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Icad Inc (ICAD-NASDAQ)

ICAD: Tomosynthesis, DermEbx Should Be Major Catalysts in 2015…

Current Recommendation	**Outperform**
Prior Recommendation	Neutral
Date of Last Change	04/29/2014
Current Price (01/22/15)	$8.90
Target Price	**$15.00**

OUTLOOK

We expect continued momentum in Therapy biz, particularly now with the addition of DermEbx. The Detection segment looks promising to return to long-term growth aided by iCAD's recent strategy shift towards a greater reliance on recurring revenue, services and a conventional software business model, new product launches, and a recently announced development agreement with Invivo (part of Philips Healthcare). New 3D breast tomo product could really accelerate Detection revenue beginning in 2015.
This coupled with a stringent focus on cost control looks like it is marking an important inflection point for iCAD.
We remain highly positive on ICAD and management's ability to continue to grow the top and bottom lines.

SUMMARY DATA

52-Week High	**$12.92**
52-Week Low	**$6.05**
One-Year Return (%)	**-28.86**
Beta	**1.05**
Average Daily Volume (sh)	**23,618**
Shares Outstanding (mil)	**16**
Market Capitalization ($mil)	**$138**
Short Interest Ratio (days)	**5.27**
Institutional Ownership (%)	**39**
Insider Ownership (%)	**15**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**7.0**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using TTM EPS	**N/A**
P/E using 2014 Estimate	**N/A**
P/E using 2015 Estimate	**59.3**
Zacks Rank	**N/A**

Risk Level	**Average,**
Type of Stock	**Small-Blend**
Industry	**Comp-Software**

ZACKS ESTIMATES

Revenue
(in '000 of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2013	7,930 A	7,712 A	8,290 A	9,135 A	33,067 A
2014	8,520 A	9,667 A	12,572 A	13,025 E	43,784 E
2015					59,410 E
2016					77,373 E

Earnings per Share

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2013	-$0.07 A	-$0.17 A	-$0.05 A	-$0.41 A	-$0.70 A
2014	-$0.02 E	-$0.07 A	$0.02 A	$0.02 E	-$0.06 E
2015					$0.15 E
2016					$0.43 E

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

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WHAT'S NEW…

Q3 2014 Results: Revenue +52% on Contribution from Acquisition, Continued Strength in Detection…

iCAD (ICAD) announced financial results for the third quarter ending August 31, 2014. Revenue in both the Therapy and Detection businesses handily beat our numbers with seemingly accelerated migration of pipeline-to-revenue generating customers from the DermEbx/Radion acquisition benefitting Therapy and a very strong quarter from MRI-license partner Invivo fueling Detection. And while Detection may see a sequential tick-down in revenue in Q4 as a result of some lumpiness, importantly management expects the Therapy business to continue its upward trajectory as additional customers come on-line and utilization increases (mostly in skin). The strong Q3 and expected continued growth in Q4 prompted management to upwardly revise its previously announced full-year financial guidance. Prior guidance, provided on the Q3 call, of revenue and adjusted EBITDA margin for the second half of 2014 of $23M - $25M and 10% - 15% was revised to $25.5M - $26M and 18% - 22%.

And while yoy and sequential comparisons in Therapy are not possible as the DermEbx/Radion acquisition was effective mid-July, it is worth noting that ICAD is already hitting the mid-to-high range of the expected annual revenue run-rate from the acquisition of $16M - $20M. We think this, along with the fact that Q3 was the only quarter since Q4 2009 where ICAD generated positive operating income, lends support that the acquisition may already be accretive. And, as we've noted recently, despite Therapy product sales (i.e. - controllers) having trended lower over the last few quarters, total Therapy revenue has increased in the strong double-digits as a result of an expanded customer base and, perhaps even more importantly, accelerating utilization. Balloon applicator sales increased 44% year-to-date. We expect Therapy-related consumable sales to continue to trend higher as a result of the ever-expanding installed base, higher per instrument utilization, broadening reimbursement, additional clinical data supporting use of eBx in both skin and breast cancer and additional contribution from the DermEbx acquisition.

