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Zacks Small-Cap Research

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Transgenomic Inc. (TBIO-OTC)

TBIO: Equity Financing Adds Flexibility But Seems Overkill

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	01/12/2011
Current Price (02/03/2012)	$1.17
Target Price	**$2.50**

OUTLOOK

Near-term growth comes from a December 2010 acquisition which bolts on over $11MM in revenue and is already providing synergies.

Long-term growth will come from TBIO's transition away from instruments and into the high-growth market of companion diagnostics. The company is just in the infancy of this transformation and early indications already suggest their novel, ultra-sensitive testing technology is garnering significant interest from pharma companies. We are maintaining our Outperform rating. Our per share price target has moved from $3.50 to $2.50, reflecting the material increase in share count from this new equity issuance.

SUMMARY DATA

52-Week High	**$1.85**
52-Week Low	**$0.66**
One-Year Return (%)	**170.59**
Beta	**1.87**
Average Daily Volume (sh)	**74,558**
Shares Outstanding (mil)	**49**
Market Capitalization ($mil)	**$58**
Short Interest Ratio (days)	**0.22**
Institutional Ownership (%)	**2**
Insider Ownership (%)	**2**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**-1.1**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using TTM EPS	**N/A**
P/E using 2011 Estimate	**N/A**
P/E using 2012 Estimate	**N/A**
Zacks Rank	**N/A**

Risk Level	**High,**
Type of Stock	**Small-Growth**
Industry	**Med Instruments**

ZACKS ESTIMATES

Revenue
(in '000 of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2010	5,442 A	5,095 A	4,419 A	5,092 A	20,048 A
2011	7,480 A	7,667 A	8,253 A	8,153 E	31,553 E
2012					36,257 E
2013					43,875 E

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

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2010	-$0.01 A	-$0.02 A	-$0.02 A	-$0.02 A	-$0.06 A
2011	-$0.06 A	-$0.13 A	-$0.03 A	-$0.03 E	-$0.25 E
2012					-$0.05 E
2013					-$0.02 E

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

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WHAT'S NEW…..

$22MM FINANCING ($19MM new)

- On 1/6/12 Transgenomic filed an 8-K announcing a $3 million commitment by Third Security to purchase convertible promissory notes. Terms of the notes included an annual interest rate of 16%, maturity of 3/31/12 and automatic conversion into common stock upon the future sale of equity of at least $3 million. Conversion price determined by the price per share paid by buyers of the (future) equity issuance.

- In a 2/3/12 press release Transgenomic announced that it entered a definitive agreement with accredited investors to raise an additional $19 million through a private placement of common stock. The deal includes the sale of 19MM shares of stock (@ $1.00/share) plus five year warrants to purchase up to 9.5MM shares @ $1.25/share. Upon sale of the shares the $3MM of promissory notes sold to Third Security in January will automatically convert to common stock @ $1.00 share.

  It's unclear right now why Transgenomic raised this amount of capital as $22MM in additional financing over the last couple of months seems overkill given TBIO had a modest cash balance (at 9/30/11) and was burning only a little over $1MM on an annual basis with nothing to indicate that this would materially increase going forward (in fact, we expect that cash burn will incrementally decrease going forward). It's possible that something yet-to-be-announced is in the works – although we have no insight that this is the case. What the new capital definitely does do, however, is afford significant flexibility in R&D efforts and allows Transgenomic to easily cover principal payments on the outstanding 3-year 10% note held by PGx Health for which $8.6MM in quarterly principal repayments begin with the quarter ending 6/30/12 and extends until the December 31, 2013 maturity – how they expected to cover these principal payments was a question mark up until now.

  Pro forma for the (estimated, net of issuance expenses) cash from this new financing, cash balance at Q3 2011 was ~ $20MM.

