Zacks Small-Cap Research

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Brian Marckx, CFA
bmarckx@zacks.com
Ph (312) 265-9474

scr.zacks.com

10 S. Riverside Plaza, Ste 1600, Chicago, IL 60606

Biomerica Inc (BMRA-OTCBB)

BMRA: Q2: Asia Still Soft But Wrinkles Should Now Be Ironed Out

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	01/23/2013
Current Price (01/16/15)	$0.81
Target Price	**$2.20**

OUTLOOK

Biomerica has been profitable twelve of the last seventeen quarters, has fairly regularly generated positive cash flow, and maintains a solid balance sheet. Revenue growth had recently softened but is bouncing back. We think this recent strength will continue, despite a huge recent hiccup in Asia sales – this should now be ironed out. New distribution in Europe and product launches have facilitated growth there. Meanwhile, U.S. sales have been less regular but we think will return to growth by late 2015. Could see a big-winner with new GI test (still under dvlmpnt). We continue to see very little to no downside risk in the share price at this level. We think the cheap valuation may have more to do with BMRA being a nano-cap and suffering from a lack of exposure rather than having anything to do with fundamentals.

SUMMARY DATA

52-Week High	**$1.10**
52-Week Low	**$0.70**
One-Year Return (%)	**-10.00**
Beta	**0.91**
Average Daily Volume (sh)	**2,173**
Shares Outstanding (mil)	**8**
Market Capitalization ($mil)	**$6**
Short Interest Ratio (days)	**1.23**
Institutional Ownership (%)	**0**
Insider Ownership (%)	**25**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**2.3**
Earnings Per Share (%)	**42.0**
Dividend (%)	**N/A**
P/E using TTM EPS	**N/A**
P/E using 2015 Estimate	**N/A**
P/E using 2016 Estimate	**27.0**
Zacks Rank	**N/A**

Risk Level	**High,**
Type of Stock	**Small-Value**
Industry	**Med-Drugs**

ZACKS ESTIMATES

Revenue
(in millions of $)

	Q1 (Aug)	Q2 (Nov)	Q3 (Feb)	Q4 (May)	Year (May)
2014	1.01 A	0.93 A	1.49 A	1.68 A	5.12 A
2015	1.03 A	1.13 A	1.52 E	1.90 E	5.59 E
2016					7.11 E
2017					8.17 E

Earnings per Share

	Q1 (Aug)	Q2 (Nov)	Q3 (Feb)	Q4 (May)	Year (May)
2014	-$0.02 A	-$0.03 A	$0.00 A	$0.02 A	-$0.03 A
2015	-$0.03 E	-$0.03 A	-$0.00 E	$0.01 E	-$0.05 E
2016					$0.03 E
2017					$0.09 E

Zacks Projected EPS Growth Rate - Next 5 Years % **NA**

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WHAT'S NEW……

Q2 Results: Asia Remains Weak But Not For Long. GI Test Could Be a Long-Term Winner…

Biomerica filed their 10-Q for the fiscal 2015 second quarter ending November 2014. Results were somewhat similar to Q1 with sales in Asia very soft and sales in the U.S. and Europe accounting for the majority of revenue. There was a an anomaly in Q2, however, that being sales in the Middle East rocketing up to $100k – for comparison Middle Eastern sales have averaged only about $10k - $15 per quarter over the last several years. The company did not detail the reason for the big jump in Middle Eastern sales.

And while sales in Asia increased 28% to $102k from just $80k in the prior year quarter, the year-earlier period was affected by a disruption caused by a switch in that territory's distributor. With the new distributor in place Asian sales then started to pick up steam again in the second half of last fiscal year. Then did another reversal over the last two quarters – all is not lost, however, and we still think sales in Asia will rebound to historical levels. The company noted the most recent hiccup was a result of a delay in receiving re-registration approval for their products in Asia and further noted that this has now been completed. As such, this hindrance should not recur in Q3 and we think sales in Asia begin to show an immediate (positive) reversal.

