Zacks Small-Cap Research

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CAS Medical Systems Inc. (CASM-NASDAQ)

CASM: Beefed Up Sales Force. 2017 Shaping Up To Be Another Record Year

Based on EV/S and P/S comps other publicly traded companies in the tissue oximeter, patient monitoring and cardiac surgery industries including BABY, MASI, BRSYF and MDT, CASM should trade near $4.50/share.

Current Price (03/14/17)	$1.53
Valuation	**$4.50**

OUTLOOK

2016 marked an important milestone for the company as management demonstrated that their recent shedding of non-core product lines and focus towards growth of the flagship FORE-SIGHT cerebral oximetry segment can successfully drive them closer to profitability. CASM's strategy of transitioning from a medical capital equipment company to one which primarily provides disposables to an installed base is well underway and, based on the recent significant revenue growth of the tissue oximetry business and substantial improvement in operating loss and cash burn, the dividends of the strategy are now obvious. And while 2016 was transformational in our opinion in those regards, we think much of the potential dividends of the strategy have yet to be realized given FORE-SIGHT's performance-leading technology and the fact that the U.S. cerebral oximetry market remains substantially under-penetrated. With a recently beefed-up sales force, we think 2017 is already shaping up to be an exciting and another record-setting year. Management is guiding for FORE-SIGHT revenue growth in the 'mid-teens' in 2017 including sensor revenue growth of 20%. We are moving our price target from $4 to $4.50/share.

SUMMARY DATA

52-Week High	**$2.15**
52-Week Low	**$1.38**
One-Year Return (%)	**-6.25**
Beta	**-0.80**
Average Daily Volume (sh)	**59,122**
Shares Outstanding (mil)	**27**
Market Capitalization ($mil)	**$41**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**32**
Insider Ownership (%)	**34**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**0.5**
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	**Above Avg.,**
Type of Stock	**N/A**
Industry	**Med Products**

ZACKS ESTIMATES

Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2016	5.5 A	5.5 A	5.8 A	5.5 A	22.2 A
2017	5.7 E	6.0 E	6.4 E	6.7 E	24.9 E
2018					29.7 E
2019					33.2 E

Earnings per Share

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2016	-$0.03 A	-$0.08 A	-$0.06 A	-$0.07 A	-$0.24 A
2017	-$0.07 E	-$0.06 E	-$0.06 E	-$0.05 E	-$0.24 E
2018					-$0.14 E
2019					-$0.03 E

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

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WHAT'S NEW…

Q4 Financial Results

CAS Medical reported financial results for the fourth quarter and year ending December 31st. As expected, following the company's preannouncement in mid-January, Q4 and full-year revenue were approximately $5.5M and $22.M, representing growth of 3% and 14% over the respective comparable prior year periods.

And while revenue was slightly below our (pre-preannouncement) estimates, much of the difference relates to a greater number of monitor returns in Q4 (37 A vs. 21 E) – but despite this, CASM was still able to ship a record number (82) of monitors to U.S. customers. As a reminder, a certain number of monitors are regularly returned each quarter as lower utilization sites are weeded out – Q4 was somewhat of an anomaly due to the loss of a top-50 account which resulted in greater than usual returns and what we expect to be a short-term hiccup in net monitor placement growth.

Total revenue increased by approximately $170k, or 3%, in Q4 with 4% growth of the bread-and-butter FORE-SIGHT segment the main catalyst. Driving FORE-SIGHT revenue was 15% growth in sensor sales – which included 16% sensors growth in the U.S. and 10% in international territories. For the full year, total FORE-SIGHT revenue was up 17% with sensor sales increasing 22% (23% in U.S., 17% OUS). Meanwhile, traditional monitoring sales posted growth of 1% in Q4 and 3% for the full year.

Importantly, growth in the monitor installed base, fueled by market share gains at the expense of competitors as well as expansion of the overall market for cerebral oximetry, continues to drive strong sales of (high margin) FORE-SIGHT sensors. FORE-SIGHT sensor sales remain particularly robust in the U.S. with Q4 '16 marking the 27th straight quarter of double-digit U.S. sensor sales growth and we think this trend will continue.