The majority of growth of the Therapy business continues to come from the skin indication as improved and expanded reimbursement, greater awareness of the therapy and additional positive clinical outcomes data continues to benefit demand. But while skin cancer is the major catalyst of the Therapy division, indications are that breast IORT is gaining additional favor and benefitting from continued greater awareness of its advantages (for those it is appropriate for) relative to whole breast radiotherapy as well as additional clinical data supporting the same.

And while Therapy has been the major catalyst to ICAD's total revenue growth as Detection had been hampered to some extent by the continued erosion of the film-based mammography line, the overall impact has gradually lessened and is now almost a non-issue relative to yoy comparisons. In fact Detection has recently made a meaningful positive contribution to total company revenue, turning in yoy growth of 27% in Q2 and 15% in Q3. Over the near-term we continue to look for the services side of Detection to show fairly consistent growth with the product side gaining more momentum with the initial roll-out of the new tomosynthesis product in Europe. We think Detection posts 10% growth in 2014 and 19% growth in 2015.

We think Therapy, which posted 87% growth in 2012 and 47% growth in 2013, can end the current year up almost 60% and grow another 63% in 2015, catalyzed in part from the contribution from DermEbx.

Guidance
Management upwardly revised prior financial guidance. Initial revenue and EBITDA margin guidance for the second half of 2014 of $23M - $25M and 10% - 15%, which was provided on the Q2 call, was revised up to $25.5M - $26M and 18% - 22% on the Q3 call.

Cash
Excluding changes in working capital, cash from operations was an inflow of $2.0M. While prior to Q3 we had expected the company to be or near cash flow break even for the full year 2014, we now think it is even more likely that ICAD will generate positive cash flow for 2014. ICAD paid $3.5M cash in Q3 towards the DermEbx/Radion acquisition and will pay the remaining $500k in Q4. Cash balance was $33.4M at the end of Q3. Management has previously noted that they do not expect to be looking for additional acquisitions, at least in the near-term, and expect instead to reinvest some of the cash in growth of the existing businesses.

Revenue
Q3 revenue of $12.6M was up 52% yoy and about 11% higher than our $11.3M estimate.

- **Cancer Detection(Q3):** $4.9M actual (+15% yoy) vs. $4.4M estimate
  - Total product revenue in cancer detection was about $2.7 million, up from about $2.2 million in Q3 2013 and well ahead of our $2.1 million estimate. Management noted on the call that sales of MRI licenses to their partner, Invivo, were particularly strong in Q3 - which is where we attribute the beat relative our number. Detection has been particularly strong the last two quarters, although we think this is at least somewhat due to short-term revenue variability in this business. Nonetheless, we think this segment will return to consistent growth on growing demand from PowerLook AMP, MRI licensing and the near-term launch of the breast tomosynthesis product. Meanwhile, the historical issue of the erosion of Detection revenues from reduced conversion by imaging facilities from film-based to digital mammography has mostly run its course given that revenue related to this had already dropped to (almost) insignificant levels by early 2013.

    We continue to expect the Detection segment to remain on track for sustained growth over the long term. This being fueled by the recent and expected new product launches (PowerLook AMP, CAD for tomosynthesis, etc.), more annual licensing agreements, increased service contracts (to iCAD's 4k+ installed base as well as OEM partners'), partnership deals with OEM's with new products, development projects and service contracts, and the recently penned MRI software development deal with Invivo.

    And as we've noted in the past, while CT colon CAD revenue has yet to gain much traction in the U.S. as a result of a dearth of reimbursement, management recently indicated they are seeing some growth internationally and this remains a viable domestic growth opportunity with sufficient reimbursement. As improvement in the reimbursement picture could improve in the near-term, we see this as one area that could surprise on the upside over the near-term. The additional data from the ACRIN study that were recently published could be a catalyst to eventually gaining Medicare reimbursement for CT colon CAD.

