

Medical Australia Limited

(Ticker: ASX:MLA / OTC:MDAUYY)

RB MILESTONE GROUP 
Equity Research and Market Intelligence

January 20, 2012

Distribution and Supply Deals Power Growth

Medical Australia Limited (MLA) is a Sydney, Australia-based company involved in the development, manufacturing and distribution of medical devices and consumables used in the human and animal healthcare markets of Australia, New Zealand and Asia. During May-November 2011, the company entered into a number of major distribution agreements and supply contracts, which is expected to provide a significant boost to the company's financial performance from FY12 onwards. The agreements include a distribution deal with MediVet for the UK market and supply contracts with the United Nations International Children's Emergency Fund (UNICEF), NSW Ambulance and Concord Repatriation, General Hospital, Healthscope, Melbourne Health, etc. The company has made impressive progress in its goal to become profitable. In FY11, MLA's revenues recorded a strong 20% YoY growth to reach \$8.8 million, while operating expenses reduced by 4.3%. Consequently, loss from operations declined to A\$0.24 million from A\$1.11 million in FY10.

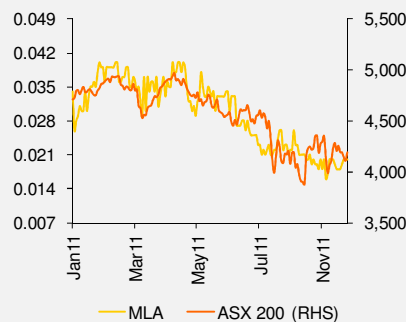
Based on our updated DCF valuation model, we reiterate our positive outlook on the company and arrive at a target price \$0.038 per share, an upside potential of 87.7% from the last traded price of \$0.020.

Investment Arguments

- **Macro Factors to Act as Long-term Catalysts.** A solid economic recovery coupled with rising income levels, aging population and increased government spending on healthcare would lead to strong demand for high-quality medical products, which is expected to drive sales in the Australian and Asian medical devices industry. This is evident from the fact that in Australia the population of those above 60 years of age is estimated to increase to 5.1 million in 2016 from 3.7 million in 2006, while government expenditure is projected to rise to A\$96.0 billion in 2017-18 from A\$71.2 billion in 2007-08, a CAGR of 3%. Australia is a key market for MLA as it derives ~84% of its revenues from the Australian healthcare industry and has recently renewed two major state government contracts. Consequently, the company is set to benefit from the increased healthcare spending and witness significant demand growth for its products over the long term
- **Agreements with MediVet to Boost Revenue and Earnings.** In July 2010, MLA secured a global supply and manufacturing agreement with MediVet, a Sydney-based global animal healthcare company. The deal enables MLA to gain a foothold in the lucrative US\$11 billion US pet health-care market and is expected to lead to annualized revenues of A\$3 million starting from 2HFY11. MLA has further strengthened this partnership by entering into a distribution agreement with MediVet in July 2011 for the UK market as well. With over 10,000 veterinary practices operating in the UK, the recent deal will further boost revenue generating opportunities for MLA
- **OEM and Supply Contracts Offer Further Upside.** Recently, MLA entered into multiple new agreements that will add A\$1.5 million to revenues in FY12 (annualized) and beyond; and significant other supply contracts with UNICEF for providing needle cutters; and with NSW Ambulance and Concord Hospital to supply Analytica's AutoStart burettes. These contracts follow the previously signed supply contract with Healthscope and OEM agreements with Terumo Medical of Japan and Fresenius Kabi (FK). We believe the supply and OEM deals will provide substantive traction to MLA's revenues starting from FY12 as well as reinforce its position as a solid and dependable supplier and OEM partner, enabling the company to garner more such deals moving forward

Price (A\$):	0.020
Target Price (A\$):	0.038
Beta:	0.82
Price/Book Ratio:	1.79
Debt/Equity Ratio:	0.31
Listed Exchange:	ASX

*Coverage initiation: May 5, 2011



Recent News

9/1/2012: MLA appoints Mr. Gary Lewis as the new Chairman, due to the sudden demise of the earlier Chairman, Mr. Tom Hartigan.

22/11/2011: MLA secured multiple new supply agreements worth A\$1.5 million.

30/09/2011: MLA launches American Depositary Receipt Program.

