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Zacks Small - Cap Research

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Electromed Inc (ELMD-AMEX)

ELMD: Revenue Growth Will Take More Time

Current Recommendation	**Neutral**
Prior Recommendation	Outperform
Date of Last Change	02/17/2013
Current Price (02/15/13)	$1.35
Target Price	**$2.00**

OUTLOOK

The slower than anticipated pace in net growth of the sales force has hampered revenue growth and resulted in the last 5 quarters missing our estimates. Management's plan continues to include growing their sales force which remains one of the catalysts for sales growth. To help facilitate this, along with implementing other growth strategies ELMD recently brought on a Director of Sales, hired a permanent CEO and added an International sales director. While we had hoped for a quicker resolution to the negative sales growth, we now think this may take some more time. We remain of the mindset that with a proper strategy and execution, ELMD is an attractive growth story. The recent changes to our model and related effect on valuation has prompted us to move our recommendation from Outperform to Neutral. We think it's also worth noting that the shares continue to trade below book value (book value = ~$1.80/share) which should provide further downside protection in our opinion.

SUMMARY DATA

52-Week High	**$3.19**
52-Week Low	**$1.21**
One-Year Return (%)	**-57.81**
Beta	**0.03**
Average Daily Volume (sh)	**4,509**
Shares Outstanding (mil)	**8**
Market Capitalization ($mil)	**$11**
Short Interest Ratio (days)	**0.39**
Institutional Ownership (%)	**17**
Insider Ownership (%)	**29**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**N/A**
Earnings Per Share (%)	**N/A**
P/E using TTM EPS	**67.5**
P/E using 2013 Estimate	**N/A**
P/E using 2014 Estimate	**16.9**
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)
2012	5,378 A	4,790 A	4,774 A	4,581 A	19,525 A
2013	4,031 A	3,856 A	4,344 E	4,288 E	16,520 E
2014					20,471 E
2015					23220 E

Earnings per Share

	Q1 (Sep)	Q2 (Dec)	Q3 (Mar)	Q4 (Jun)	Year (Jun)
2012	$0.03 A	$0.00 A	$0.01 A	-$0.02 A	$0.02 A
2013	-$0.01 A	-$0.05 A	-$0.01 E	-$0.00 E	-$0.07 E
2014					$0.08 E
2015					$0.15 E

Zacks Projected EPS Growth Rate - Next 4 Years % **17**

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Q2 2013 Financial Results

Electromed reported financial results for the fiscal 2013 second quarter ending December 31, 2012 on February 14th. Revenue has disappointed for the last several quarters and extended that streak through to Q2. Stagnation in growing the sales rep (Clinical Area Managers, or CAMs) headcount has clearly been a factor in revenue sliding every quarter since fiscal Q2 2012. Management noted in the earnings release for the most recent quarter that other factors have also (at least recently) played a part in revenue going in the wrong direction including pricing pressures and a drawn out reimbursement approval process as a result of additional administrative steps instituted by third-party payers.

We noted in our last update that while we'd been disappointed with the lack of recent revenue growth, based on our conversations with management that we remained encouraged that this was largely tied to delays in growing the CAM count and getting them up to full efficiency and felt that there had been no substantial fundamental changes to the market, reimbursement, or competitive environment. However, with revenue continuing to significantly fall quarter-to-quarter and gross margins softening, coupled with the comments in the most recent earnings release, we think it's now safe to assume that there's more hurdles to getting back to sustained top-line growth and consistent profitability than just getting the sales positions filled and CAM's fully trained and productive.

The CAM count stood at 21 at the end of fiscal Q1 2013 (Sept 2012), down from 22 at the end of fiscal Q4 2012 (June 2012). ELMD notes in the most recent 10-Q that the total sales staff fell from an average of 26 full-time equivalents (FTE) in the six months ending 12/31/2011 to 24.5 in the six months ending 12/31/2012. Also noting that turnover in CAMs was about 30% (equal to 7) in the most recent six-month period. This CAM turnover that ELMD has experienced in the recent past shows up directly in the income statement with a hit to revenue. Their strategy has been to increase the CAM base by about 1 - 3 reps per quarter but that hasn't come to fruition with the average CAM count stagnating in the low 20's since early calendar 2011 (i.e. - about the last 21 months).

