ResMed Inc. RMD [NYSE] | ★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Stewardship	Morningstar Credit Rating	Industry
33.17 USD	33.00 USD	23.10 USD	46.20 USD	Medium	Narrow	C	—	Medical Instruments & Supplies

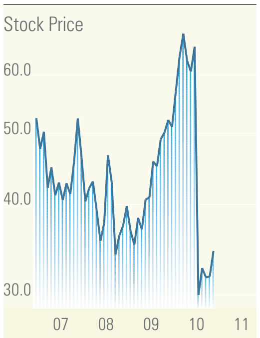
ResMed's 1Q Another Solid Performance

by James Cooper

Analysts covering this company do not own its stock.

Pricing data through January 12, 2011. Rating updated as of January 12, 2011.

Currency amounts expressed with "$" are in U.S. dollars (USD) unless otherwise denoted.



Analyst Note Dec. 15, 2010

ResMed's revenue for the first quarter of fiscal 2011 increased 14% from the year-ago period, to $282 million. In constant currency terms, the increase was 17%. Volume increases were the main growth driver. In the North and Latin American markets, net revenue grew 16% to $155.6 million. In other markets, net revenue expanded a lesser 13%, or 19% higher in constant currency terms.

Gross profit grew 16% to $174 million, with the gross margin strengthening to 61.7% from 60.8%. The main drivers of this improvement were new products, cost savings from manufacturing and supply-chain initiatives, and product mix. With most manufacturing carried out in Australia, the stronger Australian dollar limited the improvement. The future value of the Australian dollar relative to the U.S. dollar adds valuation uncertainty. Net income and earnings per share grew 35% and 33%, respectively, to $56.7 million and $0.36.

As of Sept. 30, ResMed had cash and cash equivalents of $540.0 million. Inventories were $214.2 million, an increase of $39.1 million or 22% from the Sept. 30, 2009, balance of $175.1 million. The bigger percentage increase in inventories than in sales mainly reflects an increase in the price of materials for new products and the impact of movements in foreign currency exchange rates, particularly the appreciation of the Australian dollar relative to the U.S. dollar.

We've increased our fair value estimate to reflect more optimistic assumptions about the sustainability of gross margins thanks to sustained innovation success and the positive impact on operating margins of scale benefits in manufacturing and lower growth in overhead. We now forecast the EBIT margin to trend higher to around 26% over the next five years. This compares with the previous forecast of around 20%.

Thesis Dec. 15, 2010

ResMed remains one of the key leaders of sleep apnea treatment. With its admirable innovative capabilities, we expect the firm to deliver solid returns in the long run, and we look forward to seeing what it develops next.

ResMed focuses on developing medical devices to treat sleep apnea and educating caregivers about therapy options. The firm's product portfolio consists of airflow generators, nasal masks, and pillows that introduce the airflow needed to prop open patients' respiratory pathways during sleep. These tools help patients breathe easier and avoid complications associated with sleep apnea, including exhaustion and hypertension. ResMed generates about half of its sales in the United States, while the other half is dispersed primarily throughout Europe, Japan, and Australia.

As a second-mover in sleep apnea devices, ResMed was initially forced to play catch-up by differentiating itself through technically superior devices. It still aims to maintain its technical edge, which has served it well so far. Patients can have a difficult time adjusting to sleep disruptions, and ResMed's advanced features can lead to greater patient comfort and compliance, which in turn leads to brand loyalty. As these patients return to ResMed's sleep lab and home health-care customers request ResMed products--especially masks and pillows--this highly profitable recurring revenue stream helps endear ResMed to its customer base.

ResMed faces tough competition, though, particularly from Philips Electronics (formerly Respironics). Respironics pioneered the industry and possesses admirable marketing and distribution capabilities. Also, its products are synonymous with sleep apnea treatment in the U.S., so ResMed faces a difficult challenge when trying to educate physicians about its own product set. Competitors also have shown a willingness to compete on price by blanketing the market with free samples during past new product launches, so ResMed must continue to stay ahead of the pack on innovation to prevent price erosion from substantially damaging returns.

