Zacks Small-Cap Research

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Lombard Medical (EVAR-NASDAQ)

EVAR: Exiting Underperforming U.S Market and Seeking "Strategic Alternatives"

We model 10-year revenue CAGR of 12%, gross margin widening from 45% to 58% over that period. We look for OpEx to eventually scale but now expect a more significant improvement in the front end but less leverage on the back end. The net result is our 10-year DCF model, which uses an 11% discount rate and 2% terminal growth rate, now values EVAR at approximately $2.50/share (revised from $4/share).

Current Price (08/23/16)	$1.09
Valuation	**$2.50**

OUTLOOK

Management threw a curve ball on the recent business update – noting that they are shedding U.S. operations in order to conserve capital and instead fully focus on overseas markets as they leverage early momentum from the recent launch of Altura and IntelliFlex. While a surprise, we think it may be a good move given the negative ROI in the domestic market as a result of lackluster of uptake of Aorfix and the capital-intensive nature of the direct sales force.

EVAR will continue to look to raise additional operating capital to fund their OUS commercialization of Altura and Aorfix. And concurrent with this they have engaged Cain Brothers to seek strategic alternatives – in addition to a possible outright sale of the company. We think there may be appetite for further consolidation in the AAA stent graft space.
Exit of the US market had the effect of reducing modeled revenue and gross margin, but in the near term also improves operating loss due to the capital intensive nature of the US sales and marketing program.

SUMMARY DATA

52-Week High	**$4.20**
52-Week Low	**$0.55**
One-Year Return (%)	**-71.43**
Beta	**1.45**
Average Daily Volume (sh)	**45,523**
Shares Outstanding (mil)	**20**
Market Capitalization ($mil)	**$22**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**60**
Insider Ownership (%)	**N/A**
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	**N/A**
P/E using 2016 Estimate	**N/A**
P/E using 2017 Estimate	**N/A**
Zacks Rank	**N/A**

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

ZACKS ESTIMATES

Revenue
(in 000s of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2015	3.4 A	4.5 A	4.2 A	2.9 A	15.1 A
2016	2.9 A	3.8 A	3.2 E	3.3 E	13.2 E
2017					15.0 E
2018					17.9 E

Earnings per Share

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2015	-$0.59 A	-$0.51 A	-$0.45 A	-$0.58 A	-$2.13 A
2016	-$0.38 A	-$0.42 A	-$0.32 E	-$0.27 E	-$1.39 E
2017					-$0.62 E
2018					-$0.37 E

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

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Q2 Financial Results / Operational Update: *Exiting Underperforming U.S Market and Seeking "Strategic Alternatives"....*

Lombard reported financial results for the second quarter ending June 30 and provided a business update. While not much of a surprise on the financial side with numbers largely inline with our estimates, there was a curve ball on the business update – with management noting that they are shedding U.S. operations in order to conserve capital and instead fully focus on overseas markets as they leverage early momentum from the recent launch of Altura and IntelliFlex. While a surprise, we think it may be a good move given the negative ROI in the domestic market as a result of lackluster of uptake of Aorfix and the capital-intensive nature of the direct sales force.

And in the meantime, EVAR noted, the company will "explore a number of strategic options" – including a possible outright sale of the company, sale of certain assets and/or distribution and strategic partnerships. EVAR brought on Cain Brothers investment bank for help in that regard.

This is a significant regrouping for EVAR - the U.S. market had until recently been considered the bread-and-butter growth opportunity for the company with earlier expectations of Aorfix demand-pull facilitating a rapid ramp in the direct sales force. Instead disappointing adoption of Aorfix resulted in contraction of the sales force and likely played a role in the Altura acquisition. While management cited a longer and more expensive IDE clinical trial for IntelliFlex (than what they had earlier anticipated) as the reason for the U.S. market exit, that was likely more the straw that broke the camel's back, or possibly even the scapegoat, that forced EVAR's hand.

But with the U.S. exit, so goes a significant cost base - the net result was a major overhaul of our financial model which, at least over the near-term, shows a net improvement in operating loss. The net changes result in lower revenue and tighter gross margin (U.S. direct were relatively premium) being more than offset by lower OpEx (which was bloated from 'inefficient' Aorfix sales production). How this plays out over the longer-term is, of course, much more of a guess – management indicated on the call while they've exited the U.S. for now, it's status is back-burnered, not rear-view mirrored. EVAR will continue to pursue IDE approval for U.S. studies of IntelliFlex and Altura, although if and when these studies will be funded and conducted is a big hypothetical.

All the operational focus is on the OUS territories. IntelliFlex was CE Marked in June and is expected to formally launch in Europe later this month – with a bigger push anticipated later this year. Management is still guiding for regulatory approval of the lower profile delivery system in Japan by year end as well. We continue to expect the availability of IntelliFlex to catalyze greater uptake of Aorfix.