ELMD has made some changes recently that potentially could help better address the lack of growth - as we indicated, it's now obvious this isn't a "silver-bullet"-solution situation and one that we think is going to turn on a dime. We do, as we first outlined in our December 2010 initiation report on ELMD (email me for a copy), however continue to believe that ELMD's SmartVest can be very competitive and we remain of the mindset that with a proper strategy and execution, ELMD is an attractive growth story. But, now being resigned to expecting this to take more time, we have reduced our revenue growth trajectory.

Since the end of Q1 (9/30/2012) ELMD made some changes in leadership including the appointment of Kathleen Skarvan as CEO and hiring an International sales manager. And, as a reminder, in August ELMD brought on a Director of Sales. Ms. Skarvan replaced Jim Cassidy who took over as interim CEO when Bob Hansen retired in May 2012 (Dr. Cassidy remains as ELMD's COO). Per the 8-K announcing the appointment, Ms. Skarvan served as Vice President of Operations at OEM Fabricators from November 2011 until October 2012. Prior to her position with OEM Fabricators, Ms. Skarvan served in various roles at Hutchinson Technology Incorporated, most recently as the President of the Disk Drive Components Division from April 2007 until March 2011. As President of the Disk Drive Components Division, Ms. Skarvan managed a public company division with annual revenues in excess of $300 million. Ms. Skarvan also served as a Senior Vice President of Hutchinson Technology Incorporated from December 2010 to March 2011, and as Vice President of Sales & Marketing of the Disk Drive Components Division from October 2003 until April 2007.

Revenue
Q2 revenue of $3.86 million was down almost 20% y-o-y (down 4% sequentially) and consisted of $3.33 million (-23% y-o-y) from the Homecare segment, $208k (+8% y-o-y) from International and $320k (+7% y-o-y) from Government/Institutional.

The relative weakness in the Homecare segment continues to reflect stagnation in growth of the sales force as well as the reimbursement mix. Also, as management noted this quarter, pricing pressure and drawn-out reimbursement turnaround have also impacted Homecare segment sales.

	Actual Q2 2012	Actual Q2 2013	Y-o-Y Change	Zacks Est Q2 2013	Actual +/- Zacks est.
Homecare	$4,298.0	$3,328.0	-22.6%	$3,941.0	-15.6%
International	$192.0	$208.0	8.3%	$155.0	34.2%
Gov't / Instit.	$300.0	$320.0	6.7%	$332.0	-3.6%
	$4,790.0	**$3,856.0**	**-19.5%**	**$4,428.0**	**-12.9%**

Total revenue came in about 13% less than our estimate, despite International sales coming in better than our 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, which has helped international sales which have posted yoy gains the last four quarters straight. As noted, ELMD just brought on an international sales manager in an effort to further grow this side of the business.

Gross Margin
GM came in at 65.2% compared to our 72.0% estimate. Electromed's GM can jump around from quarter-to-quarter based on the mix of reimbursement rates and, as noted in the past, this relatively low GM is not expected to persist over the longer-term. Nonetheless, there's clearly now greater pricing pressure which we think may hinder significantly expansion of GM. While we still model GM to widen over the next several years with economies of scale, we have slightly trimmed our estimates to account for the recent downward pressure on pricing.

Operating Expenses
SG&A came in at about $3.0 million, or 77.8% of sales, compared to our 64.3% estimate. Similar to the past four quarters where revenue also came in meaningfully below our estimates, the higher than modeled SG&A as a percent of sales is directly affected by the fixed-cost portion of SG&A which is more exposed with revenue coming in below our estimate. The current quarter also included legal expenses related to litigation recently brought by ELMD.

