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Zacks Small - Cap Research

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Electromed Inc (ELMD-AMEX)

ELMD: Delay in Growth of Sales Force Continues To Impact Revenue

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	5/12/2011
Current Price (11/15/12)	$1.56
Target Price	**$3.75**

OUTLOOK

The slower than anticipated pace in net growth of the sales force has hampered revenue growth and resulted in the last 4 quarters missing our estimates. Management's plan continues to be to grow their sales force which remains the main impetus for sales growth. To help facilitate this, ELMD brought on a Director of Sales in August. Despite the recent disappointing revenue, fundamentals remain unchanged and rectifying the recent issues should be addressable if mgmt can execute on their strategy. We think there is downside protection as ELMD is (at least intermittently) cash flow positive and the stock is now trading below book value.

We are maintaining our Outperform rating.

SUMMARY DATA

52-Week High	**$3.98**
52-Week Low	**$1.21**
One-Year Return (%)	**-65.21**
Beta	**-0.05**
Average Daily Volume (sh)	**7,309**
Shares Outstanding (mil)	**8**
Market Capitalization ($mil)	**$13**
Short Interest Ratio (days)	**0.12**
Institutional Ownership (%)	**4**
Insider Ownership (%)	**29**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**N/A**
Earnings Per Share (%)	**N/A**
P/E using TTM EPS	**78.0**
P/E using 2013 Estimate	**52.0**
P/E using 2014 Estimate	**9.8**
Zacks Rank	**N/A**

Risk Level	**N/A,**
Type of Stock	**Small-Blend**
Industry	**Med Instruments**

ZACKS ESTIMATES

Revenue
(in '000 of $)

	Q1 (Sep)	Q2 (Dec)	Q3 (Mar)	Q4 (Jun)	Year (Jun)
2012	5,378 A	4,790 A	4,774 A	4,581 A	19,525 A
2013	4,031 A	4,428 E	4,681 E	4,927 E	18,067 E
2014					24,990 E
2015					27,815 E

Earnings per Share

	Q1 (Sep)	Q2 (Dec)	Q3 (Mar)	Q4 (Jun)	Year (Jun)
2012	$0.03 A	$0.00 A	$0.01 A	-$0.02 A	$0.02 A
2013	-$0.01 A	$0.01 E	$0.02 E	$0.03 E	$0.05 E
2014					$0.16 E
2015					$0.22 E

Zacks Projected EPS Growth Rate - Next 4 Years % **18**

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Q1 2013 Financial Results

Electromed reported financial results for the fiscal 2013 first quarter ending September 30, 2012 on November 13th. Revenue was significantly below our estimate for the fourth straight quarter, continuing to be a result of complete stagnation in growing the sales rep (Clinical Area Managers, or CAMs) headcount. Electromed also cited lower than average reimbursement as a headwind, which has similarly been an issue over the last few reporting periods. Q1 2013 also saw the number of referrals decline (likely tied to the drop in CAM count) - which has not been the case in most of the previous quarters where revenue fell.

While we've been disappointed with the lack of revenue growth over the past 12 months, based on our conversations with management we remain encouraged that this is largely tied to delays in growing the CAM count and getting them up to full efficiency and that there have been no substantial fundamental changes to the market, reimbursement, or competitive environment. As such, we think that ELMD's recent issues are relatively easily addressable, in their direct control and can be rectified with proper execution of their strategy.

The CAM count stood at 21 at the end of fiscal Q1 (Sept 2012), down from 22 at the end of fiscal Q4 2012 (June 2012). ELMD has experienced CAM turnover in the recent past and it shows up directly in the income statement with a hit to revenue. Their strategy has been to increase the CAM base by about 1 - 3 reps per quarter but that hasn't come to fruition with the average CAM count stagnating in the low 20's since early calendar 2011 (i.e. - about the last 18 months).

The company is addressing this however and in August 2012 hired a Director of Sales and recently announced that they would realign sales territories, both of which are expected to facilitate the CAM count and increase sales. Management noted that they now expect to have 27 CAM's by the end of fiscal 2013 (June 2013) - which includes the 22 currently (they added one subsequent to end of Q1) and current postings out for the remaining.

We have significantly trimmed our revenue estimates for the current year which reflects the lower CAM count (relative to what our previous expectations had been). However, we do model sequential revenue growth throughout the current fiscal year which assumes that ELMD executes on their strategy of building the sales force.