    However, the Detection pipeline product that likely holds the most promise is the company's CAD platform for 3D breast tomosynthesis. ICAD continues to work to complete the initial product, which is expected to be rolled out in the first half of 2015 (pushed back slightly from earlier expectations) in Europe on GE's SenoClair tomosynthesis instruments. SenoClaire received CE Mark in July 2013 and FDA clearance in August 2014. Shortly after the European launch, ICAD expects to introduce the product in the U.S. We think this could be a big winner for ICAD given the criticism and debate over the utility of stand-alone mammography and increased demand for more accurate detection of breast cancer. GE's instrument is billed as producing lower x-ray dose (i.e. - safer) than Hologic's Selenia Dimensions machine (FDA cleared in 2011), currently the only other 3D breast tomosynthesis instrument sold in the U.S., providing a real opportunity for GE's machine.

    Our modeled step-up in Detection revenue beginning in 2015 represents meaningful contribution from ICAD's 3D breast tomosynthesis platform.

- **Cancer Therapy (Q3):** $7.6M (+92% yoy) actual vs. $6.9M estimate
  - Cancer therapy revenue in Q3 grew 92% yoy and 30% sequentially. ICAD did not break out legacy from acquired DermEbx revenue, although clearly the acquisition provided the bulk of revenue growth. Important to remember, however, is that DermEbx began contributing in mid-July (i.e. - two weeks short of a full quarter) - Q4 will provide a full-quarters contribution, and with additional pipeline customers migrating to revenue generating customers, we expect Q4 Therapy revenue to be significantly stronger than Q3. Service and supplies revenue (i.e. - consumables and warranties) continues to be the driver of Therapy growth as system placements slow, as evidenced by the 17% yoy and 25% sequential decrease in Therapy product revenue through Q3.

    As we have noted in the past, expansion of the Therapy user base and increase in utilization appears to be coming from several fronts, including more favorable reimbursement, positive clinical outcomes data and greater awareness of the benefits the therapy. This is particularly benefitting the skin indication, which dually benefits revenue as skin cancer treatment typically requires more than one visit.

    Relative to reimbursement, currently 21 states have a "positive policy" related to non-melanoma skin cancer whereas this stood at just 16 states in May of this year and 10 states in mid-2013. Clearly the reimbursement picture is improving which has almost certainly aided uptake and utilization of Xoft for skin cancer. In addition, a CPT code for electronic brachytherapy specific to skin cancer was recently submitted for review - a determination for approval could be made in the coming weeks. If established, we would

expect this would further benefit uptake of Ebx for non-melanoma skin cancer. Nonetheless, we think it's reasonable to expect further improvement in the reimbursement picture going forward, from both public and private payers.

Much of the recent growth in Therapy is coming from skin which we think will continue given catalysts such as positive clinical trial data supporting the use of eBx in non-melanoma skin cancer, fairly rapid geographic growth in reimbursement and overall increased awareness (by both dermatologists as well as consumers) of its benefits over traditional surgical excision. ICAD remains very active in promoting at all these levels. And as noted, the DermEbx/Radion acquisitions will immediately contribute significant additional Therapy revenue.

We think it is reasonable to expect that an increase in reimbursement, from both an uptake on the payer side as well as level of reimbursement, will be facilitated with additional positive clinical data. This will be supported by published manuscripts and presentations such as the recent presentations at ASTRO detailing positive four-year follow up data (low toxicity, no recurrence and excellent cosmetic results) on non-melanoma skin cancer patients (n=187) treated with Xoft. Other data was presented in April of a study with 364 patients (561 lesions) which showed treatment with Xoft in non-melanoma skin cancer results in comparable cure rates compared with standard therapy (fractionation teletherapy, Mohs or excision) with Xoft treated patients having excellent cosmetic results. Strong efficacy and lack of scarring have been major selling points for Xoft in skin cancer.

The company is also now tapping international markets with a handful of sites in Europe and one in Asia currently using Axxent. In April 2013 they announced distribution agreements for parts of China and Russia - launch in which is expected to happen following requisite regulatory approvals - potentially culminating in late 2014 or 2015. More recently they penned a distribution agreement in Canada.

