Zacks Small-Cap Research

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Lombard Medical (EVAR-NASDAQ)

EVAR: Benefits from IntelliFlex, Sales Reorg Not Fully Realized

We model 10-year revenue CAGR of 11%, gross margin widening from 45% to 56% 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 $2.25/share.

Current Price (11/01/16)	$0.85
Valuation	**$2.25**

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	**$3.35**
52-Week Low	**$0.55**
One-Year Return (%)	**-73.92**
Beta	**1.48**
Average Daily Volume (sh)	**16,487**
Shares Outstanding (mil)	**20**
Market Capitalization ($mil)	**$17**
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 (%)	**24.1**
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	3.0 A	3.3 E	13.0 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	-$0.37 A	-$0.33 E	-$1.50 E
2017					-$0.61 E
2018					-$0.37 E

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

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Q3 Financial Results / Operational Update: *Somewhat Disappointing But Reorg, IntelliFlex Benefits Not Yet Fully Realized....*

Lombard reported financial results for the third quarter ending September 30th. Financial results, save for a solid revenue contribution from Japan, were what we would characterize as somewhat disappointing. In contrast to recent history, the company did not hold an earnings call and noted that they continue to focus on their previously announced exploration of "strategic options".

As a reminder, when EVAR reported Q2 earnings in August, they made two significant new announcements. One was that they would shed U.S. operations in order to conserve capital and fully focus on overseas markets in an attempt to leverage early momentum from the recent launch of Altura and IntelliFlex. The other relates to exploring "a number of strategic options" – including a possible outright sale of the company, sale of certain assets and/or distribution and strategic partnerships.

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 (July 2015) Altura acquisition. While (on the Q2 call) 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, we think that was likely more the straw that broke the camel's back, or possibly even the scapegoat, that forced EVAR's hand.

Lombard noted that they expected a significant reduction in the cost base as a result of the U.S. exit. In fact, management mentioned on the Q2 call that they anticipated annualized savings in operating expenses of almost $26M from the suspension of U.S. activities. While the Q3 numbers do not reflect nearly that level of (annualized) savings, presumably Q4 (i.e. first full period of cost-reduction benefits) will be much more reflective of the anticipated 'new-normal' expense base. As we noted in our previous update, if EVAR can indeed realize this level of expense reduction, we think the U.S. exit will prove to be a good move given the negative ROI in the domestic market from lackluster of uptake of Aorfix and the capital-intensive nature of the direct sales force.

But with the U.S. exit, so goes a significant revenue territory and one that generated relatively healthy gross margins. Gross margin has averaged just better than 11% over the past two quarters – compared to about 50% in the comparable year-earlier period. While some of the GM contraction almost certainly relates to lower production/manufacturing efficiencies related to a 22% yoy slide in total revenue over that period, we think it is also likely that the 62% dip in relatively high margin U.S. revenue had a disproportionate negative impact (management also points to start-up expenses related to OUS launch of Altura as impacting GM).

But, how this plays out over the longer-term is, of course, much more of a guess – management indicated on the Q2 call while they've exited the U.S. for now, it's status is back-burnered, not rear-view mirrored. EVAR had also indicated that they would 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 (EVAR has not provided on update on this since August).

All the operational focus is on the OUS territories. IntelliFlex was CE Marked in June and (as of the last update in August) was expected to formally launch in Europe later in August – with a bigger push anticipated in the following months. As of the Q2 call management was still guiding for regulatory approval of the lower profile delivery system in Japan by year end as well. While the company has not provided a specific status since, the Q3 earnings release implies that IntelliFlex is still not yet approved for sale in Japan. However, once approved in that country, EVAR expects stocking orders from its Japanese distributor (Medico Hirata). We continue to expect the availability of IntelliFlex to catalyze greater uptake of Aorfix.

Q3 Numbers

Total revenue of $3.0M was down 28% yoy (from $4.2M), down 20% sequentially (from $3.8M) and about 6% lower than our $3.2M estimate. While the aggregate revenue number is not particularly disappointing, we had expected a better showing from the European direct sales territories. While both of these territories (UK and Germany) posted growth on a yoy basis (and UK also squeeked out sequential growth), we had anticipated that the shift in resources from the U.S. to the European direct markets in support of Altura would have had a more significant positive impact

in the quarter. But, perhaps we were hasty in modeling an unrealistic effect so quickly given the transition was started just a few months ago. We now model a more meaningful contribution from the beefed-up European direct sales force over the next three to six months.

But there was a positive as it relates to Q3 revenue. Japan posted sales of $1.5M – up 48% from Q2. And while this is down 23% from Q3 2015, the prior year comparable was a particularly tough comp. In addition, and as noted above, the earnings release indicates IntelliFlex has yet to launch in Japan. When it does, not only should EVAR benefit from significant inventory stocking from Medico, but we also expect the availability of IntelliFlex to help catalyze demand for Aorfix.

Meanwhile, U.S. sales were $185k – we had modeled $0 – the difference also indicates that we probably were too quick to model the full transition effects in both the U.S. and European direct sales markets. We continue to model no contribution from the U.S. going forward.

Q3 gross margin was a weak 11.5% - a hair better than the 10.9% in Q2 of this year and significantly tighter than the 48.8% in Q3 2015. Lombard has attributed 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. As noted earlier, we think the relatively low contribution from U.S. sales is also likely to be a meaningful factor. However, gross margin could benefit with manufacturing now fully operational in the company's U.K. facility and some of the inefficiencies starting to be worked out.