Meanwhile European sales have been relatively very strong through the first half of 2015 which included yoy growth of 25% in Q1 and 17% in Q2. Through the first six months of the year sales in Europe have increased 21% and have accounted for two-thirds of the company's total revenue. As a reminder, BMRA recently signed a distribution agreement for the company's EZ Detect colorectal cancer test with a major (un-named) pharmaceutical company for a single European country (with the potential to expand into other countries throughout Europe). This may be facilitating some of the rapid revenue growth in Europe and, if expanded, may have the potential to steepen the sales growth in Europe even further.

And while U.S. sales have not performed as well and have fallen about 7% through the first two quarters of 2015, the U.S. remains a very important territory for BMRA. Despite the slight slide in recent U.S. revenue, this business still accounts for 22% of total revenue and is important in terms of margin. The U.S. is also where we think the greatest potential lies for outsized revenue growth with the company's new G.I. test – which remains under development and for which initial patent applications were filed just this week. While we think U.S. sales may show another yoy decline in Q3, we model this business to return to growth in Q4.

Q2 revenue of $1.1 million was up 10% sequentially and up 21% yoy. While revenue grew, we note that the comparable periods were relatively weak and Q2 revenue was well below our $1.3 million estimate. Europe and the Middle East were the main drivers of the revenue growth in Q2. As we have no insight into the relative strength of Middle Eastern sales, we are treating that as anomaly and one that may not repeat in future periods.

We think European sales remain strong but only model single digit sequential growth over the next several periods – this could end up conservative, particularly if the recently signed distribution agreement is rolled out into other countries in Europe. We think U.S. sales may come in somewhat soft in Q3, as they have the last two quarters but think Q4 may show some firming up. Sales in Asia should almost certainly begin to rebound in Q3 and we think show additional sequential and yoy growth in Q4.

OpEx were $557k, mostly in line on an absolute basis with our $520k estimate but at 49% of sales were meaningfully higher than our 40% estimate. Gross margin, at 27%, was also weaker than our 35% estimate. We think some of this softness in GM has to do with lower U.S. sales – as domestic sales pick up, we think GM will be positively impacted.

The net result of lower revenue, higher OpEx as a percentage of sales and lower GM – all compared to our estimates, resulted in a $167k miss on the bottom line and $0.02 miss (-$0.03 A vs. -$0.01 E) on EPS. But while results were somewhat disappointing over the last two quarters, we feel the strong fundamentals of the company remain intact and believe revenue will turn back to positive on both a sequential and yoy basis based on the aforementioned catalysts. We also expect increased leverage in OpEx with growing sales as well as firming up of GM.

Cash

The balance sheet remains solid. BMRA exited fiscal Q2 2015 with $1.7M in cash, flat from the end of Q1 2015. Q2 cash flow from operating activities was $40k but ex-changes in working capital this was an outflow of $195k.

The balance sheet remains debt free. Book value at the end of fiscal Q2 stood at $5.5 million or approximately $0.72/share. We continue to believe that book value should put a floor on valuation of the company.

Maintaining Outlook / Recommendation
We continue to think sales to Asia will rebound throughout the remainder of 2015 and think they could return to near legacy levels by fiscal year-end. The new product launches in China should be an additional facilitator to growth of sales in that country. We look for European sales to continue to show growth and remain the majority contributor to total sales for at least the quarter as a result of the recently penned new distribution agreement, particularly as it relates to EZ Detect. And while U.S. based sales softened somewhat in the most recent quarter we do not think this is the start of a trend and think domestic revenues returns to growth in the back half of the current year.

We look for 2015 revenue and EPS of $5.6 million (+9%) and (-$0.05) and for this to grow to $8.9 million and $0.10 in fiscal 2018. We are maintaining our Outperform rating. Our price target is $2.20/share.

As we noted in our recent prior updates, over the mid-to-longer terms we think Biomerica will be looking to further exploit their existing technology. We view management's priorities as such that they will be focused on accelerating growth through bringing higher potential and novel products to market which we think likely fits into this growth strategy. We note that our current model does not incorporate an assumed contribution from "home run" type products - although we think given the company's expertise in certain disease areas (including GI, foodborne, women's health, and infectious disease), along with patentable and perhaps underexploited technology platforms and management's renewed focus on accelerating growth over the long-term, that big-winner type products could very well materialize over the coming years. The G.I. product, still under development and for which U.S. patent applications were just recently filed, could potentially be a big-winner product – we will be eagerly awaiting further development updates on this product.

