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Zacks Small - Cap Research

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Electromed Inc (ELMD-AMEX)

ELMD: Electromed

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	5/12/2011
Current Price (08/13/12)	$1.91
Target Price	**$3.70**

OUTLOOK

Following Q3 results we trimmed some of our revenue estimates due to a slower than anticipated pace in net growth of the sales force. Management's plan continues to be to grow their sales force which remains the main impetus for sales growth. New international distributors could spark more growth overseas - although the domestic business will likely remain 90%+ of total revenue. In May, following Q3 results we moved our current year EPS estimate from $0.12 to $0.09 (ex-severance expenses) and our price target from $4.00 to $3.70. We expect ELMD will report fiscal Q4 / full-year 2012 results near mid-September.

We are maintaining our Outperform rating.

SUMMARY DATA

52-Week High	**$4.49**
52-Week Low	**$1.80**
One-Year Return (%)	**-40.99**
Beta	**0.14**
Average Daily Volume (sh)	**4,010**
Shares Outstanding (mil)	**8**
Market Capitalization ($mil)	**$15**
Short Interest Ratio (days)	**0.45**
Institutional Ownership (%)	**0**
Insider Ownership (%)	**37**
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	**14.7**
P/E using 2012 Estimate	**31.8**
P/E using 2013 Estimate	**9.1**
Zacks Rank	**N/A**

Risk Level	**N/A,**
Type of Stock	**Small-Blend**
Industry	**Med Instruments**

ZACKS ESTIMATES

Revenue
(in '000 of $)

	Q1 (Sep)	Q2 (Dec)	Q3 (Mar)	Q4 (Jun)	Year (Jun)
2011	4,165 A	4,686 A	5,199 A	4,954 A	19,004 A
2012	5,378 A	4,790 A	4,774 A	5,245 E	20,198 E
2013					23,295 E
2014					26,179 E

Earnings per Share

	Q1 (Sep)	Q2 (Dec)	Q3 (Mar)	Q4 (Jun)	Year (Jun)
2011	$0.02 A	$0.04 A	$0.06 A	$0.02 A	$0.13 A
2012	$0.03 A	$0.00 A	$0.01 A	$0.01 E	$0.06 E
2013					$0.21 E
2014					$0.30 E

Zacks Projected EPS Growth Rate - Next 4 Years % **33**

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Bob Hansen, CEO, retires (from our May 16, 2012 report)

Bob Hansen, ELMD's founder and long-time CEO and Chairman announced his retirement, noting that he will devote more time to another business interest in which he was also the founder. Jim Cassidy, who was hired in 2011 as ELMD's Chief Operating Officer, has been appointed interim CEO. Jim comes from a solid background in medical devices and holds a PhD in biomedical engineering. The plan for filling the CEO and COO spots remains open for now - with the indication that Jim will cut his teeth in the CEO role for now while continuing to manage the COO functions. Stephen Craney, a member of ELMD's board of directors, was appointed Chairman.

Q3 2012 Financial Results (from our May 16, 2012 report)

Electromed reported financial results for the fiscal 2012 third quarter ending March 31, 2012 on May 15th. For the second straight quarter revenue came in well below our estimate. In Q2 management noted that layoffs of certain underperforming sales personnel impacted revenue in that period. In the most recent quarter, Q3, reimbursement hindrances impacted revenue. As has been noted in the past, reimbursement amount for SmartVest can differ among third-party payers (most notably between Medicare and private payers) as can the reimbursable diagnoses. The indication from management was that while the number of prescriptions grew y-o-y, a greater number of prescriptions were either reimbursed by Medicare or were not reimbursement altogether which caused the contraction in revenue in Q3 2012. We think another factor that caused Q3 revenue to come in lower than our estimate was slower net growth of the size of the sales force - while ELMD is still adding headcount, the pace has been slower than management had previously expected, at least some of which is likely a result of the turnover in Q2. In addition, there's a learning curve for newly hired reps which means there is typically some lag between the date of hire and when reps reach optimum productivity.

As the size of the sales force can have a very direct relationship on the level of revenue, it has been an important metric to look at. Management noted on the call that at the end of Q3 (3/31/2012) they had 21 sales reps, currently (May 2012) have 22, and have postings out for 3 more. This compares to 21 at the end of Q2 (12/31/11), which fell from 23 at the end of Q1 (9/30/11). Prior to the sales force hiccup in Q2, management had been shooting to have about 27 reps on board by the end of the current fiscal year (6/30/2012). That's now unlikely to happen. Nonetheless, management affirmed on the call their strategy to regularly add reps remains intact. We have trimmed some of our Home Care revenue estimates to account for the slower than previously anticipated growth in the sales force, although our long-term outlook remains highly positive.

