

EQUITY RESEARCH SUTHERLAND HEALTH GROUP BUY



COLLINS SARRI STATHAM
INVESTMENTS

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Research Report:

Report Date

20th April 2010

Analyst

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Collins Sarri Statham
Investments Ltd

Stock Rating: BUY

Target Price..... 2.75p
Share Price 2.25p
52 week 3p/2p
Shares o/s 55m
Market Cap £1.23m
Dividend Yield..... nil
Fiscal Year .. 31 March 10

Sutherland Health is a supplier of medical devices and healthcare products primarily to NHS and PCTs.

Key Risks to Price Target

1. Sutherland Health is increasingly dependent on new product launches to meet growth objectives.

2. Sutherland Health is exposed to changing purchasing trends in the NHS and PCTs.

3. Sutherland Health faces significant bond refinancing within the next 18 months.

Please also note the risk warnings on the last page of this document.

Encouraging H1 - marked a watershed

- Sutherland Health Group (SHG) reported maiden interim net profits of £7,245 in the six months ending 30th September 2009 helped by 14.5% top line growth (revenues £469k vs £410k). New client wins including Reading, West Berks and Wokingham CC's contributed 4%-5% of revenues. This was the first time since IPO that SHG had turned a profit in an accounting period.
- The board have achieved a sustainable improvement in gross margins to 51.2% (FY09 48.2%) due to cost savings via rationalising and sourcing product lines with new additions at higher margins. Operating margins of 4.1%(-9.68%) were helped by a 9.7% reduction in administrative expenses (circa £20k) with permanent savings in distribution, corporate/ broking costs and in contract re-negotiations.
- The positive earnings mark a watershed for SHG with consistent progress rewarded – sales are up 34.6% since 2008, despite a tough UK health market environment, with NHS counterparties keen on cost savings. SHG is keen on expanding its distribution reach to Wales and Scotland and is hiring staff to address these untapped markets. For FY 2010 our revenue expectations of £957k (+5.8% YoY) are conservative and reflect the time taken for NHS/PCT orders to build. We have not added anything for new products for FY10.

Looking forward new products should accelerate growth

- Growth drivers in FY11 (YE 31 March 2011) include significant new launch opportunities – i) Vision Vaginal Infection Swab (100k NHS cases of bacterial vaginosis pa) and ii) Vision Amniotic Leak Detector (50k cases pa). These two gynaecology products address the pre-term birth markets and are awaiting MHRA approvals, expected in Q3 2010. Combined revenues from the existing network could add £80k in FY11 revenues and £150k-£200k in FY12. There is potential for these two products to “open doors” for SHG in previously untapped NHS trusts.
- Demand from existing NHS clients, new client list additions and the expanded product range should lift organic growth to 5% in 2010-11. We expect SHG's operational gearing will translate into a greater net profit gain in FY 2011.
- Overall margin improvements should derive from the shift into diagnostic kits from the traditional mainstay, the lower margin “Condomania” range. On that point the C-Card for Condomania products introduced in Berkshire to make condoms more accessible for young people has added coverage to existing programmes in Bedford, Jersey and Newcastle.
- SHG's forthcoming trading update in May and preliminary results in August 2010 should be well received if recent trends persist. The update should point out growth in SHG's patient hygiene products, the personalised range of personal care items for hospital wards aimed at reducing patient infection risks.

Working capital pressures have abated

- Working capital pressures abated in 2009 helped by reducing losses and the July 2009 placing that raised £456.5k. The board have flagged a new raise of £250k at 2.5p (29th Jan 2010); with £110k already committed firm. Whilst the placing has yet to close, we estimate this should complete, assuming positive Plus Market conditions by end June 2010. The proceeds will be employed towards new hires, product investment and other working capital.
- SHG faces refinancing next summer as its bonds fall due. SHG has £106k in 9% CULS redeemable in July 2011 alongside an existing £146k loan note held by Sutherland “friends and family” redeemable in August 2011. Both bonds have conversion rights into ordinaries at the holder’s option at 2p per share.
- SHG potential new stock issuance in respect of its bonds (12.6m new shares) is an issue for holders given the impact on EPS – we expect a mixed ratio of conversion/ cash – outstanding share capital could rise to 67.6m at the maximum conversion, however otherwise SHG would need to hold £150k capital in a mixed ratio scenario. We welcome the refinancing as an opportunity to simplify SHG’s capital structure which has become complex.

SUMMARY

Recent progress is encouraging but has yet to result in a re-rating. SHG’s £1.23m valuation is modest and also reflects the CEO’s majority ownership. We have forecast EPS of 0.05p for FY2010 hence a forward P/E of 45x – a “recovery” multiple that should adjust if earnings normalise upwards in FY2011.

CSS forecasts FY2008 - FY2010

FY end March	2008A	2009A	2010E
Turnover (£k)	711.4	903.8	957
Cost of Sales	390.5	480.0	469
Gross Profit	320.8	423.8	488
Administrative Expenses	429.0	435.2	395
Distribution Expenses	37.6	52.9	54
Other Income	11.3	13.8	10
Operating Profit	-134.5	-50.5	49
Interest Expense	39.5	-31.4	23
Profit Before Tax	-174.0	-81.9	27
Taxation	-	-	-
Profit After Tax	-174.0	-81.9	27
EPS (p)	-0.51	-0.18	0.05
Shares o/s (m)	34.1	45.5	55.

A = Actual E = Estimated

Sutherland Health Group 1 year chart



ANALYST RATING DEFINITIONS:

BUY: A "buy" rating is applied to companies with established businesses that are profitable and where there is further profit growth expected. A "buy" recommendation means the analyst expects the share to appreciate by 20% or otherwise to reach the share price target on the note.

HOLD: The company's valuation appears to reflect investor expectations in the short-term. Alternatively the company is awaiting key developments that will impact on the share price. Investors are advised to await the resolution of these key developments.

SELL: The company's valuation appears too high having regard to material uncertainties, declining profit prospects or has sizeable funding requirements. A sell recommendation may also be applied where the board have failed in key objectives or appear to be frequently changing strategy. A sell recommendation means the analysts expects the shares to fall by up to 20% or to fall to the price target on the note or otherwise to underperform the FTSE All Share Index.

LONG :- The stock/ security is expected to appreciate to the targets within the short term

SHORT : The stock/security is expected to decline to expected targets within the short term

NEUTRAL (NR) Collins, Sarri Statham does not maintain a view in either direction

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Sutherland Health Group Relevant disclosures: N/A

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