There were 88 monitors shipped in Q4 – including 43 internationally. While there were 45 net U.S. placements in the quarter, again, a record number were shipped domestically in Q4 and if not for the unusually high number of returns, the U.S. installed base would have grown even faster than the 23% (to 1,120) it did during 2016. The total installed base at year-end was 2,088, up approximately 22% from 1,708 at the close of 2015.

The record U.S. monitor placements in Q4 was particularly encouraging given that this was accomplished with a relatively new sales force. Five of the eleven reps at the beginning of Q4 had been with CASM for less than one year – which means the company is heading into 2017 with significant potential for productivity gains from their sales force.

Record (high margin) U.S. sensor sales, in addition to some manufacturing efficiencies, has also helped propel gross margin to record levels. Gross margin was 58.2% in Q4 and 54.6% in all of 2016 – both of which appear to be new records and wider than their respective year-earlier comparable periods by 510 and 340 basis points. Gross margin is expected to have some more room to improve as FORE-SIGHT sensors, which accounted for approximately 74% and 71% of total revenue in Q4 '16 and 2016 (up from 66% and 67% in Q4 '15 and 2015), grow to account for an even greater portion of overall revenue. In addition, management expects realization of some additional manufacturing efficiencies in 2017.

Operating loss was approximately $1.1M in Q4 and $4.9M for the full year 2016 – these are significantly improved from $1.8M and $6.6M in the prior year comparable periods.

In terms of cash, CASM exited 2016 with approximately $5.5M of cash and equivalents. In addition, $2.1M of the revolver remains untapped. Management noted on the Q4 call (10-K is not yet filed) that they used approximately $1.2M in cash for operations during the quarter and also indicated that ~$400k of this was to restock inventory (implying only ~$800k in negative EBITDA). Importantly, management believes that cash on hand plus revolver availability (and additional debt if-needed) is sufficient to fund operations until they reach a point of cash flow break-even – which they think can be achieved by late 2018. Clearly, their message is that they do not expect to raise additional capital via secondary equity offerings.

Expect Record Revenue, Further Improvement in Profitability To Continue

We think 2016 marked an important milestone for the company as management demonstrated that their recent shedding of non-core product lines and focus towards growth of the flagship FORE-SIGHT cerebral oximetry segment can successfully drive them closer to profitability. CASM's strategy of transitioning from a

medical capital equipment company to one which primarily provides disposables to an installed base is well underway and, based on the recent significant revenue growth of the tissue oximetry business and substantial improvement in operating loss and cash burn, the dividends of the strategy are now obvious.

And while 2016 was transformational in our opinion in those regards, we think much of the potential upside of the strategy have yet to be realized given FORE-SIGHT's performance-leading technology and the fact that the U.S. cerebral oximetry market remains substantially under-penetrated.

We think 2017 is already shaping up to be an exciting year. Management recently mentioned that they believe their growth is only constrained by the size of their domestic sales force. With the net addition of five sales reps over just the last few months and another one expected to be added over the near-term, management is guiding for the U.S. monitor installed base to grow by another 20% in 2017. As the installed base grows, so does the opportunity for growth in sensor sales and total FORE-SIGHT revenue. Management also expects U.S. sensor sales to increase by 20% 2017 and result in "mid-teens" revenue growth in total FORE-SIGHT revenue.

CASM expects realization of their 2017 guidance to be more back-weighted in 2H based on anticipated productivity gains of their newly hired reps. This suggests that with deft execution and further productivity gains over the course of 2017 (productivity gains of new reps could be reasonably expected to be realized for as long as two years) that 2018 could see even greater acceleration in monitor placements and revenue growth.

Outlook

We have updated our model following Q4 results, which along with some tweaks to our forecasted 2017 numbers, includes the addition of 2019 as our new out-year. For 2017 we now have revenue growing 12% (largely unchanged) which includes 16% growth of the FORE-SIGHT segment and 6% contraction in traditional monitoring. Within FORE-SIGHT, we have sensor sales increasing 19% (slightly below management's 20% guidance). FORE-SIGHT sales, monitor placements and total revenue growth is weighted more to 2H, reflecting productivity gains of the sales force.

