the medium term.

Estimates reduced

It is clear from the revenue shortfall in North America that our earlier target of £10m turnover for the year to October 2008 may prove optimistic by up to 10%. Certain planned cost increases will almost certainly have been delayed, but our previous target of £0.8m pre-tax before exceptional items looks optimistic by around £0.3m. This ties in with the indication given in the trading statement that there will be 'marginal growth' in the second half, implying a full-year total of just over £0.5m.

Looking ahead to 2008/09, several factors suggest we should maintain our optimism. While we see little encouragement from the underlying trading climate, we are hopeful that the recent changes to the sales team in the US will have an increasingly positive impact on revenues, while FDA approvals for PSAwatch will, hopefully, start to deliver during the second half. Similarly, we are optimistic that the group can build further on the current year's successes in the UK, Europe and the Middle East. We have adjusted our revenue target down to £10m which, with the impact of operational gearing, would indicate pre-tax profits in the region of £0.8m.

New facilities arranged

Working capital control was one of the main challenges of the rapid increase in revenues attendant upon the planned sharp rises in throughput following the acquisition from Medtronic. The group may have been helped in this respect by the slower-than-planned rate of revenue growth, with net borrowings at the interim stage comfortably inside our estimates: inventories had been held down more effectively than we had been expecting, partially by virtue of the transfer to in-house assembly; the modest rise in debtors reflects the lower-than-expected level of throughput.

Net borrowings fell modestly over the six months to April 2008, from £0.51m to £0.46m. This compares with a target of £0.6m, which we set in our report published in March. At this stage we do not propose to change this figure, which represents about 50% of recently negotiated new facilities and may prove slightly conservative.

Aborted bid

Shortly before the results announcement in February, Mediwatch announced that it had entered takeover negotiations; these talks were fairly quickly concluded without a bid emerging, although one-off costs of £0.11m, in the form of professional fees, were incurred during the half year.

The group has an attractive product portfolio and a leading position in its chosen segment of the market. The unique group product range offers considerable attractions to a third-party bidder.

Neither the identity of the third party nor likely terms for such a bid were indicated, although Mediwatch has indicated that unforeseen problems experienced by the potential bidder were the main cause behind the takeover plan not proceeding. We sensed at the time that uncertain stock market conditions may have contributed to the decision to withdraw. We do not propose to speculate on the likelihood of a further approach in the immediate future.

Sensitivities

A year ago, the main sensitivities related to whether the acquisition of the former Medtronic business would work. To date it has proved to be a qualified success; the profile of inventories acquired and the product procurement difficulties meant that the rate of subsequent progress has been below earlier estimates. The group is now profitable, with the potential to lift profits materially over the next two to three years.

Macro issues

The healthcare industry tends to be more vulnerable to political interference than to macro issues, especially in those countries where health services are largely in the public sector. Demand for equipment will reflect the availability of funds within the various health authorities, which are frequently the subject of political interference. On the other hand, experience shows that if there is a perceived need for a particular type of investment, the funds can usually be found, almost regardless of the state of the local economy.

Urological disorders are a progressively rising trend, with an increasing awareness of prostate cancer as one of the main causes of early mortality among men. We believe demand for more user-friendly diagnostic products ought to rise as revenue costs take priority over capital costs in healthcare sector budgets.

Product development

There is a limit to which product developments can be protected by patents. Mediwatch is operating in a competitive market and cannot expect its competitors to look at its new products without trying to improve upon them. The ongoing R&D programme represents the best defence in this respect, with Mediwatch constantly looking to upgrade the specification and performance of the existing portfolio. The timescale for securing FDA and CE approvals for new products does, however, provide added protection, raising the cost of entry for potential new competitors. On the other hand, as experienced currently with the PSAwatch, the timing of the receipt of approvals can also be more protracted than expected.

There are other factors, several of which have already been mentioned in this report:

- *Procurement* – the difficulties encountered over the past 18 months appear to have been sorted quickly; customers expect delivery when indicated and will go elsewhere if Mediwatch fails to meet its commitments. Management's decision to take some assembly work in-house has led to improved quality and delivery schedules, but this must be sustained.
- *How strong are customer contacts?* – We have been encouraged by the ability of the new US sales team to build revenues using its former Medtronic customer base. However, current year targets involving further progress have not been delivered, although useful profits continue to be delivered on a monthly basis. The development of these relationships and those with former customers in Europe and the Far East remain fundamental.
- *Currencies* – A high proportion of revenues is currently being generated in the US. With the group cost base largely in sterling, exchange movements can have considerable impact on operating margins and on the translation of US profits.
- *Cash control* – Mediwatch saw a big jump in revenues last year, which looks set to continue in the immediate future. This will involve a substantial investment in working capital and management needs to ensure that the necessary disciplines are in place.