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Close Competitors	Currency(Mil)	Market Cap	TTM Sales	Oper Income	Net Income
ResMed Inc.	USD	5,015	1,127	254	205
Koninklijke Philips Electronics, N.V.	USD	29,617	64,838	2,494	1,650
Covidien, Ltd.	USD	23,210	10,429	2,063	1,632

Morningstar data as of January 12, 2011.

We think ResMed has proved its ability to develop new sleep apnea treatments, and we expect more of the same in the future. Considering those development capabilities and the large potential patient pool that still remains undiagnosed or untreated in the sleep apnea market, ResMed looks positioned to grow at a fast clip by filling the gaps in existing therapeutic options.

Valuation, Growth and Profitability

We've raised our fair value estimate to $33 per share from $27 (after a two-for-one split), assuming that strong recent trends in the firm's growth and margins continue. In fiscal 2011, we expect new products and a weaker U.S. dollar to drive high teens sales growth at ResMed. However, we think operating margins may remain constrained around 19%-20% in fiscal 2011 because of the strong Australian dollar's impact on cost of goods. During the next five years, we expect key demographic trends (especially aging and obesity) and increased penetration of the potential patient pool (through greater awareness and more convenient testing options) to drive 15% compound annual sales growth at the firm. We expect operating margins to rise to near 26% by fiscal 2015, leading to 12.1% earnings growth during the period. This reflects more optimistic assumptions about the sustainability of gross margins, thanks to sustained innovation success, and the positive impact on operating margins of scale benefits in manufacturing and lower growth in overhead. This compares with our previous forecast for EBIT margins to level off at around 20%. We use an 11% cost of equity to discount future cash flows.

Risk

Like most medical device firms, ResMed must innovate or face significant pricing pressure. The company may not be able to stay at the head of the innovation class in future years, which would create an opening for competitors. The company also faces foreign exchange risk, as substantial development and manufacturing operations remain in Australia where the firm was founded, while more than 95% of its sales are dispersed throughout the rest of the world. The U.S. accounts for about half of ResMed's sales.

Bulls Say

- ResMed pursues the large, underpenetrated sleep-disorder breathing market. Growth should continue on a high trajectory as more patients incorporate ResMed's noninvasive treatments into their sleeping patterns.
- With focus now shifted toward compliance rather than low-cost systems, ResMed should thrive, given its history of introducing innovative products that improve sleep apnea therapy.
- A significant boost of at-home sleep apnea testing could open up the market to patients who had balked at costly, uncomfortable testing in a sleep lab.

Bears Say

- ResMed's ability to sell products depends largely on the willingness of third parties to pay for treatment. Lower reimbursement rates for ResMed's products would hurt revenue and margin potential.
- ResMed invests significantly in research and development. If it is unable to successfully introduce new products in the marketplace, sales and margins may suffer.
- Competitive sampling hurt ResMed's growth in recent years. If those practices return, the attractiveness of the sleep apnea device market could diminish and

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ResMed's returns could suffer.

Financial Overview

Financial Health: With more than $540 million in net cash after debt is considered as of March, ResMed remains in excellent financial health. Given its ability to generate significant free cash flow, we expect that position to strengthen in future years.

Company Overview

Profile: ResMed develops, manufactures, and distributes medical devices--such as airflow generators and masks--to treat breathing disorders. It recently acquired a ventilation firm, but the primary focus remains sleep apnea. ResMed's reach is truly global, with distribution capabilities in more than 70 countries through wholly owned and independent firms. Most of its manufacturing capacity remains in Australia, where it was founded.

