Zacks Small-Cap Research

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Lisa Thompson
312-265-9154
lthompson@zacks.com

scr.zacks.com

10 S. Riverside Plaza, Chicago, IL 60606

Auxilio Inc. (AUXO-OTCQB)

AUXO: Zacks Company Report - Reports Record Earnings, Moves into New Services OUTPERFORM

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	08/21/2011
Current Price (04/02/14)	$1.45
Six- Month Target Price	**$2.00**

OUTLOOK

AUXILIO manages and reduces printing costs for hospitals and facilities by providing on-site staff and vendor management. It is the only vender neutral provider. Its services are in high demand and clients' budgets are squeezed and health care profitability is reduced. The company planning to roll other IT services to sell its client base to increase the company TAM as well as increase margins.

SUMMARY DATA

52-Week High	**$1.72**
52-Week Low	**$0.85**
One-Year Return (%)	**47.96**
Beta	**1.62**
Average Daily Volume (sh)	**57,408**
Shares Outstanding (mil)	**21**
Market Capitalization ($mil)	**$30**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**0**
Insider Ownership (%)	**27**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**N/A**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using TTM EPS	**24.2**
P/E using 2014 Estimate	**14.5**
P/E using 2015 Estimate	**11.1**
Zacks Rank	**N/A**

Risk Level	**High**
Type of Stock	**Small-Growth**
Industry	**Outsourcing**

ZACKS ESTIMATES

Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2012	7 A	11 A	9 A	10 A	36 A
2013	10 A	10 A	11 A	11 A	43 A
2014	13 E	13 E	13 E	13 E	51 E
2015					57 E

Earnings per Share
(EPS is operating earnings before non-recurring items)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2012	-$0.07 A	-$0.01 A	-$0.02 A	$0.00 A	-$0.11 A
2013	$0.00 A	$0.00 A	$0.04 A	$0.02 A	$0.06 A
2014	$0.02 E	$0.02E	$0.03 E	$0.05 E	$0.10 E
2015					$0.13 E

Zacks Projected EPS Growth Rate - Next 5 Years %	**N/A**
N/A	**N/A**

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WHAT'S NEW

Stellar Profits, New Services, New Estimates

On March 31, 2014, AUXILIO, Inc., California-based Managed Print Services (MPS) company for the health care industry, reported a stellar fourth quarter and year-end financial results for the period ended December 31, 2013. Sales in Q4 were up 28% to $12.3 million versus $9.6 million in 2012. For the year, sales increased to $43 million up 21% from a year ago. Sales for the quarter beat our estimates by $1.5 million. Sales growth for the year was primarily the result of adding nine new contracts during the course of the year rather than growth from existing customers. Of the $43 million in sales, $37.1 million was recurring revenue, which was up 22% from the year before.

Gross margins increased in the quarter to 18.2% versus 15.9% the year before. Sequential this was down from 20.6% in Q3 due to the addition of new customers that always has higher costs in the beginning of a contract. The company is targeting a long-term gross margin of 20-25%.

For the year, gross margins came in at 17.9% a significant improvement over the 13% in 2012. As the business scales, and contracts mature, we expect gross margin for the company to continue to improve although on a quarterly basis this may not always be the case as the timing of new contracts could cause margins to vary. In the future the company will pursue IT management business that will not have the same up front costs and this could cause margins to stabilize even sooner.

Total non-GAAP operating expenses declined year over year by $200,000 to $5.2 million compared to $5.4 million in 2012. This improvement was help primarily by the termination of a channel partner agreement with a third party.

As a result, non-GAAP income from operations during the year was $2.6 million compared to a loss from operations of $760,000 for 2012. This yielded a fully diluted non-GAAP EPS of $0.09 a share versus a loss of $0.08 the year before.

With improved profitability, company's balance sheet also improved with cash increasing to $4.7 million, up $1.6 million from the September quarter. Working capital swung to a positive $254,000. Cash flow for the year was a positive $2 million. In 2014, the company's convertible notes are due. The company expects to pay off part of them, and some will be converted to stock, which should reduce interest expense by $100,000 per quarter.

