16 December 2014 │ pages  Health Care Technology & Distribution

Western Europe │ Denmark

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| Citi Research  Deep Dive | Equities |

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| **GN Store Nord (DKK)** | | | | | |
|  |  |  |  |  |  |
| **Year to 31 Dec** | **2012A** | **2013A** | **2014E** | **2015E** | **2016E** |
| Sales (DkrM) | 6,251.0 | 6,788.9 | 7,392.3 | 8,284.3 | 9,078.8 |
| Net Income (DkrM) | 491.2 | 775.9 | 875.5 | 1,028.3 | 1,201.3 |
| Diluted EPS (Dkr) | 2.72 | 4.59 | 5.33 | 6.50 | 7.91 |
| Diluted EPS (Old) (Dkr) | 2.72 | 4.59 | 5.33 | 6.50 | 7.91 |
| PE (x) | 47.3 | 28.0 | 24.1 | 19.8 | 16.2 |
| EV/EBITDA (x) | 23.4 | 16.3 | 15.0 | 13.5 | 12.1 |
| DPS (Dkr) | 0.49 | 0.84 | 1.02 | 1.31 | 1.68 |
| Net Div Yield (%) | 0.4 | 0.7 | 0.8 | 1.0 | 1.3 |

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| **Buy** | **1** |
| Price (15 Dec 14) | Dkr128.50 |
| Target price | Dkr158.00 |
| Expected share price return | 23.0% |
| Expected dividend yield | 0.8% |
| **Expected total return** | 23.8% |
| Market Cap | Dkr21,591M |
|  | US$3,614M |

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| Price Performance (RIC: GN.CO, BB: GN DC)Price Performance (RIC: GN.CO, BB: GN DC) |
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| --- |
| Justin Morris |
| +44-20-7986-4499 |
| justin.morris@citi.com |
| Eli Krieger |
| +44-20-7986-4235 |
| eli.lawrence.krieger@citi.com |
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| * Initiation of Coverage |

GN Store Nord (GN.CO)

MFi Advantage to Last to ’16-17E, UC to Accelerate Headsets: Buy

* **Initiate with a Buy and a DKr158 TP (+23.8% ETR)** — We believe that GN can deliver a FY14-17E sales CAGR of 9.8% and an EPS CAGR of 19.7%, supported by a DKr1bn (>4%) annual share buyback. GN’s wireless connectivity advantage in hearing aids (Made for iPhone, etc) should last until 2016-17E, while the increasing uptake of Unified Communications (UC) technology should accelerate growth and margin for its headset business, Netcom, in our view.
* **Our 2017E Netcom (headset) EBITA is 14% ahead of consensus** — We expect GN to gain further share in the UC headset market in 2015-16 due to a recent large contract win, driving a >25% UC sales CAGR and accelerating Netcom’s organic growth from 10% in 2014E to 14% in 2016E vs 12% consensus. Given we estimate that UC is accretive to Netcom’s margin and our expectation of a turnaround in the music-product margin following a portfolio optimization in 1H14, we forecast a turnaround in Netcom’s EBITA margin from 17.8% in 2014E to 20.3% in 2017E (150bp ahead of cons. at 18.8%).
* **Cautious on 1H15 margin** — While we are positive on the mid-term outlook for GN, we would caution that the company could continue to face margin headwinds from US$ strength in 1H15 (due to having hedged 1-yr fwd), before this reverses from 2H15. Further to this, there could be an ongoing headwind from a narrowing gap between R&D capitalisation and amortization, but we feel this is now better understood than with Sonova, given it was flagged by the CFO on the 3Q call.
* **PEG of 0.8x; recent de-rating largely factors in near-term risks** — GN is trading on 16.2x our 2016E adj. EPS, which is <1% above consensus, for an estimated 2014E-17E adj. EPS CAGR of 19.7% (PEG 0.8x) vs 13% for the sector (PEG 1.4x). This is a 9% P/E discount to the sector despite GN’s superior earnings growth, on our forecasts, and we therefore believe GN’s recent de-rating largely factors in near-term risks to margin and GN’s Costco Kirkland Signature contract.

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **GN.CO: Fiscal year end 31-Dec** | | | **Price: Dkr128.50; TP: Dkr158.00; Market Cap: Dkr21,591m; Recomm: Buy** | | | | | | | | | | |
| **Profit & Loss (Dkrm)** | **2012** | **2013** | | **2014E** | **2015E** | **2016E** |  | **Valuation ratios** | **2012** | **2013** | **2014E** | **2015E** | **2016E** |
| Sales revenue | 6,251 | 6,789 | | 7,392 | 8,284 | 9,079 |  | PE (x) | 47.3 | 28.0 | 24.1 | 19.8 | 16.2 |
| Cost of sales | -2,623 | -2,720 | | -2,860 | -3,199 | -3,506 |  | PB (x) | 4.0 | 4.0 | 3.9 | 3.8 | 3.6 |
| Gross profit | 3,628 | 4,069 | | 4,532 | 5,086 | 5,573 |  | EV/EBITDA (x) | 23.4 | 16.3 | 15.0 | 13.5 | 12.1 |
| Gross Margin (%) | 58.0 | 59.9 | | 61.3 | 61.4 | 61.4 |  | FCF yield (%) | 11.8 | 0.4 | 1.9 | 2.8 | 4.2 |
| **EBITDA (Adj)** | **960** | **1,376** | | **1,541** | **1,754** | **1,988** |  | Dividend yield (%) | 0.4 | 0.7 | 0.8 | 1.0 | 1.3 |
| EBITDA Margin (Adj) (%) | 15.4 | 20.3 | | 20.8 | 21.2 | 21.9 |  | Payout ratio (%) | 18 | 18 | 19 | 20 | 21 |
| Depreciation | -129 | -144 | | -169 | -170 | -181 |  | ROE (%) | 5.2 | 13.5 | 14.9 | 19.6 | 23.2 |
| Amortisation | 0 | 0 | | 0 | 0 | 0 |  | **Cashflow (Dkrm)** | **2012** | **2013** | **2014E** | **2015E** | **2016E** |
| **EBIT (Adj)** | **571** | **1,137** | | **1,230** | **1,528** | **1,753** |  | EBITDA | 700 | 1,281 | 1,399 | 1,699 | 1,933 |
| EBIT Margin (Adj) (%) | 9.1 | 16.7 | | 16.6 | 18.5 | 19.3 |  | Working capital | -131 | -342 | -93 | -205 | -184 |
| Net interest | -69 | -91 | | -105 | -110 | -118 |  | Other | 2,784 | -21 | -40 | -60 | -59 |
| Associates | 0 | 0 | | 0 | 0 | 0 |  | **Operating cashflow** | **3,353** | **918** | **1,267** | **1,434** | **1,691** |
| Non-op/Except | -41 | -23 | | -8 | 0 | 0 |  | Capex | -242 | -259 | -259 | -311 | -340 |
| **Pre-tax profit** | **461** | **1,023** | | **1,117** | **1,418** | **1,634** |  | Net acq/disposals | -15 | -141 | -34 | 0 | 0 |
| Tax | -140 | -288 | | -322 | -390 | -433 |  | Other | -377 | -571 | -610 | -557 | -527 |
| Extraord./Min.Int./Pref.div. | 0 | 0 | | 0 | 0 | 0 |  | **Investing cashflow** | **-634** | **-971** | **-902** | **-868** | **-868** |
| **Reported net profit** | **321** | **735** | | **795** | **1,028** | **1,201** |  | Dividends paid | -50 | -83 | -146 | -166 | -206 |
| Net Margin (%) | 5.1 | 10.8 | | 10.8 | 12.4 | 13.2 |  | **Financing cashflow** | **-2,776** | **55** | **-201** | **-566** | **-906** |
| Core NPAT | 491 | 776 | | 876 | 1,028 | 1,201 |  | **Net change in cash** | **-60** | **-6** | **163** | **0** | **-83** |
| **Per share data** | **2012** | **2013** | | **2014E** | **2015E** | **2016E** |  | **Free cashflow to s/holders** | **2,734** | **88** | **398** | **566** | **823** |
| Reported EPS (Dkr) | 1.78 | 4.35 | | 4.85 | 6.50 | 7.91 |  | **Segment Sales (DkrM)** | **2012** | **2013** | **2014E** | **2015E** | **2016E** |
| Core EPS (Dkr) | 2.72 | 4.59 | | 5.33 | 6.50 | 7.91 |  | CC&O - Netcom | 1,530 | 1,591 | 1,846 | 2,195 | 2,599 |
| DPS (Dkr) | 0.49 | 0.84 | | 1.02 | 1.31 | 1.68 |  | Mobile - Netcom | 825 | 1,019 | 1,019 | 1,126 | 1,182 |
| CFPS (Dkr) | 18.56 | 5.43 | | 7.72 | 9.06 | 11.14 |  | GN Netcom Total | 2,355 | 2,610 | 2,865 | 3,321 | 3,781 |
| FCFPS (Dkr) | 15.14 | 0.52 | | 2.43 | 3.58 | 5.42 |  | Hearing aids - ReSound | 3,423 | 3,636 | 3,951 | 4,327 | 4,630 |
| BVPS (Dkr) | 32.51 | 32.35 | | 33.30 | 33.91 | 35.23 |  | Diagnostics - ReSound | 473.0 | 543.0 | 576.0 | 636.5 | 668.3 |
| Wtd avg ord shares (m) | 179 | 167 | | 162 | 156 | 150 |  | GN ReSound Total | 3,896 | 4,179 | 4,527 | 4,963 | 5,298 |
| Wtd avg diluted shares (m) | 181 | 169 | | 164 | 158 | 152 |  | Group | 6,251 | 6,789 | 7,392 | 8,284 | 9,079 |
| **Growth rates** | **2012** | **2013** | | **2014E** | **2015E** | **2016E** |  |  |  |  |  |  |  |
| Sales revenue (%) | 12.3 | 8.6 | | 8.9 | 12.1 | 9.6 |  | **Segment Organic Growth** | **2012** | **2013** | **2014E** | **2015E** | **2016E** |
| EBIT (Adj) (%) | 8.8 | 99.1 | | 8.2 | 24.2 | 14.7 |  | CC&O - Netcom (%) | 5.0 | 12.0 | 16.6 | 15.9 | 18.4 |
| Core NPAT (%) | 38.1 | 58.0 | | 12.8 | 17.4 | 16.8 |  | Mobile - Netcom (%) | 11.0 | 27.0 | 0.7 | 7.5 | 5.0 |
| Core EPS (%) | 54.9 | 68.9 | | 16.1 | 21.8 | 21.7 |  | GN Netcom Total (%) | 7.0 | 18.0 | 10.4 | 12.9 | 13.8 |
| **Balance Sheet (Dkrm)** | **2012** | **2013** | | **2014E** | **2015E** | **2016E** |  | Hearing aids - ReSound (%) | 5.0 | 10.0 | 8.5 | 6.0 | 7.0 |
| Cash & cash equiv. | 169 | 163 | | 326 | 325 | 242 |  | Diagnostics - ReSound (%) | 13.0 | 10.0 | 1.4 | 7.0 | 5.0 |
| Accounts receivables | 1,349 | 1,520 | | 1,626 | 1,823 | 1,997 |  | GN ReSound Total (%) | 6.0 | 10.0 | 7.6 | 6.1 | 6.7 |
| Inventory | 471 | 592 | | 622 | 696 | 763 |  | Group (%) | 6.2 | 13.0 | 8.7 | 8.8 | 9.6 |
| Net fixed & other tangibles | 1,487 | 1,793 | | 1,974 | 2,140 | 2,264 |  |  |  |  |  |  |  |
| Goodwill & intangibles | 4,234 | 4,486 | | 4,643 | 4,734 | 4,805 |  | **Segment Adj. EBITA (DkrM)** | **2012** | **2013** | **2014E** | **2015E** | **2016E** |
| Financial & other assets | 489 | 409 | | 409 | 409 | 409 |  | GN Netcom | 362.0 | 472.0 | 509.3 | 611.4 | 733.0 |
| **Total assets** | **8,199** | **8,963** | | **9,601** | **10,128** | **10,481** |  | GN ReSound | 551.0 | 841.6 | 925.9 | 1,037.0 | 1,141.4 |
| Accounts payable | 485 | 493 | | 537 | 602 | 659 |  | Group | 831 | 1,233 | 1,372 | 1,583 | 1,808 |
| Short-term debt | 123 | 60 | | 660 | 1,260 | 1,560 |  |  |  |  |  |  |  |
| Long-term debt | 276 | 1,216 | | 1,216 | 1,216 | 1,216 |  | **Segment Adj. EBITA Margin** | **2012** | **2013** | **2014E** | **2015E** | **2016E** |
| Provisions & other liab | 1,773 | 1,864 | | 1,864 | 1,864 | 1,864 |  | GN Netcom (%) | 15.4 | 18.1 | 17.8 | 18.4 | 19.4 |
| **Total liabilities** | **2,657** | **3,633** | | **4,277** | **4,942** | **5,299** |  | GN ReSound (%) | 14.1 | 20.1 | 20.5 | 20.9 | 21.5 |
| Shareholders' equity | 5,542 | 5,330 | | 5,324 | 5,186 | 5,182 |  | Group (%) | 13.3 | 18.2 | 18.6 | 19.1 | 19.9 |
| Minority interests | 0 | 0 | | 0 | 0 | 0 |  |  |  |  |  |  |  |
| **Total equity** | **5,542** | **5,330** | | **5,324** | **5,186** | **5,182** |  |  |  |  |  |  |  |
| **Net debt (Adj)** | **230** | **1,113** | | **1,550** | **2,151** | **2,534** |  |  |  |  |  |  |  |
| Net debt to equity (Adj) (%) | 4.2 | 20.9 | | 29.1 | 41.5 | 48.9 |  |  |  |  |  |  |  |
|  | | | | | | |  |  |  |  |  |  |  |
|  | | | | | | | | | | | | | |
| dataCentralLogoFor definitions of the items in this table, please click [here](https://ir.citi.com/MaJ3ziwKjiWTly4vjc62JiGgqK5Sgds%2fbKRBMJh%2blyv1UWF%2fDQlIFWw3JanS%2bw6HE%2bRUyfPDclnK6osWoQc0nw%3d%3d). | | | | | | | | | | | | | |

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Investment Summary

## Initiate with a Buy and a DKr158 TP (+23.8% ETR)

We believe that GN can deliver a FY14-17E sales CAGR of 9.8% and an EPS CAGR of 19.7%, supported by a DKr1bn (>4%) annual share buyback. GN’s wireless connectivity advantage in hearing aids (Made for iPhone, etc) should last until 2016-17E, while the increasing uptake of Unified Communications (UC) technology should accelerate growth and margin for its headset business, Netcom, in our view.