  We have adjusted our model to incorporate the additional shares outstanding as a result of this financing (we had anticipated an equity raise in 2012 to cover the debt principal - but not an equity sale of this this extent). Our valuation methodology (P/S using estimated 2012 revenue) remains unchanged but with the material increase to the share count, our price target has moved from $3.50.share to $2.50/share. If there's a (currently unknown) catalyst (i.e. – how is TBIO going to use all this cash) that would prompt us to increase our revenue estimates, we will adjust our price target accordingly. As it is now, our price target is $2.50/share.

Plavix Test / AF Test Launches

In mid-November 2011 Transgenomic announced that they launched their Plavix test, which came with the December 2010 of Clinical Data's genetics business, and an atrial fibrillation test.

- **Plavix:** Plavix (generic name, clopidogrel) is anti-blood clotting drug sold by Bristol-Myers and Sanofi-Aventis. Prescribed to patients to reduce the risk of heart attack, stroke or cardiovascular death, it is the second biggest selling drug, with worldwide sales over $9 billion in 2010.

  The FDA added a warning to the Plavix label in May 2009 but "upgraded" it to black-box in March 2010. Black-box warnings are FDA's most serious warning and are typically only issued when the agency believes the drug could carry potentially serious adverse risks. The warning notes that Plavix may be less effective in certain people (those with reduced functioning of their CYP2C19 liver enzyme) and therefore these "poor metabolizers" may remain at risk of suffering from heart attack, stroke or death. Roughly 2% to 14% of the U.S. population is estimated to fit into this "poor metabolizer" category. The FDA recommended testing to determine which individuals are susceptible to less response to Plavix.

  Transgenomic's Plavix response test, named PGxPredict:CLOPIDOGREL is based on the ABCB1 (or MDR1) gene. Prior to the November launch announcement Transgenomic had not provided specific guidance on when they expected to introduce the test - our best guess had been that the test may launch sometime during 2012 – so this puts it on the market slightly ahead of that – which could provide some very slight upside to our modeled near-term revenue. While the test will compete against several other Plavix response tests already on the market,

Transgenomic's test incorporates a different marker and, combined with leveraging their sales and distribution network, could spark uptake of the test. Plavix also loses U.S. exclusivity in 2012 - once generic, uptake of the drug will grow even more which should expand the overall market for Plavix response testing.

- The atrial fibrillation (AF) test, called Familial Atrial Fibrillation Test, is the most recent addition to the FAMILION line of tests, which also came with the Clinical Data related acquisition. AF is a relatively common heart rhythm disorder that can result in very serious consequences, including stroke. While the onset of AF is typically related to cardiovascular disease, Transgenomic's genetic test will help determine whether someone is genetically predisposed to suffering from AF – allowing for earlier intervention. The test will be offered through the FAMILION business.

OUR 2011 OUTLOOK (per our previous update – remains unchanged)

We model 2011 revenue of $31.5 million. Our current revenue estimate implies growth of 57% from 2010 (flat on an organic, ex-FAMILION, basis). We look for Laboratory Services and Instruments to generate revenue of $18.1 million and $13.5 million, respectively. We think EPS comes in at ($0.25) in 2011 or about ($0.11) if the preferred stock revaluation expense and QTDP grant income are eliminated.

Laboratory Services
Our $18.1 million revenue estimate for Laboratory Services includes $15.6 million ($4.1MM ex-FAMILION) from the Clinical Lab segment and $2.5 million from Pharmacogenomics. We assume sales of the FAMILION tests, which are seasonally soft in 1H due to the reset of insurance deductibles at the beginning of the year, to grow sequentially from Q3 but on an annual basis come in about 12% lower than 2010. We think FAMILION returns to growth in 2012, benefitting from new product launches, including the Plavix response test. We model revenue from Transgenomic's legacy clinical lab (neurology) business to grow about 14% in 2011. Meanwhile, the pharmacogenomics business should experience strong growth throughout 2011 - we look for $2.4 million in revenue from this segment, implying growth of 80% from 2010.

