BELL POTTER

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Paragon Care (PGC)

Deep Value Emerging

Recommendation
Buy (unchanged)
Price
$0.60
Target (12 months)
$0.80 (unchanged)

Expected Return	
Capital growth	33.0%
Dividend yield	3.0%
Total expected return	36.0%

Company Data & Ratios	
Enterprise value	$120m
Market cap	$95.0m
Issued capital	159.7m
Free float	94%
Avg. daily val. (52wk)	$100,000
12 month price range	$0.33 - $0.75
GICS sector	
Healthcare Equipment and Services	

Disclosure: Bell Potter Securities acted as Lead Manager for the company's 2015 capital raise and received fees for that service.

Price Performance

	(1m)	(3m)	(12m)
Price (A$)	0.60	0.65	0.36
Absolute (%)	0.83	-6.50	66.09
Rel market (%)	4.16	-7.25	69.02

AGM update confirms growth expectation

Paragon Care is an importer, manufacturer and wholesaler of consumables and capital equipment items for the hospital and aged care sectors. It has completed eleven acquisitions since 2009, with four of those since October 2014.

Approximately 70% of revenues are driven by consumables sales with the remainder being from capital equipment items. Based on the long term growth rate in health care spending, we expect the underlying business has a growth rate in the mid single digit range. Importantly, this business does not distribute regulated products – either pharmaceuticals or prosthetics, hence it is not subject to the Federal Government regulation controlling these sectors. Paragon sells product to practically every hospital in Australia with the largest clients being in the public system where buying procedures vary from hospital to hospital.

Further Acquisitions Likely

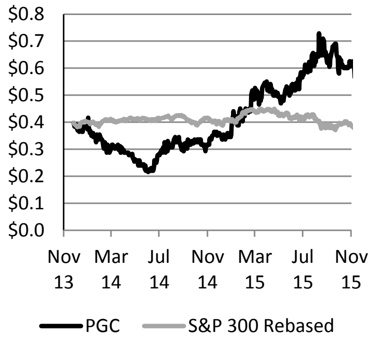
Today's AGM outlook statement re-affirmed expectations of double digit earnings growth with the vast majority of the growth driven by acquisitions. The three recently completed transactions were acquired at EV/EBITDA multiples of between 4.0x and 6.8x times – hence highly accretive to EPS. Since taking ownership, the back office integration process has proceeded smoothly and the company is now consolidating its Victorian operations into one larger site. It has also uncovered significant cost synergies with more than $250K in annualised freight forwarding savings identified.

The FY15 prof-forma EBITDA for the group (assuming a full years earnings from acquisitions) remains unchanged at $13.5m, however, the first full year of earnings from these will be FY17. Notwithstanding our FY17e remains realistic target as the company's pro rata guidance does not included any growth or cost synergies.

Retain Buy Recommendation and Price Target $0.80

There are no changes to underlying earnings following the AGM update and we retain our price target of $0.80.

Absolute Price



SOURCE: IRESS

Earnings Forecast

June Year End	FY15	FY16e	FY17e	FY18e
Revenues $m	32.2	93.6	117.2	121.3
EBITDA $m	3.7	11.7	15.0	15.2
NPAT (underlying) $m	2.1	6.3	8.9	9.2
NPAT (reported) $m	2.1	5.3	8.9	9.2
EPS underlying (cps)	3.2	4.6	5.6	5.8
Norm EPS growth %	18%	47%	20%	4%
PER (x)	18.9	12.9	10.7	10.3
FCF yield (%)	-1%	4%	10%	9%
EV/EBITDA (x)	32.5	10.3	8.0	7.9
Dividend (cps)	1.4	1.8	2.2	2.3
Franking	100%	100%	100%	100%
Yield %	2.4%	3.0%	3.7%	3.9%
ROE %	10.2%	8.8%	11.5%	11.1%

SOURCE: BELL POTTER SECURITIES ESTIMATES

Business Model Summary

The following summarises the key aspects of the Paragon business model.