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| Figure 1. GN Store Nord – Sales (DKrbn) and adj. EBITA margin |  | Figure 2. GN Store Nord – organic sales growth |
|  |  |  |
| Source: Company data, Citi Research estimates |  | Source: Company data, Citi Research estimates |

## Unified Communications to accelerate headset growth

Unified Communications (UC) is the integration of office communication services (email, telephony, audio/video conferencing) onto one common technology platform. When UC is deployed in an office, a far greater proportion of communication takes place through a computer and headset vs a desk phone. Hence, feedback from the key market participants suggests the average headset attachment rate for offices with UC is c40-45% vs <5% for those without UC.

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| Figure 3. Headset attachment rate significantly higher in UC equipped offices |
| |  |  | | --- | --- | | Office type | Headset attachment rate | | Office with UC | 40-45% | | Office without UC | <5% | |
| Source: Company data, Citi Research |

The UC market has been growing rapidly since the launch of Microsoft’s Lync in 2H10 as large corporates have increasingly adopted UC technology and we estimate that the UC headset market has grown at a c40% CAGR 2011-14E. Going forwards, we more conservatively forecast a 25% UC headset market CAGR 2014E-17E and expect GN to gain further share in the UC headset market in 2015-16 due to a recent large contract win, driving a >25% UC sales CAGR and accelerating Netcom’s organic growth from 10% in 2014E to 14% in 2016E vs 12% consensus.

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| Figure 4. UC headset market growth should remain strong (DKrbn) |  | Figure 5. Netcom UC sales (DKKmn) and market share assumptions |
|  |  |  |
| Source: Company data, Citi Research estimates |  | Source: Company data, Citi Research estimates |

Given we estimate that UC is accretive to Netcom’s margin and our expectation of a turnaround in the music-product margin following a portfolio optimization in 1H14, we forecast a turnaround in Netcom’s EBITA margin from 17.8% in 2014E to 20.3% in 2017E (150bp ahead of cons. at 18.8%).

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| Figure 6. GN Netcom – Sales (DKrbn) and adj. EBITA margin |  | Figure 7. GN Netcom – organic sales growth |
|  |  |  |
| Source: Company data, Citi Research estimates |  | Source: Company data, Citi Research estimates |

## Hearing aid share gains should last until at least 2016-17

We believe GN’s recent market share gains have been driven by the superiority of its wireless connectivity vs competitors as well as generally improved sound quality and better customer service. This has helped ReSound to gain share-of-wallet in large chains such as Amplifon and Costco as well as in independents and government channels such as the US Veteran’s Affairs (VA).

### GN holds unique ability to directly stream sound from iPhones, etc

Since the introduction of ReSound Alera in 3Q10, GN’s hearing aids have used 2.4GHz wireless connectivity – the same frequency as WiFi and Bluetooth. The relatively long range of 2.4GHz wireless enables users to stream sound directly from TVs, Hi-Fis, iPhones (since the launch of LiNX in 1Q14), etc to their hearing aids without the need for an intermediate wireless streamer/remote control as required in SOON’s and WDH’s devices, the wireless systems of which use magnetic wireless with a frequency of <15MHz as used in Telecoil systems, with a range of only c40cm.

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| Figure 8. GN ReSound – Key product launches vs hearing aid organic growth |
|  |
| Source: Company data, Citi Research estimates |

The fact that a streamer, which is usually worn around the neck, is not required improves ease-of-use and reduces the stigma of wearing a hearing aid. Moreover, the ability to stream sound directly from WiFi/Bluetooth devices has been shown in manufacturer surveys to be an attractive feature for end-users, particularly as a way for audiologists to attract first-time users in the 40-60 age bracket (albeit the magnitude of importance is disputed among the manufacturers).

### Industry standard wireless connectivity not due until 2016-17

We believe knowledge from GN’s headset division aided the development of 2.4GHz hearing aids, and competitors have struggled to achieve satisfactory battery-life with the technology and to incorporate the slightly larger antenna into an attractive product. Hence, GN’s main competitors have decided to work (along with GN) with the European Hearing Instrument Manufacturers Association (EHIMA) on the adoption of a standard Bluetooth Low Energy (LE) protocol. Feedback from the EUHA 2014 Congress suggests that this protocol is unlikely to be finalised until 2016-17, hence we believe GN should be able to continue to gain market share until at least this point in time.

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| Figure 9. Wholesale hearing aid market shares, 2013 |  | Figure 10. GN ReSound has gained c3-4ppts of market share since 2011 |
|  |  |  |
| Source: Company Reports, Citi Research |  | Note: Sonova data calendarised to Dec YE. Source: Company data, Citi Research estimates |

Valuation

### PEG of 0.8x; recent de-rating largely factors in near-term risks

GN is trading on 16.2x our 2016E adj. EPS, which is <1% above consensus, for an estimated 2014E-17E adj. EPS CAGR of 19.7% (PEG 0.8x) vs 13% for the sector (PEG 1.4x). This is a 9% P/E discount to the sector despite GN’s superior earnings growth, on our forecasts, and we therefore believe GN’s recent de-rating largely factors in near-term risks to margin and GN’s Costco Kirkland Signature contract.

### DKr158 target price assumes 5% discount to EU MedTech sector

To derive our DKr158 12-month target price on GN, we apply a 20x PE to our 12-month forward EPS at this time. This is a 5% discount to the EU MedTech sector’s ~21x 1-yr fwd PE valuation vs a 7% 5-yr average premium as, although we see above-sector sales and earnings growth for GN, we recognise its relatively weak FCF generation given current investments and also see greater risk to our forecasts given cyclical exposure in the Netcom headset business.

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| Figure 11. GN Store Nord – 1yr Fwd PE |  | Figure 12. GN Store Nord – 1yr Fwd. PE vs EU MedTech Sector |
|  |  |  |
| Source: FactSet, Citi Research |  | Source: FactSet, Citi Research |
| Figure 13. GN Store Nord – Stock price and consensus EPS revisions |  | Figure 14. YTD stock price performance of Hearing Care companies (rebased to EUR) |
|  |  |  |
| Source: FactSet, Citi Research |  | Source: FactSet, Citi Research |

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| Figure 15. European MedTech valuation table |
| |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | | **Company** | **Curr. price** | **PE** | | | | | **Prem/Disc.** | **EPS CAGR** | **PEG** | **EV/EBITDA** | | | | **Prem/Disc.** | **EV/Sales** | | | | **Sales CAGR** | **Dividend Yield** | | | | **FCF Yield** | | | | | **Eur. MedTech** |  | **2013A** | **2014E** | **2015E** | **2016E** | **2017E** | **2016E** | **14-17E** | **2016E** | **2013A** | **2014E** | **2015E** | **2016E** | **2016E** | **2013A** | **2014E** | **2015E** | **2016E** | **14-17E** | **2013A** | **2014E** | **2015E** | **2016E** | **2013A** | **2014E** | **2015E** | **2016E** | | Amplifon SpA | 4.86 | 46.0x | 27.9x | 21.4x | 17.8x | 15.7x | 0% | 21.2% | 0.8x | 10.9x | 9.8x | 8.7x | 7.9x | -25% | 1.6x | 1.5x | 1.4x | 1.3x | 5.2% | 0.9% | 0.9% | 1.0% | 1.1% | 4.9% | 5.2% | 5.7% | 6.4% | | Coloplast\* | 501.5 | 38.1x | 32.7x | 28.5x | 24.9x | 22.1x | 40% | 13.9% | 1.8x | 23.5x | 21.2x | 18.9x | 16.9x | 61% | 8.5x | 7.9x | 7.1x | 6.6x | 9.0% | 2.1% | 2.4% | 2.8% | 3.3% |  |  |  |  | | Elekta\* | 77.00 | 22.7x | 21.7x | 18.7x | 16.4x | 16.3x | -8% | 10.0% | 1.6x | 13.0x | 12.6x | 11.4x | 10.3x | -2% | 2.9x | 2.7x | 2.4x | 2.3x | 7.0% | 2.4% | 2.7% | 2.9% | 3.1% |  |  |  |  | | Essilor | 85.83 | 29.4x | 27.7x | 24.7x | 21.6x | 19.5x | 21% | 12.3% | 1.8x | 17.5x | 15.9x | 14.2x | 12.8x | 22% | 4.0x | 3.6x | 3.3x | 3.0x | 9.5% | 1.1% | 1.2% | 1.3% | 1.5% | 2.4% | 4.3% | 4.4% | 4.8% | | Fresenius\* | 42.20 | 21.7x | 20.8x | 18.0x | 15.8x | 14.1x | -11% | 13.9% | 1.1x | 9.3x | 8.9x | 7.9x | 7.2x | -31% | 1.8x | 1.6x | 1.4x | 1.3x | 7.3% | 1.0% | 1.1% | 1.2% | 1.3% |  |  |  |  | | Fresenius Medi\* | 59.25 | 19.6x | 21.1x | 18.7x | 16.9x | 15.3x | -5% | 11.1% | 1.5x | 9.1x | 9.1x | 8.4x | 7.8x | -26% | 1.8x | 1.7x | 1.6x | 1.5x | 7.1% | 1.0% | 1.2% | 1.3% | 1.4% |  |  |  |  | | Getinge\* | 166.3 | 14.1x | 16.2x | 13.5x | 11.9x | 9.1x | -33% | 21.2% | 0.6x | 9.3x | 10.7x | 8.9x | 8.1x | -23% | 2.2x | 2.1x | 2.0x | 1.9x | 5.8% | 2.5% | 2.3% | 2.7% | 2.9% |  |  |  |  | | GN Store Nord | 128.5 | 28.0x | 24.1x | 19.8x | 16.2x | 14.0x | -9% | 19.7% | 0.8x | 16.8x | 15.0x | 13.2x | 11.6x | 11% | 3.4x | 3.1x | 2.8x | 2.5x | 9.8% | 0.7% | 0.8% | 1.0% | 1.3% | 0.4% | 1.8% | 2.7% | 4.1% | | Grifols A\* | 30.54 | 23.2x | 19.0x | 17.4x | 15.7x | 13.9x | -12% | 10.8% | 1.5x | 14.2x | 12.2x | 11.6x | 10.8x | 3% | 4.8x | 3.9x | 3.7x | 3.5x | 6.1% | 1.6% | 1.7% | 2.0% | 2.3% |  |  |  |  | | Grifols B\* | 25.66 | 19.5x | 15.1x | 13.4x | 11.7x | 10.7x | -34% | 12.3% | 1.0x | 14.2x | 12.1x | 11.5x | 10.4x | -1% | 4.7x | 3.9x | 3.6x | 3.4x | 5.8% | 1.9% | 2.2% | 2.6% | 3.2% |  |  |  |  | | Nobel Biocare\* | 17.15 | 40.8x | 33.4x | 27.9x | 23.9x | 19.7x | 34% | 19.4% | 1.2x | 22.3x | 20.0x | 17.6x | 15.9x | 51% | 3.6x | 3.6x | 3.4x | 3.2x | 5.9% | 1.1% | 1.5% | 1.7% | 1.8% |  |  |  |  | | Smith & Nephew\* | 10.29 | 21.1x | 19.8x | 17.8x | 16.0x | 14.5x | -10% | 10.9% | 1.5x | 7.6x | 8.1x | 7.2x | 6.5x | -38% | 2.4x | 2.3x | 2.1x | 2.0x | 6.1% | 2.3% | 1.8% | 2.0% | 2.2% |  |  |  |  | | Sonova Hldg | 138.4 | 27.8x | 25.5x | 22.4x | 20.3x | 18.5x | 14% | 11.2% | 1.8x | 20.9x | 16.9x | 15.0x | 13.7x | 31% | 4.7x | 4.3x | 3.9x | 3.7x | 7.0% | 1.3% | 1.5% | 1.7% | 2.0% | 3.4% | 3.4% | 3.8% | 4.5% | | Straumann\* | 241.8 | 34.2x | 28.6x | 24.0x | 21.0x | 18.2x | 18% | 16.4% | 1.3x | 23.6x | 21.1x | 16.5x | 14.4x | 37% | 5.4x | 5.3x | 4.4x | 4.0x | 12.1% | 1.6% | 1.6% | 1.7% | 1.9% |  |  |  |  | | William Demant | 431.6 | 18.6x | 18.1x | 15.9x | 14.1x | 12.4x | -21% | 13.5% | 1.0x | 13.5x | 13.6x | 12.5x | 11.4x | 9% | 3.0x | 2.9x | 2.7x | 2.5x | 6.9% | 0.0% | 0.0% | 0.0% | 0.0% | 2.9% | 3.8% | 4.0% | 5.0% | | **Weighted Avg.** |  | **25.1x** | **23.0x** | **20.1x** | **17.8x** | **15.9x** |  | **13.0%** | **1.4x** | **14.1x** | **12.9x** | **11.6x** | **10.5x** |  | **3.7x** | **3.3x** | **3.1x** | **2.8x** | **7.5%** | **1.4%** | **1.5%** | **1.7%** | **2.0%** |  |  |  |  | |
| Note: Priced 15 Dec 2014. Calendarised data. E = Citi Research estimates, except for names marked \* for which consensus data used. Source: Powered by dataCentral |