While operating expenses have been higher than anticipated, some of this is one-time expenses. Also, as we noted in our last update, ELMD has recently taken steps to reduce operating expenses including bringing most marketing functions in-house which contributed to the 42% yoy drop ($574k vs. $335k) in advertising/marketing expenses in the six months ending 12/31/2012 from the same period in 2011. Similarly, travel/meals/entertainment expense was cut 24% ($941k vs. $718k) over the same periods. We think this, along with other recent changes including a new compensation structure which is now being implemented, should help soften the impact to the bottom line from near-term revenue growth variability and accelerate operating leverage over the longer-term.

R&D expense was $109k (2.8% of revenue) in Q2, well below our $199k (4.5% of revenue) estimate. Management continues to expect R&D expense to average about 5% of revenue over the long-term.

Net Income / EPS
Net income and EPS were ($411k) and ($0.05), compared to our $67k and $0.01 estimates. This miss, a combination of lower revenue, more narrow gross margin, and higher operating expenses relative to what we modeled.

Cash
Electromed exited fiscal Q2 with $1.0 million in cash and equivalents, compared to $1.5 million at the end of Q1. Despite the $411k net loss, cash from operating activities was an inflow of $1,088k in the most recent quarter. A/R, which had been growing in the past with accelerating revenues, came down by $1,125k in the quarter (which aided cash from operations). Stripping out the increase in working capital, cash from operating activities was an outflow of $195k. Investing activities used $286k in the quarter.

Along with the cash balance there's about $1.9 million in borrowing capacity under the revolver. The bank debt (terms recently amended) includes up to $2.5MM under a revolver, $1.5MM term loan A (monthly principal, due 12/2014) and $1MM term loan B (whish was repaid in full in Oct 2012). Terms of the revolver allow ELMD to borrow up to 60% of eligible A/R less balance on the term loan B. ELMD's balance sheet remains healthy, the

company remains well capitalized and we expect ELMD to have no issues in continuing to roll over the bank debt/credit line when neccessary.

Valuation and Recommendation

We now look for revenue of $20.5 million (implying growth of ~24%) in fiscal 2014, down from $22.4 million prior to Q2 results. Our 2014 EPS estimate has moved from $0.16 to $0.08. As explained earlier, the downward revision to our 2014 estimates as well as our out-years mostly reflects the delay in building the sales force, recent pricing pressures and more drawn-out reimbursement process. EPS in our out-years moved from $0.22 to $0.15 in 2015, and $0.31 to $0.27 in 2016.

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 1.4. We model ELMD to post EPS of $0.27 in 2016, implying a five-year (2011 - 2016) CAGR of ~17%. Based on a 1.4 PE/G, ELMD should trade at about 24x our 2014 EPS or ~ $2.00/share.

While we continue to believe that ELMD's SmartVest can be very competitive and we remain of the mindset that with a proper strategy and execution, ELMD is an attractive growth story, the recent changes to our model (as a result of the aforementioned recent hindrances to growth) and related effect on valuation has prompted us to move our recommendation from Outperform to Neutral. If, however, ELMD demonstrates better performance than what we model, our valuation and recommendation are subject to upgrade. We think it's also worth noting that the shares continue to trade below book value (book value = ~$1.80/share) which should provide further downside protection in our opinion.