BACKGROUND

For over 40 years Biomerica, Inc. (BMRA) has been involved in the development, manufacturing and marketing of medical diagnostics products for the early detection and monitoring of chronic diseases and medical conditions. Their product line encompasses various diseases and conditions including tests for gastrointestinal/foodborne diseases, infectious diseases, diabetes, women's health, hormone levels and even some esoteric diseases. The company's particular focus is on gastrointestinal/foodborne diseases and diabetes.

The tests are sold into two major market segments, clinical lab and point-of-care (POC). Demand for the clinical lab products mainly comes from hospitals and clinical and research laboratories. The POC segment, which may hold particularly attractive opportunities for growth given recent technological advancements which have significantly improved speed and accuracy of certain rapid tests, includes the over-the-counter retail channel as well as physician offices. Biomerica sells through distributors as well as directly. The majority of Biomerica's revenue is generated from international sales, particularly from Europe and Asia, while domestic sales account for approximately 20% - 25% of total revenue.

Biomerica recently divested the bulk of their internal research and development department in order to focus on a strategy of in-licensing technology and products from other companies, universities and institutions which they expect to result in a greater rate of revenue and earnings growth. The company, with headquarters and administrative offices in Southern California, maintains a portion of their manufacturing facilities in Mexico which helps reduce COGS and operating costs. Since the R&D divestiture in July 2010 BMRA has made meaningful progress in pursuing accelerated growth including the acquisition of several new high potential products as well as consummating additional distribution agreements.

Relative to their financials, revenue grew 24% in fiscal 2012 and was up 6% in 2013. While the first half of fiscal 2013 exhibited strong 19% growth, revenue in the second half contracted by 6%, largely due to a change in distributors in China. While we had expected the revenue contraction due to the swap in distributors in China to be a fairly short-term issue, weaker sales in Asia persisted during the first half of 2014 before rebounding nicely in last six months of the year. Unfortunately a second disruption in Asia, that being a delay in BMRA receiving re-registration approvals for their products, caused another hiccup to sales in that region during 1H fiscal 2015. The company has since received the approvals and we think Asian sales will show a more robust rebound from here on.

Biomerica has been profitable over twelve of the last seventeen quarters, has fairly regularly generated positive cash flow (from both an operational cash flow and free cash flow standpoint), and maintains a solid balance sheet.

Add to this the fact that executive compensation is relatively meager, a minimal outstanding share count (7.9 million fully-diluted), and obvious diligence on growing revenue while leveraging their cost base and we think all this is clear evidence that management and the board lead the company in a way with an eye on increasing shareholder value. In our experience, we have come across few companies that have been in existence over 40 years (as BMRA has) and possess all of these positive characteristics yet trade at what we would characterize as an incredibly cheap valuation. As of today's market price BMRA is valued at just 1.1x book value.

Given that BMRA trades at near book value, has liquid and high quality assets and no debt, and has generated positive cash flow on a fairly regular basis, we see very little to no downside risk in the share price at this level. We think the cheap valuation may have more to do with BMRA being a nano-cap and suffering from a lack of exposure rather than having anything to do with fundamentals. We think the current market value grossly undervalues the company and recommend accumulating the shares up to our $2.20 price target.

OUTLOOK

We think Asia continues to be the major catalyst driving mid-term revenue growth as Biomerica expands both their geographic reach as well as their product menu throughout the continent, both key aspects to the company's growth strategy, particularly overseas. With Asia accounting for over 60% of the world's population and experiencing increasing demand for higher quality healthcare as a result of greater economic prosperity, an aging population (particularly in China due to their high birth rate after 1949 and one-child policy), and greater adoption of Western diets, Asia represents an under-served market with potentially very attractive opportunities for the foreseeable future.

Similar to Asia, parts of South America have benefitted from rapid economic growth and a resultant increased demand for better healthcare including earlier diagnosis and intervention. While Biomerica's revenue from South America has been minimal to-date, we expect the company will look to expand their presence there through additional distribution agreements and think over the mid-to-long term South America could be a meaningful contributor to revenue.

