Selector Funds Management Ltd
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In this quarterly edition we review performance and attribution. We discuss our stock selection process. We focus on obstructive sleep apnea specialist ResMed Inc. And finally we revisit government intervention. Photo. Whale migration coincides with reporting season in Sydney.

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Dear Investor,

During the past quarter we have witnessed something rather ironic. Despite ongoing financial deadlock in Europe, sluggish growth in the US and slowdown concerns in China, world markets are hitting new four month highs. The US Dow Jones Industrial index, the London FTSE, the German DAX and even our local All Ordinaries Index have marched upwards despite the backdrop of investor uncertainty. It's hard to draw too many conclusions other than to make the observation that focusing on what drives markets is in itself rather futile.

As we discuss further in our report, investors generally approach investing from two angles. Either they form a view on the world and then make decisions based on those views or alternatively they consider each investment on a case by case basis. The first approach is often referred to as top-down investing and the second, not surprisingly, is called bottom-up investing. For our part, Selector is a bottom-up funds management business. Our skill set lies in approaching any given investment idea on an individual basis so that a view can be formed on the merits of that business.

It is an approach that makes intuitive sense to us and importantly removes the market's noise from the process. Where this approach is particularly helpful is during times of market extremes, periods not dissimilar to the issues currently facing investors today. With so much anxiety out in the market, it's little wonder that investors still view cash as an asset class currently representing the best value for money. The only problem with this approach is that it is reactionary and as we noted in our June quarterly newsletter, globally, government bond yields are pushing near zero. It certainly doesn't strike us as being a logical, well thought out investment approach.

In this quarterly newsletter, we explain why bottom-up investing works for us and follow that up with a company review on obstructive sleep apnea group ResMed Inc. Having followed the fortunes of this business since its Australian listing in 1999, the group has carved out an impressive market position, providing tangible proof of the financial returns that can be generated when wonderful businesses marry up with sensible management teams. As we will explain further in the review, there is a lot of work required to make this all happen but fortunately for the investor, all that's really required is patience, a quality sorely lacking in today's market.

Finally, over the past quarter the Fund outperformed the general market, delivering a gross positive return of **11.62%** as compared to the **8.20%** rise in the All Ordinaries Accumulation Index. We are pleased with these results during a particularly difficult investment climate.

To all our investors we trust that you find the report informative.

Regards
Tony Scenna
Corey Vincent

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Quote

Wriston Lecture 1991 – Why Government is the problem (Milton Friedman)

"The point is that the actions that serve self-interest are very different in the private sphere than they are in the public sphere. The bottom line is different. If a group of people start an enterprise in the private sphere, it may be a success or it may be a failure. Most new enterprises are failures. If the enterprise were an obvious success, it would probably already be in existence. If the enterprise is a failure, that means it loses money. The people who own it have a very clear bottom line. To keep it going, they would have to dig into their own pockets. They are reluctant to do that, so they have a strong incentive either to make the enterprise work or to shut it down.

Suppose the same group of people have the same idea, start the same enterprise in the government sector, and the initial results are the same. It is a failure; it does not work. They have a very different bottom line. Nobody likes to admit that he has made a mistake, and they do not have to. They can argue that the initial failure was only because the enterprise was not on a large enough scale. More important, they have a much different and deeper pocket to draw on. With the best intentions in the world, they can try to persuade the people who hold the purse strings to finance the enterprise on a larger scale, to dig deeper into the pockets of the taxpayers in order to keep it going. That explains what is a very general rule: if a private enterprise is a failure, it is closed down—unless it can get a government subsidy to keep it going; if a government enterprise is a failure, it is expanded. I challenge you to find exceptions."

Performance September 2012

For the quarter ending September 2012, the Fund delivered a gross positive return of **11.62%** as compared to the **8.20%** rise in the All Ordinaries Accumulation Index. Performance statistics are detailed on page 20.

Performance table since inception

% Returns	Fund % Gross Return	All Ords Index %	All Ords Acc Index %
3 months	+11.62	+6.55	+8.20
1 Year	+24.10	+8.26	+13.36
3 years	+3.99	-2.40	+1.84
Since inception compound pa	+7.34	+1.93	+6.37

Top 10 September 2012*	Top 10 June 2012*
ARB Corporation	Campbell Brothers
Blackmores	Flight Centre
Carsales	IOOF Holdings
Flexigroup	IRESS
Flight Centre	News Corporation Inc
IOOF Holdings	Pharmaxis
IRESS	ResMed Inc
ResMed Inc.	SEEK
SEEK	SIRTeX Medical
SIRTeX Medical	WorleyParsons
Top 10 = 51.61%	Top 10 = 61.96%

*Listed in alphabetical order

Selector runs a high conviction index unaware stock selection investment strategy with typically 25-40 stocks chosen for the Fund. As shown above, the Fund's top 10 positions usually represent the great majority of its equity exposure. Current and past portfolio composition has historically been very unlike that of your average run-of-the-mill "index hugger" fund manager. Our stock selection to this point has not included either retail banks or the large resource companies, RIO and BHP. Our goal remains to focus on truly differentiated broad cap stock selection rather than the closet index hugging portfolios offered by most large fund managers.