FINANCIAL STATEMENTS

INCOME STATEMENT **Electromed Inc.**

	2012 A	Q1A	Q2A	Q3E	Q4E	2013 E	2014 E	2015 E	2016
Home Care Revenue	$17,959.0	$3,574.0	$3,328.4	$3,831.4	$3,816.3	$14,550.1	$18,187.6	$20,661.1	$23,285.1
% of total revenue	*92.0%*	*88.7%*	*86.3%*	*88.2%*	*89.0%*	*88.1%*	*88.8%*	*89.0%*	*88.4%*
y-o-y growth	*3.5%*	*-30.4%*	*-22.6%*	*-12.1%*	*-8.5%*	*-19.0%*	*25.0%*	*13.6%*	*12.7%*
International Revenue	$547.0	$109.0	$207.9	$169.4	$167.2	$653.5	$874.5	$1,094.8	$1,444.5
% of total revenue	*2.8%*	*2.7%*	*5.4%*	*3.9%*	*3.9%*	*4.0%*	*4.3%*	*4.7%*	*5.5%*
y-o-y growth	*-10.0%*	*194.6%*	*8.3%*	*2.7%*	*9.3%*	*19.5%*	*33.8%*	*25.2%*	*31.9%*
Gov't / Institutional Revenue	$1,018.0	$348.0	$320.1	$343.2	$304.4	$1,315.7	$1,409.3	$1,464.3	$1,598.9
% of total revenue	*5.2%*	*8.6%*	*8.3%*	*7.9%*	*7.1%*	*8.0%*	*#DIV/0!*	*#DIV/0!*	*#DIV/0!*
y-o-y growth	*-2.9%*	*65.7%*	*6.7%*	*37.8%*	*17.5%*	*29.2%*	*7.1%*	*3.9%*	*9.2%*
Net Sales	$19,524.5	$4,031.3	$3,856.4	$4,344.0	$4,288.0	$16,519.7	$20,471.3	$23,220.2	$26,328.5
YOY Growth	*2.7%*	*-25.1%*	*-19.5%*	*-9.0%*	*-6.4%*	*-15.4%*	*23.9%*	*13.4%*	*13.4%*
Cost of product sales	$5,392.4	$1,210.5	$1,342.0	$1,285.8	$1,282.1	$5,120.4	$5,916.2	$6,594.5	$7,266.7
Gross Income	$14,132.1	$2,820.8	$2,514.4	$3,058.2	$3,005.9	$11,399.3	$14,555.1	$16,625.6	$19,061.8
Gross Margin	*72.4%*	*70.0%*	*65.2%*	*70.4%*	*70.1%*	*69.0%*	*71.1%*	*71.6%*	*72.4%*
SG&A	$12,614.5	$2,816.0	$3,000.5	$2,978.2	$2,903.0	$11,697.8	$12,815.1	$13,829.9	$14,665.0
% SG&A	*64.6%*	*69.9%*	*77.8%*	*68.6%*	*67.7%*	*70.8%*	*62.6%*	*59.6%*	*55.7%*
R&D	$911.3	$101.2	$109.3	$126.0	$120.1	$456.5	$655.1	$859.1	$921.5
% R&D	*4.7%*	*2.5%*	*2.8%*	*2.9%*	*2.8%*	*2.8%*	*3.2%*	*3.7%*	*3.5%*
Operating Income	$606.3	($96.4)	($595.4)	($46.0)	($17.2)	($755.0)	$1,085.0	$1,936.6	$3,475.4
Operating Margin	*3.1%*	*-2.4%*	*-15.4%*	*-1.1%*	*-0.4%*	*-4.6%*	*5.3%*	*8.3%*	*13.2%*
Interest income, net	($168.7)	($36.7)	($25.8)	($29.0)	($25.0)	($116.5)	($25.0)	$25.0	$50.0
Pre-Tax Income	$437.6	($133.1)	($621.2)	($75.0)	($42.2)	($871.5)	$1,060.0	$1,961.6	$3,525.4
Taxes (benefit)	$251.0	($62.0)	($210.0)	($28.5)	($16.0)	($316.5)	$402.8	$745.4	$1,339.6
Tax Rate	*57.4%*	*38.0%*	*38.0%*	*38.0%*	*38.0%*	*36.3%*	*38.0%*	*38.0%*	*38.0%*
Net Income	$186.6	($71.1)	($411.2)	($46.5)	($26.1)	($555.0)	$657.2	$1,216.2	$2,185.7
Net Margin	*1.0%*	*-1.8%*	*-10.7%*	*-1.1%*	*-0.6%*	*-3.4%*	*3.2%*	*5.2%*	*8.3%*
EPS	$0.02	($0.01)	($0.05)	($0.01)	($0.00)	($0.07)	$0.08	$0.15	$0.27
YOY Growth	*-83.0%*	*-129.0%*	*-1777.0%*	*-148.9%*	*-85.4%*	*-397.6%*	*-218.3%*	*85.5%*	*79.7%*
Diluted Shares O/S	8,119	8,114	8,114	8,115	8,115	8,115	8,120	8,100	8,100