Instruments
We model the equipment portion of Transgenomic's instrument business to fall 13% in 2011 to $7.3MM (average of ~ $1.8MM/qtr) but revenue from the consumables business to hold up much better due to new cancer kit launches and selling to a larger installed base. We model bioconsumables to fall 8% in 2011 to $6.2MM. Benefitting from the Menarini distribution agreement, along with new consumable product launches including several new cancer kits, we think the instruments business can stem the slide in revenue in 2013 and return to growth the following year.

RECOMMENDATION / VALUATION

We have adjusted our model to incorporate the additional shares outstanding as a result of the new financing announced in early February (we had anticipated an equity raise in 2012 to cover the debt principal - but not an equity sale of this this extent). Our valuation methodology (P/S using estimated 2012 revenue) remains unchanged but with the material increase to the share count, our price target has moved from $3.50.share to $2.50/share. If there's a (currently unknown) catalyst (i.e. – how is TBIO going to use all this cash) that would prompt us to increase our revenue estimates, we will adjust our price target accordingly. As it is now, our price target is $2.50/share.

Given that we model Transgenomic to post negative income and EPS through 2013, valuing the company using a near-term P/E multiple is not reasonable. Instead, we value the company using competitor price/sales multiples, calculated using estimated 2012 revenue. We looked at ten competitors which had at least one analyst estimate for 2012 sales - P/S multiples range from a low of 0.7x to a high of 16x. We removed both the high and low ratio in order to reduce the bias from outliers to the overall averages. This left average comp P/S of 4.7x.

We model Transgenomic to post revenue of $36.3MM in 2012. Using the comp P/S ratio values TBIO at approximately $2.50/share. The shares currently trade at $1.17, indicating still significant upside. We are maintaining our Outperform rating.

FINANCIAL MODEL

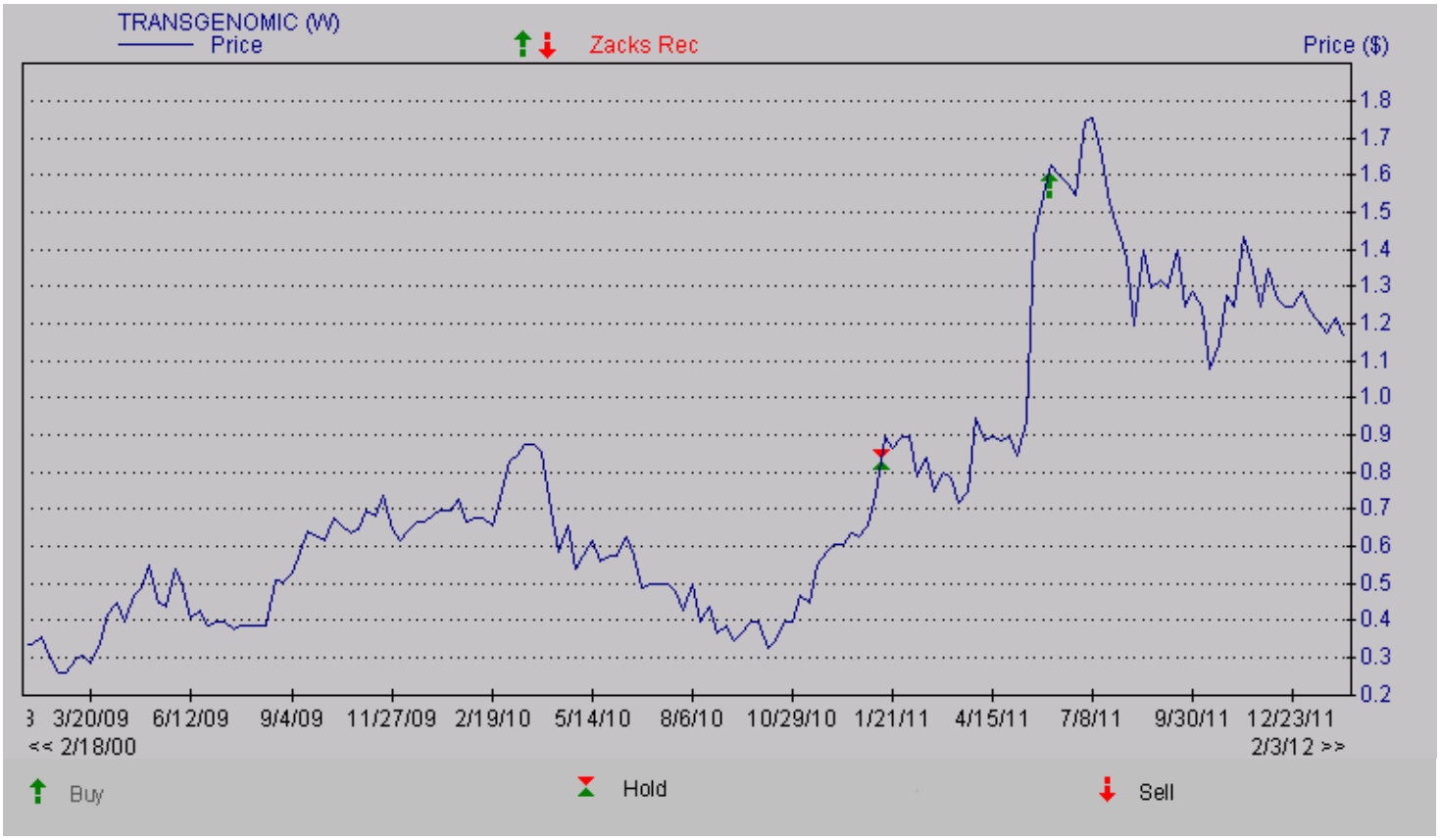
Transgenomic Inc.