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| Figure 16. Hearing Care Valuation Table |
| |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | | **Company** | **Curr. price** | **PE** | | | | | **Prem/Disc.** | **EPS CAGR** | **PEG** | **EV/EBITDA** | | | | **Prem/Disc.** | **EV/Sales** | | | | **Sales CAGR** | **Dividend Yield** | | | | **FCF Yield** | | | | | **Hearing Care** |  | **2013A** | **2014E** | **2015E** | **2016E** | **2017E** | **2016E** | **14-17E** | **2016E** | **2013A** | **2014E** | **2015E** | **2016E** | **2016E** | **2013A** | **2014E** | **2015E** | **2016E** | **14-17E** | **2013A** | **2014E** | **2015E** | **2016E** | **2013A** | **2014E** | **2015E** | **2016E** | | Amplifon SpA | 4.86 | 46.0x | 27.9x | 21.4x | 17.8x | 15.7x | 0% | 21.2% | 0.8x | 10.9x | 9.8x | 8.7x | 7.9x | -25% | 1.6x | 1.5x | 1.4x | 1.3x | 5.2% | 0.9% | 0.9% | 1.0% | 1.1% | 4.9% | 5.2% | 5.7% | 6.4% | | Cochlear Ltd | 72.88 | 34.4x | 32.0x | 25.9x | 23.6x | 22.4x | 33% | 12.6% | 1.9x | 23.0x | 21.4x | 17.6x | 15.8x | 51% | 5.6x | 5.1x | 4.6x | 4.3x | 8.0% | 3.5% | 3.0% | 2.7% | 3.0% | 1.6% | 2.4% | 2.8% | 3.3% | | GN Store Nord | 128.5 | 28.0x | 24.1x | 19.8x | 16.2x | 14.0x | -9% | 19.7% | 0.8x | 16.8x | 15.0x | 13.2x | 11.6x | 11% | 3.4x | 3.1x | 2.8x | 2.5x | 9.8% | 0.7% | 0.8% | 1.0% | 1.3% | 0.4% | 1.8% | 2.7% | 4.1% | | Sonova Hldg | 138.4 | 27.8x | 25.5x | 22.4x | 20.3x | 18.5x | 14% | 11.2% | 1.8x | 20.9x | 16.9x | 15.0x | 13.7x | 31% | 4.7x | 4.3x | 3.9x | 3.7x | 7.0% | 1.3% | 1.5% | 1.7% | 2.0% | 3.4% | 3.4% | 3.8% | 4.5% | | William Demant | 431.6 | 18.6x | 18.1x | 15.9x | 14.1x | 12.4x | -21% | 13.5% | 1.0x | 13.5x | 13.6x | 12.5x | 11.4x | 9% | 3.0x | 2.9x | 2.7x | 2.5x | 6.9% | 0.0% | 0.0% | 0.0% | 0.0% | 2.9% | 3.8% | 4.0% | 5.0% | | **Weighted Avg.** |  | **28.3x** | **25.0x** | **21.2x** | **18.8x** | **17.1x** |  | **13.9%** | **1.4x** | **18.6x** | **16.2x** | **14.2x** | **12.9x** |  | **4.1x** | **3.8x** | **3.5x** | **3.2x** | **7.5%** | **1.3%** | **1.3%** | **1.4%** | **1.6%** | **2.6%** | **3.2%** | **3.6%** | **4.4%** | |
| Note: Priced 15 Dec 2014. Calendarised data. E = Citi Research estimates. Source: Powered by dataCentral |

Company Overview

### Innovative player in the hearing care market, with a strong position in the office and mobile headset market through its Jabra brand.

GN Store Nord (GN) is a leading manufacturer of hearing aids and hearing diagnostics equipment and of headsets for use in Contact Centres & Offices (CC&O) and with mobile/cell phones through its Jabra brand.

We estimate than GN is #4 in the wholesale of hearing aids with a c14% market share, #2 in hearing diagnostics with a c23% share and #2 in the CC&O headset market with a 26% share (c46% in Unified Communications), and has a c14% share in mobile headsets.

GN is operated as two separate business units, with a CEO for each segment of the company, a CFO with duties across both businesses and an active Chairman to help drive synergies in R&D (Bluetooth connectivity, etc) and the supply chain. Its hearing aid division, GN ReSound, accounted for 62% of sales in 2013 and its headset division, GN Netcom, for 38%.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Figure 17. GN Store Nord – Sales by business\* |  | Figure 18. GN Store Nord – EBITA by segment\* |  | Figure 19. GN Store Nord – Sales by region\* |
|  |  |  |  |  |
| \*2013 Source: Company data, Citi Research |  | \*2013 Source: Company data, Citi Research |  | \*2013 Source: Company data, Citi Research |

GN was founded in 1869 as the Great Northern Telegraph Company. It entered the hearing aid market with the acquisition of Danish hearing aid manufacturer Danavox in 1977 and created its headset business as a spin-off from Danavox in 1986.

### Failed sale of ReSound to Sonova caused significant disruption

In October 2006 GN decided to sell its hearing care division ReSound to Sonova for DKK15.5bn. However, the sale was blocked as unlawful by the German cartel authorities (Bundeskartellamt) in November 2007 and GN’s financial performance suffered significantly as a result of the disruption caused by the failed sale (management departures, R&D projects cancelled during integration).

### Appeal for €1.1bn compensation could be granted in 1H15

In December 2010, GN filed claim for €1.1bn in compensation for the loss caused by the Bundeskartellamt’s prohibition. This was dismissed by the Dusseldorf Court of Appeal in March 2014 but in May 2014 GN decided to appeal the decision to the German Federal Supreme Court and expects permission to appeal to be granted in 1H15. While we do not assume a successful outcome, given the politically unpopular headlines such compensation might generate in Germany, we would expect GN to use any proceeds to extend its share buyback programme. The full €1.1bn in damages is equivalent to c.37% of GN’s market cap (12 Dec 2014).

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| Figure 20. GN Store Nord – Sales (DKrbn) and adj. EBITA margin |  | Figure 21. GN Store Nord – Organic sales growth |
|  |  |  |
| Source: Company data, Citi Research estimates |  | Source: Company data, Citi Research estimates |

### SMART has sustainably improved EBITA margin by c4ppts

In November 2010 GN set a target to increase sales to >DKK6.3bn and double its EBITA margin to c19% by 2013. This was largely achieved (2013A sales DKK6.8bn, EBITA margin 18.2%) despite significant market scepticism at announcement. The key driver of GN’s margin improvement was ReSound’s “SMART” programme, initiated in February 2012. This achieved DKK265-290mn in savings (c4ppts of margin) vs 2011 as GN:

* Offshored further production to China,
* Simplified its supply-chain and logistics,
* Reduced SKUs,
* Turned-around or disposed of underperforming businesses.

The latter point included the sale of Indian hearing aid retail to Amplifon (3Q12) and the disposal of online headset distributor Hello Direct (1Q13). Performance in GN’s operations in Germany and France, where the company has especially low market share due in part to disruption from the failed sale of ReSound to Sonova, has also improved (despite GN losing its contract with the retailer Kind in 4Q13) following management changes. However, we believe there is still considerable scope for improvement relative to other geographies.

## 2014-16 strategy shifted focus towards growth

Having successfully completed the SMART programme, GN announced its 2014-16 strategy in November 2013, which aims to drive strong top-line growth through an increase in the company’s focus on commercialisation (sales and marketing) and innovation (R&D). In our view, margin targets suggest a relatively moderate improvement in GN’s EBITA margin over the period as these additional investments absorb some of operating leverage and ongoing efficiencies that management believes it can find in the business.

Specifically, for ReSound the company expects to grow sales organically >3ppts above hearing aid market growth (GN expects this in the 1-4% over the period), while generating an EBITA margin in-line with its top-tier competitors (est. c20-25% vs 20.1% in 2013A). For Netcom, GN expects to sales to grow >10% p.a. organically while maintaining an EBITA margin of 18-19% (2013A 18.1%).

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| Figure 22. GN Store Nord – 2014-16 financial targets |
| |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | |  | **Organic revenue growth (2014-16 average)** | **EBITA Margin** | **ROIC** | **Tax Rate** | **Net debt** | | GN ReSound | >3ppts above market growth | In line with top-tier competitors | Increase >4ppts from 14 - 15% in 2013 |  |  | | GN Netcom | >10% | 18 -19% | >55% |  |  | | GN Store Nord |  |  |  | 26-27% | 1-2x EBITDA | |
| Source: Company data, Citi Research (assumes exchange rates as of 1 November 2013 (DKK/USD ~ 550) until end 2016 |

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| Figure 23. GN Store Nord – 2014 guidance |
| |  |  |  |  |  | | --- | --- | --- | --- | --- | | DKKmn | Organic  revenue growth | EBITA\* | Profit before tax | Effective tax rate | | GN ReSound | >7% | >880 |  |  | | GN Netcom | 11% | >515 |  |  | | Other |  | c -155 |  |  | | GN Store Nord | >8% | >1,240 | >1,110 | c29% | |
| Note: \* EBITA includes DKr95mn of costs for evaluating a potential large acquisition within “Other”. Source: Company data, Citi Research |

GN ReSound (62% of sales, 64% of EBITA)

## EBITA margin should expand despite investments

GN’s hearing care business, ReSound generated 87% of sales from hearing aids and 13% from its hearing diagnostics business (Otometrics) in 2013. The business has a relatively strong share in North America, due largely to its Beltone franchise network (acquired in 2000) and due to the ReSound brand’s roots in the US (GN acquired ReSound in 1999).

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| --- | --- | --- |
| Figure 24. GN ReSound – Revenues by business\* |  | Figure 25. GN ReSound – Revenues by region\* |
|  |  |  |
| \*2013. Source: Company data, Citi Research |  | \*2013. Source: Company data, Citi Research |

As detailed previously, ReSound’s “SMART” restructuring programme led to a marked improvement in the business’ EBITA margin during 2012-13 and the company now targets a margin in-line with its top-tier competitors (i.e. WDH and SOON) in 2014-16. We believe that in practice the target range is c20-25%, with the lower end being ReSound’s and WDH’s consolidated EBITA margin in 2013 and the upper end being SOON’s mid-term target Group EBITA margin.

While the top end of this range is theoretically achievable, given GN’s lower exposure to margin-dilutive retail (discussed further on p12), in our view, we believe that achieving a 25% EBITA margin would likely come at the expense of top-line growth. We note that GN ReSound’s 2014-16 strategic initiatives clearly signal additional investments into the business to maintain recent market share gains:

* Increase marketing and sales efforts
* Gain preferred supplier status
* Grow GN Otometrics into new channels and offerings
* Accelerate innovative R&D

In addition, we believe GN’s smaller scale vs SOON and WDH must also be taken into account (we estimate 14% wholesale mkt. share vs 26% and 20%, respectively). Hence, we believe GN could move towards the middle of this range and forecast a ReSound EBITA margin of 21.5% in 2016E.

|  |  |  |
| --- | --- | --- |
| Figure 26. GN ReSound – Sales (DKrbn) and adj. EBITA margin |  | Figure 27. GN ReSound – Organic sales growth |
|  |  |  |
| Source: Company data, Citi Research estimates |  | Source: Company data, Citi Research estimates |

## Hearing aids (54% of Group sales)

GN ReSound has a comparatively high market share in the US as it was built-up through the acquisitions of the US-based ReSound and Beltone brands (acquired in 1999 and 2000, respectively). On a worldwide basis, ReSound branded hearing aids account for c75% of units, Beltone >20%, with others (Interton, Danavox) <5%. R&D is shared between brands, with Beltone hearing aids essentially being rebranded ReSound products, while Interton and Danavox are “value” brand.

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| Figure 28. GN ReSound – Hearing aid brands and positioning |
| |  |  | | --- | --- | | Brand | Positioning | | ReSound | ReSound is the premium wholesale brand in the GN ReSound Group, sold in >80 countries worldwide | | Beltone | Beltone is recognised as the retail brand (franchise) and in markets where differentiation is required it is also a complementary premium brand in addition to the ReSound brand. Beltone is sold in more >50 countries worldwide | | Interton | Interton is the value brand in the Group and is sold in >70 countries worldwide | |
| Source: Company data, Citi Research |

### Limited vertical integration into owned retail…

GN generates a much lower proportion of hearing aid sales through owned retail operations than its main listed competitors (we estimate c.3% vs c.30% for SOON and WDH). Owned retail is generally margin-dilutive due to a high fixed-cost base and low productivity (the average audiologist sells only c1 hearing aid per day).

The company believes its strengths are as an innovative manufacturer of hearing aids and not as a retailer and also does not wish to be seen to compete with its wholesale customers as this has occasionally led to customer losses for SOON and WDH. On occasion, however, GN is pressured to acquire retail operations if a significant wholesale customer is coming up to retirement and a competitor looks set to acquire the account (eg GN’s acquisition of Dansk HoreCenter in Sep 2013).

### …but Beltone franchise network shores-up US market share

We estimate that the Beltone franchise system, which sells only Beltone branded hearing aids through >1,500 stores, accounts for c40% of US sales (which are booked as per wholesale revenues). GN has close to 100% share-of-wallet in the Beltone network and, given this cannot be accessed by competitors, we believe it offers an under-appreciated defensive quality to GN’s US business.

## iPhone connectivity a driver of market share gains

We believe GN’s recent market share gains have been driven by the superiority of its wireless connectivity vs competitors as well as generally improved sound quality and better customer service. This has helped ReSound to gain share-of-wallet in large chains such as Amplifon and Costco as well as in independents and government channels such as the US Veteran’s Affairs (VA).

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| --- | --- | --- |
| Figure 29. Wholesale hearing aid market shares, 2013 |  | Figure 30. GN ReSound has gained c3-4ppts of market share since 2011 |
|  |  |  |
| Source: Company data, Citi Research |  | Note: Sonova data calendarised to Dec YE. Source: Company data, Citi Research estimates |

Since the introduction of ReSound Alera in 3Q10, GN’s hearing aids have used 2.4GHz wireless connectivity – the same frequency as WiFi and Bluetooth. The relatively long range of 2.4GHz wireless enables users to stream sound directly from TVs, Hi-Fis, iPhones (since the launch of LiNX in 1Q14), etc to their hearing aids without the need for an intermediate wireless streamer/remote control as required in SOON and WDH’s devices, the wireless systems of which use magnetic wireless with a frequency of <15MHz as used in Telecoil systems, with a range of only c40cm.

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| --- |
| Figure 31. GN ReSound – Key product launches vs hearing aid organic growth |
|  |
| Source: Company data, Citi Research estimates |

The fact that a streamer, which is usually worn around the neck, is not required improves ease-of-use and reduces the stigma of wearing a hearing aid. Moreover, the ability to stream sound directly from WiFi/Bluetooth devices has been shown in manufacturer surveys to be an attractive feature for end-users, particularly as a way for audiologists to attract first-time users in the 40-60 age bracket (albeit the magnitude of importance is disputed among the manufacturers).