Revenue
Q1 revenue of $4.03 million was down almost 25% y-o-y (down 12% sequentially) and consisted of $3.57 million (-30% y-o-y) from the Homecare segment, $109k (+195% y-o-y) from International and $348k (+66% y-o-y) from Government/Institutional.

The relative weakness in the Homecare segment continues to mostly reflect stagnation in growth of the sales force as well as the reimbursement mix. As noted in the past, our modeled revenue growth estimates continue to reflect the expectation that ELMD continues to add sales headcount.

	Actual Q1 2012	Actual Q1 2013	Y-o-Y Change	Zacks Est Q1 2013	Actual +/- Zacks est.
Homecare	$5,132.0	$3,574.0	-30.4%	$4,617.0	-22.6%
International	$37.0	$109.0	194.6%	$149.0	-26.8%
Gov't / Instit.	$210.0	$348.0	65.7%	$209.0	66.5%
	$5,379.0	**$4,031.0**	**-25.1%**	**$4,975.0**	**-19.0%**

Total revenue came in about 19% less than our estimate, despite Gov't/Institutional sales coming in better than our number. ELMD recently took steps to facilitate growth of their International business including signing distribution agreements with Linde Healthcare and Leader Healthcare FZCO for the German and parts of the Middle East region, respectively, which has helped international sales which have posted yoy gains the last three quarters straight.

Gross Margin
GM came in at 70.0% compared to our 73.1% estimate. Electromed's GM can jump around from quarter-to-quarter based on the mix of reimbursement rates and, as noted in the past, this relatively low GM is not expected to persist over the longer-term. We have slightly trimmed our GM estimates, however, given that we've estimated this slightly too high in the recent past.

Operating Expenses
SG&A came in at about $2.8 million, or 69.9% of sales, compared to our 63.6% estimate. Similar to the past three quarters where revenue also came in meaningfully below our estimate, the higher than modeled SG&A as a percent of sales is likely mostly attributable to the fixed-cost portion of SG&A which is more exposed with revenue coming in below our estimate. It's worth noting, however, that ELMD has recently taken steps to reduce operating expenses including bringing most marketing functions in-house which contributed to the 49% yoy drop ($362k vs. $183k) in advertising/marketing expenses from Q1 2012 to Q1 2013. We think this, along with other recent changes including a new compensation structure which is now being implemented, should help soften the impact to the bottom line from near-term revenue growth variability and accelerate operating leverage over the longer-term.

R&D expense was $101k (2.5% of revenue) in Q1, well below our $229k (4.6% of revenue) estimate. Management continues to expect R&D expense to average about 5% of revenue going forward.

Net Income / EPS
Net income and EPS were ($71k) and ($0.01), compared to our $123k and $0.02 estimates.

Cash
Electromed exited fiscal Q1 with $1.5 million in cash and equivalents, compared to $1.5 million at the end of Q4. Cash from operating activities was an inflow of $114k in the most recent quarter. A/R, which had been growing in the past with accelerating revenues, came down by $435k in the quarter (which aided cash from operations). Stripping out the increase in working capital, cash from operating activities was an inflow of $126k. Investing activities used $224k in the quarter.

Along with the cash balance there's about $2.6 million in borrowing capacity under the revolver. The bank debt includes up to $6MM under a revolver, $1.5MM term loan A (monthly principal, due 12/2014) and $1MM term loan B (monthly principal, due 12/2012). Terms of the revolver allow ELMD to borrow up to 60% of eligible A/R less balance on the term loan B. ELMD's balance sheet remains healthy, the company remains well capitalized and we expect ELMD to have no issues in rolling over the bank debt/credit line.

Valuation and Recommendation
We now look for revenue of $22.4 million (implying growth of ~24%) in fiscal 2014, down from $25.0 million prior to Q1 results. Our 2014 EPS estimate has moved from $0.24 to $0.16. The downward revision to our 2014 estimates as well as our out-years mostly reflects the delay in building the sales force. Management is now guiding for 27 (down from the 28 - 30 estimate provided about 3 months ago) CAMs to be on-board by fiscal 2013 year-end - our financial model more conservatively assumes approximately 24 to 26 reps are detailing by the close of 2013. EPS in our out-years moved from $0.30 to $0.22 in 2015, and $0.38 to $0.31 in 2016.

