Zacks Small-Cap Research

February 9, 2017

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CombiMatrix Corporation (CBMX-NASDAQ)

CBMX: Expect Strong Fundamentals To Push Revenue, Profitability To New Records in 2017

We use a 10-year DCF model to value CBMX. We model revenue to grow from $10.1M in 2015 to $21M in 2019. Other key inputs into our DCF include a 9% discount rate and 2% terminal growth rate. Based on our DCF model, CBMX is valued at approximately $12/share.

Current Price (02/09/17)	$3.75
Valuation	**$12.00**

OUTLOOK

Positive coverage decisions by have helped push up average reimbursement in the miscarriage segment by 25% in just the last 12 months. This, along with growing demand for miscarriage analysis testing, success of the recently launched PGS (IVF) test, laboratory and operating efficiencies, and concentrating sales efforts in reimbursement-friendly areas is pushing up revenues, margins and cash flow to new records. Fundamentals point to this trend continuing. Our 2016 revenue growth, including +35% from reproductive health services testing, is driven from the recent expansion and increasing productivity of the sales force, new payor contracts, more insurers starting to cover recurrent pregnancy loss testing, increasing number of billable customers, greater awareness of the benefits of CMA analysis, improved pricing and some incremental growth from new products. Shares trade well below what we calculate as fair value.

SUMMARY DATA

52-Week High	**$7.96**
52-Week Low	**$2.15**
One-Year Return (%)	**-26.31**
Beta	**0.90**
Average Daily Volume (sh)	**293,209**
Shares Outstanding (mil)	**3**
Market Capitalization ($mil)	**$9**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**11**
Insider Ownership (%)	**3**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**22.9**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using TTM EPS	**N/A**
P/E using 2017 Estimate	**N/A**
P/E using 2018 Estimate	**N/A**
Zacks Rank	**N/A**

Risk Level	**High,**
Type of Stock	**Small-Value**
Industry	**Instru-Scientfc**

ZACKS ESTIMATES

Revenue
(in 000s of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2015	2329 A	2549 A	2526 A	2684 A	10088 A
2016	2970 A	3107 A	3248 A	3343 E	12671 E
2017					15361 E
2018					18100 E

EPS

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2015	-$2.24 A	-$1.91 A	-$2.00 A	-$1.82 A	-$7.95 A
2016	-$3.63 A	-$0.89 A	-$0.38 A	-$0.41 E	-$2.64 E
2017					-$1.23 E
2018					-$0.75 E

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

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Expect 2017 To Continue To Benefit From Growth in Test Volumes and Pricing…

Through the first nine months of 2016 CBMX's revenue is up 26%, gross margin is 800 basis points wider, operating loss is 28% lower and EBITDA loss is improved by almost 38% as compared to the same period in 2015. As we have recently noted, we characterize the improved financial performance as 'high quality' and what reasonably could be expected to be replicable given that these are the products of CombiMatrix's direct efforts and/or favorable changes in industry fundamentals.

We think these fundamentals continue to benefit both testing volumes and pricing/reimbursement and, coupled with management's diligence on cost control, expect 2017 to be another record year in revenue, profitability and cash flow. Clearly management expects the recent trends to continue as well as they have recently re-affirmed their expectation of reaching a point of cash flow break-even by Q4 2017 – the beginning of which is less than 7 months away.

	First Nine Months		
	2015	**2016**	**Change**
Revenue (k)	$7,404	$9,327	26.0%
Gross Margin	45.6%	53.6%	800 bp
Oper. Loss (k)	-$4,921	-$3,549	-27.9%
Oper. Loss/Sales	-66%	-38%	
EBITDA (k)	-$4,003	-$2,494	-37.7%

CBMX has been actively engaged in their fate by targeting geographic areas with favorable reimbursement, sponsoring or otherwise supporting evidence-based studies, communicating with payers and optimizing their product portfolio to include cash-pay products. The company's recent implementation of a new compensation model and other efficiency initiatives has resulted in a rapid and substantial shedding of expenses. And favorable changes in payers' coverage decisions, CBMX's investments in billing and collections resources and their deft updates to their product portfolio have contributed to margin expansion and greatly improved cash collections.

While growth in testing volumes has been an important catalyst to CBMX's improved financial performance, an increase in average pricing per test has been even more significant component. Based on our calculations, approximately 37% of the revenue growth through the first nine months is related to an increase in testing volumes, with the remaining ~63% due to an increase in average test pricing (aggregate average of all tests).