Brian Marckx, CFA

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BALANCE SHEET **Electromed Inc.**

		December 31, 2012	June 30, 2012
ASSETS			
Current assets:			
Cash and cash equivalents	$	1,005,616	1,702,435
Accounts Receivable		9,725,142	10,850,859
Inventories		1,899,028	2,392,416
Prepaid expenses and other current assets		358,935	359,583
Income tax receivable		605,744	340,744
Deferred income taxes		656,000	656,000
Total current assets		14,250,465	16,302,037
Property and equipment, net		3,481,373	3,170,014
Finite-life intangible assets		1,135,891	1,174,033
Deferred common stock offering costs		-	-
Other assets		276,582	274,940
Total assets	$	19,144,311	20,921,024
LIABILITIES			
Current liabilities:			
Revolving line of credit	$	600,000	1,768,128
Current maturities of long term debt		66,191	254,020
Accounts payable		753,098	749,985
Accrued compensation		615,566	636,995
Warranty reserve		661,000	610,000
Other accrued liabilities		127,077	151,558
Income tax payable		-	-
Total current liabilities		2,822,932	4,170,686
Long term debt, less current		1,356,961	1,390,003
Deferred income taxes		280,000	280,000
Total liabilites		4,459,893	5,840,689
Commitments and contingencies			
STOCKHOLDERS' EQUITY			
Common stock		81,143	81,143
Additional paid-in capital		13,045,518	12,959,136
Retained earnings		1,557,757	2,040,056
Common stock subscription receivable for shares o/s of 48,500		-	-
Total stockholders' equity		14,684,418	15,080,335
Total liabilities and stockholders' equity	$	19,144,311	20,921,024