Europe used to account for ~40% - 50% of BMRA's revenue but more recently, with the recent drop in Asia sales, has come to represent over 60% of total revenue. European sales posted low double-digit growth in fiscal 2013 with management pointing to increased sales of products not purchased previously in Europe as the catalyst. Unfortunately this did not persist in 2014 with sales falling 14%. However, Europe has done an about-face through the first half of 2015, growing 21% through the first six months of the year and contributed 66% of total sales. We think Europe will remain a major contributor to BMRA’s revenue and growth strategy.

While the regulatory environment is significantly less stringent in most of Europe as compared to the U.S. relative to diagnostic tests, POC testing there is still largely in its infancy. The recent shift in greater (although still very modest) reliance on POC testing in some parts of Europe including Germany and the U.K. as a result of more emphasis on earlier diagnosis and prevention should offer greater opportunities for growth of both BMRA's POC and clinical lab products. In addition, Eastern Europe, which is more of an emerging territory with potentially less competition could provide opportunity for growth via bolt-on distribution. In January 2014 BMRA announced an agreement with a top-five pharmaceutical company to begin distributing some of its products in parts of Europe - this will also include the EZ Detect colon cancer test. This should also help catalyze further revenue growth in that continent.

In contrast to BMRA's international markets, growth in the U.S. has less to do with expanding distribution or their overall product portfolio and more to do with exploiting niche areas and potentially bringing some of their professional POC products to the OTC/retail channel and/or seeking CLIA waiver for some of their ASR tests (both of which would require additional regulatory approval). Product differentiation such as their more user friendly fecal occult blood test as well as offering a menu of more esoteric tests provides somewhat of a competitive barrier against their much larger and deeper entrenched peers. We expect this to continue to be a part of BMRA's domestic strategy. If the company can bring more of their existing tests to the POC channel, which is already a well-established part of the U.S. healthcare system, that could provide a real opportunity to grow domestic revenue. Another real opportunity for U.S. growth could be with potential partnerships or licensing agreements to supply ASR or CLIA-waived test kits to instrument manufacturers. Instrument manufacturers have a real interest expanding their testing menus as the more tests that can be run on each instrument can provide a significant competitive advantage - BMRA's more esoteric tests potentially offer valuable competitive differentiation.

Management Focused on Accelerating Growth Over Long-Term

Over the mid-to-longer terms we think Biomerica will be looking to further exploit their existing technology. We view management's priorities as such that they will be focused on accelerating growth through bringing higher potential and novel products to market – BMRA's new G.I. product likely fits into this growth strategy. And the introduction of additional tests to international markets as well as expanding distribution overseas should provide a base for longer-term growth. We note that our current model does not incorporate an assumed contribution from "home run" type products - although we think given the company's expertise in certain disease areas (including GI, foodborne, women's health, and infectious disease), along with patentable and perhaps underexploited technology platforms and management's renewed focus on accelerating growth over the long-term, that big-winner type products could very well materialize over the coming years.

EPS: *Expect Growth Over Mid-to-Long Term*

The combination of revenue growth, incremental widening of GM and increased operating leverage should result in EPS growth. We model EPS to grow from ($0.03) in 2014 to (-$0.05) in 2015 and to $0.10 in 2018.

VALUATION / RECOMMENDATION

We use a comparable cohort of six companies of various market capitalizations in the medical diagnostics space with products/services that target the POC and/or clinical lab markets to value BMRA. Based on several metrics and excluding the low (and negative) and high values, BMRA is valued between $1.64 and $2.57 per share. Average is approximately $2.20/share.

The balance sheet remains solid. BMRA exited Q2 2015 with $1.7M in cash and equivalents and no debt. Book value at the end of fiscal Q2 2015 stood at $5.5 million or approximately $0.72/share. We continue to believe that book value should put a floor on valuation of the company.

We recommend buying the shares up to our $2.20/share target price and are maintaining our Outperform rating.