## Technological advantage should last until at least 2016-17

We believe knowledge from GN’s headset division aided the development of 2.4GHz hearing aids and competitors have struggled to achieve satisfactory battery-life with the technology and to incorporate the slightly larger antenna into an attractive product. Hence, GN’s main competitors have decided to work (along with GN) with the European Hearing Instrument Manufacturers Association (EHIMA) on the adoption of a standard Bluetooth Low Energy (LE) protocol. Feedback from the EUHA 2014 Congress suggests that this protocol is unlikely to be finalised until 2016-17, hence we believe GN should be able to continue to gain market share until at least this point in time.

## New VA contract – GN should maintain share gains

Sonova’s market share at the US Department of Veterans Affairs (c20% of the US market) has fallen from 56% in August 2013 to 43% in October 2014, on our estimates. This has been driven largely by Sonova having to rein back sales of the Phonak brand and attempt to substitute with the Unitron brand due to a cap inserted in the previous VA contract (expired of Oct ’14) that stipulated that a maximum of US$500mn of hearing aids could be bought from one supplier over the 5yr term of the contract (of note the new 5yr contract has a US$1.5bn limit).

### Losing share gains would reduce hearing aid sales by <1%

We estimate Sonova lost sales of cCHF18mn over the period of August 2013 to October 2014, assuming market share would have remained around 56% in the absence of the cap, and that GN gained >25% of the share lost by Sonova, equivalent to cUS$5mn/DKK27mn of sales.

However, we believe that innovation drove some of its share gains, given GN’s market share jumped >3ppts in May following the LiNX MFi hearing aid launch and that it is therefore likely to maintain most of the share it has gained during this period. Indeed data from November (the first months of the new contract) show that GN’s share increase 20bp MoM to 12.3%, while Sonova’s fell 80bp MoM to 42%. New entrant to the VA Widex gained 80bp share in its first month.

In a bearish scenario of Sonova’s VA market share returning the 56% level under the new contract, this would be a c70bp headwind to GN’s annualized hearing aid sales.

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| Figure 32. Sonova has lost VA market share, while GN has gained |
|  |
| Source: US Department of Veterans Affairs data, Citi Research |

## Upcoming Amplifon and Costco hearing aid contracts:

### GN has c3% of EPS at risk but only c1% probability-weighted

The upcoming contracts at large retail chains Amplifon and Costco were the subject of much discussion at the recent EUHA industry conference given their importance to the hearing aid manufacturers.

If GN were to retain its Costco Kirkland Signature (KS) contract and win the Amplifon Miracle-Ear contract by the end of 1H15, we estimate this would be c3% accretive to annualised EPS, while, given our assumption that GN has a 50% chance of retaining the KS contract and only a 10% chance of winning the Miracle-Ear contract, we estimate just over 1% EPS dilution on a probability-weighted basis.

|  |
| --- |
| Figure 33. Combined Miracle-Ear and Kirkland Signature contract sensitivity by company |
| |  |  |  |  | | --- | --- | --- | --- | | Annualised impact to adj. EPS | GN | SOON | WDH | | Probability adjusted scenario | **-1.1%** | 0.5% | 0.8% | | Best case scenario (Win both) | **3.2%** | 2.7% | 4.0% | | Worst case scenario (Lose both) | **-2.8%** | 0.0% | 0.0% | |
| Source: Citi Research estimates |

***Please see text below and the Appendix for a full breakdown of our assumptions and calculations.***

### Miracle-Ear contract announcement due by end of 1Q15

Announcement of the outcome of the Miracle-Ear contract is likely at the end of 2014 or by the end of 1Q15. We estimate that the Miracle-Ear contract is currently worth >US$50mn per annum. The contract was last renegotiated in 2010 and was won by Siemens and we assume that the contract will again be for a 3-5yr term. As the incumbent, we assume for the purposes of our analysis that Siemens has a 50% chance of retaining the contract (EQT Partners announced in November 2014 that it intends to acquire Siemens’ hearing aid business, which is likely to elevate pressure on the business to regain a key contract), while GN only has a 10% chance given it already has c1/3 share of wallet in Amplifon and we believe it is unlikely that AMP would want to further concentrate its supply base. Lastly, we assume WDH and SOON have a 20% chance each of gaining the contract.

### Costco contract announcement due by end of 2Q15

We expect the announcement of the result of Costco’s Kirkland Signature (KS) private-label hearing re-tender during 1H15, with sales under the new contract beginning in 2H15. We estimate that the KS contract is currently worth >US$35mn per annum. The contract was last re-negotiated two years ago, with GN gaining the contract from Siemens. As the incumbent, we assume GN has a 50% chance of retaining the contract, while Siemens has only a 10% chance of winning it back after having been replaced previously. We assume WDH and SOON have a 20% chance each, given both are already suppliers to Costco with their own brands (Bernafon and Phonak, respectively).

### Cochlear deal unlikely to be a significant contributor

In August 2011, GN announced a technology development and license agreement with Cochlear, whereby Cochlear will adopt GN’s 2.4GHz wireless technology in its implants. While the exact structure of the agreement of unknown, we understand from GN that the deal is unlikely to be a significant contributor even once further products are launched.

### Ability to use ReSound hearing aids with COH implants a positive

In late 2013, the first Cochlear product with 2.4 GHz technology, the Baha 4 Sound Processor, was successfully launched. This has been followed by wireless accessories for COH’s N6 CI processor (US FDA approval September 2014). It is therefore now possible to use a Resound Wireless hearing aid and the Cochlear N6 speech processor in a bimodal configuration with synchronized audio signals. This could encourage COH implant users with an N6 processor and a hearing aid on the contralateral ear (albeit a relatively small population in the scheme of the hearing aid market) to choose ReSound over other manufacturers.

## Hearing Diagnostics (8% of Group sales)

Otometrics develops, manufactures and markets computer-based hearing and balance assessment instrumentation as well as hearing aid fitting systems under the MADSEN, AURICAL, HORTMANN and ICS brands. Products are sold in >70 countries worldwide.

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| Figure 34. GN Otometrics has four diagnostic instrument brands |
| |  |  | | --- | --- | | MADSEN | AURICAL | | HORTMANN | ICS | |
| Source: Company data, Citi Research |

### We expect mid-single-digit diagnostic growth over medium term

The hearing diagnostic instrument market is worth around USD425mn, according to William Demant, and has been consolidating from a highly fragmented base as WDH has acquired a number of manufacturers (notably Amplivox and Grason Stadler in 2008-09) and both WDH and GN have acquired distributors in the past couple of years. GN Otometrics has outperformed WDH’s Diagnostic Instruments business since 2012, driven by an upgraded and expanded product portfolio but we would expect both companies to grow organically at a mid-single-digit pace over the medium term, slightly above market growth as they continue to take share from smaller players.

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| Figure 35. Hearing diagnostics market shares, 2013 |  | Figure 36. GN has outperformed WDH in diagnostics 2012-14E |
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| Source: Company data, Citi Research |  | Source: Company data, Citi Research estimates |

### 3D Ear Scanner has potential but business model unclear

In November 2012, GN acquired the global rights to manufacture and sell a 3D ear scanner (now named OTOSCAN) developed by US-based 3DM Systems within the hearing aid industry for US$12mn (cDKK69mn). The technology has the potential to significantly simplify the current industry standard of designing customised in-the-ear (ITE) hearing aids and ear moulds for behind-the-ear (BTE) hearing aids, which entails making a silicone impression of the patient’s ear followed by physical shipment to the manufacturer or ear mould lab to scan the impression into a table-top scanner.

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| Figure 37. OTOSCAN 3D Earscanning |
| http://earscanning.com/wp-content/uploads/2014/03/1.jpg |
| Source: GN Store Nord |

GN has had some teething issues in finalising the technology, hence we believe it may miss its target of launching in 2014. The commercial model is also unclear, with the most likely route being to give the scanner free in return for a minimum committed volume of scans charged on a fee-per-scan basis.

However, ITE instruments account for only c20% of the market, with this share shrinking slightly in recent years, and it may be that only large audiology practices can commit the required volumes for GN to earn a sufficient return on the scanner. The scanner could also benefit GN’s ITE sales as it has a below-average market share in this form of instrument, but the extent to which this benefit might materialise is unclear given the scanner will be an open system, with scans also being able to be used to order competitor ITE devices.

### Synergies exist in both R&D and distribution

Synergies between hearing devices and diagnostic instruments come in the form of audiology know-how (R&D) and designing of hearing aid fitting systems. Distribution benefits arise as audiologists use diagnostic instruments in retail outlets. In the case of a retail acquisition, sales synergies are relatively slowly realised as replacement cycles for diagnostic instruments are in the five- to 10- year range.

### Diagnostics has greater EM exposure

Diagnostics are also sold to ear, nose and throat (ENT) clinics and hospitals, which in turn provide a distribution link to paediatric and super-power hearing aid users and hearing implant patients. This link is especially important in the emerging markets as many EM countries (eg China) are building out hearing care and reimbursement initially just for these profoundly deaf patients, given the greater health-economic benefits. As such the diagnostic business has greater exposure to the emerging markets than the hearing aid business.

GN Netcom (38% of sales, 36% of EBITA)

## Unified Communications to accelerate Netcom’s growth

GN’s headset business, GN Netcom, generated 66% of its sales from headsets for Contact Centres & Offices (CC&O) and 34% from its Mobile headset and speakerphone business in 2013. Headsets in both businesses are sold under the high-end Jabra brand. GN acquired US-based Jabra in 2000 and brought all products under the brand in 2009.

Netcom has a significantly higher exposure to Europe than ReSound, at 50% of sales, which we believe is largely explained by Plantronics’ extremely strong position in its domestic US market.

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| Figure 38. GN Netcom – Revenues by business, 2013 |  | Figure 39. GN Netcom – Revenues by region, 2013 |
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| Source: Company data, Citi Research |  | Source: Company data, Citi Research |

### Underappreciated high ROIC business

Netcom’s margin improved dramatically in 2010 following the completion of the FAST restructuring programme, which considerably simplified its supply chain. All of Netcom’s production was outsourced to China, with most components sourced in Asia (Netcom currently works with c10 production partners and over 100 subcontractors). In addition, the mobile headset business moved to a configure-to-order business model, with a single logistics centre based in Asia. The CC&O headset business has maintained regional warehouses (US, Europe and Asia) in order to maintain high service levels. R&D is conducted at two facilities in Ballerup, Denmark, and in Xiamen, China.

The supply chain transformation greatly reduced the amount of working capital required, while allowing greater scalability and flexibility. In 2013 Netcom delivered an ROIC (EBITA/Invested Capital) of 64.7% and is aiming to remain >55% over 2014-16. Free Cash Flow conversion (FCF/EBITA) has also been strong in 9M14, at 93%, due to Netcom’s asset-light set-up and further working capital improvements.

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| Figure 40. GN Netcom – Sales (DKrbn) and adj. EBITA margin |  | Figure 41. GN Netcom – Organic sales growth |
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| Source: Company data, Citi Research estimates |  | Source: Company data, Citi Research estimates |

## Margin should recover to top 18-19% target range

As GN considers Netcom’s set-up to be efficient, its focus is on growing the top line. Over 2014-16 GN’s Netcom’s target is to grow sales >10% p.a. organically while maintaining an EBITA margin of 18-19%, in line with 18.1% in 2013.

As can be seen in Figure 40, Netcom has historically demonstrated significant operating leverage, with strong organic growth (Figure 41) also translating into substantial margin improvement during 2010-13, aided by measures taken in the FAST restructuring programme. Indeed, the EBITA margin continued to expand in 2012 and 2013 despite significant gross margin pressure (see Figure 42).

However, as with the ReSound business, GN’s 2014-16 strategy signaled an intention to increase investments in Netcom to benefit top-line growth, which has pressured the margin in FY14E (combined with gross margin pressure in the Mobile business, as described in more detail below). Key measures include:

* Increasing marketing and sales efforts
* Key market initiatives (North America and China)
* Deepening and broadening customer focus
* Strengthening online presence, including digital marketing
* Broadening music product portfolio

While we see merit in investments into the CC&O business, which has structural growth drivers within Unified Communications and a significantly higher EBITA margin than the Mobile business (est. 24% vs 6% in 2014E), we are concerned about the potential margin dilution from over-investing into the competitive music product market. We take comfort that management recognises this risk from the refocusing of its music product portfolio in 1H14.

### Gross margin pressure was caused by Mobile business

We believe pressure on Netcom’s gross margin was caused by the increasing weight of Mobile headsets in 2012-13 (aided by China banning the use of mobile phones whilst driving in Jan 2013), which are sold at an ASP of cUS$35 vs US$60-70 for office headsets. In 2014 this continued due to a refocus of Mobile’s music product portfolio, which we believe should reverse in 2015E as this process is finalised.

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| Figure 42. GN Netcom – Gross margin pressure from significant from Mobile business 2012-14E should abate going forwards |  | Figure 43. GN Netcom – Sales mix |
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| Source: Company data, Citi Research estimates |  | Source: Company data, Citi Research estimates |

### UC margin-accretive, on our estimates…

We believe there may be a misperception in the market that pressure on Netcom’s gross margin has been caused by the significant growth in Unified Communications (UC) headsets, given management commentary that UC ASPs are below those for Traditional CC&O Headsets. However, despite the c10% discount (cUS$60-70) to traditional CC&O headsets (cUS$65-75), we estimate that the UC gross margin is still above the Netcom average, given dilution from Mobile headsets (ASP cUS$35, as discussed above).

Furthermore, this accretion may be higher at the EBITA level as UC sales have scale benefits, in our view, as they tend to be sold at a higher volume per contract as many corporates are currently rolling-out firm-wide UC installations.

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| Figure 44. GN Netcom gross margin breakdown |
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| Source: Citi Research estimates |

### …and the growth driver for the business on our forecasts

Given the above and our >25% sales CAGR for Netcom’s UC headset business 2014-17E (discussed in more detail below) vs our relatively pessimistic forecasts for the mobile headset business, we forecast a turnaround in Netcom’s EBITA margin to 19.4% in 2016E – slightly above the company’s 18-19% target range in its 2014-16 strategy.

## CC&O Headsets (23% of Group sales)

### Duopolistic market

The Contact Centres & Offices (CC&O) headset market was worth around US$1.1bn in 2013 (DKK5.6bn), on our estimates, with around 80% of the market being controlled by GN Netcom and US-based competitor Plantronics (PLT). Other notable competitors include Logitech and Sennheiser Communications, although they appear to have been unsuccessful thus far in taking significant share away from GN and PLT.