19/08/2011: MLA signs distribution agreement with Smith and Nephew.

25/07/2011: MLA receives cash infusion of A\$1.3 million following conversion of options.

06/07/2011: MLA and Analytica sign supply agreement with Sydney-based Concord Repatriation and General Hospital.

05/07/2011: MLA secures Master Distributorship for MediVet in the UK.

12/05/2011: MLA and Analytica sign supply agreement with NSW Ambulance Service.

Shares in Issue

453.68 M

Market Cap

(A\$M) 9.07

52 Week (High): A\$0.055

52 Week (Low): A\$0.016

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- **Significant Improvement in Financial Performance.** MLA was able to reduce its net loss to A\$342.7K in FY11 from a loss of A\$1.3 million in FY10 primarily on the back of a strong 20% YoY growth in revenue and lower operating expenses. The revenue growth was mainly driven by recently signed supply contracts and OEM agreements with leading healthcare companies, while rationalization of inventory and supply chain drove EBIT margin expansion. We expect MLA's financial performance to improve further as new contracts start generating substantial revenues while management initiatives to streamline administrative operations positively impact margins via improved supply chain and reduced freight costs
- **Valuation.** A considerable improvement in operating performance during FY11 has enabled MLA's share price to rise from A\$0.012 on January 4, 2011 to A\$0.020 on January 11, 2012. Our updated DCF-based valuation model gives us a price target of A\$0.038 with a potential upside of 87.7%. We continue to believe that the stock is attractively priced at current levels with significant upside potential at this stage

Key Developments

Secures Master Distributorship for MediVet in the UK

In July 2011, MLA entered into a Master Distribution Agreement with animal healthcare company and OEM partner, MediVet Pty Limited for the UK market. The deal enables MLA to become the sole distributor for MediVet's patented stem cell regenerative medicines for animals in England, Wales, Scotland and Ireland.

The business model facilitates a veterinary practice in the UK to purchase MediVet's proprietary hardware upfront, valued at US\$10,000, and then order procedure packs worth at least US\$2,000 per month.

MLA already has an experienced business manager in London and is looking to actively promote MediVet's products to veterinary clinics and equine centers throughout the UK. MLA believes that with over 10,000 veterinary practices operating in the region, the master distributorship offers a major future revenue driver starting from the current financial year.

Signs a New Supply Deal With UNICEF

MLA announced in May 2011 that it has secured a new contract to supply needle cutters to the UNICEF. The contract, which will generate revenue immediately, was awarded to MLA by UNICEF's head office in Copenhagen, Denmark and provides MLA visibility with UNICEF on a global scale. The company has started booking revenues from 1HFY11 and already shipped the second order worth A\$120,000 to UNICEF.

The contract was a result of a joint program between the company and UNICEF to develop a product that meets World Health Organization (WHO) specifications for needle cutters. On the back of the extensive product development partnership with UNICEF, MLA expects to secure additional supply contracts in the near future for other international markets in which UNICEF operates.

MLA and Analytica Enter into Supply Agreements with NSW Ambulance and Concord Repatriation and General Hospital

In May 2011, Analytica Limited and MLA announced that they have secured an ongoing order for AutoStart Burettes with NSW Ambulance Service under which the devices will be carried by ambulances across New South Wales, Australia. Further, the previously announced AutoStart Burette trial yielded positive results and was subsequently expanded in scope from a single ward at a major NSW hospital to the entire facility. Both the AutoStart burette and the AutoFlush feature are patented devices, with MLA currently incorporating the AutoFlush feature into its range of TUTA burettes as well.

In July 2011, MLA and Analytica announced the successful completion of the above clinical trial using Analytica's AutoStart Burette with Concord Repatriation and General Hospital based in Sydney, NSW. The companies also stated that the project was now in the process of a full hospital roll out and annual sales based on the hospital's usage figures alone is estimated to be more than A\$500,000. MLA and Analytica also expect that the acceptance by Concord Hospital will act as an excellent reference site for the ongoing commercialization of the technology and would pave the way for rolling out the AutoStart Burette to other major hospitals across Australia.