	Volume			Pricing Per Test				Weighted Avg Contribution to Total Revenue Growth		
	2015	2016	Change	2015	2016	Change	Revenue growth (k)	Pricing	Volume	Total
Prenatal	936	860	-8%	$1,297	$1,397	8%	($13)	4.5%	-5.2%	-1%
Miscarriage	2,664	2,886	8%	$1,301	$1,629	25%	$1,234	49.9%	15.2%	65%
CombiPGS*	157	566	261%	$1,203	$1,343	12%	$571	4.2%	25.9%	30%
Pediatric	1,557	1,454	-7%	$1,084	$1,133	5%	($40)	3.7%	-5.8%	-2%
Non-array	2,125	2,497	18%	$346	$353	2%	$146	0.9%	6.8%	8%
* CombiPGS launched Q2 2015							**$1,898**	**63%**	**37%**	**100%**

And this growth in volumes and pricing both benefit gross margins. Higher volumes have resulted in lab efficiencies – something that management has talked about on recent earnings calls and, coupled with higher pricing/reimbursement per test have been the main drivers of the 800 basis point widening in gross margins over the last 12 months.

Clearly growth in the volume and pricing of the company's miscarriage tests has been the most influential catalyst to revenue growth. Positive coverage decisions by payers (at least 22 have revised in 2016) as a result of more clinical evidence supporting the use of CMA in miscarriage testing along with CBMX's direct efforts in facilitating the customer billing and reimbursement process have helped push up average reimbursement in this segment (i.e. miscarriage testing) by 25% in just the last 12 months.

CombiPGS, which launched in Q2 2015 and has already experienced strong uptake, has also been a driver of the top-line. And importantly, as PGS (i.e. IVF) remains a cash-pay (patient out-of-pocket) business, it eliminates risk of insurance denials and speeds average cash collections.

CBMX recently launched PGS on a Next Generation Sequencing (NGS) platform which provides benefits of even greater accuracy and greater throughput should further benefit demand and testing volume. CBMX's IVF business could also see incremental benefit from their recently launched multi-cycle PGS offering as well as the more recently introduced PGD test. PGD tests an embryo for specific genetic disorders or genetic abnormalities based on the genetic status of the parents (which may be carriers of certain genetic abnormalities). Similar to PGS, PGD is offered on a per-embryo or multicycle basis. If PGD adoption is as swift as PGS has been, it will be needle-mover for CBMX – this, along with the newly launched PGS-NGS test will be something to keep on eye on.

And while the prenatal business has been relatively flat in 2016, much of what we attribute to a strong headwind from NIPT/NIPS testing as well as LabCorp's (LH) recent acquisition of CBMX's distribution partner, Sequenom, we think prenatal could return to growth in 2017. On the positive side, management noted that they have been able to pick up some of Sequenom's accounts to which they can now sell direct.

And there are other reasons to be optimistic about the prenatal business. This includes the recent improvement in average reimbursement (up 8% through the first nine months of 2016), recent updated recommendations from ACOG and SMFM supporting the use of CMA for prenatal diagnosis and additional recent clinical evidence highlighting the significant accuracy issues (i.e. susceptibility to high rates of false-positive and false-negative results) of NIPS. And while NIPS demand remains robust, and could benefit further from a recent update by the American College of Medical Genetics and Genomics (ACMGG) recommending use of it for screening of Patau, Edwards and Down Syndrome in place of conventional screening, its accuracy issues mean that CMA will continue to be used as a confirmatory diagnosis. In fact ACMG's recent recommendation notes that*, "For some patients the goal in prenatal screening may be to maximize the detection of fetal genetic diagnoses. In this scenario, fetal diagnostic testing (e.g., chorionic villous sampling or amniocentesis) followed by chromosomal microarray (CMA) using fetal DNA should be offered, and NIPS may not be the best choice."*

Expect Any New Products Will Be 'Add-to-the-Bag' and Accretive..

We also expect CBMX will remain diligent in seeking additional products to add to their portfolio – but are also confident that they are looking for only products that offer a seamless fit into their existing infrastructure and footprint. Our expectation is that any product acquisitions would be in the 'add-to-the-bag' category – that is, only products that can be detailed at existing call points with existing sales and marketing infrastructure and that can be immediately accretive to cash flow.

Management has done an impressive job of shedding costs – operating expenses fell almost 16% yoy through the first nine months of 2016 as revenue grew 26% over the same period. That was not by accident. Management runs a tight ship and as such, we expect any new product that comes aboard will carry its own weight.

OUTLOOK

Our 2016 revenue growth, including +35% from reproductive health services testing, is driven from the recent expansion and increasing productivity of the sales force, new payor contracts, more insurers starting to cover recurrent pregnancy loss testing, increasing number of billable customers, greater awareness of the benefits of CMA analysis, improved pricing and some incremental growth from new products. Relative to the sales force, management has noted increased productivity per rep, which they think will continue to help drive revenue higher – we think as additional add-to-the-bag products come online there will be even more room for productivity gains.