Electromed, Inc

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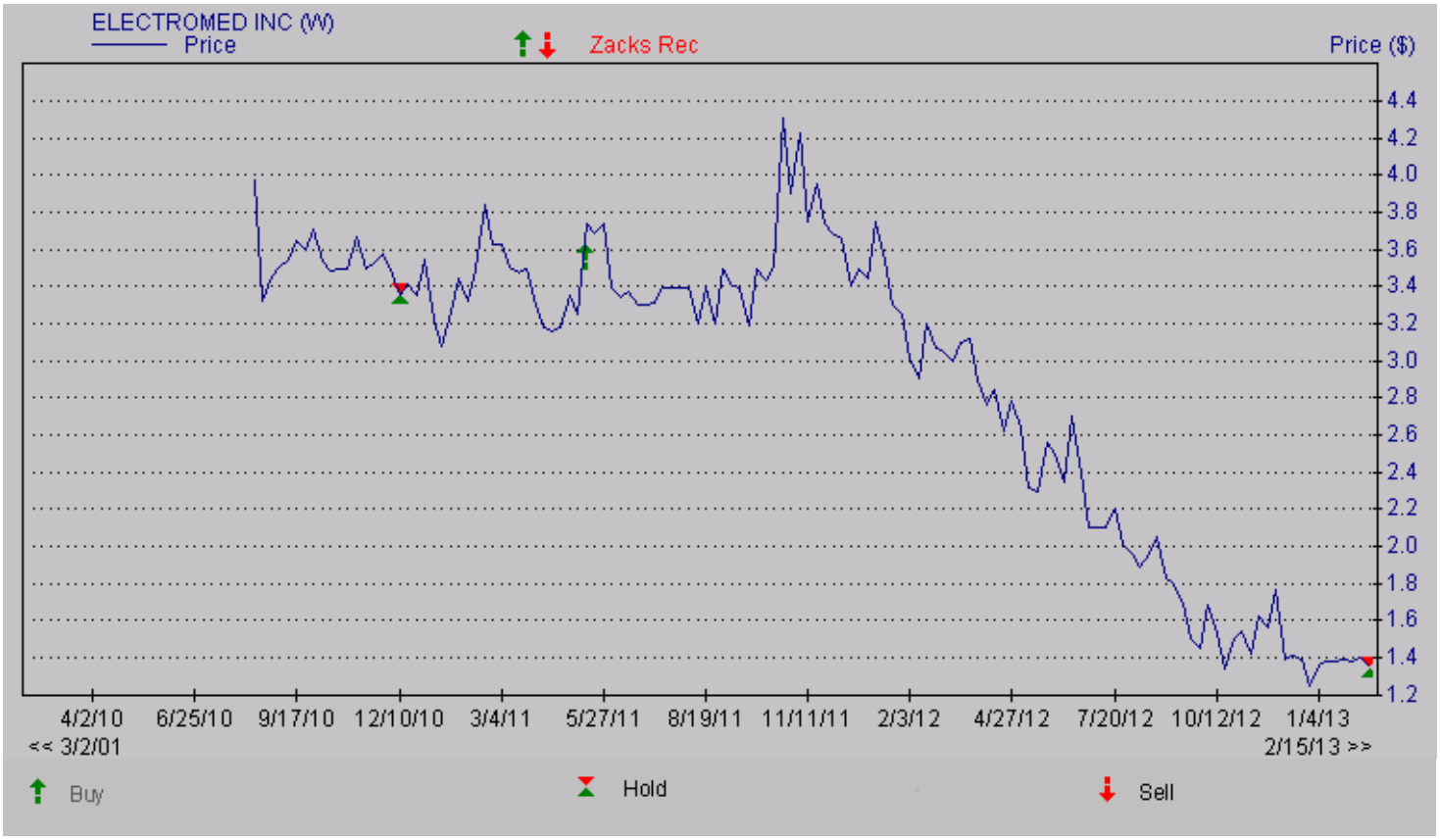
CASH FLOW STATEMENT **Electromed Inc.**

	Three months December 31, 2012	2011
Cash flows from operating activities:		
Net income	(411,191) $	24,554
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	116,939	103,238
Amortization of finite-life intangible assets	32,265	30,193
Amortization of debt issuance costs	3,014	2,769
Share based compensation expense	45,065	31,055
Deferred income taxes	-	-
Loss on disposal of P&E	18,105	1
Issuance of common stock for services	-	-
Changes in operating assets and liabilities:		
Accounts receivable	690,346	(304,239)
Inventory	406,248	(233,832)
Prepaid expenses and other assets	(84,665)	(61,441)
Accounts payable and accrued liabilites	272,254	(302,337)
Net cash provided by operating activities	1,088,380	(710,039)
Cash flows from investing activities:		
Expenditures for P&E, net	(285,102)	(403,655)
Purchase of nonctonrolling interest in Electromed Financial, LLC	-	-
Expenditures for finite-life intangible assets	(1,019)	(900)
Net cash used in investing activities	(286,121)	(404,555)
Cash flows from financing activities:		
Payments on revolving line of credit	(1,168,128)	-
Proceeds from LT debt	-	-
Noncontrolling interest distributions paid	-	-
Principal pymnts on LT debt inc. capital lease obligations	(111,070)	(79,086)
Payments of deferred financing fees	-	(10,526)
Proceeds from stock issuance	-	-
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	(1,279,198)	(86,111)
Net increase (decrease) in cash and cash equivalents		
Cash and cash equivalents, beginning of period	1,482,555	2,946,173
Cash and cash equivalents, end of period	1,005,616 $	1,745,468

Electromed, Inc

HISTORICAL ZACKS RECOMMENDATIONS



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