We continue to value Electromed using Hill-Rom's (HRC) long-term PE/G ratio as a comparable. Hill-Rom's long-term PE/G currently sits at 1.3. We model ELMD to post EPS of $0.31 in 2016, implying a five-year (2011 - 2016) CAGR of 18%. Based on a 1.3 PE/G, ELMD should trade at about 23x 2014 EPS or ~ $3.70/share. The stock currently trades at about $1.50. We think the stock still trades significantly below fair value. Current market value is below book value (stock currently trades at ~0.75x book value). The combination of the company being (at least intermittently) cash flow positive and the stock trading below book value should provide further downside protection in our opinion. We are maintaining our Outperform rating and moving our price target from $4.00 to $3.70 per share.

FINANCIAL STATEMENTS

INCOME STATEMENT **Electromed Inc.**

	2012 A	Q1A	Q2E	Q3E	Q4E	2013 E	2014 E	2015 E	2016
Home Care Revenue	$17,959.0	$3,574.0	$3,940.9	$4,212.9	$4,483.6	$16,211.4	$20,264.2	$23,020.2	$25,943.7
% of total revenue	*92.0%*	*88.7%*	*89.0%*	*90.0%*	*91.0%*	*89.7%*	*90.5%*	*90.6%*	*90.2%*
y-o-y growth	*3.5%*	*-30.4%*	*-8.3%*	*-3.4%*	*7.5%*	*-9.7%*	*25.0%*	*13.6%*	*12.7%*
International Revenue	$547.0	$109.0	$155.0	$149.8	$152.7	$566.5	$758.0	$949.0	$1,252.1
% of total revenue	*2.8%*	*2.7%*	*3.5%*	*3.2%*	*3.1%*	*3.1%*	*3.4%*	*3.7%*	*4.4%*
y-o-y growth	*-10.0%*	*194.6%*	*-19.3%*	*-9.2%*	*-0.2%*	*3.6%*	*33.8%*	*25.2%*	*31.9%*
Gov't / Institutional Revenue	$1,018.0	$348.0	$332.1	$318.3	$290.7	$1,289.1	$1,380.7	$1,434.6	$1,566.6
% of total revenue	*5.2%*	*8.6%*	*7.5%*	*6.8%*	*5.9%*	*7.1%*	*237.0%*	*235.3%*	*247.6%*
y-o-y growth	*-2.9%*	*65.7%*	*10.7%*	*27.8%*	*12.2%*	*26.6%*	*7.1%*	*3.9%*	*9.2%*
Net Sales	$19,524.5	$4,031.3	$4,428.0	$4,681.0	$4,927.0	$18,067.3	$22,403.0	$25,403.8	$28,762.4
YOY Growth	*2.7%*	*-25.1%*	*-7.6%*	*-2.0%*	*7.6%*	*-7.5%*	*24.0%*	*13.4%*	*13.2%*
Cost of product sales	$5,392.4	$1,210.5	$1,239.8	$1,334.1	$1,379.6	$5,163.9	$6,228.0	$6,935.2	$7,765.8
Gross Income	$14,132.1	$2,820.8	$3,188.2	$3,346.9	$3,547.4	$12,903.3	$16,174.9	$18,468.5	$20,996.5
Gross Margin	*72.4%*	*70.0%*	*72.0%*	*71.5%*	*72.0%*	*71.4%*	*72.2%*	*72.7%*	*73.0%*
SG&A	$12,614.5	$2,816.0	$2,847.2	$2,844.2	$2,961.1	$11,468.5	$13,240.2	$14,632.6	$15,991.9
% SG&A	*64.6%*	*69.9%*	*64.3%*	*60.8%*	*60.1%*	*63.5%*	*59.1%*	*57.6%*	*55.6%*
R&D	$911.3	$101.2	$199.3	$201.3	$206.9	$708.7	$851.3	$939.9	$1,006.7
% R&D	*4.7%*	*2.5%*	*4.5%*	*4.3%*	*4.2%*	*3.9%*	*3.8%*	*3.7%*	*3.5%*
Operating Income	$606.3	($96.4)	$141.7	$301.5	$379.4	$726.2	$2,083.5	$2,896.0	$3,998.0
Operating Margin	*3.1%*	*-2.4%*	*3.2%*	*6.4%*	*7.7%*	*4.0%*	*9.3%*	*11.4%*	*13.9%*
Interest income, net	($168.7)	($36.7)	($33.0)	($29.0)	($25.0)	($123.7)	($25.0)	$25.0	$50.0
Pre-Tax Income	$437.6	($133.1)	$108.7	$272.5	$354.4	$602.4	$2,058.5	$2,921.0	$4,048.0
Taxes (benefit)	$251.0	($62.0)	$41.3	$103.5	$134.7	$217.5	$782.2	$1,110.0	$1,538.2
Tax Rate	*57.4%*	*38.0%*	*38.0%*	*38.0%*	*38.0%*	*36.1%*	*38.0%*	*38.0%*	*38.0%*
Net Income	$186.6	($71.1)	$67.4	$168.9	$219.7	$384.9	$1,276.3	$1,811.0	$2,509.7
Net Margin	*1.0%*	*-1.8%*	*1.5%*	*3.6%*	*4.5%*	*2.1%*	*5.7%*	*7.1%*	*8.7%*
EPS	$0.02	($0.01)	$0.01	$0.02	$0.03	$0.05	$0.16	$0.22	$0.31
YOY Growth	*-83.0%*	*-129.0%*	*174.8%*	*77.7%*	*-223.0%*	*106.4%*	*230.1%*	*42.8%*	*38.6%*
Diluted Shares O/S	8,119	8,114	8,115	8,115	8,115	8,115	8,150	8,100	8,100