Signs Distribution agreement with Smith & Nephew

On August 19, 2011 MLA signed a new distribution agreement with the Canadian arm of London-based medical device major, Smith & Nephew Plc. Under the agreement, Smith & Nephew would become the exclusive distributor of MLA's TUTA irrigation products across Canada. With revenues of nearly US\$4 billion during 2010, Smith & Nephew is an industry leader in more than 100 markets and operates via three main business units – Orthopedic Reconstruction and Trauma, Endoscopy and Advanced Wound Management.

Secured multiple new supply agreement worth A\$1.5 million

On November 22, 2011, MLA entered into multiple new agreements ranging from one to three years. The contracts would enhance MLA's revenues for FY12 (annualized) and beyond by A\$1.5 million. The contracts include:

- Product supply agreement with Healthscope, one of Australia's largest private hospital operators, for an initial period of one year;
- Supply of IV consumables and surgical irrigation products to Epworth Private Hospital on a rolling basis;
- Agreement with Vic Ambulance to supply life saving IV consumables;
- Supply of new innovative burette technology to Concord Repatriation and General Hospital; and
- Product supply agreements with Melbourne Health (17 hospitals), Austin and Repatriation Hospitals (2 hospitals), Eastern Health (3 hospitals), Saint Vincent's and Mercy Private Group (3 hospitals), and Cabrini Health Group Network (6 hospitals).

Other than the above contracts, MLA also secured smaller supply agreements with Mater South Brisbane, Princess Margaret Hospital, Mater North Sydney, Macquarie University Teaching Hospital, North Middlesex NHS Trust in the UK, and NSW Ambulance. With such agreements the company is likely to witness strong revenues going ahead.

Other Developments

- **A\$1.3 million Cash Infusion:** MLA received a cash infusion of A\$1.3 million in July 2011 as a portion of its options were converted into ordinary shares. The company stated that ~64.9 million options were exercised by investors at A\$0.02 per share including a shortfall of ~10.9 million options which were taken up by Auckland Trust Company Limited. With the infusion, MLA had a cash balance of more than A\$1.5 million on 25 July 2011, which will enable the company to aggressively pursue organic growth opportunities and ensure continued traction in financial performance.
- **Management Changes:** During FY11, MLA also announced significant changes in the Board and senior management team. In March 2011, Mr. Suraj Sethuram was appointed as General Manager – Finance & Administration in place of Mr. Greg Lewis who resigned from the position of CFO. In June 2011, Mr. Gary Lewis resigned as Non-executive director and was replaced by Mr. Mark Donnison, as Managing Director and CEO. Later in January 2012, Mr. Gary Lewis was appointed as the new non-executive Chairman due to death of earlier Chairman, Mr. Tom Hartigan.
- **ADR listing:** On September 30, 2011, MLA announced the launch of its American Depository Receipt (ADR) program and subsequent listing on the U.S. Over-The-Counter (OTC) market under the ticker 'MDAU'. The listing enables MLA to create a broader secondary market for its securities for investors in the crucial North American market where the company is looking to establish a strong presence. MLA also stated

that it has appointed one of the leading banks in the U.S., BNY Mellon as its Depositary to establish and maintain the ADR facility.

Latest Financial Results

Exhibit 1 : Annual Income Statements

Australian \$	Year Ended Jun 30, 2010	Year Ended Jun 30, 2011	YoY%
Revenue	7,298,003	8,781,299	20.3%
Cost of sales	(2,995,078)	(3,836,911)	28.1%
Gross profit / (loss)	4,302,925	4,944,388	14.9%
Administration and consultants	(712,610)	(849,662)	19.2%
Depreciation	(137,563)	(141,192)	2.6%
Write down of inventory	(303,934)	-	-
Employee expenses	(3,051,202)	(3,161,818)	3.6%
Travel and accommodation	(220,062)	(193,652)	-12.0%
Occupancy costs	(331,989)	(381,987)	15.1%
Other	(663,712)	(460,857)	-30.6%
Profit/ (Loss) from operations (EBIT)	(1,118,147)	(244,780)	-78.1%
Financial income	5,143	13,796	168.2%
Financial expense	(229,885)	(186,842)	-18.7%
Profit/ (Loss) before income tax (PBT)	(1,342,889)	(417,826)	-68.9%
Income tax benefit	-	75,103	-
Total Comprehensive Loss for the Year	(1,342,889)	(342,723)	-74.5%
Basic and diluted EPS (in cents)	(0.51)	(0.09)	-82.4%

Source: Company Filings, RB Milestone

During FY11, MLA recorded a strong 20.3% YoY growth in revenues to A\$8.8 million driven by the recently signed OEM and supply agreements with leading healthcare companies. Accordingly, gross profit also grew by 14.9% YoY to A\$4.9 million, compared to A\$4.3 million in the year ago period. Despite a number of one-off costs, which totaled A\$360k during FY11, the company posted a significantly lower comprehensive loss of A\$342.7K compared to a loss of A\$1.3 million in FY10 primarily on the back of robust revenue growth and absence of inventory write-downs.