Auxilio now serves 100 campuses comprised of 2,100 facilities and has been able to penetrate larger customers due to their track record. For the 2013 year the company had its four largest customers generate 52% of sales, which remains the biggest risk to investors. This is down from 59% the year before so the company is making slow progress alleviating this risk.

As of December 31, 2013, the had 193 full-time employees and three part-time employees, including 174 employees engaged in providing services, 7 employees engaged in sales and marketing, and 15 employees engaged in general and administrative activities.

New Senior Management Hire to Provide New Service Offerings

Last week the company announced the hiring of a new EVP, Mark Dressel who will head up the new Consulting and Managed IT Services Group. He will be creating new service offerings to sell to existing clients for health care consulting and IT sourcing and outsourcing as well as services to sell to companies outside of the health care industry. Within health care, new government mandates for medical record keeping has stretched in-house IT departments thin and Auxilio plans to offer help. We expect these

offerings to leverage the company's existing relationships and expertise, and to smooth out its margins long term as well as significantly increase its total addressable market (TAM) to aid future growth. Mark has an impressive background with more than 25 years of experience in assisting health care clients as Director and Global Practice Manager for Dell's Healthcare Consulting Group, as well as similar roles with Accenture, Ernst & Young and Cerner Corporation. Mark received a BS in applied mathematics at University of Wisconsin at Stout and has a MBA from Pepperdine University.

Progress in Q1 2014

The company also announced the signing of three major contracts since December 31, 2013. Since only nine were signed in all of 2013, the company is on track to add more new business this year than last. During the call today, the company indicated that is already had contracts signed to get the company to a total of $42 million in recurring revenue versus the $37.1 million it generated in 2014. If we add the same $6 million in additional revenues sold last year to that $42 we could reach $48 million for 2014 without any further growth for the rest of the year.

INVESTMENT THESIS

- Auxilio is a services company with over 86% recurring revenue and should command a higher earnings multiple due to a high degree of visibility.
- It is a smaller player in a market at least ten times its size and as the only non-vendor specific provider in the health care marketplace. It should be able to capture market share due to its focus on customer cost savings rather than hardware sales.
- The company is a pure-play on the need for health care providers to cut costs as well as comply with new IT regulations.
- On a non-GAAP basis the company is trading at 13Xs our expected 2014 non-GAAP EPS of $0.13 with earnings growth over 40%
- Given the earnings and revenue growth we believe the company should trade at 20Xs 2014 non-GAAP EPS of $0.13 or $2.60
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INDUSTRY OUTLOOK

Our outlook for the business services industry is **neutral**. Companies in this broadly characterized industry provide consulting, information and data, information technology (IT), marketing, payment processing, staffing, and other outsourcing services to businesses. The industry is generally tied to the economy, and is related to growth in business spending. Most firms in this industry have straightforward business models that generate healthy cash flows, low debt levels, and negligible dividend payouts. Firms in this industry are wide-ranging in terms of size, market share, and geographic reach.

The business services industry has posted a wide range of year-over-year earnings growth. Our calculated median fourth quarter 2004 year-over-year earnings per share growth was an impressive 14%, which was a sequential increase of 4% (compared to third quarter earnings). This growth rate is impressive, as the industry is leveraged to an improving economy and has also been facing easier comparisons. We expect the group to experience wide-ranging results in 2005, and slower earnings growth in the second half of 2005 when comparisons become more challenging. However, many firms are still tied to a later stage economic recovery and should benefit accordingly. The overall

long-term earnings per share growth outlook is solid for the industry at 15%, compared to just 6% for the S&P 500.