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| Figure 45. Contact Centre & Office headset market shares, 2013 |  | Figure 46. CC&O headset market growth has improved due to UC |
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| Source: Company data, Citi Research |  | Note: Plantronics rebased to DKK for comparability with GN Netcom. Source: Company data, Citi Research |

### Barriers to entry underappreciated

Being a B2B market, we believe that barriers to entry are higher than many market participants appreciate as business telephony and software providers (eg Microsoft, Cisco and Avaya) employ rigorous headset certification processes to ensure that compatible headsets work seamlessly and do not adversely effect user experience. In addition, headset manufacturers need to build and maintain relationships with system integrators (IT consultants), who also play an important role in recommending which manufacturers’ headsets to deploy across an organisation. GN believes that its proximity to customers and ability to provide customized solutions has been key to its recent CC&O market share gains (see Figure 49).

### Netcom has preferred supplier status with UC software providers

Netcom has obtained preferred supplier status among all of the largest suppliers of UC software and solutions, being Microsoft (Lync, etc), Cisco (Jabber, etc) and Avaya (Aura, etc). Indeed, during 2013 GN Netcom was appointed a Cisco “Preferred Solution Developer”, the highest ranking within the Cisco Developer Network, as the only B2B headset supplier.

### UC deployment to drive up office headset attachment rates

Unified Communications (UC) is the integration of office communication services (email, telephony, audio/video conferencing) onto one common technology platform. When UC is deployed in an office, a far greater proportion of communication takes place through a computer and headset vs a desk phone. Hence, feedback from the key market participants suggests the average headset attachment rate for offices with UC is c40-45% vs <5% for those without UC.

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| Figure 47. Headset attachment rate significantly higher in UC equipped offices |
| |  |  | | --- | --- | | Office type | Headset attachment rate | | Office with UC | 40-45% | | Office without UC | <5% | |
| Source: Company data, Citi Research |

Importantly, UC also represents an attractive proposition for corporates as communication is simplified and efficiency improved by the ability to see whether an employee is in the office, travelling, offline, etc. and for employees to automatically redirect calls to their headsets when travelling (eg via mobile/cell phone or laptop). According to Frost & Sullivan, 80% of all companies deploying UC achieve a payback period of less than two years.

### We forecast a 25% UC headset market CAGR 2015-18

The UC market has been growing rapidly since the launch of Microsoft’s Lync in 2H10 as large corporates have increasingly adopted UC technology and we estimate that the UC headset market has grown at a c40% CAGR 2011-14E. Going forwards, GN expects the UC headset market to grow at a 30% CAGR 2014-16, while competitor Plantronics expects a 38-40% CAGR 2013-18.

We more conservatively forecast a 25% UC headset market CAGR 2014E-17E as we caution that the CC&O headset market could slow somewhat in the event of an economic slowdown, leading corporates to revise their capital expenditure plans (see 2008-09). Within CC&O, we think UC should be relatively sheltered vs traditional CC&O, given the short payback period mentioned above.

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| Figure 48. UC headset market growth should remain strong (DKrbn) |  | Figure 49. Netcom UC sales (DKKmn) and market share assumptions |
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| Source: Company data, Citi Research estimates |  | Source: Company data, Citi Research estimates |

### GN should be able to take UC market share over 2015-16

We estimate that GN will have c45% UC market share in 2014E, having gained market leadership from Plantronics in 4Q13 and grown 36% organically in 9M14. Given large recent contract wins (see below), we think GN could gain further share in 2015-16 due to a recent large contract win (see below) but then assume some share loss, given the potential for new entrants or for Logitech and Sennheiser Communications (part-owned by William Demant) to gain some momentum in the market. Nevertheless, this implies a >25% UC sales CAGR 2014-17E and, given the increasing weight of UC sales, we believe Netcom’s organic CC&O growth could accelerate from 10% in 2014E to 14% in 2016E (see Figure 41).

### 200k UC contract win should help sustain growth in 2015-16

Netcom won the largest contract in its history in July 2014. The contract is for c200,000 headsets for a financial institution’s global UC implementation, which we believe is likely to be fulfilled over 2015-16. Assuming an ASP of US$60, we estimate the contract could be worth $12mn (cDKK72.5mn), equivalent to 7% of 2014E UC sales or 2.5% of 2014E total Netcom sales.

### US court case against Plantronics could change market dynamics

In 2012, GN Netcom filed suit against Plantronics for “attempted monopolization of the distributors’ market in the US”. In Sep 2013, the federal district court in Wilmington, Delaware, dismissed Plantronics’ motion to dismiss the case in its entirety. The court also stated that GN Netcom’s allegations were sufficiently substantiated to allow the case to proceed into discovery. The discovery phase commenced in mid-November 2013 and has been extended into 1Q15.

Furthermore, GN believes that Netcom’s CC&O headset business “has significant potential to increase its market shares with distributors where its presence is fundamentally under-represented” and that “growth traction in North America may be positively influenced by the legal measures that GN Netcom is taking against Plantronics.” Hence, a successful outcome to the suit could represent upside to our Netcom forecasts

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| Figure 50. GN Netcom’s market position is much weaker in the US than in Europe |
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| Note: GN data LTM to Mar 14 (we assume same regional split as in 2013) Source: Company data, Citi Research |

Plantronics reported total US sales of US$475mn in its FY14 (YE Mar), whereas GN Netcom’s total North American sales were cUS$155mn, on our estimates. By comparison, Plantronics reported US$195mn sales in EMEA in its FY14 vs cUS$240mn in Europe for GN Netcom, on our estimates.

## Mobile Headsets (15% of Group sales)

### Cyclical, fragmented market

Netcom’s Mobile business addresses the consumer headset and speakerphone market. Products are sold globally via multiple channels, including mobile operators, telecom retailers, consumer electronics channels and mass market retailers.

The mobile headset market is far more fragmented and competitive than the market for office headsets, with an ASP roughly half that of the latter, at cUS$30-35. Key competitors besides Plantronics include Sony, Nokia, Samsung, Motorola, Bose and Sennheiser. GN believes it is market leader in the key growth market of China.

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| Figure 51. Mobile headset (excl. music) market shares, 2013 |  | Figure 52. Mobile headset market more cyclical than CC&O |
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| Source: Company data, Citi Research |  | Note: Plantronics rebased to DKK for comparability with GN Netcom. Source: Company data, Citi Research |

### Business was expended into music products in 2012-13

Having expanded the business beyond mobile headsets into music headsets and Bluetooth speakers in late 2012 (eg Jabra Revo, Jabra Vox and Jabra Solemate), GN now believes the business’ addressable market has doubled to cDKK13bn (US$2.3bn) vs cDKK6.5bn previously (US$1.2bn). During 2013, GN believes the market segment where music and voice integrate grew by >40%, driven primarily by a doubling of the Bluetooth speaker market.

### Mobile profitability should recover on music product refocus

However, GN’s market share in this expanded portion of the market is only c1% and stiff competition in products where GN did not have a technological edge pressured Netcom Mobile’s EBITA margin in 1H14 as GN sold off inventory of some of the less successful music launches (eg Bluetooth speakers) from 2013 at reduced prices.

Going forwards we expect the company to focus on innovative products such as the Jabra Sport Pulse Wireless headset (launched Oct 2014). This headset, which tracks the user’s heart rate and has integrated training management via the Jabra Sport Life app, has received positive online reviews, and sells for a significantly higher ASP than the current Mobile average (US$200 vs the US$30-35 average).

We estimate the Mobile business achieved only a 3-4% margin in 1H14 vs the high-single-digit margin achieved by in 2013 (albeit aided by China banning the use of mobile phones whilst driving, which led to c40% organic growth in mobile headsets for GN in 1H13). However, now that GN has had an opportunity to refocus towards products where it has had greater success, we believe the Mobile business’ profitability should recover, with the first signs of this seen in 3Q14 as the Mobile business was a key factor behind Netcom’s gross margin improving to 54.7% (+180bp YoY) vs 51.8% in 2Q14 (-130bp YoY).

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| Figure 53. Netcom Mobile EBITA margin should recover on music product refocus |
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| Source: Company data, Citi Research estimates |

### US e-commerce platform launched July 2014, offers margin upside

As part of the increase in its marketing efforts, Netcom aims to make the Jabra brand more visible by positioning it as “the wireless company”, while digital marketing will become a more integrated part of the marketing initiatives as it believes that online sales will account for >50% of the market for its Mobile business vs c20% in 2013.

In July 2014, Netcom launched a consumer focused e-commerce platform in the US for the Jabra brand, which while currently a small part of the business could offer margin upside to the Mobile business given that profitability is not given away to online intermediaries, who can take up to a 50% retail markup.

# Management

### Recent management changes raise execution risks

The CEOs of both GN ReSound and GN Netcom have changed during 2014. Given the strong turnaround of both segments under previous management over the last five years, we believe this raises the risk of executing on GN’s 2014-16 strategy (announced under previous management but maintained to date).

Anders Hedegaard (b. 1960) has been **CEO of GN ReSound** since August 2014, having replaced Lars Viksmoen (CEO since March 2010), who decided to step down to change his work-life balance but will continue to work with the GN strategy committee. Mr. Hedegaard was previously CEO of biotech company Bavarian Nordic A/S from 2007-14.

Niels Svenningsen (b. 1964) has been **CEO of GN Netcom** since January 2014, having replaced Mogens Elsberg (CEO since June 2009), who departed to pursue other career opportunities. Mr Svenningsen was previously Senior Vice President in Hitachi Data Systems in the EMEA region.

Anders Boyer (b. 1970) has been **CFO** of GN Store Nord since August 2009, having previously been CFO of GN Netcom since 2007.

Per Wold-Olsen (b. 1947) has been **Chairman** of GN Store Nord since 2008, having worked in Merck & Co., Inc. from 1991 to 2006 where he was member of the Management Committee. He is also a member of the board at Novo A/S, Gilead Sciences Inc. and Exiqon A/S.

### Remuneration

Remuneration of the executive management is based on a fixed base salary plus a target bonus of up to 50% of the base salary, with a potential bonus ranging from 0 - 100% of the base salary. Management are also granted warrant programmes in GN ReSound and GN Netcom, whose value is calculated based on the value of GN Store Nord shares.

In 2013, GN Netcom CEO’s bonus was subject to GN Netcom’s performance vs its EBITA, revenue and individual performance targets. The bonuses of the GN ReSound CEO and the CFO were subject to GN ReSound’s performance vs its EBITA, revenue, gross margin and individual targets.

# Shareholder Structure

GN Store Nord’s shares are close to 100% free float, on our estimates.

Forecasts and Assumptions

We forecast FY14E-17E sales and adj. EPS CAGRs of 9.8% and 19.7%, respectively, and believe the lower-end of Group FY14 guidance is achievable (2014E PBT DKr1,117mn vs >DKr1,110mn guidance.

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| Figure 54. GN Store Nord – Summary forecasts |
| |  |  |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | | **DKrmn** | **2011** | **2012** | **2013** | **1Q14** | **2Q14** | **3Q14** | **4Q14E** | **2014E** | **2015E** | **2016E** | **2017E** | | CC&O Headset Sales | 1,400 | 1,530 | 1,591 | 430 | 461 | 413 | 542 | 1,846 | 2,195 | 2,599 | 2,987 | | % organic YoY | 12.0% | 5.0% | 12.0% | 13.0% | 26.0% | 9.0% | 18.5% | 16.6% | 15.9% | 18.4% | 15.0% | | % chg. YoY | 10.7% | 9.3% | 3.8% | 10.5% | 23.3% | 8.1% | 21.5% | 16.0% | 18.9% | 18.4% | 15.0% | |  |  |  |  |  |  |  |  |  |  |  |  | | Mobile Headsets Sales | 706 | 825 | 1,019 | 222 | 237 | 214 | 348 | 1,019 | 1,126 | 1,182 | 1,241 | | % organic YoY | 3.0% | 11.0% | 27.0% | -11.0% | -10.0% | 3.0% | 20.0% | 0.7% | 7.5% | 5.0% | 5.0% | | % chg. YoY | -0.3% | 16.9% | 23.5% | -14.0% | -12.9% | 2.9% | 23.0% | 0.0% | 10.5% | 5.0% | 5.0% | |  |  |  |  |  |  |  |  |  |  |  |  | | **GN Netcom Sales** | **2,106** | **2,355** | **2,610** | **652** | **698** | **627** | **890** | **2,865** | **3,321** | **3,781** | **4,229** | | **% organic YoY** | **9.0%** | **7.0%** | **18.0%** | **4.0%** | **11.0%** | **6.9%** | **19.1%** | **10.4%** | **12.9%** | **13.8%** | **11.8%** | | % chg. YoY | 6.7% | 11.8% | 10.8% | 0.8% | 8.0% | 6.3% | 22.1% | 9.8% | 15.9% | 13.8% | 11.8% | |  |  |  |  |  |  |  |  |  |  |  |  | | **GN Netcom adj. EBITA** | **310** | **362** | **472** | **104** | **108** | **109** | **189** | **509** | **611** | **733** | **860** | | **margin** | **14.7%** | **15.4%** | **18.1%** | **16.0%** | **15.4%** | **17.4%** | **21.2%** | **17.8%** | **18.4%** | **19.4%** | **20.3%** | | % chg. YoY | 38.4% | 16.8% | 30.4% | -12.8% | -3.1% | 8.0% | 34.0% | 7.9% | 20.0% | 19.9% | 17.4% | |  |  |  |  |  |  |  |  |  |  |  |  | | Hearing aid Sales | 3,058 | 3,423 | 3,636 | 895 | 969 | 966 | 1,121 | 3,951 | 4,327 | 4,630 | 4,861 | | % organic YoY | 9.0% | 5.0% | 10.0% | 9.0% | 8.0% | 9.0% | 8.0% | 8.5% | 6.0% | 7.0% | 5.0% | | % chg. YoY | 9.3% | 11.9% | 6.8% | 6.5% | 5.3% | 8.8% | 13.5% | 8.7% | 9.5% | 7.0% | 5.0% | |  |  |  |  |  |  |  |  |  |  |  |  | | Diagnostics Sales | 392 | 473 | 543 | 132 | 139 | 142 | 163 | 576 | 637 | 668 | 702 | | % organic YoY | 5.0% | 13.0% | 10.0% | -7.0% | 6.0% | 2.0% | 5.0% | 1.4% | 7.0% | 5.0% | 5.0% | | % chg. YoY | 7.2% | 20.6% | 15.1% | -5.7% | 7.8% | 8.4% | 14.0% | 6.1% | 10.5% | 5.0% | 5.0% | |  |  |  |  |  |  |  |  |  |  |  |  | | **GN ReSound Sales** | **3,450** | **3,896** | **4,179** | **1,027** | **1,108** | **1,108** | **1,284** | **4,527** | **4,963** | **5,298** | **5,563** | | **% organic YoY** | **9.0%** | **6.0%** | **10.0%** | **7.0%** | **7.8%** | **8.1%** | **7.6%** | **7.6%** | **6.1%** | **6.7%** | **5.0%** | | % chg. YoY | 9.0% | 12.9% | 7.3% | 4.8% | 5.6% | 8.7% | 13.6% | 8.3% | 9.6% | 6.7% | 5.0% | |  |  |  |  |  |  |  |  |  |  |  |  | | **GN ReSound adj. EBITA** | **451** | **551** | **842** | **170** | **209** | **226** | **320** | **926** | **1,037** | **1,141** | **1,207** | | **margin** | **13.1%** | **14.1%** | **20.1%** | **16.6%** | **18.9%** | **20.4%** | **24.9%** | **20.5%** | **20.9%** | **21.5%** | **21.7%** | | % chg. YoY | 26.0% | 22.2% | 52.7% | 7.6% | 4.3% | 8.8% | 16.4% | 10.0% | 12.0% | 10.1% | 5.7% | |  |  |  |  |  |  |  |  |  |  |  |  | | **Group Sales** | **5,564** | **6,251** | **6,789** | **1,679** | **1,806** | **1,735** | **2,174** | **7,392** | **8,284** | **9,079** | **9,792** | | **% organic YoY** | **9.0%** | **6.2%** | **13.0%** | **6.0%** | **9.0%** | **7.7%** | **12.1%** | **8.7%** | **8.8%** | **9.6%** | **7.9%** | | % chg. YoY | 8.1% | 12.3% | 8.6% | 3.2% | 6.5% | 7.8% | 16.9% | 8.9% | 12.1% | 9.6% | 7.9% | |  |  |  |  |  |  |  |  |  |  |  |  | | **Group adj. EBITA** | **604** | **831** | **1,233** | **253** | **302** | **323** | **494** | **1,372** | **1,583** | **1,808** | **1,998** | | **Group adj. EBITA Margin** | **10.9%** | **13.3%** | **18.2%** | **15.1%** | **16.7%** | **18.6%** | **22.7%** | **18.6%** | **19.1%** | **19.9%** | **20.4%** | | % chg. YoY | 21.3% | 37.6% | 48.3% | -2.0% | 3.9% | 10.0% | 26.7% | 11.3% | 15.4% | 14.1% | 10.5% | |  |  |  |  |  |  |  |  |  |  |  |  | | **Adj. Net income** | **355.8** | **491.2** | **775.9** | **171.0** | **188.9** | **198.3** | **317.2** | **875.5** | **1028.3** | **1201.3** | **1338.6** | | **% chg. YoY** | **15.3%** | **38.1%** | **58.0%** | **-0.8%** | **8.7%** | **4.5%** | **32.2%** | **12.8%** | **17.4%** | **16.8%** | **11.4%** | |  |  |  |  |  |  |  |  |  |  |  |  | | **Adj. diluted EPS** | **1.76** | **2.72** | **4.59** | **1.03** | **1.15** | **1.22** | **1.96** | **5.33** | **6.50** | **7.91** | **9.15** | | **% chg. YoY** | **17.3%** | **54.9%** | **68.9%** | **2.4%** | **11.8%** | **7.3%** | **36.0%** | **16.1%** | **21.8%** | **21.7%** | **15.6%** | |
| Source: Company data, Citi Research estimates |