In June 2011, MLA received a cash infusion of A\$1.3 million as a portion of the company's options were exercised by shareholders. Accordingly, MLA ended FY11 with cash and cash equivalents of A\$828.3k compared to a cash balance of A\$190.7k as of end FY10. Moving forward, the company expects significant improvement in revenues and earnings in FY12 mainly driven by the MediVet agreement, which is anticipated to gain further traction, as well as reduced overheads from MLA's initiatives to streamline various administrative functions.

Valuation & Investment View

MLA is engaged in the manufacturing, distribution and sale of a broad range of medical devices used by acute and primary healthcare facilities in Australian and global markets. The company has made impressive progress in its goal of making profits and has reduced its net loss considerably during FY11.

We believe the company has the capability to generate strong cash flows from operations in FY12 on the back of robust growth from the MediVet partnership, recent supply contracts and OEM agreements; increased healthcare spending; margin improvement; and prudent cost management initiatives. Hence, we use the DCF valuation model with explicit forecasts until FY15 to value MLA's operations. We have also assumed in our valuation that 25% of the recent cash infusion of A\$1.3 million would be used to further reduce debt in FY12.

Exhibit 2 : WACC Computation

Cost of debt	
Average pre-tax interest cost of debt	14.5%
Average tax rate	30.0%
Average post-tax interest cost of debt (k_d)	10.2%
Debt/(Debt+Equity) (W_d)	9.5%
Weighted average cost of debt ($W_d \times k_d$)	1.0%
Cost of equity (CAPM)	
Risk free rate (R_f)	3.8%
Market rate of return (R_m)	14.9%
Beta (β)	1.00
Risk premium $\beta(R_m - R_f)$	11.1%
Cost of equity (k_e)	14.9%
Equity/(Debt+Equity) (W_e)	90.5%
Weighted average cost of equity ($W_e \times k_e$)	13.5%
Weighted average cost of capital	14.4%

Source: Company Filings, Bloomberg, RB Milestone

Exhibit 3 : Per share value

Value per common stock	
Sum of PV of FCFF	3,742,521
PV of terminal value	13,557,689
Value of operations	17,300,210
Adjusted for	
Total debt	955,128
Cash and cash equivalents	686,755
Minority interest	0
Value available to common stockholders	17,031,838
Shares outstanding	453,676,000
Value per share	0.038
Current Market Price	0.020
Upside/ (downside)	87.7%