Valuation

The February announcement of takeover talks demonstrates the vulnerability of medical technology companies as they break through into profits. Following the price setback after the recent interim announcement, the shares stand at well under half their value immediately following the bid approach and look distinctly undervalued on the basis of our estimates for the next two years. There are several hurdles to be negotiated before we can be confident of these targets, but the strategy is in place and there is an experienced management team to ensure delivery.

Earnings based calculation

On the basis of our current profit estimates for the years to October 2008 and 2009, Mediwatch shares are valued at 15 times current-year prospective earnings, coming down to under eight times for next year. Established medical equipment manufacturers tend to command a rating in the high teens, to reflect the intellectual property in their product base and the anticipated consistent and growing market for the products.

Revenue based calculation

Many development businesses tend to be valued on a sales multiple. In our report last year, we suggested that such a model is more appropriate to earlier stages of business development and becomes suspect when revenues start to flow rapidly. With an enterprise value almost exactly in line with our 2008/09 revenue estimate, the shares would appear distinctly undervalued on this basis.

Exhibit 3: Financials

30 April to 2005; then 31 October	£'000s	2005	2006	2007	2008e	2009e
Accounting basis		UK GAAP	UK GAAP	IFRS	IFRS	IFRS
PROFIT & LOSS						
Revenue		1,768	2,651	5,684	9,100	10,000
Cost of Sales		(1,046)	(1,660)	(3,157)	(4,900)	(5,400)
Gross Profit		722	991	2,527	4,200	4,600
EBITDA		(677)	(838)	173	642	940
Operating Profit (before GW and except.)		(713)	(896)	108	562	850
Goodwill Amortisation		(347)	(521)	0	0	0
Exceptionals		0	0	(347)	(112)	0
Other		0	0	0	0	0
Operating Profit		(1,060)	(1,417)	(239)	450	850
Net Interest		4	(56)	(26)	(60)	(50)
Profit Before Tax (norm)		(709)	(952)	82	502	800
Profit Before Tax (FRS 3)		(1,056)	(1,473)	(265)	390	800
Tax		0	0	0	0	0
Profit After Tax (norm)		(709)	(952)	82	502	800
Profit After Tax (FRS3)		(1,056)	(1,473)	(265)	390	800
Average Number of Shares Outstanding (m)		89.9	95.9	127.4	126.9	126.9
EPS - normalised (p)		(0.79)	(0.99)	0.06	0.40	0.63
EPS - FRS 3 (p)		(1.17)	(1.54)	(0.21)	0.31	0.63
Gross Margin (%)		40.8%	37.4%	44.5%	46.2%	46.0%
EBITDA Margin (%)		(38.3%)	(31.6%)	3.0%	7.1%	9.4%
Operating Margin (before GW and except.) (%)		(40.3%)	(33.8%)	1.9%	6.2%	8.5%
BALANCE SHEET						
Fixed Assets		2,955	2,484	2,898	3,468	4,278
Intangible Assets		2,777	2,256	2,464	2,764	3,064
Tangible Assets		178	228	434	704	1,214
Investment in associates		0	0	0	0	0
Current Assets		702	2,349	3,269	3,173	3,464
Stocks		177	243	1,533	1,700	1,868
Debtors		346	851	1,568	1,300	1,429
Cash		179	1,255	168	173	167
Current Liabilities		(582)	(682)	(2,042)	(2,126)	(2,126)
Creditors		(567)	(616)	(1,460)	(1,448)	(1,586)
Short term borrowings		(15)	(66)	(582)	(678)	(540)
Long Term Liabilities		(235)	(152)	(98)	(98)	(98)
Long term borrowings		(235)	(152)	(98)	(98)	(98)
Other long term liabilities		0	0	0	0	0
Net Assets		2,840	3,999	4,027	4,417	5,517
CASH FLOW						
Operating Cash Flow		(718)	(1,360)	(1,238)	619	782
Net Interest		4	(56)	(26)	(60)	(50)
Tax		0	0	0	0	0
Capex		(30)	(96)	(521)	(650)	(600)
Acquisitions/disposals		0	0	0	0	0
Financing		610	2,632	236	0	0
Dividends		0	0	0	0	0
Net Cash Flow		(134)	1,120	(1,549)	(91)	132
Opening net debt/(cash)		(63)	71	(1,037)	512	603
HP finance leases initiated		0	(12)	0	0	0
Other		0	0	0	0	0
Closing net debt/(cash)		71	(1,037)	512	603	471

Source: Company accounts/Edison Investment Research

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