## Sales: 9.8% CAGR FY14-17E

Our 9.8% forecast sales CAGR is driven by an 8.8% organic growth CAGR and an FX tailwind of 3.3% in 2015E, driven primarily by US$ strength (North America is c40% of sales).

### GN ReSound: 7.2% CAGR FY14E-17E

We forecast a 6.0% organic growth CAGR for ReSound, which is slightly below the company’s guidance to grow >3ppts above market growth given our 3.6% market growth forecast. While we see ReSound’s technological advantage in wireless connectivity (Made for iPhone, etc) lasting until 2016-17, when an industry-standard Bluetooth Low Energy (LE) protocol is likely to be released, we err on the cautious side given our assumption of a 50% chance of GN losing its Kirkland Signature (KS) contract with Costco (est. US$36mn/cDKr215mn sales, or 4-5% or ReSound sales). We would expect the announcement of the result of the KS re-tender during 1H15, with sales under the new contract beginning in 2H15.

We forecast a 5.7% organic sales CAGR for diagnostics (Otometrics), slightly above market growth as it continues to take share from the smaller players.

### GN Netcom: 13.9% CAGR FY14E-17E

Given large recent contract wins in Unified Communications (UC), we believe GN could gain further share in 2015-16 but then assume some share loss given the potential for new entrants or for Logitech and Sennheiser Communications to gain some momentum in the market. Nevertheless, this implies a >25% UC sales CAGR 2014-17E and, given the increasing weight of UC sales, we believe Netcom’s organic CC&O growth could accelerate from 10% in 2014E to 14% in 2016E (see Figure 41).

We are more cautious on the highly competitive Mobile business. We forecast 7.5% organic growth in 2015, given an easy comparable and the launch of the innovative Jabra Sport Pulse Wireless in Oct 2014 following a refocusing of the music product portfolio. Beyond 2015 we forecast 5% organic growth as we think exposure to the music market should enable growth above the c2-4% market growth in traditional mobile headsets.

## Adj. EBITA margin: 180bp improvement FY14E-17E

We believe GN’s adj EBITA margin can recover move from 18.6% in FY14E to 20.4% in FY17E.

### GN ReSound: 120bp margin improvement FY14E-17E

As detailed earlier in the note, the company targets a ReSound margin in-line with its top-tier competitors (i.e. WDH and SOON) in 2014-16. We believe that in practice the target range is c20-25%, with the lower end being ReSound’s and WDH’s consolidated EBITA margin in 2013 and the upper-end being SOON’s mid-term target Group EBITA margin.

While GN has significantly less margin-dilutive retail than SOON or WDH, we believe that achieving a 25% EBITA margin would likely come at the expense of top-line growth and that GN’s smaller scale must also be taken into account. Hence, we believe GN could move towards the middle of this range and forecast a ReSound EBITA margin of 21.5% in 2016E and 21.7% in 2017E, below 2017E consensus at 22.1%.

### GN Netcom: 250bp margin improvement FY14E-17E

Given our forecast >25% sales CAGR for Netcom’s UC headset business in 2014E-17E, which is accretive to Netcom’s gross margin vs relatively pessimistic forecasts for the low-margin mobile headset business, we forecast a turnaround in Netcom’s EBITA margin to 19.4% in 2016E – slightly above the company’s 18-19% target range in 2014-16, and 20.3% in 2017E, when we would expect the company to decelerate investments following the end of its current strategic plan. This is 150bp ahead of the consensus 2017E EBITA margin of 18.8%.

### Cautious on 1H15 margin on FX headwinds

While we are positive on the mid-term margin outlook for GN, we would caution that the company could continue to face margin headwinds from US$ strength in 1H15 (as signalled by the CFO on the 3Q call), before this reverses from 2H15. GN hedges currency 1-yr forward and hence is still suffering from US$/DKr weakness that lasted until 3Q14 and will not see the full benefits of recent US$ strength until 2H15. We are below c2% below consensus net profit in 2015E (see Figure 58).

### R&D amortisation a headwind, but may already be factored into consensus

Further to this there could be an ongoing headwind from a narrowing gap between R&D capitalisation and amortisation (as signalled by the CFO on the 3Q call), which we estimate is at a 1.1ppt benefit to GN’s margin in 2014E (1.2ppts in Netcom and 0.9ppts in ReSound), or a c6.5% benefit to adj. EPS. On this point, we are not as concerned as we are for [Sonova](https://ir.citi.com/5L1ZBf8d0Og9oHVV4susGx6xc0YBlVVbn20oO4heYhc3kFot6NoXmsVfBaScmBGP%2fsfsFTrJ9YI%3d) as we feel this may be better understood by consensus, given that our 2016E and 2017E margin estimates are above consensus (see Figure 58) despite our factoring in a 10% CAGR in R&D expenses (14% at Netcom, 8% at ReSound) to account for this.

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| Figure 55. GN – Margin benefit (ppts) from net R&D capitalisation could become a headwind |
|  |
| Source: Company data, Citi Research estimates |

## Adj. EPS: 20% CAGR FY14E-17E

### Tax to benefit from Danish corporate tax rate reduction

The Danish government is currently in the process of reducing its corporate tax rate by 1ppt per annum – from 25% in 2013 to 22% in 2016. We estimate GN’s adjusted tax rate will fall from 27.8% in 2014E to 26.5% by 2016E, in-line with guidance for a 26-27% tax rate in 2016.

### Share buybacks – >4% of current market cap. per annum

GN targets a Net debt/EBITDA ratio of 1.0x at the end of 2014 and 1-2x over the remainder of its 2014-16 strategy. Our forecasts assume GN repurchases DKr1bn of shares per annum 2015E-17E, or c4.5% of current market cap while remaining within its leverage target (Figure 57). GN has conducted its share buybacks via relatively small programs that are announced on an ongoing basis. The current DKr500mn program was initiated on 6 Nov 2014 and is due to conclude no later than 19 Mar 2015.

### Interest expenses could rise more than consensus expects

As this buyback seems likely to be partly debt-funded (we estimate DKr600mn additional borrowing in 2015E and DKr300mn thereafter), the accretion from the buyback is somewhat offset by rising interest expenses, which we believe consensus may not have fully factored in, given that our EBITA forecasts are further ahead of consensus than our net profit forecasts (where we are 1-2% below consensus in 2014E and 2015E) over 2014E-17E (see Figure 58).

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| Figure 56. GN – >4% (DKr1bn) annual buyback within leverage target |
|  |
| Source: Company data, Citi Research estimates |

### Dividend payout should rise gradually

GN’s dividend policy is to pay out 15-25% of adjusted net income. The payout ratio has increased steadily in recent years and stood at 18% in 2013. We expect this trend to continue and forecast a gradual increase in the payout ratio of 1ppt per annum.

## Risks

We believe the main risks to our target price for GN Store Nord are:

1. Downside to our hearing aid forecasts from the introduction of an industry standard Low Energy (LE) protocol, which could erode GN’s technological advantage;
2. Downside to our hearing aid forecasts should GN lose its Costco Kirkland Signature contract in 1H15;
3. Downside to our hearing aid forecasts if market price/mix pressure is greater than the 1-2% p.a. we anticipate;
4. Downside to our headset forecasts if growth in Unified Communications slows more than we anticipate;
5. Downside to our headset forecasts from economic weakness as we believe the headset business is more cyclical than hearing aids;
6. Downside to our EBITA margin estimates in 1H15 from US$ strength and GN’s 1-yr forward hedging policy.

Citi forecasts vs consensus

Our FY17E net profit is 2.6% above consensus, which is explained primarily by our relatively optimistic margin forecast in the headset business Netcom. We are 2.2% below consensus for 2015E, given our caution on FX hedging headwinds and increasing R&D amortization.

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| Figure 57. GN Store Nord – Citi forecasts vs consensus |
| |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | | **DKrmn** | **2014E** | **2015E** | **2016E** | **2017E** | **2018E** | | **GN Resound** |  |  |  |  |  | | Sales - Citi | 4,527 | 4,963 | 5,298 | 5,563 | 5,841 | | Sales - Consensus | 4,482 | 4,867 | 5,186 | 5,475 | 5,740 | | **Sales - Citi Vs. Consensus** | **1.0%** | **2.0%** | **2.2%** | **1.6%** | **1.8%** | | Organic Growth - Citi | 7.6% | 6.1% | 6.7% | 5.0% | 5.0% | | Organic Growth - Consensus | 7.5% | 7.2% | 6.4% | 5.5% | 5.0% | | EBITA - Citi | 926 | 1,037 | 1,141 | 1,207 | 1,282 | | EBITA - Consensus | 898 | 1,027 | 1,131 | 1,212 | 1,228 | | **EBITA - Citi Vs. Consensus** | **3.1%** | **1.0%** | **0.9%** | **-0.4%** | **4.4%** | | EBITA Margin - Citi | 20.5% | 20.9% | 21.5% | 21.7% | 21.9% | | EBITA Margin - Consensus | 20.0% | 21.1% | 21.8% | 22.1% | 21.4% | |  |  |  |  |  |  | | **GN Netcom** |  |  |  |  |  | | Sales - Citi | 2,865 | 3,321 | 3,781 | 4,229 | 4,630 | | Sales - Consensus | 2,852 | 3,243 | 3,628 | 4,017 | 4,559 | | **Sales - Citi Vs. Consensus** | **0.5%** | **2.4%** | **4.2%** | **5.3%** | **1.6%** | | Organic Growth - Citi | 10.4% | 12.9% | 13.8% | 11.8% | 9.5% | | Organic Growth - Consensus | 10.6% | 12.8% | 12.0% | 11.0% | 10.5% | | EBITA - Citi | 509 | 611 | 733 | 860 | 957 | | EBITA - Consensus | 511 | 594 | 679 | 756 | 851 | | **EBITA - Citi Vs. Consensus** | **-0.3%** | **2.9%** | **7.9%** | **13.8%** | **12.4%** | | EBITA Margin - Citi | 17.8% | 18.4% | 19.4% | 20.3% | 20.7% | | EBITA Margin - Consensus | 17.9% | 18.3% | 18.7% | 18.8% | 18.7% | |  |  |  |  |  |  | | **Group** |  |  |  |  |  | | Sales - Citi | 7,392 | 8,284 | 9,079 | 9,792 | 10,471 | | Sales - Consensus | 7,335 | 8,117 | 8,825 | 9,492 | 10,299 | | **Sales - Citi Vs. Consensus** | **0.8%** | **2.1%** | **2.9%** | **3.2%** | **1.7%** | | Organic Growth - Citi | 8.7% | 8.8% | 9.6% | 7.9% | 6.9% | | Organic Growth - Consensus | 8.7% | 9.5% | 8.8% | 8.1% | 7.5% | |  |  |  |  |  |  | | EBITA - Citi | 1,372 | 1,583 | 1,808 | 1,998 | 2,168 | | EBITA - Consensus | 1,265 | 1,560 | 1,749 | 1,907 | 2,017 | | **EBITA - Citi Vs. Consensus** | **8.5%** | **1.5%** | **3.3%** | **4.8%** | **7.5%** | | EBITA Margin - Citi | 18.6% | 19.1% | 19.9% | 20.4% | 20.7% | | EBITA Margin - Consensus | 17.2% | 19.2% | 19.8% | 20.1% | 19.6% | |  |  |  |  |  |  | | Net Profit (reported) - Citi | 795 | 1,028 | 1,201 | 1,339 | 1,443 | | Net Profit (reported) - Consensus | 806 | 1,051 | 1,197 | 1,305 | 1,356 | | **Net Profit - Citi Vs. Consensus** | **-1.3%** | **-2.2%** | **0.4%** | **2.6%** | **6.4%** | |
| Source: Company-compiled consensus (27 Nov 2014), Citi Research estimates |

