February 14, 2012

Zacks Small - Cap Research

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Electromed Inc (ELMD-AMEX)

ELMD: Q2 Misses Big On Sales Force Disruption

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	5/12/2011
Current Price (02/14/12)	$2.87
Target Price	**$4.00**

OUTLOOK

ELMD reshuffled the sales-rep deck in Q2, causing a hiccup in revenue and EPS. We've baked in some incremental disruption throughout the remainder of the current fiscal year. Management continues to build for the future and expects to continue to grow the sales force, which remains the major catalyst to sales growth. New international distributors could spark more growth overseas - although the domestic business will likely remain 90%+ of total revenue. We've moved our current year EPS estimate from $0.18 to $0.12 mostly reflecting the $0.04 miss in Q2. Our price target has moved from $5.50 to $4.00. The stock has traded down since ELMD warned in early January but remains cheaper than where we see fair value. We are maintaining our Outperform rating.

SUMMARY DATA

52-Week High	**$4.49**
52-Week Low	**$2.69**
One-Year Return (%)	**-17.85**
Beta	**0.21**
Average Daily Volume (sh)	**8,046**
Shares Outstanding (mil)	**8**
Market Capitalization ($mil)	**$25**
Short Interest Ratio (days)	**0.11**
Institutional Ownership (%)	**4**
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	**22.1**
P/E using 2012 Estimate	**23.9**
P/E using 2013 Estimate	**11.5**
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	5,525 E	5,935 E	21,629 E
2013					24,893 E
2014					27,968 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	$0.04 E	$0.05 E	$0.12 E
2013					$0.25 E
2014					$0.33 E

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

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Q2 2012 Financial Results

Electromed reported financial results for the fiscal 2012 second quarter ending December 31, 2011 on February 14th. Breaking the prior streak of beating our revenue estimates for four straight quarters, Q2 came in well below our numbers. In mid-January the company warned that Q2 results would be softer than previously anticipated due to layoffs of certain underperforming sales personnel (we had not updated our estimates following the pre-announcement so the miss on Q2 was not unexpected). Management made the decision to layoff about 5 or 6 sales people (~ 15% - 20% of the total sales force) during Q2 due to underperformance and not hitting sales targets, which caused a serious hiccup in Q2 revenue. Management indicated on this morning's conference call that these positions have been filled with people that they believe can produce the rate of sales growth that they expect going forward. We expect there will be at least a few month (possibly a few quarters) period for these new hires to get up to speed and get to optimal efficiency and productivity - which (along with a temporary net drop in the sales force) is reflected in our trimming of our revenue estimates. The sales force stood at about 20 or 21 at the end of fiscal Q2 (12/31/11), down from 23 at the end of Q1 - management noted that they're shooting for about 27 by fiscal year-end (6/30/12). As we've noted in the past, a major component of ELMD's strategy to grow sales and EPS is expansion and increased efficiency of its sales force.

Revenue
Q2 revenue of $4.79 million was up 2% yoy (-11% sequentially) and consisted of $4.30 million (+1% yoy) from the Homecare segment, $192k (-4% yoy) from International and $300k (+25% yoy) from Government/Institutional.

The relative weakness in the Homecare segment reflects the turnover of sales personnel. The net size of the sales force fell from about 23 at the end of Q1 (9/30/11) to 21 at the end of Q2 and is currently back up to about 23 - our revenue growth estimates 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 Q2 2011	Actual Q2 2012	Y-o-Y Change	Zacks Est Q2 2012	Actual +/- Zacks est.
Homecare	$4,246.0	$4,298.0	1.2%	$5,644.0	-23.8%
International	$199.0	$192.0	-3.5%	$120.0	60.0%
Gov't / Instit.	$241.0	$300.0	24.5%	$283.0	6.0%
	$4,686.0	**$4,790.0**	**2.2%**	**$6,047.0**	**-20.8%**

Total revenue came in about 21% less than our estimate. Revenue from International, by contrast, came in significantly above our estimate and was up over 400% sequentially. 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. In particular, Linde in Germany could potentially move the needle on ELMD's international business as Linde is a major international distributor already calling on customers in ELMD's target market space and a significant portion of Germans have private insurance (public insurance coverage in Europe for HFCWO is spotty at best). We have made some slight upward adjustments to our International revenue estimates as a result - although there could end up being more traction in this segment than what we currently model.

Gross Margin
GM came in at 72.6% 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 $3.13 million, or 65.3% of sales, compared to our 58.7% estimate. There difference is likely most 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 current quarter where revenue falls short, these expenses are highlighted and crimp the bottom line.