Brian Marckx, CFA

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BALANCE SHEET **Electromed Inc.**

	September 30, 2012	June 30, 2012
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,482,555	$ 1,702,435
Accounts Receivable	10,415,488	10,850,859
Inventories	2,305,276	2,392,416
Prepaid expenses and other current assets	463,426	359,583
Income tax receivable	405,494	340,744
Deferred income taxes	656,000	656,000
Total current assets	15,728,239	16,302,037
Property and equipment, net	3,254,872	3,170,014
Finite-life intangible assets	1,167,136	1,174,033
Deferred common stock offering costs	-	-
Other assets	290,689	274,940
Total assets	$ 20,440,936	$ 20,921,024
LIABILITIES		
Current liabilities:		
Revolving line of credit	$ 1,768,128	$ 1,768,128
Current maturities of long term debt	159,869	254,020
Accounts payable	554,086	749,985
Accrued compensation	484,812	636,995
Warranty reserve	604,000	610,000
Other accrued liabilities	165,144	151,558
Income tax payable	-	-
Total current liabilities	3,736,039	4,170,686
Long term debt, less current	1,374,353	1,390,003
Deferred income taxes	280,000	280,000
Total liabilites	5,390,392	5,840,689
Commitments and contingencies		
STOCKHOLDERS' EQUITY		
Common stock	81,143	81,143
Additional paid-in capital	1,300,453	12,959,136
Retained earnings	1,968,948	2,040,056
Common stock subscription receivable for shares o/s of 48,500	-	-
Total stockholders' equity	15,050,544	15,080,335
Total liabilities and stockholders' equity	$ 20,440,936	$ 20,921,024