Figure 1 - Paragon Care - Business Model Summary

High end products provides stable revenue and repeat customers

- Value proposition to customers is based on a platform offering of high quality products and premium customer service around those products
- Key competitive advantage and the point of differentiation that drives repeat purchases despite low-cost competitors

	Sourcing	Product mix	Sales mix	Key customers
Approach	**90%** Exclusive distribution products **10%** designed and manufactured products	**70%** Consumables **30%** Capital equipment	**80%** Acute care **10%** Aged care **10%** Primary care	**Includes:** Melbourne Health • Alfred Health • Austin Health • NSW Health • Healthscope Private • WA Health • Lend Lease • Hansen & Yuncken
Benefit	✓ High quality products ✓ Minimal capital and R&D expenditure ✓ Ability to adjust product range to suit customer needs ✓ Aggressive hedging keeps COGS low	✓ High consumables provides decreased earnings volatility ✓ Sustainable earnings growth ✗ Lower gross profit margin	✓ Acute and aged care are growing industries ✓ Strong demand ✓ Premium prices ✓ Repeat purchases	✓ Customers include Australia's top hospitals and care providers ✓ Repeat customers driven by standard of service and full partnering solution

SOURCE: COMPANY DATA

- Paragon does not operate in the high volume, low margin business of consumables. For this reasons it does not have paper products, needles, gloves dressings etc. in its range.
- It will only acquire/distribute brands where there is a realistic prospect of a developing a minimum $1m business within the short term. Generally, original equipment suppliers will not set up a distribution in Australia for less than a $20m business. Below that level distributors such as Paragon remain viable.
- The value of intellectual property on the balance sheet is modest. Intangibles are limited to acquired goodwill. For this reason the risk of product obsolescence is practically nil as new products are continually added to the range.
- The blended gross margin is approximately 35% with the capital equipment higher items being higher margin. The target EBITDA margin is approximately 12%.
- The key barriers to entry in this market is scale of product offering. Increasingly buyers are looking to cut the number of suppliers and stream line business processes in order to reduce cost. As PGC grows its product range, it may be expected to increase its penetration into each market.

Following the AGM update there are no changes to our underlying earnings or target price. Based on FY17 earnings forecasts, the stock remains deep value with an EV/EBITDA multiple of just 8.0x relative to the 10.3x for FY16.

The management team led by CEO Mark Simari continues to execute on its business plan and we remain confident they will deliver on earnings expectation.

Paragon Care

Paragon Care is an industry consolidator of specialist medical distributors. It has exclusive distribution rights in Australia for leading brands of beds, mattresses stainless steel equipment, storage and shelving solutions, plus a range of consumable items and other capital equipment items.

In September 2015 the company diversified into medical consumables via the acquisition of Western Biomedical, Designs For Vision and Meditron. Following this transaction more than 70% of its revenues will be sourced from consumable sales rather than capital items.

PGC has completed 9 acquisitions since 2009 for a total of $83.0m. The market for medical distributors remains disaggregated and consequently we expect there is a pipeline of future acquisition opportunities. Paragon Care has funded acquisitions with debt and equity.

The company sells to a range of buyers including hospital (both public and private) as well as aged care and primary care providers. Hospitals are the largest market representing approximately 80% of revenues.

Industry growth will continue to be driven by Australia's ageing population which may continue to demand high quality healthcare services. The products distributed by Paragon have a limited lifespan and will be subject to ongoing replacement.

The hospital industry is highly regulated and accreditation is dependent upon maintaining minimal standards for cleanliness – primarily for the purpose of infection control in the hospitals. Many of the products sold by Paragon are manufactured to satisfy these accreditation requirement and are therefore considered non-discretionary.

The sector is well funded through a combination of Federal and State funding for hospitals, aged care services and Medicare for primary health care. The vast majority of the customer group are healthcare service providers as opposed to retail.

VALUATION

We determine Enterprise Value by applying a multiple to the sustainable EBITDA. The estimation of the multiple is based on the market multiple of a peer group, plus our estimate of value for particular matters as they apply to Paragon Care.

The cross check of value is a discounted cash flow model.