We believe firms will continue to increase spending for equipment, consulting, staffing, and outsourcing services. While rising business volume is the most significant factor promoting spending on capital equipment and services, other factors will likely play a supporting role, such as a historically low interest rate environment and improving balance sheets. Stronger balance sheets and favorable capital markets may also lead to consolidation in the industry. Notably, we do forecast that business investment in computers and software will be strong in 2005 and 2006 (16% and 12%, respectively), but slowing.

We expect strong growth in the outsourcing industry over the next three-to-five years, as it allows corporations to focus more on their core businesses. This also reduces the growing costs associated with in-house systems. Outsourcing has advanced from running software and data centers to a growing trend toward business-process outsourcing (BPO), where a company takes over the back-office functions for clients, such as human resources, payroll, travel services, and accounting. Additionally, customer contact outsourcing is also expected to support strong growth opportunities over the next few years. There are significant growth opportunities in the various outsourcing markets. However, competition is fierce, making pricing very competitive. Many of the new agreements involve outsourcing of data centers, technology, accounting functions, human resources and customer contact management. Globally, telecommunications, manufacturing, and financial services are the largest buyers of outsourcing services.

Generally, employment services firms, such as staffing, permanent placement and search firms should benefit from the recovering job market. In 2004, U.S. job growth was volatile, but was solid overall. These companies generally participate in a later stage economic recovery. Typically, staffing firms initially benefit from an economic recovery, followed by placement firms. Hiring had previously been muted over the last couple years, as firms were managing the economic downturn by cutting costs and restructuring, particularly by reducing headcount. Primarily due to corporate America's efforts at streamlining company's operations and creating a leaner cost structure, corporations had been experiencing improved productivity upon better demand conditions.

We are now forecasting labor productivity to remain near a healthy 3% in 2005, and not slowing as much as previously expected. Strong productivity, combined with our view of a stronger second half 2005 economic outlook, support further hiring activity, albeit at a more modest pace. Near-term there are risks of a slower economy, which would bode poorly for employment-related and certain other business services tied to investment spending. First quarter GDP growth came in weaker than expected. Continued hiring, and a stricter regulatory environment, combined with robust mergers & acquisitions (M&A) activity are supporting solid growth opportunities for search firms that are responsible for finding top-level executives, and consulting firms that are tied to helping provide advice on mergers and regulatory issues. Furthermore, recent hiring surveys by staffing/placement firms have been supportive of favorable hiring trends in 2005, with notable strength in finance and accounting jobs, as well as in industrial staffing with expectations of a better IT staffing environment in 2005. However, anecdotal evidence take from certain earnings releases and management guidance is suggesting mixed signals. There is some weakness in first quarter demand, and a cautious near-term outlook to others suggesting demand trending strongly in the first quarter and into the second. All in all, we believe the outlook on employment services firms, such as staffing/placement/search firms is mixed near-term and favorable over the longer-term.

The employment services firms tied to hiring trends have significant operating leverage, particularly as most of these firms managed the slowdown in the labor market, since early 2001 through May 2003, by reducing headcount and closing down offices or disposing of certain practices. As a result, these companies will be able to leverage strong top-line growth into much stronger bottom-line growth over the next cycle. In addition, many companies in the staffing industry generate a significant portion of their revenues outside the U.S. Internationally, the hiring outlook appears strong in the United Kingdom and the Asia/Pacific region, with varied hiring activity in continental Europe, stable to improving conditions in

France and weaker hiring activity in Germany over the near-term. While employment services stocks should post strong growth over the next couple years, valuations are starting to factor in decelerating hiring, which supports selective buying opportunities for the longer-term in our opinion. Near-term, these stocks could be under pressure on concern over weak economic growth and GDP

Overall, because of the broad range of companies in this industry, we expect the industry to perform in-line with the S&P 500.