Operating expenses, while down considerably from the comparable year-earlier period and less dramatically from Q2 of this year, did not fall as much as we had anticipated. Q3 OpEx were $7.1M, down 38% (or $4.3M) from Q3 2015 and 8% lower from Q2 of this year ($7.7M). We were looking for Q3 OpEx of $6.8M. While the miss relative to our number may also reflect unrealistic timing of benefits from the sales force and operational restructuring, we do expect to see more considerable savings in the coming periods. Time will tell if management's prior guidance of an almost $26M annualized savings (relative to full-year 2015) in OpEx is attainable.

Q3 EPS, excluding non-cash change in value of contingent liabilities, was ($0.36), compared to our ($0.32) estimate. Cash used in operating activities was $4.9M ($6.0M ex-changes in working capital) and $22.4M ($18.7M ex-changes in working capital) in the three and nine months ending September 30th. EVAR exited the quarter with $9.9M in cash, which management expects will be sufficient to fund operations up until between Q3 2016 and Q1 2017.

'Strategic Alternatives' and/or Another Cash Raise…

We expect that 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

With the Q2 earnings release in August management provided updated 2016 revenue guidance of $13M - $15M. The Q3 earnings release did not include any revenue guidance. We now look for full year 2016 revenue of $13.0M, downwardly revised from $13.2M prior to Q3 results – the ~$200k revision reflecting the miss to our Q3 estimate.

But we also expect a significant reduction in OpEx with the move out of the U.S. 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 $27.5M, which compares to 2015 operating loss of $39.3M.

We now model 10-year revenue CAGR of 11% (revised from 21% due to removing U.S. sales from our model), and gross margin widening from 45% to 56% (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 $2.25/share.

FINANCIAL MODEL

Lombard Medical, Inc.

	2015 A	Q1A	Q2A	Q3A	Q4E	2016 E	2017 E	2018 E	2019 E
Total Revenues	$15,114.0	$2,922.0	$3,803.0	$3,044.0	$3,266.0	$13,035.0	$15,039.1	$16,940.2	$19,889.8
YOY Growth	*13.8%*	*-14.3%*	*-16.1%*	*-28.0%*	*11.0%*	*-13.8%*	*15.4%*	*12.6%*	*17.4%*
Cost of Goods Sold	$8,296.0	$1,938.0	$3,388.0	$2,694.0	$2,906.7	$10,926.7	$11,429.7	$11,011.2	$11,536.1
Gross Income	$6,818.0	$984.0	$415.0	$350.0	$359.3	$2,108.3	$3,609.4	$5,929.1	$8,353.7
Gross Margin	*45.1%*	*33.7%*	*10.9%*	*11.5%*	*11.0%*	*16.2%*	*24.0%*	*35.0%*	*42.0%*
Sell, Mktg & Dist	$23,125.0	$4,110.0	$3,487.0	$3,600.0	$3,007.0	$14,204.0	$12,761.0	$13,111.0	$14,121.8
% SM&D	*153.0%*	*140.7%*	*91.7%*	*118.3%*	*92.1%*	*109.0%*	*84.9%*	*77.4%*	*71.0%*
R&D	$11,279.0	$2,306.0	$2,291.0	$1,739.0	$1,715.0	$8,051.0	$7,010.0	$7,115.0	$7,250.0
% R&D	*74.6%*	*78.9%*	*60.2%*	*57.1%*	*52.5%*	*61.8%*	*46.6%*	*42.0%*	*28.2%*
Admin	$11,707.0	$1,888.0	$1,930.0	$1,776.0	$1,740.0	$7,334.0	$7,020.0	$7,210.0	$7,515.0
% Admin	*77.5%*	*64.6%*	*50.7%*	*58.3%*	*53.3%*	*56.3%*	*46.7%*	*42.6%*	*37.8%*
Operating Income	($39,293.0)	($7,320.0)	($7,293.0)	($6,765.0)	($6,102.7)	($27,480.7)	($23,181.6)	($21,506.9)	($20,533.0)
Operating Margin	*-260.0%*	*-250.5%*	*-191.8%*	*-222.2%*	*-186.9%*	*-210.8%*	*-154.1%*	*-127.0%*	*-103.2%*
Total Other Income (Expense)	($726.0)	($491.0)	($1,232.0)	($818.0)	($599.0)	($3,140.0)	($1,914.3)	($1,702.5)	($760.2)
Pre-Tax Income	($40,019.0)	($7,811.0)	($8,525.0)	($7,583.0)	($6,701.7)	($30,620.7)	($25,095.9)	($23,209.5)	($21,293.3)
Tax expense (benefit)	($2,215.0)	($205.0)	($210.0)	($161.0)	($147.4)	($723.4)	($501.9)	($464.2)	($425.9)
Tax Rate	*5.5%*	*2.6%*	*2.5%*	*2.1%*	*2.2%*	*2.4%*	*2.0%*	*2.0%*	*2.0%*
Net Income	($37,804.0)	($7,606.0)	($8,315.0)	($7,422.0)	($6,554.3)	($29,897.3)	($24,594.0)	($22,745.3)	($20,867.4)
YOY Growth	*8.8%*	*-23.6%*	*1.4%*	*-8.9%*	*-13.4%*	*-20.9%*	*-17.7%*	*-7.5%*	*-8.3%*
Net Margin	*-250.1%*	*-260.3%*	*-218.6%*	*-243.8%*	*-200.7%*	*-229.4%*	*-163.5%*	*-134.3%*	*-104.9%*
EPS	($2.13)	($0.38)	($0.42)	($0.37)	($0.33)	($1.50)	($0.61)	($0.37)	($0.30)
YOY Growth	*-10.8%*	*-40.9%*	*-19.5%*	*-13.5%*	*-12.0%*	*-29.5%*	*-59.0%*	*-40.3%*	*-18.7%*
Diluted Shares O/S	17,745	19,886	19,886	19,886	20,000	19,915	40,000	62,000	70,000

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