Revenue
Q3 revenue of $4.77 million was down 8% y-o-y (flat sequentially) and consisted of $4.36 million (-7% y-o-y) from the Homecare segment, $165k (+15% y-o-y) from International and $249k (-32% y-o-y) from Government/Institutional.

The relative weakness in the Homecare segment reflects the reimbursement factors as well as the hangover from the recent turnover in sales personnel. As noted, our modeled revenue growth estimates continue to reflect the expectation that ELMD continues to add sales headcount throughout the remainder of the current year and beyond. While Q2 and Q3 are typically stronger quarters, this may not be the case for the current year as a result of restocking the sales force and getting the replaced positions up to speed and productive - we expect that this might result in Q4 revenue coming in stronger than either Q2 or Q3.

	Actual Q3 2011	Actual Q3 2012	Y-o-Y Change	Zacks Est Q3 2012	Actual +/- Zacks est.
Homecare	$4,689.0	$4,360.0	-7.0%	$5,025.0	-13.2%
International	$143.0	$165.0	15.4%	$165.0	0.0%
Gov't / Instit.	$367.0	$249.0	-32.2%	$335.0	-25.7%
	$5,199.0	**$4,774.0**	**-8.2%**	**$5,525.0**	**-13.6%**

Total revenue came in about 14% less than our estimate, despite International sales coming in right on with our $165k number. ELMD recently took steps to facilitate growth of their International business including signing distribution agreements with Linde Healthcare and Leader Healthcare FZCO for the German and parts of the Middle East region, respectively.

Gross Margin
GM came in at 70.6% compared to our 74.0% estimate. Electromed's GM can jump around from quarter-to-quarter based on the mix of reimbursement rates and management indicated on the call that this relatively low GM is not expected to persist over the longer-term.

Operating Expenses
SG&A came in at $2.90 million, or 60.8% of sales, compared to our 58.0% estimate. Similar to Q2 where revenue also came in meaningfully below our estimate, the higher than modeled SG&A as a percent of sales is likely mostly attributable to the fixed-cost portion of SG&A which is more exposed with revenue coming in below our estimate. ELMD continues to invest in support infrastructure and personnel - mostly customer service, reimbursement and billing - activities which are essential to growth of the business. As we've noted in the past, we expect these fixed expenses in SG&A to be leverageable as revenue grows - but in the case of the past two quarters where revenue falls short, these expenses are highlighted and crimp the bottom line.

Q4 2012 expenses will include a severance charge of approximately $230k related to Bob Hansen's retirement. The charge is included in our SG&A number for Q4.

R&D expense was $238k in Q3, well below our $304k estimate. Management expects R&D expense for the full-year 2012 to be about 5% of revenue.

Net Income / EPS
Net income and EPS were $95k and $0.01, well below our $338k and $0.04 estimates - the difference fairly evenly spread between the miss on revenue, lower GM and higher SG&A as a percent of sales.

Cash
Electromed exited fiscal Q3 with $1.39 million in cash and equivalents, compared to $1.75 million at the end of Q2. Cash from operating activities was an inflow of $147k in the most recent quarter, but stripping out the increase in working capital, cash from operating activities was an inflow of $284k. Through the first nine months of fiscal 2012 cash used operating activities was $1.68 million and was an inflow of $886k ex-changes in working capital.

Along with the cash balance there's about $3.5 - $4.0 million in borrowing capacity under the revolver. The bank debt, which was renewed in January for another year (margin went up slightly from 2.75% to 3.08% over LIBOR) includes up to $6MM under a revolver, $1.5MM term loan A (monthly principal, due 12/2014) and $1MM term loan B (monthly principal, due 12/2012). Terms of the revolver allow ELMD to borrow up to 60% of eligible A/R less balance on the term loan B. Assuming A/R continues to grow at the recent pace and capex uses on average another ~$250k/quarter (capex averaged ~$254k/qtr the last three quarters), cash balance plus short-term borrowing capacity represents about 18 months worth of operating cash (includes capex and monthly principal payments) - this assumes ELMD continues to successfully roll over the bank loans. If, when and how much cash ELMD may need to raise to fund growth of the business (mostly working capital) will depend on a number of things including timing of A/R collections and capex and inventory investments. Raising capital is not a near-term need, however and we do not view this as a significant concern.