Electromed, Inc

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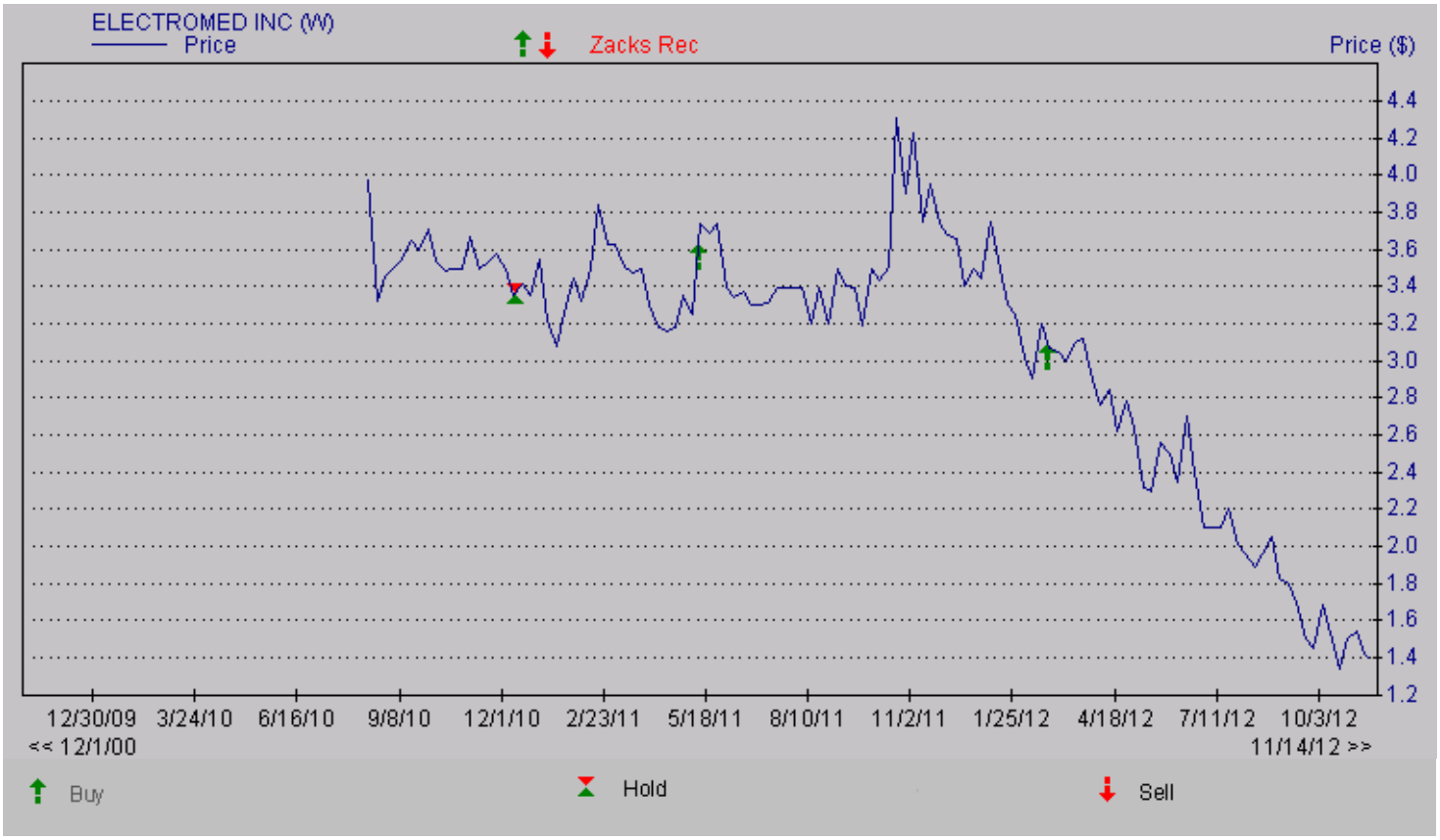
CASH FLOW STATEMENT **Electromed Inc.**

	Three months September 30, 2012		2011
Cash flows from operating activities:			
Net income	(71,108)	$	245,539
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	114,979		90,552
Amortization of finite-life intangible assets	33,969		30,006
Amortization of debt issuance costs	3,363		3,297
Share based compensation expense	41,317		31,053
Deferred income taxes	-		-
Loss on disposal of P&E	3,915		9,864
Issuance of common stock for services	-		-
Changes in operating assets and liabilities:			
Accounts receivable	435,371		(807,361)
Inventory	87,140		(307,845)
Prepaid expenses and other assets	(187,706)		(77,186)
Accounts payable and accrued liabilites	(347,226)		(40,754)
Net cash provided by operating activities	114,014		(822,835)
Cash flows from investing activities:			
Expenditures for P&E, net	(197,020)		(215,311)
Purchase of nonctonrolling interest in Electromed Financial, LLC			
Expenditures for finite-life intangible assets	(27,073)		(21,750)
Net cash used in investing activities	(224,093)		(237,061)
Cash flows from financing activities:			
Payments on revolving line of credit			-
Proceeds from LT debt			
Noncontrolling interest distributions paid			
Principal pymnts on LT debt inc. capital lease obligations	(109,801)		(109,970)
Payments of deferred financing fees			-
Proceeds from stock issuance			-
Payments of deferred offering costs			
Proceeds of warrant exercises	-		1,800
Expenditures of IPO			
Income tax benefit related to exercise of stock warrants			
Repurchase of common stock			
Proceeds from subscription notes receivable	-		22,500
Net cash provided by (used in) financing activities	(109,801)		(85,670)
Net increase (decrease) in cash and cash equivalents			
Cash and cash equivalents, beginning of period	1,702,435		4,091,739
Cash and cash equivalents, end of period	1,482,555	$	2,946,173

Electromed, Inc

HISTORICAL ZACKS RECOMMENDATIONS



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