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Performance attribution for the quarter

Top 5 stock contributors	%	Top 5 stock detractors	%
SIRTeX Medical	+3.19	Whitehaven Coal	-0.96
Flight Centre	+1.33	NRW Holdings	-0.77
ResMed	+1.31	Fleetwood Corporation	-0.22
Flexigroup	+1.27	Monadelphous	-0.14
Carsales	+1.09	Navitas	-0.12

The Fund benefited from a strong reporting season among its business investments. While markets value companies daily, according to investor sentiment, the true test of a business's worth is far more tangible and measureable. For that reason, reporting season is a wakeup call for investors and management alike. While we accept that the whole process of what management teams choose to report is subject to abuse, a little bit of due diligence quickly exposes the winners and the losers.

What we look for and what matters most to us when analysing any business, are a clean set of profit numbers, that are not subject to one-off items that distort the true earnings of the business, a solid cash flow statement that leaves more questions answered than unanswered, an improving balance sheet carrying little net debt and a focus on shareholder returns by way of rising earnings per share and dividend flows.

We might be asking for a great deal but that is what we are seeking and over time the great majority of our investments have done just that as reflected in the latest set of profit releases. By way of example, of the Fund's 23 business investments, 16 reported higher earnings, representing 76% of the Fund's total value of dollars invested. In terms of dividends, 78% of companies chose to pay out dividends that were either higher or equal to the previous year's payment. These are impressive statistics that speak volumes to their individual business achievements despite the economic backdrop of tougher conditions both locally and abroad. It should therefore come as no surprise that the Fund has performed particularly well during the past quarter.

A particular highlight during the period included SIRTeX Medical that continued to post impressive growth in dose unit sales for the treatment of liver cancer. Apart from enjoying increasing public awareness, the business has delivered top and bottom line growth over a number of years whilst maintaining a conservative balance sheet, carrying net cash of $49 million and paying fully franked dividends of ten cents for the 2012 year, up from seven cents. Investors who wish to re-visit this business can access our company review of SIRTeX, undertaken in our September 2009 quarterly newsletter review via our website.

Equally impressive have been the achievements of both Flight Centre, which delivered record net profits up 16.3% to $200 million and lifted full year dividends from 84 cents to $1.12 as well as medical device company ResMed Inc which is our feature business story in this quarterly. ***SFM***

Selector – our view of the investing world

If you apply your trade for long enough in any field of endeavour, your hope would be that it delivers some worthwhile outcomes. For some it may come in the form of a competitive edge in business, perhaps brand recognition or simply a greater appreciation of history. For our part, having spent our entire working lives applying our trade within the investment world, a knowledge of history counts for something. Our greatest asset is how we apply what we know, with what we have witnessed and the relevance extracted. Some call this experience, we simply call it applying the grey matter of lessons learnt.

In truth, history is only a guide. Past cycles are never the same although they are most similar during times of market turmoil or investor exuberance. This is where the grey matter counts most, at points of extremes.

During August 2012, Bill Gross the co-founder and co-chief investment officer of the world's largest bond fund – PIMCO – declared that the world was "witnessing the death of the equities cult". Founded in 1971 in Newport Beach California, PIMCO's growing presence on the global bond market stage has seen it become the world's largest and most influential bond fund manager, with assets under management exceeding US$1.8 trillion. In 2007, Bill Gross was named by Morningstar as Fixed Income Manager of the year for the third time and followed this up in 2010, when Morningstar awarded Gross the status of Fund Manager of the Decade award for the period 2000-2009.

PIMCO's: Bill Gross

In his most recent investment outlook review, Bill Gross started his piece with the following "The cult of equity is dying. Like a once bright green aspen turning to subtle shades of yellow then red in the Colorado fall, investors' impressions of stocks for the long run or any run have mellowed as well."

Gross backs up his views, looking back over one hundred years of history, highlighting why the past will not be repeated in the future. Rather than debate the merits of Gross's analysis, history has taught us not to jump to conclusions when markets are trading at extremes. Trying to conclude that equities are in a death spiral is a bridge too far and not because the logic and evidence behind this view is lacking but because humans are conditioned to extrapolate the most recent events into the future, be it good or bad.

In fact, history or more precisely humans, have a habit of repeating themselves. In August 1979, BusinessWeek magazine ran the cover story titled, "Death of Equities." The long list of reasons given as to why investors should brace themselves included this gem, "For better or for worse, then, the U.S. economy probably has to regard the death of equities as a near-permanent condition – reversible some day, but not soon." Such was its timing, that within a short period after publishing, equities began one of its strongest runs in history.

In our experience the media usually gets it wrong, and the pieces that get the most attention tend to be highly emotive, where the facts usually get in the way of a good story. It is also why many investors act in such a rear guard fashion, looking to exit when things are depressed but plunging in when prices are soaring.

