Edison investment research

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Mediwatch

Year End	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	PE (x)	Yield (%)
04/05	1.8	(0.71)	(0.79)	0.00	N/A	N/A
10/06	2.7	(0.95)	(0.99)	0.00	N/A	N/A
10/07e	6.2	0.13	0.10	0.00	N/M	N/A
10/08e	11.0	1.08	0.85	0.00	12.6	N/A

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

Investment summary: Coming together

While interim results confirm that the integration of the former Medtronic business is knitting together more slowly than initially expected, the overall potential remains. Management has been strengthened during the past twelve months, while the sales momentum remains firmly in the right direction. As previously indicated, the risk/reward ratio remains high, but the group is now moving ahead strongly.

Merger starts to deliver

An 87% increase in revenues includes strong organic growth and a material maiden contribution from the former Medtronic business. Planned increased losses stem from investment to expand the group infrastructure to meet the demands of the rapid growth in turnover over the next two to three years. While there have been some delays, positive early indications reinforce the optimism of group management.

Management strengthened

A change of chairman and two new key board appointments have established an appropriate balance of medical, financial and commercial experience to board deliberations. The work force has more than doubled to accommodate the new US office and manage the business expansion.

Trade show successes

Group marketing strategy, aimed at consultants and other industry specialists, has contributed to the establishment of more than 60 global distributors for Mediwatch. The group has raised its profile at a number of focused conferences and seminars in Europe and North America during recent months.

Valuation: Medium term potential builds

The share price appears to have stabilised at around current levels, following the major acquisition late last year. They look firmly underpinned at current levels and offer considerable potential on the assumption that our targets can be delivered.

Price	10.75p
Market Cap	£14.6m

Share price graph

Share details

Code	MDW
Listing	AIM
Sector	Healthcare
Shares in issue	126.9m

Price

	High	Low
52 week	13.8p	7.4p

Balance Sheet as at 30 April 2007

Debt/Equity (%)	11
NAV per share (p)	3.2
Net borrowings (£m)	0.35

Business

Mediwatch develops and distributes specialist equipment for the detection of urological disorders. It has recently extended the business, by acquisition, building a major presence in the US.

Valuation

	2006	2007e	2008e
P/E relative			
P/CF			
EV/Sales			
ROE			

Revenues on geography

UK	Europe	US	Other
67%	N/A	N/A	33%

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Revenues start to build

The clear message emanating from the Mediwatch interim statement is that the planned build up of revenues has begun, albeit a few months behind schedule. First half turnover has been almost doubled, with strong organic growth supplemented by the initial income from last year's major acquisition from Medtronic. Early teething problems following the acquisition have led to a further reduction in our full year sales targets, but we remain optimistic that the group will deliver profits (before goodwill amortisation) over the full year.

Revenues doubled

Interim results are largely in line with revised expectations, with the early build-up in revenues from the former Medtronic business supplementing useful organic growth in sales of products from the original Mediwatch portfolio. Operating losses were sharply higher, up from £0.22m to £0.73m. There were two key factors:

- The planned increase in infrastructure costs ahead of the targeted jump in sales over the next two to three years;
- Non-recurring items related to the establishment of the group's US office (£0.17m) and bonus/salary payments to existing and former directors (£0.18m) which had not been provided for in the previous year.

Without the non-recurring items, the increased loss would have been 74% to £0.39m

Exhibit 1: Interim results to April 2007

Note: before goodwill amortisation and one-off expenditure; 18 month trading period to October 2006

	6 Months to April 2007 £000s	6 Months to April 2006 £000s	Change %	18 Months to October 2006 £000s
Turnover	1,829	979	+87	2,651
Cost of Sales	(1,184)	(621)	+91	(1,660)
Gross profit	645	358	+80	991
Operating profit (loss)	(387)	(222)	+231	(896)
Pre-tax profit (loss)	(392)	(245)	+202	(952)

Source: Mediwatch

We had originally been hoping for a more rapid build up in sales during the half year. However, as indicated in our May update note, when reducing our revenue targets, negotiations with Medtronic over the transfer of inventories were far more protracted than expected. This led to a number shortages once the US sales process became more effective, while a run-down in revenues on certain key Medtronic product lines and consumables during 2006, prior to the acquisition, left several of the group's suppliers inadequately prepared to respond to the new challenges.

Management has acted to improve the performance of suppliers. This has involved providing clearer indications on delivery requirements and the introduction of dual-sourcing on a number of key items, where appropriate. Inventory levels are already becoming more appropriate to anticipated demand levels. The sales momentum has continued to build, with up to £3.3-3.5m now targeted for the second half, indicating a total of some £6.2m for the full year.

Whilst this figure is some £1.3m lower than our previous estimate, the cost-basis also likely to be lower. Management strengthening has led to a far more effective use of manpower. In addition, while R&D expenditure continues to be focused towards both existing products and new innovations, management emphasis on revenue development, suggests that current year costs may not rise to the extent which we had built into our earlier estimates. The net result is that we still believe that the group can earn useful profits during the second half, to enable it to deliver a small pre-tax profit over the full year to October 2007, before goodwill amortisation and the one-off costs mentioned above.