Q2 Numbers

Total revenue of $3.8M was down 16% yoy but was up 30% on a sequential basis and was about 4% better than our $3.6M estimate. Every itemized territory except the U.S. posted sequential sales growth - while EVAR does not disclose Altura vs Aorfix sales, we think the recent (February) launch of Altura in Europe was a significant contributor. Management has indicated that early feedback of Altura has been positive – the device has been used in more than two dozen hospitals in Europe with the roll-out expected to continue to expand throughout the remainder of the year. Benefits, including its ultra-low profile, shorter procedural time and relative simplicity as compared to other stent grafts seems to be resonating with physicians.

And sales in Japan, while down 44% yoy, rebounded from Q1, turning in 90% sequential growth. Management noted that while yoy sales were sharply down, this is not reflective of fundamental demand as procedural volume actually increased 42% (from 95 to 135) over that period – the disconnect continues to be that EVAR's Japanese distributor, Medico Hirata, continues to burn through inventory in anticipation of the IntelliFlex launch. EVAR still expects IntelliFlex to gain regulatory approval in Japan by current year end.

Meanwhile, U.S. sales were $696k, down 45% and 19% on a yoy and sequential basis, respectively. At just 18% of total revenue, U.S. sales' relative contribution was the lowest since Q4 2013. With EVAR's domestic market exit, we have removed all forecasted U.S. sales of Aorfix and Altura (the latter which we modeled initial contribution in 2022) from our model.

Q2 gross margin was a relatively paltry 10.9% - which compares to an average 45.1%in all of 2015 and 33.7% in Q1 of this year. Management attributes the GM weakness to manufacturing start-up expenses (i.e. add'l waste, inefficiencies, etc) related to the OUS Altura launch along with less overhead absorption from lower production volumes. We think the relatively low contribution from U.S. sales may also have been a factor. The removal of U.S. sales from our model has also had the effect of tightening to our modeled aggregate GM's. But gross margin could

benefit now with manufacturing now fully operational in the company's U.K. facility and some of the inefficiencies starting to be worked out.

Operating expenses were somewhat of a highlight in Q2 – and we think provide an early glimpse of the net benefits of exiting the U.S. market. OpEx were $7.7M in Q2 - which includes $3.5M in sales, marketing and distribution (SM&D) expense – the total is down 7% from $8.3M in Q1 with almost all of the decrease coming from a 15% reduction in SM&D expense. So, while loss of the U.S. market will constrain revenue growth potential and margin expansion, we think the offset from shedding the high cost of a (not productive enough) sales force, coupled with expected revenue growth in OUS territories should result in consistent improvement of operating loss.

Q2 EPS, excluding non-cash change in value of contingent liabilities, was ($0.39), compared to our ($0.40) estimate. EVAR exited the quarter with $13M in cash. Subsequent to quarter-end they secured a $2.4M low interest (3%) loan from Medico Hirata (Japan distributor) and in return, Hirata exercised their right to extend their Aorfix distribution agreement to 2028. EVAR expects their current cash resources to be sufficient fund operations not longer than through Q1 2017.

'Strategic Alternatives' and/or Another Cash Raise…

EVAR will continue to look to raise additional operating capital to fund their OUS commercialization of Altura and Aorfix. And concurrent with this they have engaged Cain Brothers to seek strategic alternatives – in addition to a possible outright sale of the company. We think another of those alternatives could be shopping U.S. marketing rights to Altura. We remind investors that FDA clearance of Altura would require significant resources to fund a PMA-supported clinical study – which would be a significantly costly and time-consuming endeavor. While EVAR is clearly in no position to undertake this, it potentially does present a partnering (or sale) opportunity – either in the form of a development/commercialization partnership or partial or full U.S. marketing rights to Altura. We expect these will be considerations in the "strategic alternatives" that are being considered.

We also think the recent ELGX / TRIV combination may suggests appetite for further consolidation in the AAA stent graft space. This is something that we had suggested immediately following EVAR's acquisition of Altura given the race for value-add product differentiation in the space and the particular appeal (and market/label expansion opportunity) for low profile stent grafts and delivery systems. Other "majors" including Medtronic, Cook Medical and WL Gore as well as a much longer list of smaller, niche players (many of which are well funded) could have an interest.

VALUATION

Management has updated 2016 revenue guidance to $13M - $15M, downwardly revised from ~$18.M (i.e. ~20% growth from the $15.1M generated in 2015) prior to the Q2 earnings announcement. We note that following Q1 2016 results we dropped our 2016 revenue estimate to ~$16M (i.e. implying 6% yoy growth) – our most recent revision to $13.2M is a significantly lower revision then compared to the (previously relatively higher) Street consensus.

But management also expects a significant reduction in OpEx with the move out of the U.S. – guiding for ~$25M reduction in annualized OpEx. While our 2016 revenue estimated came in by 17% and estimated gross margin contracted from 39% (prior to Q2 results) to 21% (currently) due to the U.S. exit, we think significant OpEx reduction from shedding of the domestic sales and marketing program (including 10 U.S reps) more than offsets the top-line slide. We now have 2016 operating loss of $26.4M, compared to $32.0M operating loss prior to the strategy revision.