Looking up rather than down

At Selector our investment approach is to look up rather than down. The industry has termed this bottom-up investing. The key premise is that we look to identify businesses that have the characteristics that we deem attractive, so as to warrant both our initial attention and perhaps ultimately making an investment as shareholders. We are in essence stock pickers, where the direction of markets and macroeconomic conditions are of secondary importance. It's not that we ignore these issues but consider the individual merits of a business and management team to be quite frankly, more important. Ultimately the decision to invest or not is made on a case by case basis, irrespective of whether markets are roaring or falling.

Selector's investment approach is thus all about the individual business. At the moment, all eyes are on China and the flow on impacts to our resources boom. Unfortunately the media is so obsessed with the potential fallout, that many companies just don't get a look in. And yet with over 2,000 listed Australian companies, it's easy to see why many remain off the investor's radar. Add to that, the desire of the many industry fund managers, who choose solely to track and mirror the stock index and you can understand why BHP Billiton, Rio Tinto and the four major banks get so much attention.

And quite frankly this is a situation that we relish. Great businesses reside in all pockets of commercial life. Some are considered for inclusion in the broader stock market index, the great many are not. Some are too small in market value to attract investor interest whilst others may have lost their way but are on the cusp of recovery. We don't play favourites. Our attitude is to cast the net far and wide with the aim of finding some great businesses. In this regard our attention is restricted to Australian listed businesses even though a great many now have significant operations extending offshore, earning considerable profits.

The selection process that allows us to determine which businesses are worthy of inclusion extends well beyond an adherence to a specific investment style. And yet most analysts feel they must choose between two investment approaches customarily thought to be in opposition, value and growth. If you are a value manager, the impression formed is of an investor who is both disciplined and buying cheaply whereas growth managers are viewed as lacking financial prudence, paying over the odds for a business's future earnings prospects.

Nothing could be further from the truth. In our opinion, the two approaches are joined at the hip and should be viewed as inseparable. Growth is always a component in the calculation of value. Identifying investments with valuations offering us a good margin of safety is just as important as those that can grow shareholder value well into the future.

At Selector our "value-based growth" approach is just that, one that aims to marry both sides of the investment spectrum. This is not a play on words, but reflective of our investment style that encapsulates how we view a business. Underpinning this approach are the four business qualities we seek in any investment opportunity considered;

1. Strongly aligned management team
2. Business with leadership qualities
3. Balance sheet, conservatively positioned
4. Shareholder returns treated with paramount importance

For those who are new to Selector and have not read our previous quarterly newsletters, it may surprise some to learn that of all the qualities considered, management is given the highest priority.

The reason why is straight forward. The most important management act is the allocation of a company's capital. It is the most important because capital over time determines shareholder value. Deciding what to do with the company's earnings – reinvest in the business or return money to shareholders is an exercise both in logic and rationality. If a company fails this hurdle it will invariably fail the shareholder. While most financial schools emphasis the importance of financial numbers as the key tool for financial success, the grey matter that we carry, reinforces our view that high quality managers sit above most financial metrics.

Those who may not agree with our thinking should closely consider some of the following examples. Why has building group Adelaide Brighton Cement delivered excellent results over the years whereas fellow competitor Boral struggles? Why has plumbing group Reece traversed the difficult housing industry environment while Fletcher Building has tripped up? Why has obstructive sleep apnea specialist ResMed Inc. (see article review) manoeuvred itself into such a powerful industry position while Fisher & Paykel Healthcare has lost ground? Equally, why has engineering group Monadelphous Group maintained financial discipline while larger competitor Leighton has shown such lax standards?

Good management does not come about by accident. There are those that embrace the responsibility whilst accepting the accountability that comes with the title and there are those that do not. In our experience if investors get this key aspect right, the chance that a more durable and transparent business emerges over time increase dramatically.

There are countless business examples that Selector has discussed over the years which perfectly fit this description. Some discussed in previous quarterlies include WorleyParsons (March 2009), SIRTeX Medical (September 2009), IRESS (March 2010), Blackmores (June 2010) and most recently Technology One (June 2012). The majority of these businesses do not get media coverage and too many remain unknown and undiscovered. This is how we like it because ultimately good performance gets discovered and rewarded. ***SFM***

ResMed Inc. (RMD)