Comparable Multiples

Ticker	P/E (ttm)	P/E (FY1)	P/E (FY4)	P/Book	EV / EBITDA (ttm)	P/S (ttm)	P/S (FY1)
TRIB	25.0	18.7	12.5	2.1	20.0	4.0	3.6
CEMI	32.0	N/A	11.5	1.7	32.7	1.2	1.2
VIVO	20.0	19.1	13.2	4.3	11.1	3.7	3.5
ERB	N/A	N/A	N/A	8.2	50.0	5.4	N/A
CONX	25.0	25.0	12.6	2.5	21.0	1.5	1.2
ABAX	75.1	46.3	31.6	6.3	34.4	6.9	5.5
Average	**35.4**	**27.3**	**16.3**	**4.2**	**23.8**	**3.8**	**3.3**

FY1, FY4 = forecast year 1, forecast year 4

Biomerica Stock Value Based On Comp:

	P/E (ttm)	P/E (FY1)	P/E (FY4)	P/Book	EV / EBITDA (ttm)	P/S (ttm)	P/S (FY1)	AVG
BMRA	~~$1.04~~	~~$1.43~~	$1.64	~~$3.13~~	~~$0.33~~	$2.57	$2.41	**$2.21**

FINANCIAL MODEL

Biomerica Inc.

	2014 A	Q1A	Q2A	Q3E	Q4E	2015 E	2016 E	2017 E	2018 E
Total Revenues	$5,120.4	$1,034.5	$1,133.6	$1,523.1	$1,902.8	$5,593.9	$7,105.5	$8,171.1	$8,884.1
YOY Growth	*-20.9%*	*2.0%*	*21.3%*	*2.0%*	*13.3%*	*9.2%*	*27.0%*	*15.0%*	*8.7%*
Cost of Goods Sold	$3,451.2	$724.5	$826.4	$991.5	$1,229.2	$3,771.6	$4,490.6	$4,943.5	$5,330.5
Gross Income	$1,669.2	$309.9	$307.2	$531.5	$673.6	$1,822.3	$2,614.8	$3,227.6	$3,553.7
Gross Margin	*32.6%*	*30.0%*	*27.1%*	*34.9%*	*35.4%*	*32.6%*	*36.8%*	*39.5%*	*40.0%*
SG&A	$1,526.0	$338.3	$375.0	$370.1	$456.7	$1,540.1	$1,790.6	$1,895.7	$1,998.9
% SG&A	*29.8%*	*32.7%*	*33.1%*	*24.3%*	*24.0%*	*27.5%*	*25.2%*	*23.2%*	*22.5%*
R&D	$589.9	$195.7	$182.1	$177.0	$154.0	$708.8	$557.0	$487.0	$472.0
% R&D	*11.5%*	*18.9%*	*16.1%*	*11.6%*	*8.1%*	*12.7%*	*7.8%*	*6.0%*	*5.3%*
Operating Income	($446.6)	($224.1)	($249.9)	($15.6)	$62.9	($426.6)	$267.2	$844.9	$1,082.7
Operating Margin	*-8.7%*	*-21.7%*	*-22.0%*	*-1.0%*	*3.3%*	*-7.6%*	*3.8%*	*10.3%*	*12.2%*
Total Other Income (Expense)	$20.1	$4.8	$11.8	$4.0	$5.0	$25.6	$9.1	$14.2	$18.0
Pre-Tax Income	($426.5)	($219.3)	($238.0)	($11.6)	$67.9	($401.0)	$276.3	$859.1	$1,100.7
Tax expense (benefit)	($210.7)	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$128.9	$242.2
Tax Rate	*49.4%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*15.0%*	*22.0%*
Net Income	($215.8)	($219.3)	($238.0)	($11.6)	$67.9	($401.0)	$276.3	$730.2	$858.6
YOY Growth	*448.9%*	*21.2%*	*20.1%*	*-22.6%*	*46.7%*	*85.8%*	*-168.9%*	*164.3%*	*17.6%*
Net Margin	*-4.2%*	*-21.2%*	*-21.0%*	*-0.8%*	*3.6%*	*-7.2%*	*3.9%*	*8.9%*	*9.7%*
EPS	($0.03)	($0.03)	($0.03)	($0.00)	$0.01	($0.05)	$0.03	$0.09	$0.10
YOY Growth	*440.0%*	*18.0%*	*55.8%*	*-22.2%*	*46.1%*	*79.3%*	*-162.2%*	*163.0%*	*16.9%*
Diluted Shares O/S	7,371	7,548	7,552	7,700	7,750	7,637	8,460	8,500	8,550