Average pricing is one variable that could be particularly influential to updates to our model. As noted, 2016 has seen very strong pricing in miscarriage and gains in IVF. Going into 2017 we think contribution from the additional, aforementioned, catalysts begin to make a more substantial impact. We also think it is not

unreasonable to believe that additional future studies and publications will provide further insight into the human genome, soften certain current headwinds to adoption of CMA (i.e. - provide more knowledge related to variants of unknown significance) and provide support for the utility of chromosomal microarray analysis in the prenatal space. These catalysts should result in steepening of the rate of adoption of chromosomal microarray analysis. This, coupled with the company's competitive positioning and our assumption that CBMX continues to opportunistically grow their distribution footprint, provide what we believe will be a position of strength for CBMX in terms of being able to increase penetration of their target markets and grow revenue over the long-term. Additional new product launches could prompt an upward revision to our forecast, particularly as it relates to our out-years.

FINANCIAL MODEL

CombiMatrix Corporation

	2015 A	Q1A	Q2A	Q3A	Q4E	2016 E	2017 E	2018 E
Diagnostic Svcs	$9,941.0	$2,930.0	$3,049.0	$3,211.0	$3,302.4	$12,492.4	$15,180.5	$17,900.4
YOY Growth	*25.95%*	*28.12%*	*20.8%*	*29.4%*	*24.7%*	*25.67%*	*21.52%*	*17.92%*
Royalties	$147.0	$42.0	$58.0	$37.0	$42.0	$179.0	$180.0	$200.0
YOY Growth	*-1.34%*	*0.00%*	*132.0%*	*-17.8%*	*20.0%*	*21.8%*	*0.6%*	*11.1%*
Total Revenues	$10,088.0	$2,972.0	$3,107.0	$3,248.0	$3,344.4	$12,671.4	$15,360.5	$18,100.4
YOY Growth	*25.4%*	*27.6%*	*21.9%*	*28.6%*	*24.6%*	*25.6%*	*21.2%*	*17.8%*
Cost of Services	$5,444.0	$1,419.0	$1,432.0	$1,476.0	$1,519.1	$5,846.1	$6,831.2	$7,876.2
Gross Income	$4,644.0	$1,553.0	$1,675.0	$1,772.0	$1,825.3	$6,825.3	$8,529.3	$10,224.2
Services Margin	*46.0%*	*51.6%*	*53.0%*	*54.0%*	*54.0%*	*53.9%*	*55.0%*	*56.0%*
R&D	$466.0	$143.0	$149.0	$88.0	$115.0	$495.0	$555.0	$600.0
% R&D	*4.6%*	*4.8%*	*4.8%*	*2.7%*	*3.4%*	*3.9%*	*3.6%*	*3.3%*
SG&A	$10,519.0	$2,862.0	$2,727.0	$2,505.0	$2,662.4	$10,756.4	$11,229.6	$11,889.3
% SG&A	*104.3%*	*96.3%*	*87.8%*	*77.1%*	*79.6%*	*84.9%*	*73.1%*	*65.7%*
Patent amort. & royalties	$100.0	$25.0	$25.0	$25.0	$25.0	$100.0	$110.0	$110.0
Operating Income	($6,441.0)	($1,477.0)	($1,226.0)	($846.0)	($977.1)	($4,526.1)	($3,365.3)	($2,375.1)
Operating Margin	*-63.8%*	*-49.7%*	*-39.5%*	*-26.0%*	*-29.2%*	*-35.7%*	*-21.9%*	*-13.1%*
Total Other income	($63.0)	($14.0)	($9.0)	($10.0)	($12.0)	($45.0)	($75.0)	($100.0)
Pre-Tax Income	($6,601.0)	($1,491.0)	($1,235.0)	($856.0)	($989.1)	($4,571.1)	($3,440.3)	($2,475.1)
Taxes	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Tax Rate	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*
Preferred Dividends	$890	$1,643	$0	$0	$0	$0	$0	$0
Net Income	($7,491.0)	($3,134.0)	($1,235.0)	($856.0)	($989.1)	($4,571.1)	($3,440.3)	($2,475.1)
YOY Growth	*-14.0%*	*18.0%*	*-23.4%*	*-49.3%*	*-35.6%*	*-39.0%*	*-24.7%*	*-28.1%*
Net Margin	*-74.3%*	*-105.5%*	*-39.7%*	*-26.4%*	*-29.6%*	*-36.1%*	*-22.4%*	*-13.7%*
EPS	($9.02)	($3.63)	($0.89)	($0.38)	($0.41)	($2.64)	($1.23)	($0.75)
YOY Growth	*-23.8%*	*7.5%*	*-53.1%*	*-81.0%*	*-77.5%*	*-70.7%*	*-53.5%*	*-39.0%*
Diluted Shares O/S	831	864	1,382	2,254	2,420	1,730	2,800	3,300

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