Healthy prospects for Fisher & Paykel Healthcare
by Roger Montgomery

As the global commodity rout continues, investors are searching for sectors that can provide safe haven for their capital. Many are seeking exposure to the anticipated growth benefits of an ageing population, which has caused some healthcare stocks to trade at levels that are difficult to justify. Fisher & Paykel Healthcare (ASX: FPH) is one such company, whose NZ$8.50 share price is factoring in considerable earnings growth, but such is its prospects we feel the company may present reasonable value.

Based in New Zealand, Fisher & Paykel Healthcare is the market leader in the humidification of gases for patients requiring respiratory support. Humidification is particularly critical for patients requiring invasive ventilation, as the gases directly enter their lungs, bypassing the body’s natural respiratory system.

Historically, ventilator manufacturers provided their own humidification devices with their machines, yet the wide variety of patient needs made the standardisation of care difficult. With an exclusive focus on humidification, Fisher & Paykel Healthcare developed a device that was superior at delivering gases at optimal humidity. As Fisher & Paykel Healthcare’s device was embraced by hospitals, the ventilator manufacturers opted to partner with them rather than directly compete.

Over time, Fisher & Paykel Healthcare became the dominant humidifier in hospitals, providing a highly recurring revenue stream from the sale of consumables. Their business model is similar to the printing industry, where printers are sold on low margins to secure ongoing demand for high-margin ink cartridges. One humidifier typically treats 30 patients per year, and each unique use requires a new tube, water chamber and interface.

The recurring consumables model has provided Fisher & Paykel Healthcare with consistent revenue growth, but its dominance was constrained to the invasive ventilation market. Less critical patients that could breathe unassisted were typically treated with traditional oxygen therapy, which involved lower airflow and sub-optimal humidity. Lower sophistication also meant higher competition.

Yet clinical research is demonstrating the benefit of optimal humidity in lower acuity care, which is opening up a whole new market to the company. Patients that receive optimal humidification are showing higher tolerance to treatment, which is highly appealing for hospitals that are under pressure to reduce costs and improve recovery times.

Fisher & Paykel Healthcare estimates that for every invasive patient it treats, there are between three to five additional patients who could benefit from humidified oxygen therapy. The company is already entrenched in the hospital network, placing the sales force directly in front of the clinicians, who determine the administration of care. What’s more, the technological overlap across invasive ventilation and oxygen therapy means Fisher & Paykel Healthcare can market a range of oxygen therapy devices that are already proven in high-acuity care.

Management identified the strong potential in oxygen therapy many years ago when it built its first offshore manufacturing facility in Mexico. Such was the demand for its oxygen therapy products that management accelerated the expansion of the plant, and Mexico is now expected to produce half of the company’s consumables in the coming years.

Respiratory and Acute Care accounts for just over half of Fisher & Paykel Healthcare’s revenue. The company also sells devices that treat Obstructive Sleep Apnea (OSA), a condition that causes the airway to temporarily close during sleep and is linked to chronic diseases.
Fisher & Paykel Healthcare has leveraged its intellectual property in respiratory care to develop a highly successful mask range for sleep apnea sufferers. Its masks are gaining share against the two largest players in the market, Resmed (ASX: RMD) and Respironics. The Montgomery funds are invested in Resmed, as we consider its new flow generator is superior to the competition, and while Fisher & Paykel Healthcare plans to launch a new machine, management has recognised it’s in the company’s best interests to focus on consumables across both divisions.

The strategic focus on consumables, combined with the decision to shift production to lower cost environments and a weaker New Zealand dollar, is having a very positive effect on the company’s earnings. In the past four years, gross profit margins have expanded from 54.9% to 63.3%, and management expects margins to expand by 1% to 2% per annum in the coming years. With modest debt and strong cash flows, we believe Fisher & Paykel Healthcare is one of the highest quality companies on the Australian and New Zealand stock exchanges.

Such is the strength of the company’s research pipeline that management intends to release a new product across all patient groups in the coming 18 months. While oxygen therapy could provide strong growth for many years to come, management is already planning for the next horizon of growth by proving the benefit of humidification in new medical disciplines. Provided that management continues to execute successfully on their strategy, Fisher & Paykel Healthcare may justify, and even exceed, the growth implied by its current share price.

**Fisher & Paykel Healthcare (FPH)**

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