We now have gross margin expanding to 56.4% in 2017 (vs. 54.6% in 2016), which is adjusted up from 54.4%. While we expect incremental growth in SG&A expense reflecting additions to the sales force, we continue to think growth of gross income outpaces that of operating expenses, resulting in continued improvement in operating loss.

We also believe that given the potential for even greater average productivity of the sales force and additional benefits to gross margin (including launch of next-gen, higher margin sensors as well as additional efficiencies), that 2018 could show an even more substantial improvement in profitability and cash burn.

Our price target has moved from $4/share to $4.50/share based on comparable valuation methodology.

OUTLOOK / VALUATION

We think the performance advantages of FORE-SIGHT compared to competing systems, most notably market-leading INVOS, coupled with increasing adoption of cerebral oximetry in surgical and other applications sets the stage for deeper and wider market penetration of FORE-SIGHT. Sales force expansion and improved productivity should further facilitate growth of the installed base and, most importantly, increase utilization and related sensor sales. The transition to a disposables company is already well underway, the benefits of which we think will accelerate and result in continued double-digit growth of the tissue oximetry business, widening of gross margin and more rapid improvement towards reaching profitability.

Valuation

We value CASM using comparable EV/S and P/S ratios of other publicly traded companies in the tissue oximeter, patient monitoring and cardiac surgery industries including direct competitors Masimo Corporation (MASI) and Medtronic (MDT). As the other tissue oximetry competitors are not publicly traded, we have rounded out our comparable cohort with companies which have similar exposure to CASM's end markets including Brainsway (BRSYF), a manufacturer non-invasive brain stimulation devices and Natus Medical (BABY), which makes monitoring and detection devices for neonatal neurological disorders.

Both EV/S and P/S value CASM at approximately $4.50/share, indicating the market is substantially undervaluing the stock.

	Sales Estimate (M)							
	2017	2018	EV	EV/2017	EV/2018	MC	P/S '17	P/S '18
BABY	$504	$515	$1,120	2.2	2.2	$1,220	2.4	2.4
MASI	$752	$802	$4,550	6.1	5.7	$4,830	6.4	6.0
BRSYF	$10	$14	$57	5.7	4.1	$65	6.5	4.6
MDT	$29,660	$31,810	$134,190	4.5	4.2	$112,960	3.8	3.6
Avg.				**4.6**	**4.0**		**4.8**	**4.1**

CASM Valuation Based On:					
Comparable EV/Sales			Comparable Price/Sales		
	EV	Implied Share Value		MC	Implied Share Value
2017 S	$115	$4.23	2017 S	$119	$4.44
2018 S	$120	$4.41	2018 S	$123	$4.58
Average		**$4.32**	**Average**		**$4.51**

FINANCIAL MODEL

CAS Medical Systems Inc. (figures in 000s of $)