R&D expense was $250k in Q2, well below our $327k estimate. R&D expense will likely increase throughout the year, however, as Electromed works to bring new products and product enhancements to market. Prior R&D expense guidance was ~5% of revenue - on the Q2 call management noted that this will likely now be above 5% of revenue. Continually updating and enhancing their product line is another component (along with expansion of the sales force and international distribution deals) of ELMD's growth strategy.

Net Income / EPS

Net income and EPS were $25k and $0.00, well below our $345k 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 Q2 2012 with $1.75 million in cash and equivalents, compared to $2.95 million at 9/30/2011. Cash used in operating activities was $710k in the most recent quarter, but stripping out the increase in working capital (including a $304k and $302k increase in A/R and inventory, respectively), operating cash flow was $192k. As we've repeated in the past, long collection times, typical of the industry and associated with the payment policies of many public insurers (i.e. - Medicaid), means there can be intermittent spikes in Electromed's A/R. This can be exacerbated by rapid growth, similar to what Electromed is experiencing. We continue to see no concern with the increase in or quality of A/R. ELMD used $404k for capex in Q2 - management noted that this is level of capex should come down in future quarters. Repayment of principal on the term loans used $79k.

Along with the cash balance there's about $3.5 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 ~$310k/qtr the last two quarters), cash balance plus short-term borrowing capacity represents about 15 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 now look for EPS of $0.12 in fiscal 2012, down from $0.18, mostly a result of the $0.04 miss in Q2. EPS in our out-years have moved from $0.27 to $0.25 in 2013, $0.36 to $0.33 in 2014, and $0.44 to $0.41 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 1.02 (up from 0.89 since our last update on 11/9/2011). We model ELMD to post EPS of $0.41 in 2015, implying a four-year CAGR of 33%. Based on a 1.02 PE/G, ELMD should trade at about 34x 2012 EPS - or ~ $4.00/share. We are moving our price target from $5.50 to $4.00/share. The stock has traded down since ELMD warned in early January and now trades at $2.87 - cheaper than where we value it - as such, we are maintaining our Outperform rating.

FINANCIAL STATEMENTS

INCOME STATEMENT **Electromed Inc.**

	2011 A	Q1A	Q2A	Q3E	Q4E	2012 E	2013 E	2014 E	2015 E
Home Care Revenue	$17,347.0	$5,132.0	$4,298.0	$5,025.0	$5,550.0	$20,005.0	$22,925.7	$25,585.1	$28,092.5
% of total revenue	*91.3%*	*95.4%*	*89.7%*	*91.0%*	*93.5%*	*92.5%*	*92.1%*	*91.5%*	*90.1%*
y-o-y growth	*32.3%*	*34.9%*	*1.2%*	*7.2%*	*20.4%*	*15.3%*	*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%*	*3.0%*	*2.3%*	*2.4%*	*3.1%*	*3.9%*	*5.3%*
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	$335.0	$250.0	$1,095.0	$1,190.0	$1,283.0	$1,448.0
% of total revenue	*5.5%*	*3.9%*	*6.3%*	*6.1%*	*4.2%*	*5.1%*	*4.8%*	*4.6%*	*4.6%*
y-o-y growth	*91.2%*	*3.4%*	*24.5%*	*-8.7%*	*5.5%*	*4.5%*	*8.7%*	*7.8%*	*12.9%*
Net Sales	$19,003.7	$5,378.9	$4,790.3	$5,525.0	$5,935.0	$21,629.3	$24,892.7	$27,968.1	$31,190.5
YOY Growth	*32.9%*	*29.1%*	*2.2%*	*6.3%*	*19.8%*	*13.8%*	*15.1%*	*12.4%*	*11.5%*
Cost of product sales	$5,156.3	$1,321.3	$1,310.4	$1,436.5	$1,572.8	$5,641.0	$6,472.1	$7,103.9	$7,797.6
Gross Income	$13,847.3	$4,057.6	$3,479.9	$4,088.5	$4,362.2	$15,988.3	$18,420.6	$20,864.2	$23,392.8
Gross Margin	*72.9%*	*75.4%*	*72.6%*	*74.0%*	*73.5%*	*73.9%*	*74.0%*	*74.6%*	*75.0%*
SG&A	$10,942.7	$3,397.6	$3,129.4	$3,204.5	$3,335.5	$13,067.0	$13,765.7	$15,158.7	$16,718.1
% SG&A	*57.6%*	*63.2%*	*65.3%*	*58.0%*	*56.2%*	*60.4%*	*55.3%*	*54.2%*	*53.6%*
R&D	$1,033.7	$207.6	$250.3	$303.9	$344.2	$1,106.0	$1,294.4	$1,454.3	$1,497.1
% R&D	*5.4%*	*3.9%*	*5.2%*	*5.5%*	*5.8%*	*5.1%*	*5.2%*	*5.2%*	*4.8%*
Operating Income	$1,870.9	$452.5	$100.1	$580.1	$682.5	$1,815.3	$3,360.5	$4,251.2	$5,177.6
Operating Margin	*9.8%*	*8.4%*	*2.1%*	*10.5%*	*11.5%*	*8.4%*	*13.5%*	*15.2%*	*16.6%*
Interest income, net	($191.4)	($43.9)	($43.6)	($44.0)	($46.0)	($177.5)	($50.0)	$95.0	$120.0
Pre-Tax Income	$1,679.6	$408.5	$56.6	$536.1	$636.5	$1,637.7	$3,310.5	$4,346.2	$5,297.6
Taxes (benefit)	$623.0	$163.0	$32.0	$198.4	$238.7	$632.1	$1,258.0	$1,651.5	$2,013.1
Tax Rate	*37.1%*	*39.9%*	*56.6%*	*37.0%*	*37.5%*	*38.6%*	*38.0%*	*38.0%*	*38.0%*
Income before non-control interest	$1,056.6	$245.5	$24.6	$337.8	$397.8	$1,005.7	$2,052.5	$2,694.6	$3,284.5
Margin	*5.6%*	*4.6%*	*0.5%*	*6.1%*	*6.7%*	*4.6%*	*8.2%*	*9.6%*	*10.5%*
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	$337.8	$397.8	$1,005.7	$2,052.5	$2,694.6	$3,284.5
Net Margin	*5.6%*	*4.6%*	*0.5%*	*6.1%*	*6.7%*	*4.6%*	*8.2%*	*9.6%*	*10.5%*
EPS	$0.13	$0.03	$0.00	$0.04	$0.05	$0.12	$0.25	$0.33	$0.41
YOY Growth	*-10.0%*	*89.0%*	*-91.6%*	*-30.8%*	*140.6%*	*-8.2%*	*103.4%*	*31.3%*	*22.6%*
Diluted Shares O/S	7,837	8,119	8,125	8,125	8,125	8,124	8,150	8,150	8,100