We continue to see tremendous upside in the breast cancer indication. We think utilization remains relatively low and penetration of Axxent in the U.S. breast IORT market is likely only in the low single digits. Greater awareness and improved reimbursement could provide catalysts to ramp penetration, utilization and revenue. Support from a continued flow of positive clinical data, including recently published updated data from the landmark TARGIT-A trial which continued to show non-inferiority of IORT to whole breast radiotherapy at five years follow-up, should further facilitate uptake and support for greater reimbursement.

Despite the slow ramp in breast to-date, demand for Axxent in the breast cancer application is increasing. ICAD clearly remains highly committed to fully exploiting this opportunity and continues to dedicate time and resources towards building awareness and generating additional clinical data in support of the treatment. This includes a multi-center IORT early-stage breast cancer study expected to enroll ~1,000 patients at 50 sites . The study, which is expected to have ~500 patients enrolled could have interim data available in 2015. Positive outcomes from which should provide additional support for utilization and reimbursement of the treatment.

And in addition to skin and breast cancer, the Therapy business should further benefit as additional indications come online, including for cervical cancer which is now still in the early launch phase. This is an area in the Therapy business that could potentially surprise on the upside.

EPS

Q3 EPS of $0.02 was ahead of our ($0.03) estimate. The difference coming from the beat on revenue and better than modeled gross margin (72.9% A vs 70.2% E). Recent gross margin improvement has been the result of outpaced growth of higher margin service/supplies (relative to product sales and related margin). We continue to think gross margin will expand in future periods with further growth of service and supplies revenue and volume efficiencies.

VALUATION / RECOMMENDATION

We have made minor adjustments to our model following Q3 results. We now look for EPS of ($0.06) in 2014. We continue to model positive net income and EPS to materialize in 2015.

We continue to value iCAD based on competitor price/sales (P/S) and enterprise value /sales (EV/S) multiples. Using analyst's revenue estimates for the years 2014 and 2015, we calculated P/S and EV/S ratios from imaging (HOLX, MRGE) as well as surgical (VAR, ARAY, ISR, EKTAF) companies. The six companies currently trade at an average P/S-2014 of 4.7x and P/S-2015 of 4.1x and average EV/S-2014 of 3.9x and EV/S-2015 of 3.4x.

Based on the average of the 2014 and 2015 EV/S multiples iCAD is valued at $14.4/share. Based on the average of the 2014 and 2015 P/S multiples iCAD is valued at $14.8/share. We use the average of the two which values iCAD at approximately $15/share. We are maintaining our Outperform recommendation.

FINANCIAL MODEL

iCAD Inc.