Table 1: ResMed Inc. time line 1989 – 2012

Year	Event
1980	Professor Colin Sullivan & colleagues at University of Sydney provide first successful non invasive treatment of obstructive sleep apnea (OSA), commonly referred to as Continuous Positive Airway Pressure (CPAP).
1987	Baxter Centre acquires CPAP technology rights from University.
1989	Dr Peter Farrell via Rescare Group acquires technology rights relating to CPAP treatment and a CPAP device business from Baxter.
1993	“Wake up America” report to Congress in 1993, estimated that approximately 40 million individuals in the United States suffer from chronic disorders of sleep. Nomura Jafco invests in ResCare.
1994	ResCare incorporated as a Delaware Corporation. Net revenues US$13.8 million, pre tax earnings US$1.8 million.
1995	June - Company name changed to ResMed Inc. lists on Nasdaq, offering 2 million shares, raising US$24 million.
1998	Announces 2:1 stock split.
1999	Company transfers principal listing to New York Stock Exchange (RMD), establishes secondary listing on ASX.
1999	RMD completes 10th anniversary, opens new 120,000 square foot manufacturing and R&D facility in Sydney.
1999	Net revenues climb to US$88.6 million, earnings before tax US$24.5 million.
1999	November – begins trading on the New York Stock Exchange (NYSE), secondary listing on ASX, known as CDI’s and trading at a ratio of 10 CDI’s for each NYSE share.
1999	RMD releases the AutoSet T; a pre-emptive device that automatically adjusts air pressure to suit patient’s needs.
2000	Revenues exceed US$100 million for first time, announces 2:1 stock split, full time staff 625
2001	RMD acquires MAP Medizin Technologie GmbH for US$70 million, leading German designer, manufacturer and distributor of medical devices for treatment of sleep breathing disorders (SBD). German market second largest for OSA products.
2001	June – RMD issues five year US$180 million convertible subordinated notes to fund acquisition.
2002	RMD operates directly in 14 countries and additional 50 countries through a network of distributors.
2002	Revenue tops US$200 million, AutoSet Spirit launched worldwide, company buys-back 4 million company shares.
2004	Records 37th consecutive quarter of growth, revenue passes US$300 million, net profits exceed US$50 million for first time.
2005	Mirage Swift Nasal Pillows released, becoming company’s most successful product launch. New company flow generator platform S8 unveiled.
2006	USA health approval received for VPAP Adapt SV device to treat central sleep apnea. Revenues pass US$600 million, staff numbers exceed 2,500 and operations extends over 67 countries.
2007	Global sleep therapy market estimated at US$2billion, currently 10% penetrated.
2007	April – RMD announces total worldwide voluntary recall of 300,000 S8 flow generators at a cost of US$60 million.
2007	Aug - Internal executive Kieran Gallahue appointed new CEO, succeeding founder Peter Farrell.
2008	Net profits exceed US$100 million for first time.
2009	Company enters oral appliance market with acquisition of French dental sleep company Laboratories Narval.
2010	Launched products for home sleep testing market, released new S9 AutoSet flow generators.
2010	Revenues pass US$1.0 billion, research and development spend exceeds US$75 million.
2011	February – CEO Kieran Gallahue resigns as CEO, Peter Farrell resumes role as interim CEO.
2012	Revenues hit US$1.3 billion, net profits pass $US250 million, company starts payment of quarterly dividends.

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History

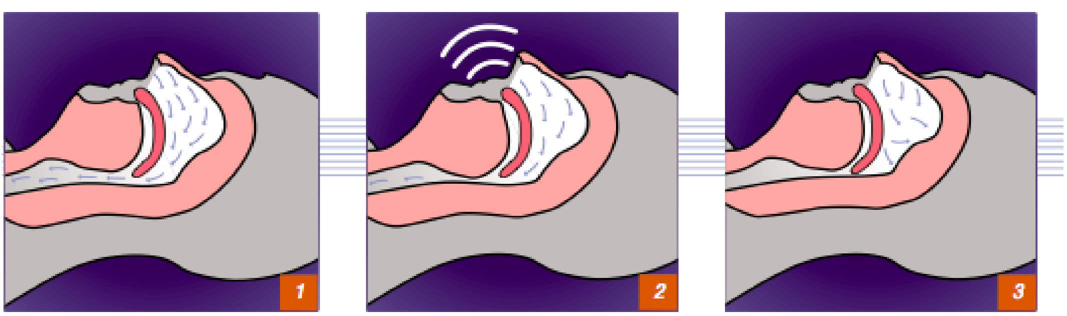
In the healthcare arena, Australia has given birth to a pretty impressive list of current global leaders. They include blood plasma group CSL, bionic hearing implant maker Cochlear, protective glove manufacturer Ansell and the focus of this review, sleep apnea specialist ResMed Inc. In many ways Cochlear and ResMed Inc. have travelled similar time paths. The technologies that underpin both businesses had their origins inspired by local inventors Professor Graeme Clark and Professor Colin Sullivan respectively. Since the 1980's both have forged a leading position in their respective healthcare field.

While Professor Sullivan and colleagues from Sydney University provided the first successful treatment for obstructive sleep apnea (OSA) in 1980, it took Dr Peter's Farrell's acquisition of the technology in 1989 to firmly establish the business case.

What is OSA?

People with OSA experience re-current episodes where respiratory airflow ceases during sleep. These episodes are due to a temporary collapse of the upper airway. This happens when the muscles, which normally hold the upper airway open during sleep **1**, relax and cause the airway to narrow **2**. If the throat is particularly narrow or the muscles relax too much, the airway can become completely blocked **3**. This is called an obstructive apnea.*

Diagram 1: OSA



* Source: ResMed Inc. annual reports

After a period of time, which may be anything from ten seconds to two minutes, the brain realises the level of oxygen in the blood is low and alerts the body to wake-up. Typically, the person subconsciously arouses from sleep, causing the throat muscles to contract and open the airway. Although the sufferer is often unaware of it, this cycle can occur several hundred times during six to eight hours of sleep. The main symptoms of OSA are heavy snoring, apneas, and excessive daytime sleepiness due to disrupted sleep. Other more serious consequences include depression, high blood pressure, serious heart conditions, sexual problems, memory lapses, intellectual deterioration, and morning headaches.