Top 5 Public Companies in the industry

Ticker	*Company*	Market Share	*Zacks Rec*
ADP	Automatic Data	28.10557	Neutral
RRD	Donnelley (Rr)	26.04352	Neutral
BCO	Brinks Co The	9.79635	N/A
BR	Broadridge Finl	6.04053	Outperform
CGEMY	Cap Gemini Sa	N/A	N/A

VALUATION

Auxilio is a traditional services company with a high degree of recurring revenues and as such should be afforded a PE in line with its growth rate. We believe the company can grow revenues at 20% and earnings much faster than that as it is has a scalable business model and has just moved to sustainable profitability in 2013. It should be able to improve margins for the next few years as it grows into it long term goals. On a PE basis we believe the company should trade at 15Xs its 2015 EPS or approximately $2.00 within the next six months.

The company is also inexpensive on an enterprise value to sales basis. Its enterprise value is $42 million and 2013 sales were $43 million. At the industry average for business services companies of 2 to 3 times market value to sales the company is worth $86 to $130 million or $3.30 to $5 per share.

Business Services	Industry Avg	Sector Avg	S&P Avg
Market Capitalization	**4.3 B**	**5.7 B**	**34.5 B**
Price/Earnings	**25.4x**	**25.1x**	**17.7x**
Price/Book	**8.5x**	**5.2x**	**4.3x**
Price/Sales	**3.1x**	**2.2x**	**1.6x**
Price/Cash Flow	**15.6x**	**12.7x**	**9.3x**
Return on Equity	**22.60%**	**17.25%**	**15.04%**
Total Debt/Equity	**0.5x**	**1.3x**	**0.7x**
Dividend Yield	**0.85%**	**1.26%**	**1.92%**

RISKS

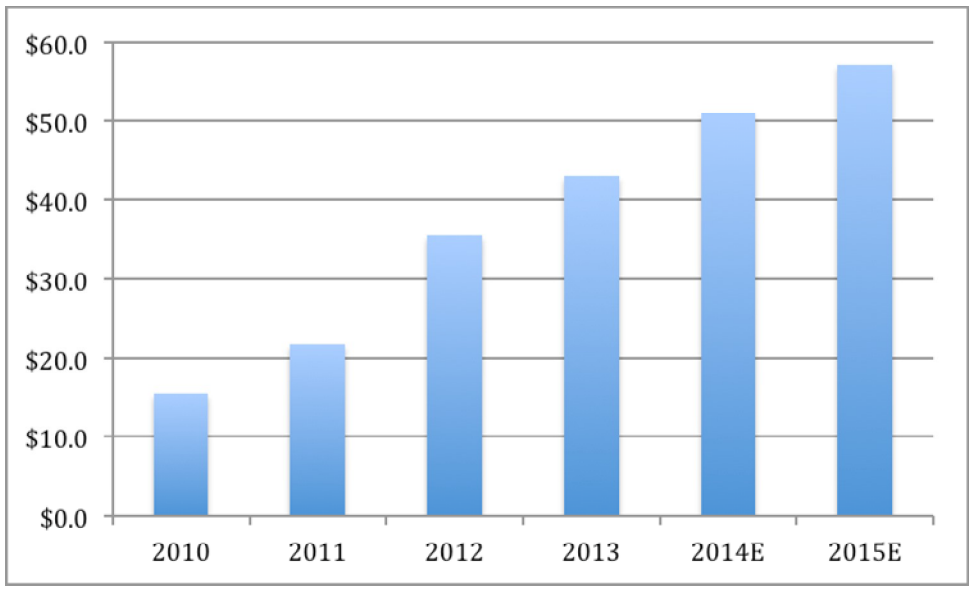
- The greatest risk in Auxilio is its reliance of 52% of its revenue on four large customers. The loss of any of them could cause great damage to the stock price.
- Auxilio has very low trading volume that could make it difficult to get in and out of the stock.
- The health care industry is in flux and there could be an increase in the sales cycle as hospitals focus on other aspects of their business
- The new electronic medical record mandate could cut into the production of paper documents

PROJECTED INCOME STATEMENT

For 2014 we are forecasting Auxilio to generate $51 million in revenues versus $43 million in 2013 given long term contracts already booked, growth in its sales force, and its increased ability to penetrate larger customers given its now-proven track record. With increased margins due to operating efficiencies, we believe the company can grow earnings even faster. Moving from just 4% operating margins today to 6% next year could increase operating earnings over 50%. Given a slightly higher state tax rate and lower interest expense due to the maturing of convertible notes, we believe non-GAAP EPS could go from $0.09 to $0.13 in 2014. The company still has $15.5 million in federal tax loss carry-forward and $8.5 million in state tax loss carry-forward that should keep them at virtually zero taxes except for certain states.