Industry Events and Catalysts

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| Figure 58. Industry Events and Catalysts |
| |  |  |  |  | | --- | --- | --- | --- | | **Date** | **Company / Industry Body** | **Event** | **Location** | | 27 Jan 2015 | Plantronics | 3QFY15 Results |  | | 10 Feb 2015 | Cochlear | 1HFY15 Results\* |  | | 18 Feb 2015 | GN Store Nord | FY14 Results |  | | 26 Feb 2015 | William Demant | FY14 Results |  | | 03 Mar 2015 | Amplifon | FY14 Results |  | | 25-28 Mar 2015 | American Academy of Audiology | AudiologyNOW! 2015 | San Antonio, TX | |  |  |  |  | | 29 Apr 2015 | Amplifon | 1QFY15 Results |  | | 29 Apr 2015 | GN Store Nord | 1QFY15 Results |  | | 07 May 2015 | William Demant | 1QFY15 Results |  | | 19 May 2015 | Sonova | FY15 Results |  | |  |  |  |  | | 23 Jul 2015 | Amplifon | 2QFY15 Results |  | | 11 Aug 2015 | Cochlear | FY15 Results\* |  | | 13 Aug 2015 | GN Store Nord | 2QFY15 Results |  | | 14 Aug 2015 | William Demant | 2QFY15 Results |  | |  |  |  |  | | 14-16 Oct 2015 | European Union of Hearing Aid Acousticians | EUHA Congress 2015 | Nürnberg, Germany | | 22 Oct 2015 | Amplifon | 3QFY15 Results |  | | 30 Oct 2015 | GN Store Nord | 3QFY15 Results |  | | 12 Nov 2015 | William Demant | 3QFY15 Results |  | | 16 Nov 2015 | Sonova | 1HFY16 Results |  | |
| \*Denotes indicative dates. Source: Company websites |

Financial Statements

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| Figure 59. GN Store Nord Annual Profit and Loss Account |
| |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | | **DKrmn** | **2011** | **2012** | **2013** | **2014E** | **2015E** | **2016E** | **2017E** | | **Revenue** | **5,564** | **6,251** | **6,789** | **7,392** | **8,284** | **9,079** | **9,792** | | *% chg. YoY* | 8.1% | 12.3% | 8.6% | 8.9% | 12.1% | 9.6% | 7.9% | | Cost of sales | -2,269 | -2623 | -2720 | -2860 | -3199 | -3506 | -3797 | | **Gross profit** | **3,295** | **3,628** | **4,069** | **4,532** | **5,086** | **5,573** | **5,995** | | Gross profit margin (%) | 59.2% | 58.0% | 59.9% | 61.3% | 61.4% | 61.4% | 61.2% | | R&D expense | -517 | -547 | -545 | -605 | -676 | -742 | -801 | | *% chg. YoY* | 14.4% | 5.8% | -0.4% | 11.0% | 11.7% | 9.8% | 8.0% | | *% sales* | *9.3%* | *8.8%* | *8.0%* | *8.2%* | *8.2%* | *8.2%* | *8.2%* | | Selling expenses | -1,657 | -1,933 | -1,895 | -2,100 | -2,344 | -2,542 | -2,722 | | *% chg. YoY* | 7.8% | 16.7% | -2.0% | 10.8% | 11.6% | 8.4% | 7.1% | | *% sales* | *29.8%* | *30.9%* | *27.9%* | *28.4%* | *28.3%* | *28.0%* | *27.8%* | | Administrative expenses | -608 | -581 | -499 | -599 | -537 | -536 | -528 | | *% chg. YoY* | 17.1% | -4.4% | -14.1% | 19.9% | -10.3% | -0.1% | -1.5% | | *% sales* | *10.9%* | *9.3%* | *7.4%* | *8.1%* | *6.5%* | *5.9%* | *5.4%* | | S,G&A expenses | -2,265 | -2,514 | -2,394 | -2,699 | -2,881 | -3,078 | -3,250 | | *% chg. YoY* | 10.2% | 11.0% | -4.8% | 12.7% | 6.8% | 6.8% | 5.6% | | *% sales* | *40.7%* | *40.2%* | *35.3%* | *36.5%* | *34.8%* | *33.9%* | *33.2%* | | Other operating income (expenses) | 12 | 4 | 7 | 2 | 0 | 0 | 0 | | EBIT ex TPSA Case & Others | 525 | 571 | 1,137 | 1,230 | 1,528 | 1,753 | 1,943 | | margin (%) | 9.4% | 9.1% | 16.7% | 16.6% | 18.5% | 19.3% | 19.8% | | Award from TPSA Case & Others | 731 | 15 | -19 | -8 | 0 | 0 | 0 | | EBIT (reported) | 1,256 | 586 | 1,118 | 1,222 | 1,528 | 1,753 | 1,943 | | EBIT margin (%) | 22.6% | 9.4% | 16.5% | 16.5% | 18.5% | 19.3% | 19.8% | | Amortization of other intangible assets acquired | 28 | 30 | 61 | 55 | 55 | 55 | 55 | | EBITA (reported) | 1,284 | 616 | 1,180 | 1,277 | 1,583 | 1,808 | 1,998 | | EBITA margin (%) | 23.1% | 9.9% | 17.4% | 17.3% | 19.1% | 19.9% | 20.4% | | % chg. YoY | -50.5% | -52.0% | 91.5% | 8.3% | 24.0% | 14.1% | 10.5% | | Exceptionals in EBITA | 680 | -215 | -53 | -95 | 0 | 0 | 0 | | **EBITA (adj.)** | **604** | **831** | **1,233** | **1,372** | **1,583** | **1,808** | **1,998** | | **Adj. EBITA margin (%)** | **10.9%** | **13.3%** | **18.2%** | **18.6%** | **19.1%** | **19.9%** | **20.4%** | | % chg. YoY | 21.3% | 37.6% | 48.3% | 11.3% | 15.4% | 14.1% | 10.5% | | Depreciation | 127 | 129 | 144 | 169 | 170 | 181 | 192 | | EBITDA (adj.) | 731 | 960 | 1,377 | 1,541 | 1,754 | 1,988 | 2,190 | | Adj. EBITDA margin (%) | 13.1% | 15.4% | 20.3% | 20.8% | 21.2% | 21.9% | 22.4% | | Interest income | 178 | 74 | 73 | 108 | 107 | 105 | 97 | | Interest expense | -206 | -143 | -164 | -213 | -218 | -223 | -219 | | **Net Financial income/ expense** | **-28** | **-69** | **-91** | **-105** | **-110** | **-118** | **-122** | | Gain on disposal of operations | -9 | -58 | 0 | 0 | 0 | 0 | 0 | | Impairment loss on investment in subsidiaries | 0 | 0 | 0 | 0 | 0 | 0 | 0 | | Associate income | 6 | 2 | -4 | 0 | 0 | 0 | 0 | | **Other financial income** | **-3** | **-56** | **-4** | **0** | **0** | **0** | **0** | | **Profit before tax** | **1,225** | **461** | **1,023** | **1,117** | **1,418** | **1,634** | **1,821** | | **Adj. Profit before tax** | **545** | **676** | **1,076** | **1,212** | **1,418** | **1,634** | **1,821** | | Income taxes on adjusted pre-tax income | -189 | -185 | -300 | -337 | -390 | -433 | -483 | | Underlying tax rate (%) | 34.7% | 27.3% | 27.9% | 27.8% | 27.5% | 26.5% | 26.5% | | Exceptional/ Deferred tax | -171 | 45 | 12 | 15 | 0 | 0 | 0 | | **Income tax expense** | **-360** | **-140** | **-288** | **-322** | **-390** | **-433** | **-483** | | Effective tax rate (%) | 29.4% | 30.4% | 28.2% | 28.8% | 27.5% | 26.5% | 26.5% | | **Profit after tax** | **865** | **321** | **735** | **795** | **1,028** | **1,201** | **1,339** | | Minority interest |  | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | Profit from discontinuing operations |  |  |  |  |  |  |  | | **Net Profit** | **865** | **321** | **735** | **795** | **1,028** | **1,201** | **1,339** | | % chg. YoY | -53.4% | -62.9% | 128.9% | 8.3% | 29.3% | 16.8% | 11.4% | | Net exceptionals | 509.2 | -170.2 | -41.2 | -80.0 | 0.0 | 0.0 | 0.0 | | **Adj. Net income** | **356** | **491** | **776** | **876** | **1,028** | **1,201** | **1,339** | | % chg. YoY | 15.3% | 38.1% | 58.0% | 12.8% | 17.4% | 16.8% | 11.4% | |  |  |  |  |  |  |  |  | | **Basic EPS (DKr)** | **4.31** | **1.80** | **4.40** | **4.90** | **6.57** | **8.01** | **9.26** | | % chg. YoY | -52.9% | -58.3% | 144.9% | 11.5% | 34.1% | 21.8% | 15.7% | | **Adj. diluted EPS (DKr)** | **1.76** | **2.72** | **4.59** | **5.33** | **6.50** | **7.91** | **9.15** | | % chg. YoY | 17.3% | 54.9% | 68.9% | 16.1% | 21.8% | 21.7% | 15.6% | |  |  |  |  |  |  |  |  | | **DPS (DKr)** | **0.27** | **0.49** | **0.84** | **1.02** | **1.31** | **1.68** | **2.04** | | YoY growth (%) | 42.1% | 81.5% | 71.4% | 22.0% | 28.3% | 27.9% | 21.2% | |
| Source: Company data, Citi Research estimates |

|  |
| --- |
| Figure 60. GN Store Nord Annual Cash Flow Statement |
| |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | | **DKrmn** | **2011** | **2012** | **2013** | **2014E** | **2015E** | **2016E** | **2017E** | | **Operating profit** | **1,256** | **586** | **1,118** | **1,222** | **1,528** | **1,753** | **1,943** | | Total depreciation,amortization and impairment | 484 | 442 | 398 | 564 | 611 | 673 | 740 | | Gain on disposal of assets | -6 | -2 | 19 | 0 | 0 | 0 | 0 | | Share-based payment | 15 | 10 | 10 |  |  |  |  | | Provision for bad debt and inventory write-down | 31 | 13 | 8 |  |  |  |  | | Adjustment for provisions | -27 | -37 | -17 |  |  |  |  | | Restructuring costs | 0 | 217 | 104 |  |  |  |  | | Award from arbitration case against TPSA | -748 | 3,064 |  |  |  |  |  | | Other adjustments | -735 | 3,265 | 124 | 0 | 0 | 0 | 0 | | **Operating cash flow before change in working capital** | **1,005** | **4,293** | **1,640** | **1,786** | **2,139** | **2,426** | **2,683** | | Change in inventories | -89 | -26 | -116 | -30 | -74 | -67 | -63 | | Change in receivables | -267 | -81 | -323 | -106 | -196 | -175 | -157 | | Change in trade payables and other payables | 150 | -24 | 97 | 44 | 65 | 58 | 52 | | **Change in working capital** | **-206** | **-131** | **-342** | **-93** | **-205** | **-184** | **-168** | | Restructuring/non-recurring costs,paid | -2 | -93 | -94 | 0 | 0 | 0 | 0 | | **Operating cash flow before financial items and tax** | **797** | **4,069** | **1,204** | **1,693** | **1,934** | **2,242** | **2,515** | | Interest and dividends,etc. received | 16 | 18 | 32 | 108 | 107 | 105 | 97 | | Interest paid | -88 | -91 | -69 | -213 | -218 | -223 | -219 | | Tax paid | -23 | -643 | -249 | -322 | -390 | -433 | -483 | | **Cash flow from operating activities** | **702** | **3,353** | **918** | **1,267** | **1,434** | **1,691** | **1,910** | | Investment in intangible assets | -54 | -139 | -139 | -142 | -124 | -136 | -147 | | Investment in PP&E | -82 | -103 | -120 | -116 | -186 | -204 | -220 | | **Total Capex** | **-136** | **-242** | **-259** | **-259** | **-311** | **-340** | **-367** | | Development costs | -265 | -296 | -349 | -388 | -407 | -427 | -449 | | Investment in other non-current assets | -21 | -81 | -222 | -222 | -150 | -100 | -100 | | Disposal of intangible assets | 1 | 0 | 2 | 0 | 0 | 0 | 0 | | Disposal & sale of property, plant and equipment | 14 | 2 | 2 | 0 | 0 | 0 | 0 | | Disposal of other non-current assets | 2 | 20 | 1 | 0 | 0 | 0 | 0 | | Acquisition of companies/operations | -82 | -42 | -136 | -34 | 0 | 0 | 0 | | Company disposals | 1 | 5 | -10 | 0 | 0 | 0 | 0 | | **Cash flow from investing activities** | **-486** | **-634** | **-971** | **-902** | **-868** | **-868** | **-916** | | Increase of long-term loans | 327 |  | 944 |  |  |  |  | | Decrease of long term loans | 0 |  |  |  |  |  |  | | **Net Increase/(decrease) in long-term debt** | **327** | **0** | **944** | **0** | **0** | **0** | **0** | | Increase of short term loans | 62 |  |  |  |  |  |  | | Decrease of short-term loans | 0 | -1,109 | -60 | 600 | 600 | 300 | 300 | | **Net Increase/(decrease) in short-term debt** | **62** | **-1,109** | **-60** | **600** | **600** | **300** | **300** | | Dividends paid | -39 | -50 | -83 | -146 | -166 | -206 | -252 | | Share-based payment (exercised) | 137 | 23 | 54 | 0 | 0 | 0 | 0 | | Purchase/sale of treasury shares | -641 | -1,614 | -787 | -655 | -1,000 | -1,000 | -1,000 | | Other adjustments | 7 | -26 | -13 | 0 | 0 | 0 | 0 | | **Cash flow from financing activities** | **-147** | **-2,776** | **55** | **-201** | **-566** | **-906** | **-952** | | Net cash flow from discontinuing operations |  |  |  |  |  |  |  | | **Net cash flow** | **69** | **-57** | **2** | **163** | **0** | **-83** | **42** | | Exchange rate movement effects | 3 | -3 | -8 |  |  |  |  | | **Net change in cash and cash equivalents** | **72** | **-60** | **-6** | **163** | **0** | **-83** | **42** | |
| Source: Company data, Citi Research estimates |