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How Does CPAP Work?

Like many great technologies, the actual science behind the Continuous Positive Airway Pressure (CPAP) treatment is rather simple. Patients are connected to a unit that delivers air pressure through a small nasal mask. Some describe the treatment method similar to how a vacuum cleaner works, only in reverse. The air pressure that is applied via the nasal passages, acts like an "air splint" to keep the upper airway open to prevent obstructive apneas. While the treatment path is not a cure, the growing patient and medical acceptance of this nightly routine has delivered a thriving business with annuity type revenues.

"Wake up America" report to Congress in 1993

Prior to CPAP, patients diagnosed with OSA were primarily treated with a tracheotomy, a surgical procedure to cut a hole in the patient's windpipe to create a channel for airflow. However a turning point for the OSA industry took effect with the release of the "Wake up America" report to US Congress in 1993, in which the National Commission on Sleep Disorders Research estimated that approximately 40 million individuals suffer chronic disorders of sleep apnea.

Birth of ResMed Inc.

In 1994, the commercialisation of sleep apnea began in earnest with Farrell registering the ResCare business in the US. A name change to ResMed Inc. in 1995 coincided with its listing on Nasdaq and the issuing of two million shares, raising US$24 million in new capital. In 1999, the company transferred its primary listing to the New York Stock Exchange (NYSE), along with a secondary listing on the Australian Stock Exchange (ASX).

ResMed Inc. lists on NYSE 30 September 1999

Table 1 provides a timeline of highlights covering the group's seventeen years of commercial progress. What is most apparent as you scroll through the years, is the market's rapid uptake of the group's products and services. **Table 2** outlines the financial performance, which captures as a starting point, the year 2000 to the current period. Denoted in US dollars, revenues have risen over tenfold from US$115 million to the current US$1.3 billion while operating earnings have kept pace from a starting point of US$33 million to US$303 million. At the same time, the company has invested heavily in maintaining product leadership via its commitment to research and development and highlighted further in the report.

Table 2: ResMed Inc. Financial Snapshot

US$'M	2000	2005	2006	2007	2008	2009	2010	2011	2012
Revenue	115.6	425.5	607.0	716.3	835.4	920.7	1,092.4	1,243.1	1,368.5
Operating Expenses	(37.0)	(298.1)	(437.7)	(515.0)	(624.0)	(666.1)	(770.6)	(873.4)	(955.9)
Research & Development	(8.5)	(30.0)	(37.2)	(50.1)	(60.5)	(63.1)	(75.2)	(92.0)	(109.7)
EBIT	33.1	97.4	132.1	151.2	150.9	191.5	246.6	277.7	302.9
NPAT	22.2	64.8	88.2	126.0	113.4	146.4	190.1	227.0	254.9
EBIT Margins (%)	28.6	22.9	22.8	22.1	19.0	21.6	23.3	23.2	23.2
Shareholders' Equity	93.9	474.1	738.1	931.2	1,081.8	1,115.2	1,287.5	1,730.7	1,607.6
Net Debt / (net cash)	(18.2)	32.1	(98.4)	(141.8)	(183.4)	(254.0)	(367.1)	(635.1)	(558.6)
Market Capitalisation	1,399	2,473	3,623	3,229	2,716	3,064	4,586	4,720	4,558
Enterprise Value	1,381	2,505	3,525	3,087	2,533	2,810	4,219	4,085	3,999
Buyout (%) **	2.4	3.9	3.7	4.9	6.0	6.8	5.8	6.8	7.6
ROCE (%) ***	43.5	19.2	20.6	19.1	16.8	22.2	26.8	25.3	28.9
GOCF / EBITDA (%)	61.0	57.0	55.0	44.0	81.0	98.0	86.0	95.0	110.0
Underlying EPS (¢)	18.4	43.2	57.1	80.5	74.6	97.2	126.1	148.9	174.5
PER	63.0	38.2	41.1	25.6	23.9	20.9	24.1	20.7	17.9
Dividend per share (¢)	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Dividend Yield %	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Share Price 30 June ($US)	11.60	16.50	23.48	20.63	17.87	20.36	30.41	30.95	31.20
Issued shares (m)*	120.6	149.9	154.3	156.5	152.0	150.5	150.8	152.5	146.1

* Adjusted for stock splits
** Buyout represents EBIT / EV as a percentage
*** ROCE = EBIT / (Shareholders Equity + debt – cash. Share price as at 30 June 2012

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Growing market opportunity

While many patients who suffer with OSA are unaware they have the condition, over the past decade a growing pool of evidence is giving rise to the significant long term consequences that “unhealthy sleep” has on people’s daily lives. The long list of serious health conditions includes obesity, both as a cause and a symptom of OSA, coronary disease, stroke, diabetes and hypertension. Such is the extent of the disease that it is estimated that one in five adults have some form of OSA. In the US, this gives rise to approximately 40 million adults, yet the lack of awareness among both the medical community and the general public has resulted in less than 20% of this group being treated or diagnosed thus far.