	2013 A	Q1A	Q2A	Q3A	Q4E	2014 E	2015 E	2016 E	2017 E
Cancer Detection	$16,905.0	$4,175.0	$4,832.0	$4,936.0	$4,695.0	$18,638.0	$22,106.5	$27,267.5	$34,040.0
YOY Growth	*-2.1%*	*-10.0%*	*26.9%*	*14.5%*	*13.1%*	*10.3%*	*18.6%*	*23.3%*	*24.8%*
% of total revenue	*50.4%*	*49.0%*	*50.0%*	*39.3%*	*36.0%*	*42.6%*	*37.2%*	*35.2%*	*35.8%*
Therapy	$16,162.0	$4,345.0	$4,835.0	$7,636.0	$8,330.0	$25,146.0	$37,303.0	$50,105.0	$60,975.0
YOY Growth	*46.7%*	*32.0%*	*23.8%*	*91.9%*	*67.1%*	*55.6%*	*48.3%*	*34.3%*	*21.7%*
% of total revenue	*48.2%*	*51.0%*	*50.0%*	*60.7%*	*64.0%*	*57.4%*	*62.8%*	*64.8%*	*64.2%*
Total Revenues	$33,519.0	$8,520.0	$9,667.0	$12,572.0	$13,025.0	$43,784.0	$59,409.5	$77,372.5	$95,015.0
YOY Growth	*18.5%*	*7.4%*	*25.4%*	*51.7%*	*42.6%*	*30.6%*	*35.7%*	*30.2%*	*22.8%*
Cost of Revenues	$9,981.0	$2,586.0	$2,837.0	$3,405.0	$3,960.6	$12,788.6	$17,049.6	$20,574.1	$24,092.3
Gross Income	$23,538.0	$5,934.0	$6,830.0	$9,167.0	$9,064.4	$30,995.4	$42,359.9	$56,798.4	$70,922.7
Gross Margin	*70.2%*	*69.6%*	*70.7%*	*72.9%*	*69.6%*	*70.8%*	*71.3%*	*73.4%*	*74.6%*
R&D	$7,694.0	$2,027.0	$2,170.0	$2,086.0	$2,155.0	$8,438.0	$10,445.0	$12,214.0	$12,250.0
% R&D	*23.0%*	*23.8%*	*22.4%*	*16.6%*	*16.5%*	*19.3%*	*17.6%*	*15.8%*	*12.9%*
Selling & Mktg	$10,427.0	$2,619.0	$2,903.0	$3,448.0	$3,594.9	$12,564.9	$16,931.7	$21,819.0	$25,654.0
% Sell&Mktg	*31.1%*	*30.7%*	*30.0%*	*27.4%*	*27.6%*	*28.7%*	*28.5%*	*28.2%*	*27.0%*
G&A	$6,740.0	$1,748.0	$1,923.0	$2,707.0	$2,402.0	$8,780.0	$10,640.0	$12,711.0	$14,442.3
% G&A	*20.1%*	*20.5%*	*19.9%*	*21.5%*	*18.4%*	*20.1%*	*17.1%*	*16.1%*	*15.2%*
Operating Income	($1,323.0)	($460.0)	($166.0)	$926.0	$912.5	$1,212.5	$4,343.2	$10,054.3	$18,576.4
Operating Margin	*-3.9%*	*-5.4%*	*-1.7%*	*7.4%*	*7.0%*	*2.8%*	*7.3%*	*13.0%*	*19.6%*
Other income	($2,429.0)	$1,140.0	($192.0)	$11.0	$40.0	$999.0	$200.0	$150.0	$125.0
Interest income, net	($3,277.0)	($817.0)	($614.0)	($647.0)	($633.0)	($2,711.0)	($900.0)	($581.3)	$0.0
Pre-Tax Income	($7,029.0)	($137.0)	($972.0)	$290.0	$319.5	($714.5)	$2,993.2	$9,191.7	$18,701.4
Taxes	$126.0	$53.0	$25.0	$16.0	$55.0	$149.0	$404.1	$1,856.7	$4,862.4
Tax Rate	*-1.8%*	*-38.7%*	*-2.6%*	*5.5%*	*17.2%*	*-20.9%*	*13.5%*	*20.2%*	*26.0%*
Net Income	($7,155.0)	($190.0)	($997.0)	$274.0	$264.5	($863.5)	$2,589.1	$7,335.0	$13,839.0
YOY Growth	*23.7%*	*73.9%*	*47.0%*	*146.5%*	*106.0%*	*87.9%*	*399.8%*	*-183.3%*	*-88.7%*
Net Margin	*-21.3%*	*-2.2%*	*-10.3%*	*2.2%*	*2.0%*	*-2.0%*	*4.4%*	*9.5%*	*14.6%*
EPS	($0.66)	($0.02)	($0.07)	$0.02	$0.02	($0.06)	$0.15	$0.43	$0.81
YOY Growth	*24.0%*	*75.3%*	*59.2%*	*130.9%*	*104.0%*	*91.0%*	*358.8%*	*-181.6%*	*-87.6%*
Pro-forma adjustments	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Pro-forma EPS	($0.66)	($0.02)	($0.07)	$0.02	$0.02	($0.06)	$0.15	$0.43	$0.81
Diluted Shares O/S	10,842	11,429	14,074	16,348	16,490	14,585	16,900	17,000	17,100