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| --- |
| Figure 61. GN Store Nord Annual Balance Sheet |
| |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | | **DKrmn** | **2011** | **2012** | **2013** | **2014E** | **2015E** | **2016E** | **2017E** | | **Assets** |  |  |  |  |  |  |  | | Property, plant & equipment | 262 | 254 | 465 | 424 | 440 | 464 | 492 | | Goodwill | 3,048 | 2,960 | 2,974 | 2,985 | 2,985 | 2,985 | 2,985 | | Other Intangibles | 1,200 | 1,274 | 1,512 | 1,658 | 1,749 | 1,820 | 1,868 | | Total Intangible Assets | 4,248 | 4,234 | 4,486 | 4,643 | 4,734 | 4,805 | 4,853 | | Investment in associates | 16 | 17 | 17 | 17 | 17 | 17 | 17 | | Other securities | 175 | 0 | 0 | 0 | 0 | 0 | 0 | | Deferred tax assets | 569 | 563 | 502 | 502 | 502 | 502 | 502 | | Other non-current assets | 2 | 670 | 826 | 1,048 | 1,198 | 1,298 | 1,398 | | **Non-current Assets** | **5,272** | **5,738** | **6,296** | **6,634** | **6,892** | **7,086** | **7,262** | | Inventories | 549 | 471 | 592 | 622 | 696 | 763 | 826 | | Trade Receivables | 1,269 | 1,349 | 1,520 | 1,626 | 1,823 | 1,997 | 2,154 | | Tax receivables | 13 | 34 | 90 | 90 | 90 | 90 | 90 | | Prepayments | 178 | 0 | 0 | 0 | 0 | 0 | 0 | | Other receivables | 3,517 | 214 | 302 | 302 | 302 | 302 | 302 | | Cash and cash equivalents | 229 | 169 | 163 | 326 | 325 | 242 | 284 | | Assets held for sale | 154 | 224 | 0 | 0 | 0 | 0 | 0 | | **Current Assets** | **5,909** | **2,461** | **2,667** | **2,966** | **3,236** | **3,395** | **3,657** | | **Total Assets** | **11,181** | **8,199** | **8,963** | **9,601** | **10,128** | **10,481** | **10,919** | |  |  |  |  |  |  |  |  | | **Liabilities** |  |  |  |  |  |  |  | | Minority interests | 0 | 0 | 0 | 0 | 0 | 0 | 0 | | Share capital | 833 | 775 | 693 | 693 | 693 | 693 | 693 | | Other reserves | 906 | -648 | -1,497 | -2,152 | -3,152 | -4,152 | -5,152 | | Proposed dividends for the year | 57 | 94 | 146 | 166 | 206 | 252 | 294 | | FX adjustments | 0 | 0 |  |  |  |  |  | | Retained earnings | 5,082 | 5,321 | 5,988 | 6,617 | 7,439 | 8,388 | 9,432 | | **Shareholder's equity** | **6,878** | **5,542** | **5,330** | **5,324** | **5,186** | **5,182** | **5,268** | | **Long-term borrowings** | **1,374** | **276** | **1,216** | **1,216** | **1,216** | **1,216** | **1,216** | | Pension obligations | 110 | 100 | 44 | 44 | 44 | 44 | 44 | | Provisions | 130 | 152 | 167 | 167 | 167 | 167 | 167 | | Deferred tax liabilities | 825 | 373 | 403 | 403 | 403 | 403 | 403 | | Other non-current liabilities | 59 | 185 | 209 | 209 | 209 | 209 | 209 | | **Long-term liabilities** | **2,498** | **1,086** | **2,039** | **2,039** | **2,039** | **2,039** | **2,039** | | **Short-term borrowings** | **124** | **123** | **60** | **660** | **1,260** | **1,560** | **1,860** | | Trade payables | 486 | 485 | 493 | 537 | 602 | 659 | 711 | | Tax payable | 36 | 11 | 34 | 34 | 34 | 34 | 34 | | Provisions | 260 | 225 | 214 | 214 | 214 | 214 | 214 | | Other payables | 899 | 727 | 793 | 793 | 793 | 793 | 793 | | **Current liabilities** | **1,805** | **1,571** | **1,594** | **2,238** | **2,903** | **3,260** | **3,612** | | **Total Liabilities** | **11,181** | **8,199** | **8,963** | **9,601** | **10,128** | **10,481** | **10,919** | |
| Source: Company data, Citi Research estimates |

Appendix

## Miracle-Ear and Kirkland Signature contract analysis

|  |
| --- |
| Figure 62. GN has c3% of EPS at risk but only c1% probability-weighted |
| |  |  |  |  |  | | --- | --- | --- | --- | --- | | **Amplifon Miracle-Ear (M-E) contract sensitivity by company (incumbent Siemens)** | | | |  | | **Contract assumptions** |  |  |  |  | | Amplifon units per annum (mn) | 0.95 |  |  |  | | M-E share within Amplifon | 16.8% |  |  |  | | M-E contract units per annum (mn) | 0.16 |  |  |  | | Contract ASP (US$) | 315 |  |  |  | | **M-E contract value per annum (US$mn)** | **50.4** |  |  |  | | Contract EBIT margin (%) | 25.0% |  |  |  | | **Contract EBIT (US$mn)** | **12.6** |  |  |  | | Contract Tax rate (%) | 40.0% |  |  |  | | **Contract Earnings (US$mn)** | **5.0** |  |  |  | |  |  |  |  |  | | **Sensitivity by company** | **GN** | **SOON** | **WDH** | **Siemens** | | Group Sales (US$mn, CY14E) | 1,315 | 2,007 | 1,682 |  | | **Annualised Group Sales effect (%)** | **3.8%** | **2.5%** | **3.0%** |  | | Group Adj. Earnings (US$mn, CY14E) | 156 | 351 | 236 |  | | **Annualised Adj. EPS effect (%)** | **3.2%** | **1.4%** | **2.1%** |  | |  |  |  |  |  | | **Probability of contract win / loss if incumbent** | **10.0%** | **20.0%** | **20.0%** | **50.0%** | | Probability adjusted Group Sales effect (%) | 0.4% | 0.5% | 0.6% |  | | **Probability adjusted EPS effect (%)** | **0.3%** | **0.3%** | **0.4%** |  | |  |  |  |  |  | | **Costco Kirkland Signature (KS) contract sensitivity by company (incumbent GN)** | | |  |  | | **Contract assumptions** |  |  |  |  | | Costco units per annum (mn) | 0.23 |  |  |  | | KS share within Costco | 40.0% |  |  |  | | KS contract units per annum (mn) | 0.09 |  |  |  | | Contract ASP (US$) | 400 |  |  |  | | **KS contract value per annum (US$mn)** | **36.0** |  |  |  | | Contract EBIT margin (%) | 30.0% |  |  |  | | **Contract EBIT (US$mn)** | **10.8** |  |  |  | | Contract Tax rate (%) | 40.0% |  |  |  | | **Contract Earnings (US$mn)** | **4.3** |  |  |  | |  |  |  |  |  | | **Sensitivity by company** | **GN** | **SOON** | **WDH** | **Siemens** | | Group Sales (US$mn, CY14E) | 1,315 | 2,007 | 1,682 |  | | **Annualised Group Sales effect (%)** | **2.7%** | **1.8%** | **2.1%** |  | | Group Adj. Earnings (US$mn, CY14E) | 156 | 351 | 236 |  | | **Annualised Adj. EPS effect (%)** | **2.8%** | **1.2%** | **1.8%** |  | |  |  |  |  |  | | **Probability of contract win / loss if incumbent** | **50.0%** | **20.0%** | **20.0%** | **10.0%** | | Probability adjusted Group Sales effect (%) | -1.4% | 0.4% | 0.4% |  | | **Probability adjusted EPS effect (%)** | **-1.4%** | **0.2%** | **0.4%** |  | |  |  |  |  |  | | **Combined contract sensitivity by company** |  |  |  |  | | **Annualised impact to adj. EPS** | **GN** | **SOON** | **WDH** |  | | **Probability adjusted scenario** | **-1.1%** | **0.5%** | **0.8%** |  | | **Best case scenario (Win both)** | **3.2%** | **2.7%** | **4.0%** |  | | **Worst case scenario (Lose both)** | **-2.8%** | **0.0%** | **0.0%** |  | |
| Price/rating for other stock mentioned: Siemens (SIEGn.DE; €92.40; 1) Source: Citi Research estimates |

**Companies Mentioned**

Amplifon SpA (AMPF.MI; €4.85; 2)

Cochlear Ltd (COH.AX; A$73.00; 3)

Essilor (ESSI.PA; €87.84; 2)

GN Store Nord (GN.CO; Dkr134.10, 1)

William Demant (WDH.CO; Dkr440.00; 1)

Siemens (SIEGn.DE; €92.40; 1)

# GN Store Nord

## Company description

GN Store Nord (GN) is a leading manufacturer of hearing aids and hearing diagnostics equipment and of headsets for use in Contact Centres & Offices (CC&O) and with mobile/cell phones through its Jabra brand.

## Investment strategy

We have a Buy rating on GN Store Nord. We believe that GN can deliver a FY14-17E sales CAGR of 10% and an EPS CAGR of 19.7%, supported by a DKr1bn (>4%) annual share buyback. GN's wireless connectivity advantage in hearing aids (Made for iPhone, etc) should last until 2016-17E, while the increasing uptake of Unified Communications (UC) technology should accelerate growth and margin for its headset business, Netcom, in our view.

## Valuation

To derive our DKr158 12-month target price on GN, we apply a 20x PE to our 12-month forward EPS at this time. This is a 5% discount to the EU MedTech sector's ~21x 1-yr fwd PE valuation vs a 7% 5-yr average premium as, although we see above-sector sales and earnings growth for GN, we recognise its relatively weak FCF generation given current investments and also see greater risk to our forecasts given cyclical exposure in the Netcom headset business.

## Risks

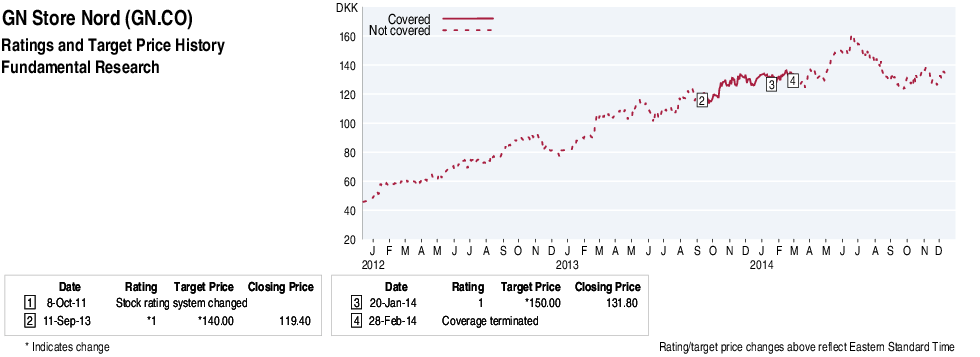
We believe the main risks to our target price for GN Store Nord are: 1) downside to our hearing aid forecasts from the introduction of an industry standard Low Energy (LE) protocol, which could erode GN’s technological advantage; 2) further downside to our hearing aid forecasts should GN lose its Costco Kirkland Signature contract in 1H15; 3) downside to our headset forecasts if growth in Unified Communications slows more than we anticipate 4) downside to our EBITA margin estimates in 1H15 from US$ strength and GN’s 1-yr forward hedging policy.

Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

**IMPORTANT DISCLOSURES**



GN Store Nord (GN.CO)

Ratings and Target Price History - Fundamental Research

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Target Closing

Price Price

Date Rating (DKK) (DKK)

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8 Oct 11 Stock rating system changed

11 Sep 13 \*1 \*140.00 119.40

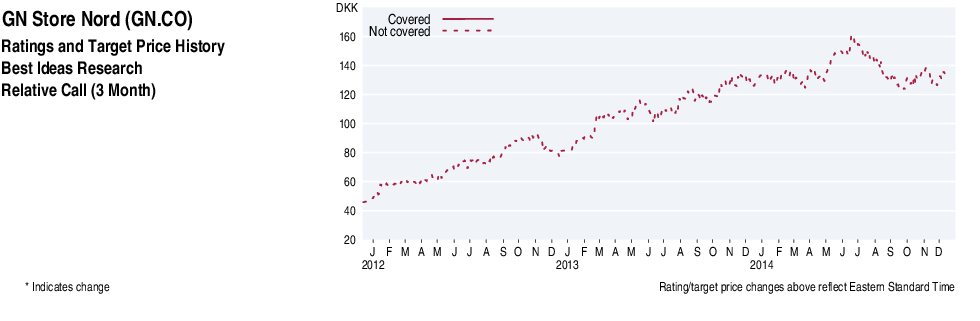
20 Jan 14 1 \*150.00 131.80

28 Feb 14 Coverage terminated

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\* Indicates change

Rating/target price changes above reflect Eastern Standard Time



GN Store Nord (GN.CO)

Ratings and Target Price History - Best Ideas Research

Relative Call (3 Month)

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Target Closing

Price Price

Date Rating (DKK) (DKK)

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\* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
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|  | 12 Month Rating | | | Relative Rating | | |
| Data current as of 30 Sep 2014 | Buy | Hold | Sell | Buy | Hold | Sell |
| Citi Research Global Fundamental Coverage | 48% | 40% | 12% | 0% | 100% | 0% |
| % of companies in each rating category that are investment banking clients | 66% | 63% | 56% | 0% | 64% | 0% |

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