In 2015 we expect the company to grow another 15% or faster as it adds additional IT services to its product offerings and continues its market penetration. Revenues could reach $57 million and non-GAAP EPS of $0.16.

Auxilio Revenues (in millions)



	Dec Q4 12	Dec Q4 13	March Q1 14E	June Q2 14E	Sept Q3 14E	Dec Q4 14E	2011	2012	2013	2014E	2015E
REVENUE											
Net Revenue	$9.6	$12.3	$12.5	$12.7	$12.9	$12.9	$21.8	$35.6	$43.0	$51.00	$57.1
Yr.-to-yr. Gr.		28%	24%	30%	19%	5%	42%	63%	21%	19%	12%
OPERATING EXPENSES											
Cost of goods sold	8.1	10.0	10.5	10.5	10.5	10.0	19.1	31.0	$35.3	41.5	46.2
Gross Margin	1.5	2.2	2.0	2.2	2.4	2.9	2.7	4.6	7.7	9.5	10.9
% Of Sales	15.9%	18.2%	16.0%	17.3%	18.6%	22.5%	12.4%	13.0%	17.9%	18.6%	19.1%
S&M	2.2	0.46	0.5	0.6	0.6	$0.6	1.8	2.6	2.1	2.3	2.6
G&A	2.4	0.96	1.0	1.0	1.1	$1.1	3.4	3.7	3.8	4.2	4.9
Tot Operating Exp.	4.6	1.41	1.5	1.6	1.7	1.7	5.2	6.3	5.9	6.5	7.6
Operating Income	(3.0)	0.8	0.5	0.6	0.7	1.2	(2.5)	(1.6)	1.8	3.0	3.4
Net Interest	(0.1)	(0.100)	(0.1)	0.0	0.0	0.0	(0.1)	(0.5)	(0.4)	(0.2)	0.0
Other income		0.000	0.0	0.0	0.0	0.0	0.1	(0.3)	0.1	0.1	0.1
Pretax Income	(3.1)	0.721	$0.4	$0.6	$0.7	$1.2	($2.5)	(2.4)	1.4	2.8	3.4
Taxes	(0.5)	0.1	0.0	0.1	0.1	0.1	0.0	0.0	0.1	0.3	0.3
Tax Rate	17.1%	8.6%	10.0%	10.0%	10.0%	10.0%	(0.0)	-0.3%	5.5%	10.0%	10.0%
Net Income	(2.6)	0.7	0.4	0.5	0.6	1.1	(2.5)	(2.4)	1.3	2.5	3.0
EPS-Basic	$0.00	$0.03	$0.02	$0.02	$0.03	$0.05	($0.13)	($0.12)	$0.07	$0.12	$0.15
EPS-Fully dil.	**$0.00**	**$0.03**	**$0.02**	**$0.02**	**$0.03**	**$0.05**	**($0.13)**	**($0.12)**	**$0.06**	**$0.10**	**$0.13**
Non-GAAP Fully Dil								($0.08)	$0.09	$0.13	$0.16
Share Out	19.6	20.6	20.6	20.7	20.8	20.9	19.4	19.6	20.3	20.3	20.4
Fully diluted shares	19.6	22.8	23.0	23.2	23.2	23.6	19.4	19.6	22.8	23.7	24.0
Yr.-to-yr. Gr.							0.8%	1.1%	16.6%	3.7%	1.3%