Valuation and Recommendation

We look for EPS of approximately $0.09 (excluding expected severance expenses in Q4) in fiscal 2012, down from $0.12 prior to Q3 results. EPS in our out-years moved from $0.25 to $0.21 in 2013, $0.33 to $0.30 in 2014, and $0.41 to $0.38 in 2015.

We continue to value Electromed using Hill-Rom's (HRC) long-term PE/G ratio as a comparable. Hill-Rom's long-term PE/G currently sits at 1.31. We model ELMD to post EPS of $0.38 in 2015, implying a four-year CAGR of 31%. Based on a 1.31 PE/G, ELMD should trade at about 41x 2012 EPS - or ~ $3.70/share. The stock currently trades at about $1.91. We are maintaining our Outperform rating.

FINANCIAL STATEMENTS

INCOME STATEMENT — Electromed Inc.

	2011 A	Q1A	Q2A	Q3A	Q4E	2012 E	2013 E	2014 E	2015 E
Home Care Revenue	$17,347.0	$5,132.0	$4,298.0	$4,360.0	$4,869.0	$18,659.0	$21,383.2	$23,863.7	$26,202.3
% of total revenue	*91.3%*	*95.4%*	*89.7%*	*91.3%*	*92.7%*	*92.4%*	*91.8%*	*91.2%*	*89.7%*
y-o-y growth	*32.3%*	*34.9%*	*1.2%*	*-7.0%*	*5.6%*	*7.6%*	*14.6%*	*11.6%*	*9.8%*
International Revenue	$608.0	$37.0	$192.0	$165.0	$135.0	$529.0	$777.0	$1,100.0	$1,650.0
% of total revenue	*3.2%*	*0.7%*	*4.0%*	*3.5%*	*2.6%*	*2.6%*	*3.3%*	*4.2%*	*5.7%*
y-o-y growth	*-6.0%*	*-76.7%*	*-3.5%*	*15.4%*	*26.2%*	*-13.0%*	*46.9%*	*41.6%*	*50.0%*
Gov't / Institutional Revenue	$1,048.0	$210.0	$300.0	$249.0	$250.0	$1,009.0	$1,135.0	$1,215.0	$1,350.0
% of total revenue	*5.5%*	*3.9%*	*6.3%*	*5.2%*	*4.8%*	*5.0%*	*4.9%*	*4.6%*	*4.6%*
y-o-y growth	*91.2%*	*3.4%*	*24.5%*	*-32.2%*	*5.5%*	*-3.7%*	*12.5%*	*7.0%*	*11.1%*
Net Sales	$19,003.7	$5,378.9	$4,790.3	$4,774.3	$5,254.0	$20,197.6	$23,295.2	$26,178.7	$29,202.3
YOY Growth	*32.9%*	*29.1%*	*2.2%*	*-8.2%*	*6.1%*	*6.3%*	*15.3%*	*12.4%*	*11.6%*
Cost of product sales	$5,156.3	$1,321.3	$1,310.4	$1,405.8	$1,392.3	$5,429.8	$6,149.9	$6,754.1	$7,388.2
Gross Income	$13,847.3	$4,057.6	$3,479.9	$3,368.5	$3,861.7	$14,767.8	$17,145.3	$19,424.6	$21,814.1
Gross Margin	*72.9%*	*75.4%*	*72.6%*	*70.6%*	*73.5%*	*73.1%*	*73.6%*	*74.2%*	*74.7%*
SG&A	$10,942.7	$3,397.6	$3,129.4	$2,904.5	$3,340.4	$12,771.9	$13,091.9	$14,241.2	$15,535.6
% SG&A	*57.6%*	*63.2%*	*65.3%*	*60.8%*	*63.6%*	*63.2%*	*56.2%*	*54.4%*	*53.2%*
R&D	$1,033.7	$207.6	$250.3	$238.2	$304.7	$1,000.9	$1,211.4	$1,361.3	$1,401.7
% R&D	*5.4%*	*3.9%*	*5.2%*	*5.0%*	*5.8%*	*5.0%*	*5.2%*	*5.2%*	*4.8%*
Operating Income	$1,870.9	$452.5	$100.1	$225.8	$216.6	$995.0	$2,842.0	$3,822.1	$4,876.8
Operating Margin	*9.8%*	*8.4%*	*2.1%*	*4.7%*	*4.1%*	*4.9%*	*12.2%*	*14.6%*	*16.7%*
Interest income, net	($191.4)	($43.9)	($43.6)	($42.7)	($46.0)	($176.2)	($50.0)	$95.0	$120.0
Pre-Tax Income	$1,679.6	$408.5	$56.6	$183.1	$170.6	$818.8	$2,792.0	$3,917.1	$4,996.8
Taxes (benefit)	$623.0	$163.0	$32.0	$88.0	$64.0	$347.0	$1,061.0	$1,488.5	$1,898.8
Tax Rate	*37.1%*	*39.9%*	*56.6%*	*48.1%*	*37.5%*	*42.4%*	*38.0%*	*38.0%*	*38.0%*
Income before non-control interest	$1,056.6	$245.5	$24.6	$95.1	$106.6	$471.8	$1,731.0	$2,428.6	$3,098.0
Margin	*5.6%*	*4.6%*	*0.5%*	*2.0%*	*2.0%*	*2.3%*	*7.4%*	*9.3%*	*10.6%*
Income to non-controlling interest	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
% of total	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*
Net Income	$1,056.6	$245.5	$24.6	$95.1	$106.6	$471.8	$1,731.0	$2,428.6	$3,098.0
Net Margin	*5.6%*	*4.6%*	*0.5%*	*2.0%*	*2.0%*	*2.3%*	*7.4%*	*9.3%*	*10.6%*
EPS	$0.13	$0.03	$0.00	$0.01	$0.01	$0.06	$0.21	$0.30	$0.38
YOY Growth	*-10.0%*	*89.0%*	*-91.6%*	*-80.5%*	*-35.5%*	*-56.9%*	*265.6%*	*40.3%*	*28.4%*
Diluted Shares O/S	7,837	8,119	8,125	8,117	8,125	8,122	8,150	8,150	8,100