Brian Marckx, CFA

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BALANCE SHEET **Electromed Inc.**

	December 31, 2011	September 30, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,745,468	$ 2,946,173
Accounts Receivable	10,704,705	10,400,466
Inventories	2,397,634	2,163,802
Prepaid expenses and other current assets	466,976	419,203
Deferred income taxes	722,000	722,000
Total current assets	16,036,783	16,651,644
Property and equipment, net	3,255,311	3,070,662
Finite-life intangible assets	1,198,279	1,227,572
Deferred common stock offering costs	-	-
Other assets	239,332	217,907
Total assets	$ 20,729,705	$ 21,167,785
LIABILITIES		
Current liabilities:		
Revolving line of credit	$ 1,768,128	$ 1,768,128
Current maturities of long term debt	437,297	403,745
Accounts payable	623,370	758,986
Accrued compensation	702,274	906,425
Warranty reserve	469,624	475,019
Other accrued liabilities	68,753	174,613
Income tax payable	-	-
Total current liabilities	4,069,446	4,486,916
Long term debt, less current	1,426,934	1,506,654
Deferred income taxes	167,000	167,000
Total liabilites	5,663,380	6,160,570
Commitments and contingencies		
STOCKHOLDERS' EQUITY		
Common stock	81,023	81,011
Additional paid-in capital	12,861,759	12,827,215
Retained earnings	2,123,543	2,098,989
Common stock subscription receivable for shares o/s of 48,500	-	-
Total stockholders' equity	15,006,325	15,007,215
Total liabilities and stockholders' equity	$ 20,729,705	$ 21,167,785