	2010 A	Q1A	Q2A	Q3A	Q4E	2011 E	2012 E	2013 E	2014 E
Laboratory Services	$4,979.0	$3,757.0	$4,866.0	$4,637.0	$4,810.0	$18,070.0	$22,887.9	$29,926.3	$37,546.5
% of total revenue	24.8%	50.2%	63.5%	56.2%	59.0%	57.3%	63.1%	68.2%	71.7%
YOY Growth	*9.0%*	*195.6%*	*292.1%*	*266.9%*	*299.8%*	*262.9%*	*26.7%*	*30.8%*	*25.5%*
Instruments	$15,069.0	$3,723.0	$2,801.0	$3,616.0	$3,343.0	$13,483.0	$13,368.9	$13,949.0	$14,841.6
% of total revenue	75.2%	49.8%	36.5%	43.8%	41.0%	42.7%	36.9%	31.8%	28.3%
YOY Growth	*-13.7%*	*-10.7%*	*-27.3%*	*14.6%*	*-14.0%*	*-10.5%*	*-0.8%*	*4.3%*	*6.4%*
Total Revenues	$20,048.0	$7,480.0	$7,667.0	$8,253.0	$8,153.0	$31,553.0	$36,256.8	$43,875.3	$52,388.2
YOY Growth	*-9.0%*	*37.4%*	*50.5%*	*86.8%*	*60.1%*	*57.4%*	*14.9%*	*21.0%*	*19.4%*
Laboratory Services	$3,541.0	$1,970.0	$1,802.0	$1,945.0	$2,007.8	$7,724.8	$8,637.8	$10,631.2	$12,692.8
Lab Svcs margin	*28.9%*	*47.6%*	*63.0%*	*58.1%*	*58.3%*	*57.3%*	*62.3%*	*64.5%*	*66.2%*
Instruments	$6,743.0	$1,356.0	$1,310.0	$1,868.0	$1,644.5	$6,178.5	$6,230.6	$6,410.9	$6,789.4
Instruments margin	*55.3%*	*63.6%*	*53.2%*	*48.3%*	*50.8%*	*54.2%*	*53.4%*	*54.0%*	*54.3%*
Cost of Revenues	$10,284.0	$3,326.0	$3,112.0	$3,808.0	$3,652.3	$13,898.3	$14,868.5	$17,042.1	$19,482.2
Gross Income	$9,764.0	$4,154.0	$4,555.0	$4,445.0	$4,500.7	$17,654.7	$21,388.3	$26,833.2	$32,906.0
Gross Margin	*48.7%*	*55.5%*	*59.4%*	*53.9%*	*55.2%*	*56.0%*	*59.0%*	*61.2%*	*62.8%*
SG&A	$10,933.0	$4,323.0	$5,589.0	$4,364.0	$4,760.8	$19,036.8	$20,023.1	$22,911.7	$25,534.4
% SG&A	*54.5%*	*57.8%*	*72.9%*	*52.9%*	*58.4%*	*60.3%*	*55.2%*	*52.2%*	*48.7%*