We now model 10-year revenue CAGR of 12% (revised from 21% due to removing U.S. sales from our model), and gross margin widening from 45% to 58% (revised from 71% due to U.S. exit). We look for OpEx to eventually scale but now expect a more significant improvement in the front end (as discussed) but less leverage on the back end. The net result is our 10-year DCF model, which uses an 11% discount rate and 2% terminal growth rate, now values EVAR at approximately $2.50/share (revised from $4/share).

FINANCIAL MODEL

Lombard Medical, Inc.

	2015 A	Q1A	Q2A	Q3E	Q4E	2016 E	2017 E	2018 E	2019 E
Total Revenues	$15,114.0	$2,922.0	$3,803.0	$3,231.0	$3,268.0	$13,224.0	$15,038.7	$17,906.2	$20,854.7
YOY Growth	*13.8%*	*-14.3%*	*-16.1%*	*-23.6%*	*11.0%*	*-12.5%*	*13.7%*	*19.1%*	*16.5%*
Cost of Goods Sold	$8,296.0	$1,938.0	$3,388.0	$2,630.0	$2,477.1	$10,433.2	$9,925.6	$10,564.7	$11,261.5
Gross Income	$6,818.0	$984.0	$415.0	$601.0	$790.9	$2,790.8	$5,113.2	$7,341.5	$9,593.2
Gross Margin	*45.1%*	*33.7%*	*10.9%*	*18.6%*	*24.2%*	*21.1%*	*34.0%*	*41.0%*	*46.0%*
Sell, Mktg & Dist	$23,125.0	$4,110.0	$3,487.0	$2,874.0	$2,607.0	$13,078.0	$12,265.0	$12,811.0	$13,347.0
% SM&D	*153.0%*	*140.7%*	*91.7%*	*89.0%*	*79.8%*	*98.9%*	*81.6%*	*71.5%*	*64.0%*
R&D	$11,279.0	$2,306.0	$2,291.0	$2,044.0	$2,015.0	$8,656.0	$8,644.0	$8,710.0	$8,642.0
% R&D	*74.6%*	*78.9%*	*60.2%*	*63.3%*	*61.7%*	*65.5%*	*57.5%*	*48.6%*	*28.2%*
Admin	$11,707.0	$1,888.0	$1,930.0	$1,831.0	$1,840.0	$7,489.0	$7,584.0	$7,712.0	$7,716.2
% Admin	*77.5%*	*64.6%*	*50.7%*	*56.7%*	*56.3%*	*56.6%*	*50.4%*	*43.1%*	*37.0%*
Operating Income	($39,293.0)	($7,320.0)	($7,293.0)	($6,148.0)	($5,671.1)	($26,432.2)	($23,379.8)	($21,891.5)	($20,112.1)
Operating Margin	*-260.0%*	*-250.5%*	*-191.8%*	*-190.3%*	*-173.5%*	*-199.9%*	*-155.5%*	*-122.3%*	*-96.4%*
Total Other Income (Expense)	($726.0)	($491.0)	($1,232.0)	($615.0)	($624.0)	($2,962.0)	($1,914.3)	($1,702.5)	($760.2)
Pre-Tax Income	($40,019.0)	($7,811.0)	($8,525.0)	($6,763.0)	($6,295.1)	($29,394.2)	($25,294.1)	($23,594.0)	($20,872.3)
Tax expense (benefit)	($2,215.0)	($205.0)	($210.0)	($338.2)	($314.8)	($1,067.9)	($505.9)	($471.9)	($417.4)
Tax Rate	*5.5%*	*2.6%*	*2.5%*	*5.0%*	*5.0%*	*3.6%*	*2.0%*	*2.0%*	*2.0%*
Net Income	($37,804.0)	($7,606.0)	($8,315.0)	($6,424.9)	($5,980.4)	($28,326.3)	($24,788.2)	($23,122.1)	($20,454.8)
YOY Growth	*8.8%*	*-23.6%*	*1.4%*	*-17.5%*	*-14.9%*	*-25.1%*	*-12.5%*	*-6.7%*	*-11.5%*
Net Margin	*-250.1%*	*-260.3%*	*-218.6%*	*-198.9%*	*-183.0%*	*-214.2%*	*-164.8%*	*-129.1%*	*-98.1%*
EPS	($2.13)	($0.38)	($0.42)	($0.32)	($0.27)	($1.39)	($0.62)	($0.37)	($0.29)
YOY Growth	*-10.8%*	*-40.9%*	*-19.5%*	*-22.4%*	*-14.6%*	*-35.0%*	*-55.3%*	*-39.8%*	*-21.6%*
Diluted Shares O/S	17,745	19,886	19,886	20,000	22,000	20,443	40,000	62,000	70,000

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