Management: We give ResMed a C Stewardship Grade. We frown upon the ongoing perks and compensation doled out to chairman Peter Farrell and other executives. Current disclosure requirements shed clear light on those practices, which include personal use of company aircraft and club memberships; we do not think shareholders should have to foot those bills. We also don't like how much overall compensation Farrell continues to receive ($2.8 million in salary, incentives, and options last year) after stepping down as CEO. Even though Farrell founded and ran ResMed very well for nearly two decades, we don't think shareholders should have to continue paying such generous compensation to him during his retirement. We also don't like the staggered terms and clubby feel of the board of directors, which could make stewardship changes difficult at ResMed.

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Analyst Notes

Dec. 15, 2010

ResMed's 1Q Another Solid Performance

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Aug. 12, 2010

ResMed Under Review

We're placing ResMed under review as we transfer coverage to a new analyst.

Disclaimers & Disclosures

No Morningstar employees are officers or directors of this company. Morningstar Inc. does not own more than 1% of the shares of this company. Analysts covering this company do not own its stock. The information contained herein is not represented or warranted to be accurate, correct, complete, or timely. This report is for information purposes only, and should not be considered a solicitation to buy or sell any security.

ResMed Inc. RMD

Sales USD Mil	Mkt Cap USD Mil	Industry	Sector
1,127	5,015	Medical Instruments & Supplies	Health Care

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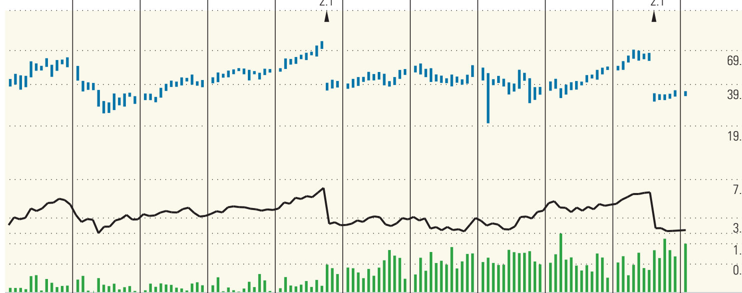
Morningstar Rating	Last Price	Fair Value	Uncertainty	Economic Moat™	Stewardship Grade
★★★	33.17	33.00	Medium	Narrow	C

per share prices in USD

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	YTD	
62.20	53.92	46.70	51.99	81.35	51.17	56.16	52.42	53.38	70.65	35.36	Annual Price High
36.25	24.30	29.33	40.35	35.75	36.80	38.34	20.51	31.49	29.67	32.54	Low
				2:1					2:1		Recent Splits



Price Volatility
Monthly High/Low
Rel Strength to S&P 500
52 week High/Low
35.90 - 25.26
10 Year High/Low
81.35 - 20.51
Bear-Market Rank
1 (10=worst)
Trading Volume Million

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	YTD	Stock Performance
35.2	-43.3	35.9	23.0	49.9	28.5	6.7	-28.6	39.5	32.5	-4.2	Total Return %
48.2	-19.9	9.5	14.0	46.9	14.9	3.2	9.9	16.1	19.7	-6.5	+/- Market
28.5	-30.2	-3.6	4.6	44.4	33.8	-13.0	3.4	6.6	29.1	-5.6	+/- Industry
—	—	—	—	—	—	—	—	—	—	0.0	Dividend Yield %
1734	1009	1411	1734	2714	3743	4061	2837	3931	5237	5015	Market Cap USD Mil

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	TTM	Financials
155	204	274	339	426	607	716	835	921	1092	1127	Revenue USD Mil
67.5	65.3	63.3	63.9	64.6	62.1	53.7	59.1	60.1	60.0	60.3	Gross Margin %
26	-51	67	85	97	131	90	143	190	240	254	Oper Income USD Mil
16.8	-25.1	24.6	25.2	22.9	21.6	12.6	17.1	20.7	22.0	22.5	Operating Margin %
12	38	46	57	65	88	66	110	146	190	205	Net Income USD Mil
0.09	0.28	0.33	0.41	0.46	0.58	0.43	0.70	0.95	1.23	1.31	Earnings Per Share USD
—	—	—	—	—	—	—	—	—	—	—	Dividends USD
134	136	138	140	150	154	157	157	154	155	156	Shares Mil
1.00	1.66	2.45	3.15	3.71	5.59	6.56	6.37	8.36	9.77	9.77	Book Value Per Share USD
30	36	59	77	71	99	91	138	239	188	183	Oper Cash Flow USD Mil
-27	-28	-26	-57	-40	-103	-78	-76	-110	-57	-58	Cap Spending USD Mil
2	7	34	19	31	-4	14	62	129	131	125	Free Cash Flow USD Mil