R&D	$2,305.0	$557.0	$579.0	$515.0	$660.0	$2,311.0	$3,060.0	$3,180.0	$3,480.0
% R&D	*11.5%*	*7.4%*	*10.7%*	*10.2%*	*9.1%*	*7.3%*	*8.4%*	*7.2%*	*6.6%*
Restructuring charges	$138.0	$24.0	$11.0	$5.0	$0.0	$40.0	$0.0	$0.0	$0.0
Operating Income	($3,612.0)	($750.0)	($1,624.0)	($439.0)	($920.1)	($3,733.1)	($1,694.8)	$741.5	$3,891.5
Operating Margin	*-18.0%*	*-10.0%*	*-21.2%*	*-5.3%*	*-11.3%*	*-11.8%*	*-4.7%*	*1.7%*	*7.4%*
Interest income, net	($4.0)	($238.0)	($240.0)	($238.0)	($230.0)	($946.0)	($800.0)	($780.0)	$10.0
Expense on preferred stock	$0.0	($2,027.0)	($4,239.0)	($600.0)	($200.0)	($7,066.0)	$0.0	$0.0	$0.0
Other income	$632.0	$231.0	$1.0	($2.0)	$0.0	$230.0	$0.0	$0.0	$0.0
Pre-Tax Income	($2,984.0)	($2,784.0)	($6,102.0)	($1,279.0)	($1,350.1)	($11,515.1)	($2,494.8)	($38.5)	$3,901.5
Taxes	$150.0	($6.0)	($104.0)	($9.0)	$33.4	($85.6)	$133.7	$139.5	$148.4
Tax Rate	*-5.0%*	*0.2%*	*1.7%*	*0.7%*	*-2.5%*	*0.7%*	*-5.4%*	*-362.4%*	*3.8%*
Expense on Preferred	$0.0	($260.0)	($267.0)	($275.0)	($262.0)	($1,064.0)	($1,042.0)	($1,042.0)	($1,042.0)
Net Income	($3,134.0)	($3,038.0)	($6,265.0)	($1,545.0)	($1,645.6)	($12,493.6)	($3,670.5)	($1,220.0)	$2,711.1
YOY Growth	*-63.2%*	*-837.7%*	*-446.7%*	*72.0%*	*114.8%*	*-298.6%*	*-70.6%*	*-66.8%*	*-322.2%*
Net Margin	*-15.6%*	*-40.6%*	*-81.7%*	*-18.7%*	*-20.2%*	*-39.6%*	*-10.1%*	*-2.8%*	*5.2%*
EPS	($0.06)	($0.06)	($0.13)	($0.03)	($0.03)	($0.25)	($0.05)	($0.02)	$0.03
YOY Growth	*-63.0%*	*835.7%*	*445.6%*	*71.9%*	*113.9%*	*297.7%*	*-79.3%*	*-68.6%*	*-284.8%*
Diluted Shares O/S	49,244	49,293	49,300	49,328	49,500	49,355	70,000	74,000	89,000

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