Source: Company Filings, RB Milestone

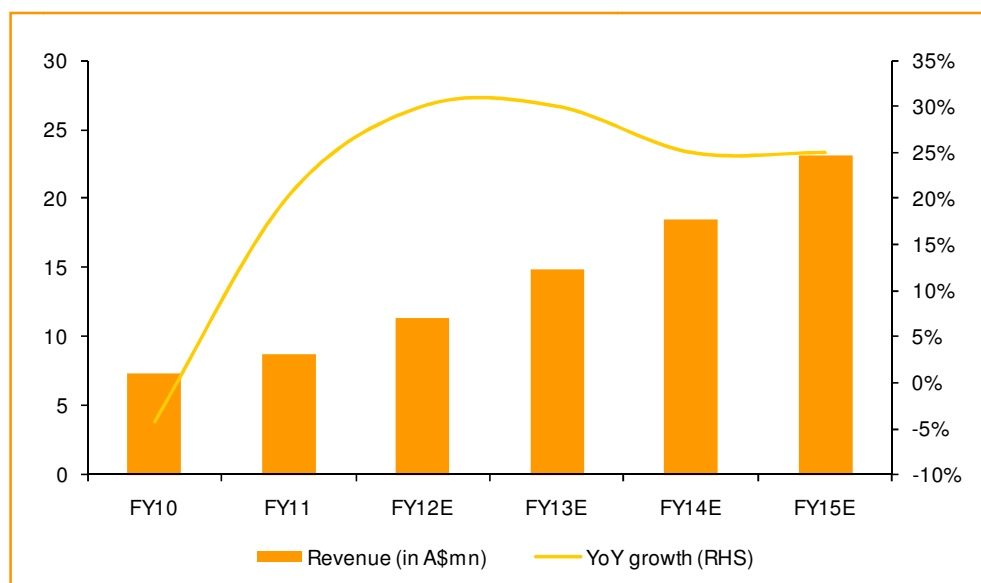
Exhibit 4 : Sensitivity Analysis

	Weighted average cost of capital							
		8.4%	10.4%	12.4%	14.4%	16.4%	18.4%	20.4%
Perpetual growth	1.5%	0.067	0.051	0.041	0.034	0.029	0.025	0.022
	2.0%	0.072	0.054	0.043	0.035	0.029	0.025	0.022
	2.5%	0.078	0.057	0.044	0.036	0.030	0.026	0.023
	3.0%	0.085	0.060	0.047	0.038	0.031	0.027	0.023
	3.5%	0.093	0.064	0.049	0.039	0.032	0.027	0.024
	4.0%	0.102	0.069	0.051	0.041	0.033	0.028	0.024

Source: Company Filings, RB Milestone

We expect MLA's revenues to reach A\$11.4 million in FY12, with significant contributions from MediVet and supply contracts in FY12. By FY15, we expect revenues to reach A\$23.2 million, as the company expands in both domestic and international operations.

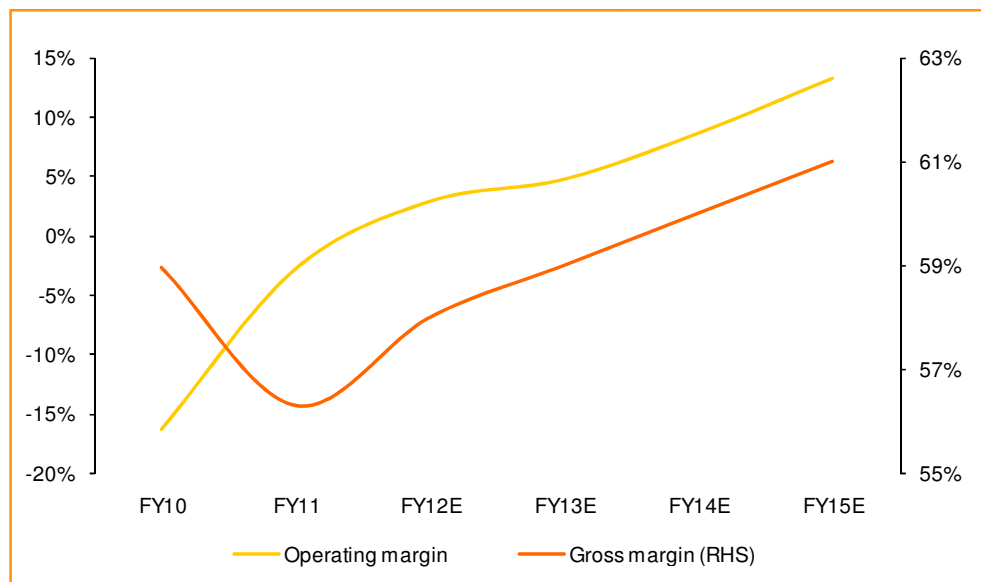
Exhibit 5 : Revenue Forecast



Source: Company Filings, RB Milestone

MLA has undertaken a comprehensive restructuring program in the past few years, which included rationalization of the supplier bases, consolidation of manufacturing facilities and distribution network in China, as well as streamlining administrative portfolios. We believe the company will continue to reap the benefits of these initiatives which would stabilize gross margin in the range of 58.0%-61.0% over FY12-15E, while we expect EBIT margin to improve from -16.3% in FY11 to 2.9% in FY12E and to eventually rise to 13.3% in FY15E.

Exhibit 6 : Margins



Source: Company Filings, RB Milestone

Our updated DCF valuation model gives a target price of A\$0.038, an upside of 87.7% based on the last traded price of A\$0.020. For deriving fair value per share, we have assumed a beta of 1.0 to approximate the underlying risk associated with investing in MLA.

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