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	TTM	Profitability
5.8	11.3	10.9	11.4	9.8	9.9	5.9	8.3	10.1	12.1	12.0	Return on Assets %
12.0	25.6	19.1	17.7	15.5	14.6	7.9	11.0	13.3	15.8	15.3	Return on Equity %
7.5	18.4	16.7	16.9	15.2	14.5	9.3	13.2	15.9	17.4	18.2	Net Margin %
0.77	0.61	0.65	0.68	0.65	0.68	0.63	0.63	0.63	0.70	0.66	Asset Turnover
2.9	2.0	1.6	1.5	1.6	1.4	1.3	1.3	1.4	1.3	1.2	Financial Leverage

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	09-10	Financial Health
144	145	191	217	142	381	466	547	584	673	782	Working Capital USD Mil
150	123	113	113	59	116	87	94	94	0	—	Long-Term Debt USD Mil
100	193	286	362	474	738	931	1082	1115	1288	1477	Total Equity USD Mil
1.49	0.64	0.40	0.31	0.12	0.16	0.09	0.09	0.08	—	—	Debt/Equity

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	TTM	Valuation
119.1	26.0	27.8	29.7	40.5	37.0	65.4	24.1	23.3	26.4	25.3	Price/Earnings
—	—	—	—	—	—	—	—	—	1.5	1.6	P/E vs. Market
9.9	4.5	4.8	4.9	5.8	5.7	5.4	3.3	4.0	4.8	4.6	Price/Sales
13.6	4.6	4.2	4.1	5.2	4.4	4.0	2.9	3.1	3.5	3.4	Price/Book
55.3	25.9	22.2	20.7	46.5	34.1	43.7	13.6	21.1	29.5	28.3	Price/Cash Flow

Growth Rates Compound Annual

Grade: B	1 Yr	3 Yr	5 Yr	10 Yr
Revenue %	18.6	15.1	20.8	25.2
Operating Income %	26.3	38.7	19.8	21.9
Earnings/Share %	28.9	42.3	21.9	21.7
Dividends %	—	—	—	—
Book Value/Share %	14.8	12.3	20.2	27.2
Stock Total Return %	29.0	10.5	11.5	13.3
+/- Industry	25.0	12.7	10.8	7.9
+/- Market	15.8	13.3	11.5	13.8

Profitability Analysis

Grade: C	Current	5 Yr Avg	Ind	Mkt
Return on Equity %	15.3	12.5	3.8	22.0
Return on Assets %	12.0	9.3	2.1	8.5
Fixed Asset Turns	2.8	2.7	4.7	7.2
Inventory Turns	2.3	2.3	3.6	14.0
Revenue/Employee USD K	352.3	322.8*	—	884.1
Gross Margin %	60.3	59.0	51.7	39.6
Operating Margin %	22.5	18.8	14.2	14.2
Net Margin %	18.2	14.1	3.3	9.5
Free Cash Flow/Rev %	11.1	—	11.5	0.1
R&D/Rev %	6.8	0.1	—	10.0

Financial Position

Grade: A	06-10 USD Mil	09-10 USD Mil
Cash	489	540
Inventories	186	214
Receivables	232	238
Current Assets	985	1069
Fixed Assets	387	424
Intangibles	230	272
Total Assets	1626	1792
Payables	80	72
Short-Term Debt	122	94
Current Liabilities	313	286
Long-Term Debt	0	—
Total Liabilities	339	315
Total Equity	1288	1477