Sleep Clinics

Historically, patients diagnosed as suffering from OSA were referred by a general practitioner to a sleep specialist for further evaluation. Invariably this would involve a visit to a sleep clinic where the patient would be observed overnight. It is important to appreciate how this process is now changing and what it will mean for the industry players. Until very recently, the only viable option open to patients suspected of having a sleep disorder was the overnight stay, however the stigma and inconvenience of attending resulted in a large number avoiding the procedure altogether, thereby remaining undiagnosed.

The rising cost of US healthcare and technology advancements in new CPAP devices has led to an uptake in home sleep testing. Under this scenario, rather than being sent to a clinic for overnight observation, the general practitioner sends the patient home with a self titrating CPAP device. Whilst the use of sleep clinics will continue, the cost and convenience factors that support home sleep testing suggests a growing number of OSA diagnosed patients.

ResMed’s Inc. role

ResMed’s Inc. primary role is that of a developer, manufacturer and distributor of medical equipment for diagnosing, treating and managing sleep-disordered breathing. A growing public awareness of the illness that is OSA has seen ResMed Inc. lead the industry both in terms of innovation and market share. Importantly the company has re-invested heavily in designing flow generators that are smaller, quieter and masks that are more comfortable for the nightly wearer. The group does not sell to the end user but to home healthcare dealers and sleep clinics.

ResMed’s Inc. product suite

Patients diagnosed with OSA remain on therapy for life. While the nightly regime of fitting a facial mask connected to an airflow generator has obvious drawbacks for users, the long term health consequences of doing otherwise are now well documented. **Diagram 2** illustrates ResMed’s Inc. latest airflow generator the S9 AutoSet and some of the group’s extensive mask range. The requirement for users to replace masks regularly, provides ResMed Inc. with a highly attractive, annuity type revenue model in much the same way as the classic razor and blades business model.

Operations / Geographical coverage

From its startup position in 1994, the ResMed Inc. business has experienced enormous organic growth both financially and geographically. Today, ResMed Inc. products are sold in over 70 countries through a network of distributors and a direct sales force. As at June, employee numbers totaled 3,700, with 500 employed in research and development, 1,700 in sales and 1,500 in manufacturing. The biggest market contributor to group revenue remains the US market as outlined in **Table 3**.

Diagram 2

Mask range

Swift FX Nasal Pillow Mask

Quattro FX Nasal Mask

Quattro Full Face Mask

Airflow Generator range

The S9 AutoSet

Apnea Link Plus home sleep test device

While management is reluctant to discuss market share, industry analysts estimate levels in excess of 40% in both the domestic and offshore regions. Importantly, the company's share is more pronounced in masks. This segment of the business is the highest contributor to profits, where gross margins sit above 80% and where the replacement cycle contributes annuity type revenue.

Manufacturing is undertaken in both Sydney and Singapore. Management's preparedness to set up operations in Singapore is in many ways a reflection of the limited benefits provided to local manufacturers. The group's ability to maintain gross margins at circa 60% illustrates how successful management has been in growing the top line without comprising its contribution to profits.

Table 3: ResMed Inc. financial snapshot 2005-2012

Year	2005	2006	2007	2008	2009	2010	2011	2012
Group revenue (US$m)								
US	210.5	320.9	376.7	409.6	493.4	590.4	662.2	749.0
Germany	72.8	96.4	107.9	132.2	132.2	155.9	171.4	181.4
France	47.5	59.4	75.9	100.7	106.3	118.5	137.3	139.3
Australia	14.2	18.7	19.8	22.8	21.0	26.1	34.9	35.6
Rest of world	80.5	111.5	134.6	170.0	167.7	201.4	237.2	263.1
Total revenue	**425.5**	**606.9**	**714.9**	**835.3**	**920.6**	**1,092.2**	**1,243.0**	**1,368.4**
Product sales split								
Airflow generators	208.5	315.6	370.4	418.5	532.1	633.5	699.1	736.5
Masks	217.0	291.3	344.5	416.8	3885	458.7	543.9	631.9
Total product sales	**425.5**	**606.9**	**714.9**	**835.3**	**920.6**	**1092.4**	**1,243.2**	**1,368.4**
Group Net Revenue								
Cost of sales	150.6	230.1	272.1	338.5	366.9	436.9	501.8	547.8
Gross profit	274.9	376.9	384.5	493.7	553.8	655.5	741.3	820.7
Gross profit margin %	*64.6*	*62.2*	*53.8*	*59.1*	*60.1*	*60.1*	*59.6*	*60.0*
Expenses								
Selling, general, admin	135.7	200.1	237.3	278.1	289.9	328.9	371.2	401.6
Research & development	30.0	37.2	50.1	60.5	63.1	75.2	92.0	109.7
other	11.8	8.2	6.9	12.6	10.5	8.0	11.1	14.9
Total expenses	131.5	245.5	294.3	363.2	363.5	415.1	474.4	526.3
Net income	57.3	88.2	66.3	110.3	146.4	190.1	226.9	254.9
R&D / Revenue %	7.1	6.1	7.0	7.2	6.8	6.9	7.4	8.0