	2016 A	Q1 E	Q2 E	Q3 E	Q4 E	2017 E	2018 E	2019 E
FORE-SIGHT Sensors	$15,883.0	$4,338.0	$4,565.2	$4,874.0	$5,112.9	$18,890.1	$23,773.6	$27,441.9
yoy growth	*22.0%*	*16.2%*	*12.7%*	*19.8%*	*26.9%*	*18.9%*	*25.9%*	*15.4%*
% of total oximetry sales	88.2%	91.6%	90.9%	89.8%	89.4%	90.4%	91.8%	92.7%
FORE-SIGHT Monitors & Access.	$2,124.0	$396.9	$455.0	$551.2	$603.2	$2,006.3	$2,114.0	$2,157.8
yoy growth	*-10.6%*	*-26.9%*	*5.6%*	*-23.4%*	*40.3%*	*-5.5%*	*5.4%*	*2.1%*
% of total oximetry sales	11.8%	8.4%	9.1%	10.2%	10.6%	9.6%	8.2%	7.3%
Tissue Oximetry Total Sales	**$18,007.0**	**$4,734.9**	**$5,020.2**	**$5,425.2**	**$5,716.1**	**$20,896.4**	**$25,887.6**	**$29,599.8**
yoy growth	*16.9%*	*10.7%*	*12.0%*	*13.3%*	*28.2%*	*16.0%*	*23.9%*	*14.3%*
% of total revenue	**81.0%**	**82.6%**	**83.2%**	**84.5%**	**85.6%**	**84.0%**	**87.3%**	**89.2%**
Traditional Mntrng Total Sales	**$4,231.0**	**$999.8**	**$1,014.7**	**$994.5**	**$959.7**	**$3,968.7**	**$3,770.3**	**$3,581.8**
yoy growth	*3.5%*	*-15.2%*	*-4.0%*	*2.1%*	*-6.0%*	*-6.2%*	*-5.0%*	*-5.0%*
% of total revenue	**19.0%**	**17.4%**	**16.8%**	**15.5%**	**14.4%**	**16.0%**	**12.7%**	**10.8%**
Total Revenues	$22,237.8	$5,734.7	$6,034.9	$6,419.6	$6,675.9	$24,865.1	$29,657.9	$33,181.5
YOY Growth	*14.1%*	*5.1%*	*9.0%*	*11.4%*	*21.8%*	*11.8%*	*19.3%*	*11.9%*
Cost of Revenues	$10,091.3	$2,569.1	$2,613.1	$2,843.9	$2,803.9	$10,830.01	$12,752.9	$13,936.2
Gross Income	$12,146.5	$3,165.5	$3,421.8	$3,575.7	$3,872.0	$14,035.1	$16,905.0	$19,245.3
Gross Margin	*54.6%*	*55.2%*	*56.7%*	*55.7%*	*58.0%*	*56.4%*	*57.0%*	*58.0%*
R&D	$3,436.6	$852.0	$817.0	$795.0	$812.0	$3,276.0	$3,150.0	$3,170.0
% R&D	*15.5%*	*14.9%*	*13.5%*	*12.4%*	*12.2%*	*13.2%*	*10.6%*	*9.6%*
SG&A	$13,575.2	$3,584.2	$3,651.1	$3,794.0	$3,905.4	$14,934.7	$15,955.9	$16,723.5
% SG&A	*61.0%*	*62.5%*	*60.5%*	*59.1%*	*58.5%*	*60.1%*	*53.8%*	*50.4%*
Operating Income	($4,865.4)	($1,270.6)	($1,046.3)	($1,013.3)	($845.4)	($4,175.6)	($2,200.9)	($648.2)
Operating Margin	*-21.9%*	*-22.2%*	*-17.3%*	*-15.8%*	*-12.7%*	*-16.8%*	*-7.4%*	*-2.0%*
Interest Income, net	($1,048.2)	($225.8)	($229.8)	($221.9)	($209.4)	($887.0)	($843.9)	($566.2)
Other income	$42.5	$5.0	$3.0	$12.0	$10.0	$30.0	$30.0	$30.0
Pre-Tax Income	($5,871.1)	($1,491.4)	($1,273.1)	($1,223.2)	($1,044.8)	($5,032.6)	($3,014.9)	($1,184.4)
Taxes	($948.4)	$14.9	$12.7	$12.2	$10.4	$50.3	$0.0	$0.0
Tax Rate	*16.2%*	*-1.0%*	*-1.0%*	*-1.0%*	*-1.0%*	*-1.0%*	*0.0%*	*0.0%*
Income (loss) from discont. ops	$2,709.9	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Preferred Dividends	$1,482.6	$387.0	$394.0	$401.0	$408.0	$1,590.0	$1,700.0	$0.0
Net Income (cont ops)	($6,405.2)	($1,893.4)	($1,679.9)	($1,636.4)	($1,463.3)	($6,672.9)	($4,714.9)	($1,184.4)
YOY Growth	*-26.1%*	*108.8%*	*-18.0%*	*-0.9%*	*-18.7%*	*4.2%*	*-29.3%*	*-74.9%*
Net Margin	-	-	-	-	-	-	-	*-3.6%*
EPS (cont ops)	($0.24)	($0.07)	($0.06)	($0.06)	($0.05)	($0.24)	($0.14)	($0.03)
YOY Growth	*-29.2%*	*103.5%*	*-20.0%*	*-3.3%*	*-20.6%*	*1.6%*	*-42.9%*	*-78.1%*
Diluted Shares O/S	26,827	27,500	27,500	27,500	27,500	27,500	34,000	39,000

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