Valuation Analysis

	Current	5 Yr Avg	Ind	Mkt
Price/Earnings	25.3	35.2	27.5	16.2
Forward P/E	19.0	—	—	15.1
Price/Cash Flow	28.3	28.4	14.8	8.5
Price/Free Cash Flow	41.3	—	22.4	16.9
Dividend Yield %	—	—	1.1	1.8
Price/Book	3.4	3.6	3.0	2.2
Price/Sales	4.6	4.6	2.6	1.4
PEG Ratio	1.0	—	—	1.7

*3Yr Avg data is displayed in place of 5Yr Avg

Quarterly Results

Revenue USD Mil	Dec 09	Mar 10	Jun 10	Sep 10
Most Recent Period	275.1	278.7	291.6	282.0
Prior Year Period	223.0	227.9	252.0	247.0

Rev Growth %	Dec 09	Mar 10	Jun 10	Sep 10
Most Recent Period	23.4	22.3	15.7	14.2
Prior Year Period	10.0	7.6	7.2	13.3

Earnings Per Share USD	Dec 09	Mar 10	Jun 10	Sep 10
Most Recent Period	0.30	0.32	0.34	0.36
Prior Year Period	0.22	0.26	0.30	0.28

Industry Peers by Market Cap

	Mkt Cap USD Mil	Rev USD Mil	P/E	ROE%
ResMed Inc.	5015	1127	25.3	15.3
Koninklijke Philips	29617	64838	18.5	8.5
Covidien, Ltd.	23210	10429	15.1	19.2

Major Fund Holders

	% of shares
American Funds Growth Fund of Amer A	2.41
Fidelity Contrafund	0.98
American Funds NVIT Growth II	0.73

TTM data based on rolling quarterly data if available; otherwise most recent annual data shown.

Morningstar's Approach to Rating Stocks

Our Key Investing Concepts

- Economic Moat™ Rating
- Discounted Cash Flow
- Discount Rate
- Fair Value
- Uncertainty
- Margin of Safety
- Consider Buying/Consider Selling
- Stewardship Grades

At Morningstar, we evaluate stocks as pieces of a business, not as pieces of paper. We think that purchasing shares of superior businesses at discounts to their intrinsic value and allowing them to compound their value over long periods of time is the surest way to create wealth in the stock market.

We rate stocks 1 through 5 stars, with 5 the best and 1 the worst. Our star rating is based on our analyst's estimate of how much a company's business is worth per share. Our analysts arrive at this "fair value estimate" by forecasting how much excess cash--or "free cash flow"--the firm will generate in the future, and then adjusting the total for timing and risk. Cash generated next year is worth more than cash generated several years down the road, and cash from a stable and consistently profitable business is worth more than cash from a cyclical or unsteady business.

Stocks trading at meaningful discounts to our fair value estimates will receive high star ratings. For high-quality businesses, we require a smaller discount than for mediocre ones, for a simple reason: We have more confidence in our cash-flow forecasts for strong companies, and thus in our value estimates. If a stock's market price is significantly above our fair value estimate, it will receive a low star rating, no matter how wonderful we think the business is. Even the best company is a bad deal if an investor overpays for its shares.

Our fair value estimates don't change very often, but market prices do. So, a stock may gain or lose stars based just on movement in the share price. If we think a stock's fair value is $50, and the shares decline to $40 without much change in the value of the business, the star rating will go up. Our estimate of what the business is worth hasn't changed, but the shares are more attractive as an investment at $40 than they were at $50.

Because we focus on the long-term value of businesses, rather than short-term movements in stock prices, at times we may appear out of step with the overall stock market. When stocks are high, relatively few will receive our highest rating of 5 stars. But when the market tumbles, many more will likely garner 5 stars. Although you might expect to see more 5-star stocks as the market rises, we find assets more attractive when they're cheap.

We calculate our star ratings nightly after the markets close, and issue them the following business day, which is why the rating date on our reports will always be the previous business day. We update the text of our reports as new information becomes available, usually about once or twice per quarter. That is why you'll see two dates on every Morningstar stock report. Of course, we monitor market events and all of our stocks every business day, so our ratings always reflect our analyst's current opinion.