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BALANCE SHEET **Electromed Inc.**

	March 31, 2012	June 30, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,392,935	$ 4,091,739
Accounts Receivable	11,091,562	9,593,105
Inventories	2,411,937	1,855,957
Prepaid expenses and other current assets	515,021	371,257
Deferred income taxes	722,000	722,000
Total current assets	16,133,455	16,634,058
Property and equipment, net	3,252,940	2,807,082
Finite-life intangible assets	1,169,942	1,235,828
Deferred common stock offering costs	-	-
Other assets	264,761	191,964
Total assets	$ 20,821,098	$ 20,868,932
LIABILITIES		
Current liabilities:		
Revolving line of credit	$ 1,768,128	$ 1,768,128
Current maturities of long term debt	351,477	438,267
Accounts payable	724,505	733,621
Accrued compensation	632,870	868,229
Warranty reserve	464,559	444,096
Other accrued liabilities	88,980	161,166
Income tax payable	-	-
Total current liabilities	4,030,519	4,413,507
Long term debt, less current	1,403,220	1,582,102
Deferred income taxes	167,000	167,000
Total liabilites	5,600,739	6,162,609
Commitments and contingencies		
STOCKHOLDERS' EQUITY		
Common stock	81,005	81,005
Additional paid-in capital	12,920,575	12,794,368
Retained earnings	2,218,641	1,853,450
Common stock subscription receivable for shares o/s of 48,500	-	(22,500)
Total stockholders' equity	15,220,359	14,706,323
Total liabilities and stockholders' equity	$ 20,821,098	$ 20,868,932