Brian Marckx, CFA

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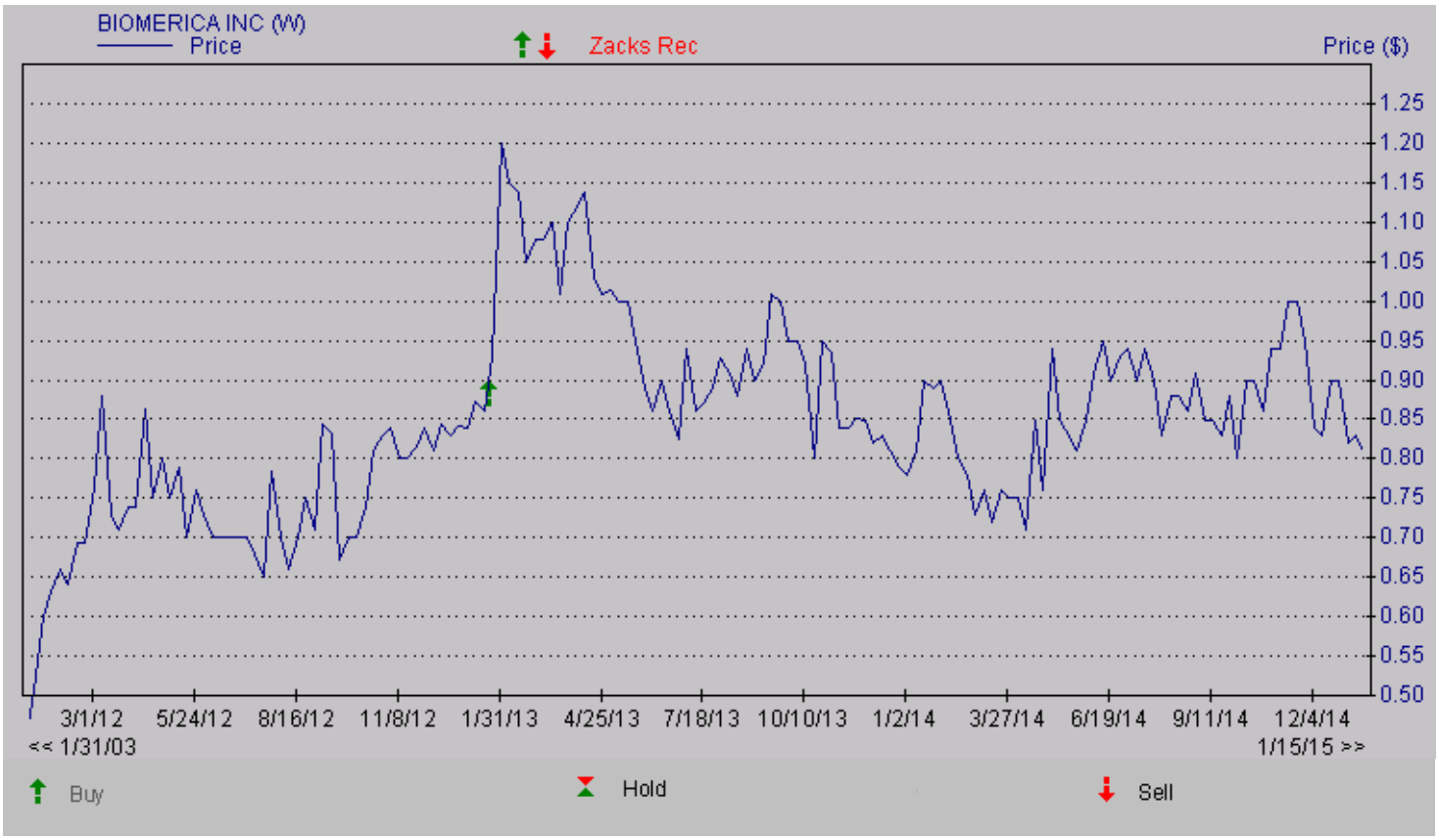

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