Economic Moat™ Rating

The Economic Moat™ Rating is our assessment of a firm's ability to earn returns consistently above its cost of capital in the future, usually by virtue of some competitive advantage. Competition tends to drive down such

Morningstar Research Methodology for Valuing Companies

Competitive Analysis →	**Economic Moat™ Rating** →	Company Valuation →	**Fair Value Estimate** →	Uncertainty Assessment →	★★★★★
Analyst conducts company and industry research: • Management interviews • Conference calls • Trade-show visits • Competitor, supplier, distributor, and customer interviews	The depth of the firm's competitive advantage is rated: • None • Narrow • Wide	Analyst considers company financial statements and competitive position to forecast future cash flows. Assumptions are input into a discounted cash-flow model.	DCF model leads to the firm's Fair Value Estimate, which anchors the rating framework.	An uncertainty assessment establishes the margin of safety required for the stock rating.	★ ★★ ★★★ ★★★★ ★★★★★ The current stock price relative to fair value, adjusted for uncertainty, determines the rating.

economic profits, but companies that can earn them for an extended time by creating a competitive advantage possess an Economic Moat. We see these companies as superior investments.

Discounted Cash Flow

This is a method for valuing companies that involves projecting the amount of cash a business will generate in the future, subtracting the amount of cash that the company will need to reinvest in its business, and using the result to calculate the worth of the firm. We use this technique to value nearly all of the companies we cover.

Discount Rate

We use this number to adjust the value of our forecasted cash flows for the risk that they may not materialize. For a profitable company in a steady line of business, we'll use a lower discount rate, also known as "cost of capital," than for a firm in a cyclical business with fierce competition, since there's less risk clouding the firm's future.

Fair Value

This is the output of our discounted cash-flow valuation models, and is our per-share estimate of a company's intrinsic worth. We adjust our fair values for off-balance sheet liabilities or assets that a firm might have--for example, we deduct from a company's fair value if it has issued a lot of stock options or has an under-funded pension plan. Our fair value estimate differs from a "target price" in two ways. First, it's an estimate of what the business is worth, whereas a price target typically reflects what other investors may pay for the stock. Second, it's a long-term estimate, whereas price targets generally focus on the next two to 12 months.

Uncertainty

To generate the Morningstar Uncertainty Rating, analysts consider factors such as sales predictability, operating leverage, and financial leverage. Analysts then classify their ability to bound the fair value estimate for the stock into one of several uncertainty levels: Low, Medium, High, Very High, or Extreme. The greater the level of uncertainty, the greater the discount to fair value required before a stock can earn 5 stars, and the greater the premium to fair value before a stock earns a 1-star rating.

Margin of Safety

This is the discount to fair value we would require before recommending a stock. We think it's always prudent to buy stocks for less than they're worth.The margin of safety is like an insurance policy that protects investors from bad news or overly optimistic fair value estimates. We require larger margins of safety for less predictable stocks, and smaller margins of safety for more predictable stocks.

Consider Buying/Consider Selling

The consider buying price is the price at which a stock would be rated 5 stars, and thus the point at which we would consider the stock an extremely attractive purchase. Conversely, consider selling is the price at which a stock would have a 1 star rating, at which point we'd consider the stock overvalued, with low expected returns relative to its risk.

Stewardship Grades

We evaluate the commitment to shareholders demonstrated by each firm's board and management team by assessing transparency, shareholder friendliness, incentives, and ownership. We aim to identify firms that provide investors with insufficient or potentially misleading financial information, seek to limit the power of minority shareholders, allow management to abuse its position, or which have management incentives that are not aligned with the interests of long-term shareholders. The grades are assigned on an absolute scale--not relative to peers--and can be interpreted as follows: A means "Excellent," B means "Good," C means "Fair," D means "Poor," and F means "Very Poor."