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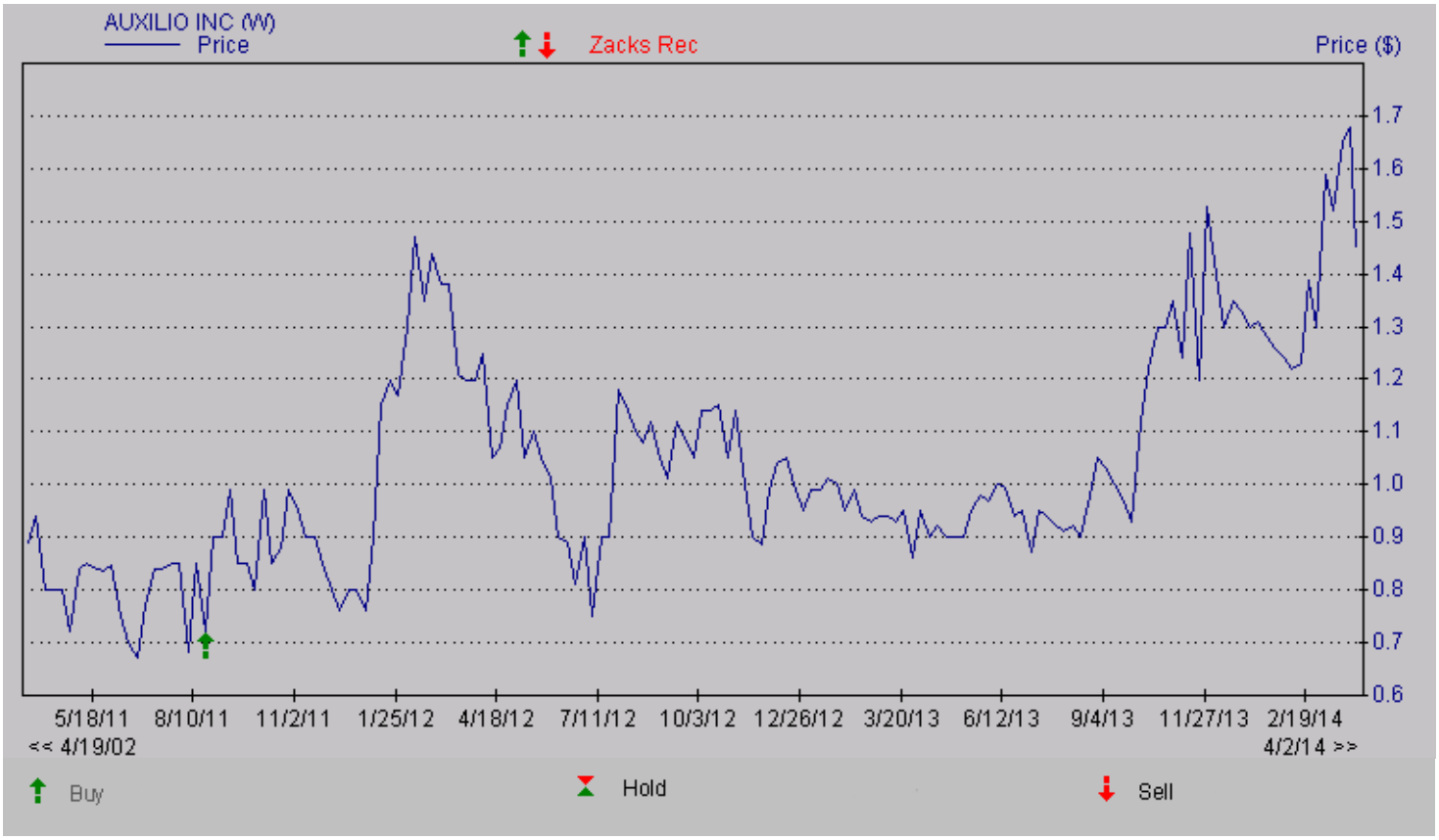

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