Research & development

Critical to that success, has been the commitment to research and development. As **Table 3** highlights, the company invests upwards of 8.0% of revenue on product development. During 2012, this amounted to $110 million, a not insignificant sum when compared to group profits of $255 million. However, the point is not necessarily to question the merit of the investment but to acknowledge that to date, it has provided the group with a compelling product offering in a market experiencing continued solid growth. It is a significant item in the company's cost of doing business line and appropriately the expenditure is totally written off as an expense during the course of the year.

Competitors

While the markets for the group's products are highly competitive, the number of direct players has declined over the past decade. Consolidation within the healthcare industry has resulted in a hand full of direct competitors namely Philips BV, DeVilbiss and Fisher & Paykel Healthcare. The gap

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between the two leading players, ResMed Inc. and Philips BV and the rest of the field is significant with an estimated combined market share of greater than eighty per cent. Interestingly, the Amsterdam based Philips BV arrived onto the scene in late December 2007, when it bought out medical equipment maker Respironics Inc. for 3.6 billion Euros (US$5.2 billion) in its largest ever acquisition. At the time, Respironics was ResMed's Inc. most direct and fiercest competitor and the offer represented a PER multiple of 36 times.

Capital Management

In our earlier article you may recall that we outlined four business qualities we seek when considering new investments namely;

1. Strongly aligned management team
2. Business with leadership qualities
3. Balance sheet, conservatively positioned
4. Shareholder returns treated with paramount importance

The last, surrounding shareholder returns is ultimately how we measure the long term worthiness of any investment. While a business can get overvalued by the market in the short run, over time a share price will largely reflect the company's underlying financial performance. An investor studying the share price action of ResMed Inc. as highlighted in **Graph 1** could conclude that things have been tough of recent years. Since peaking in mid 2010 at close to $4.00 per share the company's valuation has been heading south for some time, sliding below $2.50 in recent months.

Graph 1: ResMed Inc. ten year share price performance

Source: Business Spectator

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However as we have highlighted above, nothing could be further from the truth. In fact ResMed's most recent price action has more to do with lofty investor expectations and the multiple applied to the business than the business itself.

To be fair it hasn't always been that way. A period associated with significant capital investment coupled with difficult industry conditions led many to question the merit of investors ever receiving an adequate return on their investment. The growing pains of business, was reflected in high working capital requirements during the mid 2000's that constrained the group's free cash flow.

ResMed Inc. 2012

Fast forward to 2012 and management has the group well positioned and reaping the rewards of past investment. The ResMed Inc. business is hitting its straps and management should be roundly applauded. On almost every business metric ResMed Inc. is in good shape and the outlook is equally positive. The group has just reported record revenues of US$1.4 billion, net profits of US$254 million, invested over US$100 million in fully expensed research and development, declared its first dividend to shareholders at the rate of US17 cents per quarter (equal to full year dividend yield of 2%) and ended the year with over US$500 million net cash in the bank. At the micro level, gross margins are being maintained at 60%, free cash flow is on the up and capital expenditure is trailing the group's annual depreciation charge.

Not surprisingly the group's share price has responded and is trading close to all time highs. Looking out, there are perhaps three aspects of the business that give us confidence that should ResMed Inc. maintain its current financial discipline, years down the track investors will view today's share price as a wonderful entry point.

Firstly, the health issues surrounding OSA and awareness among clinicians continues to grow while the growing use of home sleep testing will undoubtedly lead to further patient awareness. Secondly, as a business, ResMed Inc. has reached a critical inflection point where its manufacturing scale and level of investment has allowed it to respond to competitive pressures and yet maintain improving returns on capital invested. The group's rising cash balance and commencement of dividend payments should be viewed as a sign of strength rather than a business hitting maturity. Finally, management has always invested with an eye to the future. The group's product range, particularly the current self titrating AutoSet airflow generator and its bevy of masks have enabled the business to maintain a competitive edge.

Apart from its initial capital raising, totaling just US$24 million, ResMed's inc. has achieved this success and the business that it has, without calling on shareholders for additional capital. Nothing is certain in life or investing but ResMed Inc. appears well prepared to meet both the challenges and opportunities that inevitably lie ahead. ***SFM***

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Tabcorp Holdings (TAH) – taking on the Victorian Government

The old adage you can run but you can't hide, might be wagering group Tabcorp's message to the Victorian Government. When Tabcorp floated back in 1994 under the previous Kennett Government, it agreed to pay $597 million for its wagering and gaming licence for a period extending out 18 years. The group raised at its listing, $675 million, with the bulk of the funds earmarked for the government. The government sponsored prospectus issued to the public, noted that the licences did not need to be amortised over the life of the 18 year period, thus allowing Tabcorp to report higher profits and thus be promoted as a high dividend paying business.