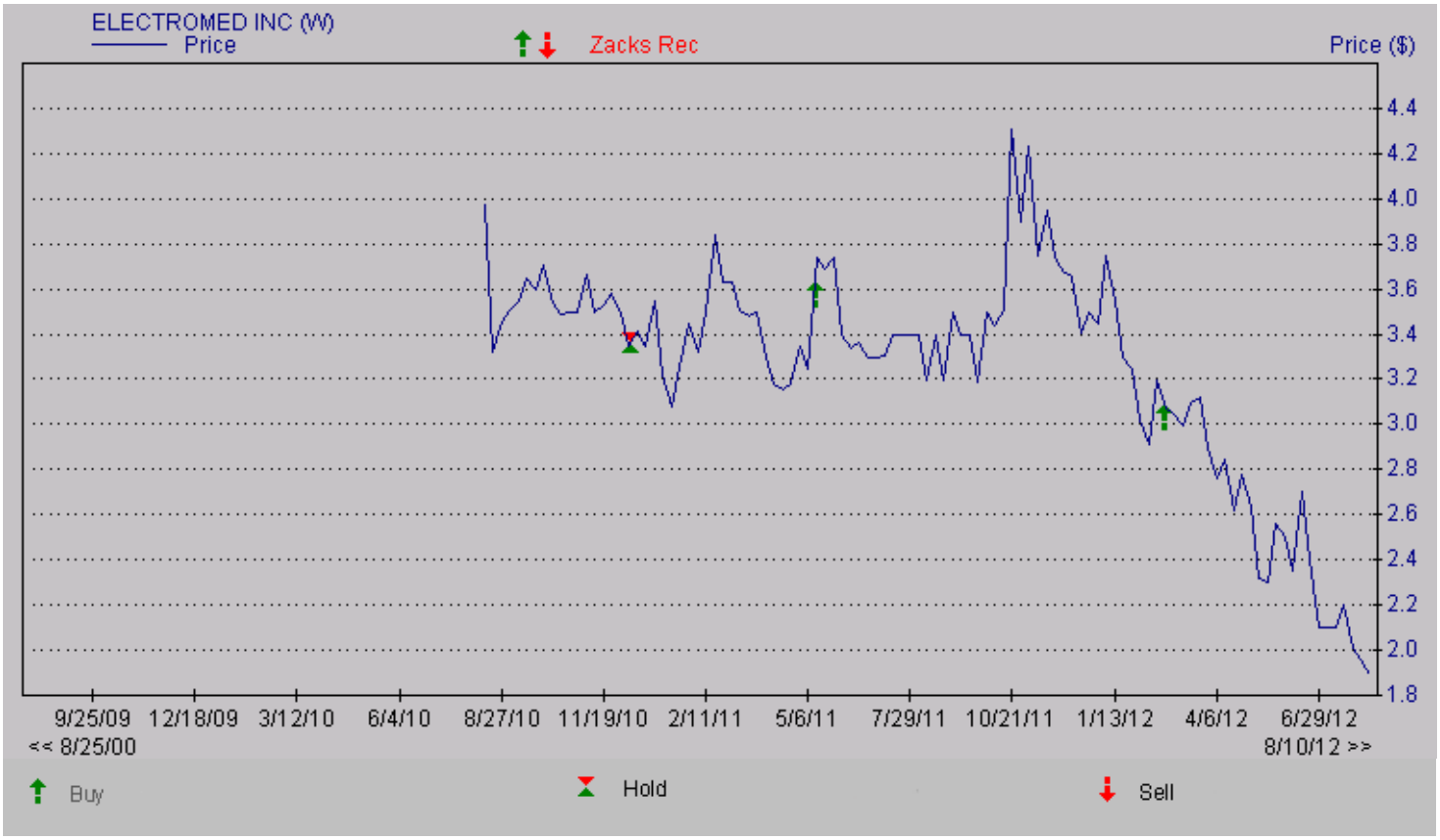
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CASH FLOW STATEMENT **Electromed Inc.**

	Three months March 31, 2012	2011
Cash flows from operating activities:		
Net income	95,098	375,358
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	106,458	5,732
Amortization of finite-life intangible assets	30,833	3,343
Amortization of debt issuance costs	3,395	(13,223)
Share based compensation expense	34,936	236
Deferred income taxes	-	-
Loss on disposal of P&E	13,145	7,720
Issuance of common stock for services	-	-
Changes in operating assets and liabilities:		
Accounts receivable	(386,857)	(913,052)
Inventory	(14,303)	(165,491)
Prepaid expenses and other assets	(76,082)	(58,101)
Accounts payable and accrued liabilites	46,893	(220,985)
Net cash provided by operating activities	(146,485)	(978,463)
Cash flows from investing activities:		
Expenditures for P&E, net	(117,231)	(9,659)
Purchase of nonctonrolling interest in Electromed Financial, LLC	-	-
Expenditures for finite-life intangible assets	(2,496)	196,332
Net cash used in investing activities	(119,727)	186,673
Cash flows from financing activities:		
Payments on revolving line of credit	-	0
Proceeds from LT debt	-	-
Noncontrolling interest distributions paid	-	-
Principal pymnts on LT debt inc. capital lease obligations	(109,534)	(111,405)
Payments of deferred financing fees	(787)	(2,058)
Proceeds from stock issuance	-	
Payments of deferred offering costs	-	-
Proceeds of warrant exercises	24,000	24,000
Expenditures of IPO	-	
Income tax benefit related to exercise of stock warrants	-	
Repurchase of common stock	-	
Proceeds from subscription notes receivable	0	27,000
Net cash provided by (used in) financing activities	(86,321)	(62,463)
Net increase (decrease) in cash and cash equivalents		
Cash and cash equivalents, beginning of period	1,745,468	5,161,270
Cash and cash equivalents, end of period	1,392,935	4,307,017

Electromed, Inc

HISTORICAL ZACKS RECOMMENDATIONS



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