Brian Marckx, CFA

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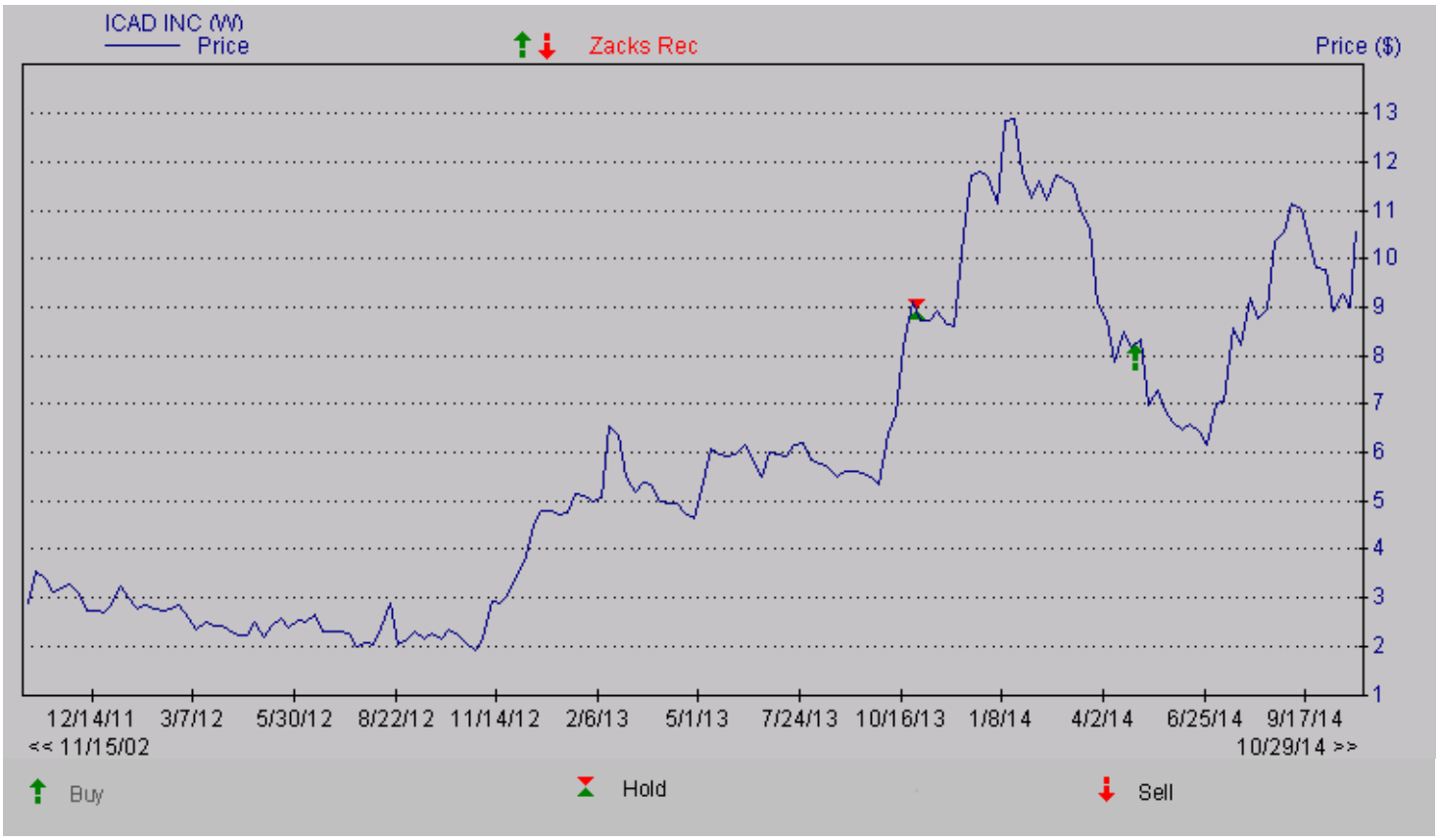

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