RISK AREAS

The key risk areas are:

Currency risk – Paragon sources most of its product from offshore, either as imported finished goods or from contract manufacturers of its own proprietary designed products. The majority of product is invoiced in foreign currency being mainly USD & EUR. A significant devaluation of AUD would affect gross profit margin if the company were unable to offset the impact through either price rises, FX currency hedges or renegotiation of terms with suppliers.

Regulatory reform – the healthcare industry is highly regulated and is dependent upon government funding and private health insurance for the majority of its revenues. A significant adverse change in the funding mechanism for hospitals in particular is likely to impact ordering patterns of key customers.

Paragon Care
as at 30 November 2015

Recommendation	Buy
Price	$0.60
Target (12 months)	$0.80

Table 1 - Financial summary

Profit & Loss (A$m)	FY14	FY15	FY16e	FY17e	FY18e
Year Ending June					
Total revenues *	19.4	32.2	93.6	117.2	121.3
Revenues growth	-59.6%	65.8%	190.6%	25.2%	3.5%
EBITDA	**2.2**	**3.7**	**11.7**	**15.0**	**15.2**
Margin	**11.1%**	**11.5%**	**12.5%**	**12.8%**	**12.5%**
Depreciation	0.2	0.3	1.4	1.2	1.2
Amortisation	- 0.4	-	-	-	-
EBIT	1.9	3.4	10.3	13.8	13.9
margin	10%	11%	11%	12%	12%
Net interest	(0.4)	(0.7)	(1.4)	(1.1)	(0.8)
Pre tax profit	1.5	2.7	8.9	12.7	13.2
Tax expense	(0.0)	(0.6)	(2.6)	(3.8)	(4.0)
NPAT- normalised	1.5	2.1	6.3	8.9	9.2
Net abnormal items	(0.4)	-	(1.0)	-	-
Reported NPAT	1.1	2.1	5.3	8.9	9.2

Cashflow (A$m)					
Gross cashflow	(1.7)	1.7	9.1	15.3	14.5
Net interest	(0.4)	(0.7)	(1.4)	(1.1)	(0.8)
Tax paid	-	(0.3)	(2.9)	(3.3)	(3.9)
Operating cash flow	**(2.1)**	**0.8**	**4.8**	**10.9**	**9.8**
Maintenance capex	(0.2)	(1.3)	(1.4)	(1.2)	(1.2)
Free cash flow	**(2.3)**	**(0.5)**	**3.4**	**9.8**	**8.6**
Business acquistions	(3.5)	(5.9)	(55.4)	-	-
Other	(0.0)	-	(1.6)	-	-
Proceeds from equity issuance	6.5	0.2	40.7	-	-
Net movement in borrowings	1.9	7.9	14.5	(6.9)	(5.1)
Dividends paid	(0.8)	(0.9)	(1.7)	(2.9)	(3.6)
Issue and transaction costs	(1.5)	-	-	-	-
Change in cash held	**0.3**	**0.8**	**(0.0)**	**0.0**	**0.0**
Cash at beginning of period	2.5	2.9	3.8	3.8	3.8
Cash at year end	2.9	3.8	3.8	3.8	3.8

Balance Sheet (A$m)	FY14	FY15	FY16e	FY17e	FY18e
Receivables	5.1	7.1	19.8	19.5	20.2
Inventory	4.1	8.4	25.3	25.0	25.9
Other current assets	-	0.3	0.3	0.3	0.3
Trade payables	(3.6)	(6.3)	(23.0)	(22.7)	(23.5)
Employee provisions	(0.5)	(0.8)	(2.0)	(2.1)	(2.2)
Net working capital	**5.0**	**8.7**	**20.3**	**20.0**	**20.6**
Property, Plant and Equipment	0.6	1.2	2.4	2.4	2.4
Intangible assets	13.6	19.0	71.2	71.2	71.2
Deferred tax assets	0.8	0.8	0.8	0.8	0.8
Provision for income tax	(0.2)	(0.6)	(0.3)	(0.8)	(0.8)
Net Assets employed	**19.7**	**29.1**	**94.5**	**93.6**	**94.2**
Funded by:					
Cash	2.8	3.8	3.8	3.8	3.8
Debt - interest bearing debt	(4.2)	(12.3)	(26.8)	(19.9)	(14.8)
Net debt	(1.4)	(8.5)	(23.0)	(16.1)	(11.1)
Share capital	(22.8)	(23.6)	(70.8)	(70.8)	(70.8)
Retained earnings	4.5	3.3	(0.4)	(6.4)	(12.1)
Reserves	0.1	(0.3)	(0.3)	(0.3)	(0.3)
Net Equity	(18.2)	(20.6)	(71.5)	(77.5)	(83.2)
Total capital employed	(19.6)	(29.1)	(94.5)	(93.6)	(94.2)
Net Assets	18.3	20.6	71.5	77.5	83.2