We see no reason, at this stage, to adjust our earlier £11m revenue target for 2007/08, which should be sufficient to lift adjusted group pre-tax profits above £1m.

Positive sales initiatives

The trading statement refers to 60 international distributorships for the Mediwatch brand, providing global coverage for the group's extended product-base. Mediwatch has successfully exhibited at a number of key conferences/seminars in recent months, including events sponsored by the American Urology Association (AUA), the European Urology Association (EUA) and the British Association of Urological Surgeons (BAUS – Glasgow). Meanwhile, two of the group's non-executive directors (Omer Karim and Mark Emberton) who are urology industry specialists, have presented specialist papers at recent industry events.

These occasions have enabled the group to demonstrate the effectiveness and comprehensive nature of its extended product range, leading to the emergence of a number of new sales initiatives. Management intends to build on these opportunities, presenting at a forthcoming event organised by the International Continence Society (ICS - Brussels). Experience has shown that securing recommendations from industry specialists/surgeons represent the most effective form of marketing over the longer term.

Management strengthening

There were three fundamental board changes during the half year. Chairman, Dr John Forrest, stepped down to be replaced by Omer Karim; Omer is a globally recognised consultant urological surgeon, who has been a non-executive director of Mediwatch for a number of years. Colin Kunz replaced Kevin Middis as group finance director; Colin brings appropriate full-time financial and administrative skills to the group, as necessitated by the planned rapid growth in revenues. In addition, the non-executive element of the board has been broadened, with the appointment of Charles Cattaneo, a qualified accountant and experienced investment banker.

Sound balance sheet

The inventory difficulties mentioned above mean that the rise in borrowings was somewhat below expectations; we had been looking for an outflow of £2.0m over the full year to October 2007, with the group largely cash neutral during the second half. We remain optimistic that net borrowings will be below £1.0m (gearing 26%) at October 2007, but there will now be a rise in working capital during the second six months, to reflect the delayed rise in revenues. Mediwatch should be operationally cash positive in subsequent years.

Exhibit 2: Financial summary

30th April to 2005; then 31October	£'000s	2005	2006	2007e	2008e
Accounting basis		UK GAAP	UK GAAP	UK GAAP	UK GAAP
PROFIT & LOSS					
Revenue		1,768	2,651	6,200	11,000
Cost of Sales		(1,046)	(1,660)	(3,600)	(5,850)
Gross Profit		722	991	2,600	5,150
EBITDA		(677)	(838)	289	1,241
Operating Profit (before GW and except.)		(713)	(896)	197	1,147
Goodwill Amortisation		(347)	(521)	(347)	(347)
Exceptionals		0	0	(350)	0
Other		0	0	0	0
Operating Profit		(1,060)	(1,417)	(500)	800
Net Interest		4	(56)	(66)	(63)
Profit Before Tax (norm)		(709)	(952)	131	1,084
Profit Before Tax (FRS 3)		(1,056)	(1,473)	(566)	737
Tax		0	0	0	0
Profit After Tax (norm)		(709)	(952)	131	1,084
Profit After Tax (FRS3)		(1,056)	(1,473)	(566)	737
Average Number of Shares Outstanding (m)		89.9	95.9	126.9	126.9
EPS - normalised (p)		(0.79)	(0.99)	0.10	0.85
EPS - FRS 3 (p)		(1.17)	(1.54)	(0.45)	0.58
Gross Margin (%)		40.8%	37.4%	41.9%	46.8%
EBITDA Margin (%)		(38.3%)	(31.6%)	4.7%	11.3%
Operating Margin (before GW and except.) (%)		(40.3%)	(33.8%)	3.2%	10.4%
BALANCE SHEET					
Fixed Assets		2,955	2,484	2,226	1,846
Intangible Assets		2,777	2,256	1,909	1,562
Tangible Assets		178	228	317	284
Investment in associates		0	0	0	0
Current Assets		702	2,349	4,108	4,428
Stocks		177	243	1,388	1,634
Debtors		346	851	2,720	2,794
Cash		179	1,255	0	0
Current Liabilities		(582)	(682)	(2,396)	(1,654)
Creditors		(567)	(616)	(1,579)	(1,374)
Short term borrowings		(15)	(66)	(817)	(280)
Long Term Liabilities		(235)	(152)	(155)	(99)
Long term borrowings		(235)	(152)	(155)	(99)
Other long term liabilities		0	0	0	0
Net Assets		2,840	3,999	3,783	4,521
CASH FLOW					
Operating Cash Flow		(718)	(1,360)	(1,762)	716
Net Interest		4	(56)	(66)	(63)
Tax		0	0	0	0
Capex		(30)	(96)	(181)	(61)
Acquisitions/disposals		0	0	0	0
Financing		610	2,632	0	0
Dividends		0	0	0	0
Net Cash Flow		(134)	1,120	(2,009)	592
Opening net debt/(cash)		(63)	71	(1,037)	972
HP finance leases initiated		0	(12)	0	0
Other		0	0	0	0
Closing net debt/(cash)		71	(1,037)	972	380

Source: Company accounts, Edison Investment Research