However for this to occur, the accountants signing off on the prospectus needed to be satisfied on how this licence payment should be treated in the company accounts. It was decided that the licence would be sold to Tabcorp on the basis that the company would be entitled to a refund at the end of the licence period – that being August 2012. That refund was to be paid irrespective of whether it successfully re-tendered for the licence or chose not to.

Time has a way of blurring the truth however a passage from the original Tabcorp prospectus in 1994 helps to explain the case that on expiry of the initial licence the company was entitled;

"whether or not it is the successful tenderer to receive an amount equal to the lesser of the sum paid for the new licences and a benchmark, which would be not greater than 115 per cent or less than 85 per cent of the sum paid for the initial licences."

Based on this refund formula Tabcorp now calculates that it is entitled to $686.8 million in compensation from the government. What gave rise to this claim was the former government's move in April 2008 to announce that it would not be renewing the gaming licences when they expired but would instead allow the state's pubs and clubs to own and operate their gaming machines. As such it formed the view that neither Tattersall's (also a gaming licence holder) nor Tabcorp were entitled to compensation.

And why do you think the John Brumby government took this view? Simple, by working on a technicality that no "new licences" were issued. In one stroke of the pen, the government which had recognised a liability to make payment for these licences in its budget papers between 1994 and 2008 took leave of its responsibilities.

The government will now have to defend itself in court, having auctioned the gaming machine entitlements in 2010 for $981 million to the state's clubs and pub owners. Tabcorp has in our opinion a very strong hand and in the fullness of time the government may rue the manner in which it avoided its responsibility to act in good faith to both shareholders and the people of Victoria who will be left with the clean up bill should the court's rule in Tabcorp's favour. Our original comment on this topic appeared in our June 2008 quarterly newsletter – titled "Governments – Perfecting the art of stealing" available on our website under the heading newsletters. ***SFM***

Company visit diary September Quarter 2012

July

MYX	Mayne Pharma Group management meeting	06/07/12
ILU	Iluka Resources	09/07/12
MLB	Melbourne IT management meeting	19/07/12
PXS	Pharmaxis quarterly conference call	18/07/12
SRX	SIRTeX Medical conference	18/07/12
IRE	IRESS management meeting	26/07/12
NVT	Navitas FY12 conference call	31/07/12

August

RMD	ResMed FY12 conference call	03/08/12
RFL	Rubik Financial management meeting	06/08/12
ANN	Ansell acquisition conference call	07/08/12
COH	Cochlear FY12 conference briefing	07/08/12
NWS	News Corp FY12 conference briefing	08/08/12
FXL	Flexigroup conference briefing	09/08/12
CWN	Crown FY12 conference briefing	10/08/12
JHX	James Hardie quarterly conference call	13/08/12
ANN	Ansell FY12 conference briefing	14/08/12
CRZ	Carsales.com FY12 conference briefing	14/08/12
DMP	Domino’s Pizza Enterprises FY12 conference briefing	14/08/12
EGP	Echo Entertainment FY12 conference briefing	15/08/12
ABC	Adelaide Brighton Cement HY12 conference briefing	17/08/12
REA	REA Group FY12 conference briefing	16/08/12
APN	APN News & Media H12 conference briefing	17/08/12
QBE	QBE Insurance Group HY12 conference briefing	17/08/12
SAI	SAI Global FY12 conference briefing	17/08/12
MCP	McPherson's FY12 conference briefing	20/08/12
FWD	Fleetwood Corporation FY12 conference briefing	20/08/12
MLB	Melbourne IT HY12 conference briefing	21/08/12
MND	Monadelphous Group FY12 conference briefing	21/08/12
SUL	Super Retail Group FY12 conference briefing	22/08/12
SEK	SEEK FY12 conference briefing	22/08/12
JIN	Jumbo Interactive FY12 conference briefing	22/08/12
IFL	IOOF FY12 conference briefing	23/08/12
WTF	Wotif.com Holdings FY12 conference briefing	23/08/12
IRE	IRESS HY12 conference briefing	24/08/12
CSL	CSL FY12 conference briefing	22/08/12
BBG	Billabong International FY12 conference briefing	27/08/12
CDD	Cardno FY12 conference briefing	27/08/12
ALL	Aristocrat Leisure HY12 conference briefing	28/08/12
FLT	Flight Centre FY12 conference briefing	29/08/12
PPT	Perpetual FY12 conference briefing	30/08/12

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WOR	WorleyParsons FY12 conference briefing	29/08/12
BKL	Blackmores FY12 conference briefing	31/08/12

September

APE	AP Eagers HY12 conference briefing	04/09/12
NHF	NIB Holdings FY12 conference briefing	05/09/12
DTL	Data#3 FY12 conference briefing	05/09/12
SGM	Sims Metal Group conference briefing	05/09/12
CTD	Corporate Travel Management FY12 conference briefing	10/09/12
IPD	Impedimed conference briefing	11/09/12
SRX	SIRTeX Medical FY12 conference briefing	12/09/12

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