Profitability Ratios	FY14	FY15	FY16e	FY17e	FY18e
Year Ending June					
EBITDA margin	11.1%	11.5%	12.5%	12.8%	12.5%
EBIT margin	9.8%	10.5%	11.0%	11.8%	11.5%
EBIT growth	-100.0%	77.4%	203.9%	33.9%	1.2%
Valuation Ratios					
Reported EPS (cps)	2.0	3.2	3.9	5.6	5.8
Normalised EPS (cps)	2.7	3.2	4.6	5.6	5.8
EPS growth (%)	-107%	18%	47%	20%	4%
PE(x)	22	18.9	12.9	10.7	10.3
EV/EBITDA (x)	55.7	32.5	10.3	8.0	7.9
EV/EBIT (x)	62.8	35.4	11.7	8.7	8.6
NTA (cps)	5.9	1.1	- 0.3	3.4	7.0
P/NTA (x)	10	54.3	- 175.9	17.3	8.5
Book Value (cps)	27.9	30.4	44.8	48.6	52.1
Price/Book (x)	2.1	2.0	1.3	1.2	1.1
DPS (cps)	1.3	1.4	1.8	2.2	2.3
Payout ratio %	64%	44%	40%	40%	40%
Dividend Yield %	2.1%	2.4%	3.0%	3.7%	3.9%
Franking %	100%	100%	100%	100%	100%
FCF yield %	-6%	-1%	4%	10%	9%

Performance Ratios	FY14	FY15	FY16e	FY17e	FY18e
ROA	5.5%	5.2%	5.1%	7.2%	7.4%
ROE	8.2%	10.2%	8.8%	11.5%	11.1%
ROIC	6.8%	8.2%	7.6%	10.3%	10.4%
Net debt/Equity	8%	41%	32%	21%	13%
Net debt/Assets	5%	21%	19%	13%	9%
Gearing	7%	29%	24%	17%	12%
Net debt/EBITDA (x)	0.7	2.3	2.0	1.1	0.7
Interest cover (x)	4.8	4.9	7.6	12.7	18.5

Interim results (A$m)	2H15	1H16	2H16	1H17	2H17
Total revenues *	19.1	34.3	59.3	58.6	58.6
Revenues growth	69%	154%	211%	71%	-1%
Gross profit	8.7	12.3	21.4	21.1	21.1
Gross profit margin	46%	40%	36%	36%	36%
EBITDA	2.2	4.3	7.4	7.5	7.5
EBITDA margin	11%	13%	0%	0%	0%
NPAT- normalised	1.3	2.3	4.0	4.4	4.4

SOURCE: BELL POTTER SECURITIES ESTIMATES

Recommendation structure

Buy: Expect >15% total return on a 12 month view. For stocks regarded as 'Speculative' a return of >30% is expected.

Hold: Expect total return between -5% and 15% on a 12 month view

Sell: Expect <-5% total return on a 12 month view

Speculative Investments are either start-up enterprises with nil or only prospective operations or recently commenced operations with only forecast cash flows, or companies that have commenced operations or have been in operation for some time but have only forecast cash flows and/or a stressed balance sheet.

Such investments may carry an exceptionally high level of capital risk and volatility of returns.

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