Electromed, Inc

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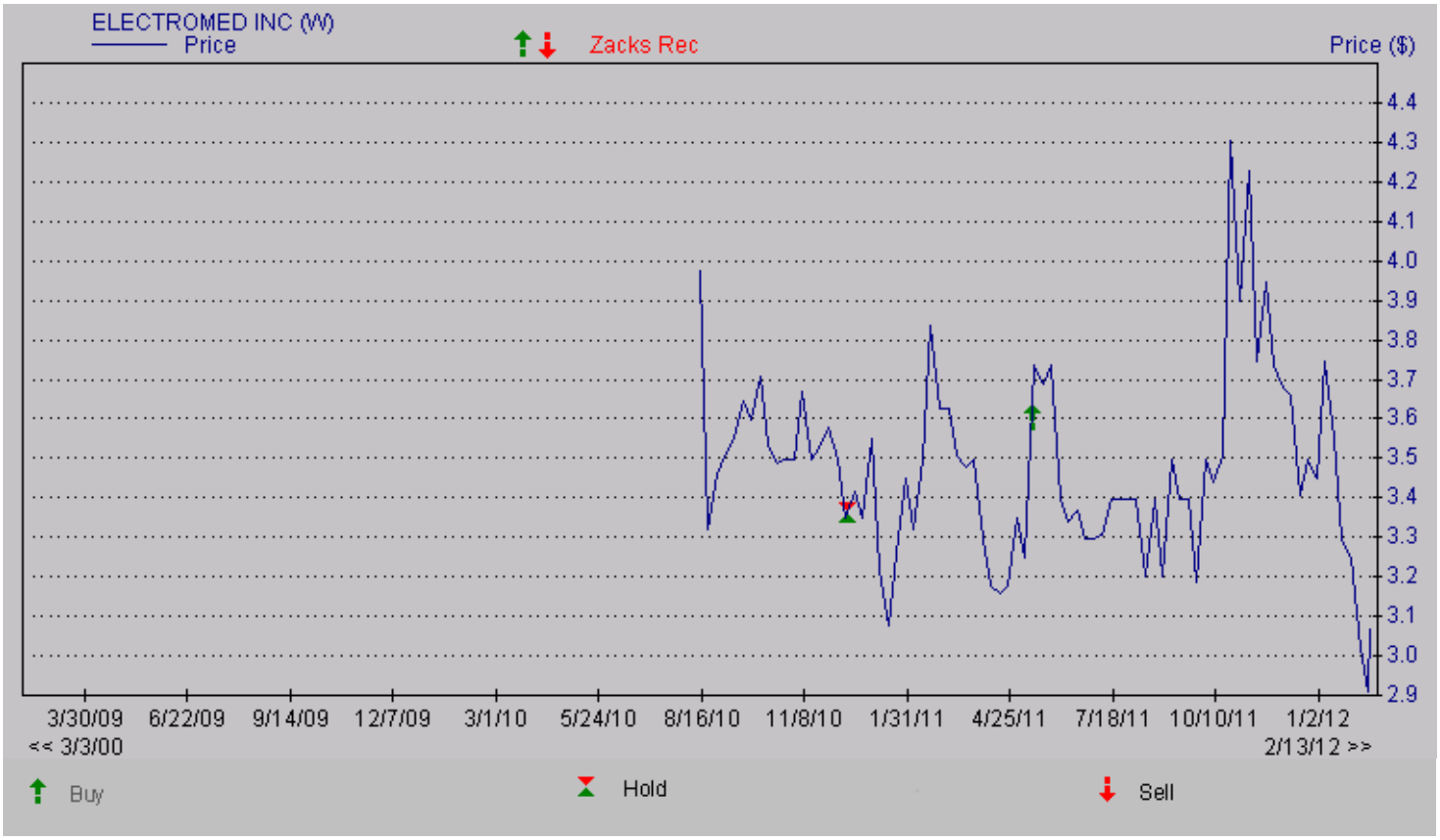
CASH FLOW STATEMENT **Electromed Inc.**

	Three months December 31, 2011	2010
Cash flows from operating activities:		
Net income	24,554	403,943
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	103,238	162,010
Amortization of finite-life intangible assets	30,193	54,784
Amortization of debt issuance costs	2,769	27,593
Share based compensation expense	31,055	86,260
Deferred income taxes	-	-
Loss on disposal of P&E	1	5,653
Issuance of common stock for services	-	-
Changes in operating assets and liabilities:		
Accounts receivable	(304,239)	(1,271,774)
Inventory	(233,832)	(64,429)
Prepaid expenses and other assets	(61,441)	4,769
Accounts payable and accrued liabilites	(302,337)	355,257
Net cash provided by operating activities	(710,039)	(235,934)
Cash flows from investing activities:		
Expenditures for P&E, net	(403,655)	(208,253)
Purchase of nonctonrolling interest in Electromed Financial, LLC	-	-
Expenditures for finite-life intangible assets	(900)	(648,616)
Net cash used in investing activities	(404,555)	(856,869)
Cash flows from financing activities:		
Payments on revolving line of credit	-	(500,000)
Proceeds from LT debt	-	-
Noncontrolling interest distributions paid	-	-
Principal pymnts on LT debt inc. capital lease obligations	(79,086)	(215,708)
Payments of deferred financing fees	(10,526)	(4,659)
Proceeds from stock issuance	-	6,363,713
Payments of deferred offering costs	-	-
Proceeds of warrant exercises	3,501	-
Expenditures of IPO	-	-
Income tax benefit related to exercise of stock warrants	-	-
Repurchase of common stock	-	-
Proceeds from subscription notes receivable	0	-
Net cash provided by (used in) financing activities	(86,111)	5,643,346
Net increase (decrease) in cash and cash equivalents		
Cash and cash equivalents, beginning of period	2,946,173	610,727
Cash and cash equivalents, end of period	1,745,468	5,161,270

Electromed, Inc

HISTORICAL ZACKS RECOMMENDATIONS



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