Zacks Small-Cap Research

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NeoGenomics Inc. (NGNM-OTC)

NGNM: still reports 26% revenue growth in 3Q12 in spite of the expiration of TC Grandfather Clause---Outperform

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	10/09/2011
Current Price (11/02/12)	$2.80
Twelve- Month Target Price	**$4.00**

OUTLOOK

NeoGenomics reported 26% of revenue growth for 3Q2012 in spite of the expiration of TC Grandfather Clause.

Management has done a great job to limit the impact of the TC Grandfather Clause expiration by increasing test volume, launching new products, and saving costs. Going forward, revenue will continue to grow in the 4Q12 and beyond. NGNM is well poised for long term growth.

We continue to rate NGNM shares Outperform based on the Company's strong fundamentals.

SUMMARY DATA

52-Week High	**$3.10**
52-Week Low	**$1.32**
One-Year Return (%)	**108.96**
Beta	**0.96**
Average Daily Volume (sh)	**48,025**
Shares Outstanding (mil)	**45**
Market Capitalization ($mil)	**$126**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**1**
Insider Ownership (%)	**43**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**51.6**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using TTM EPS	**N/A**
P/E using 2011 Estimate	**N/A**
P/E using 2012 Estimate	**N/A**
Zacks Rank	**N/A**

Risk Level	**Above Avg.,**
Type of Stock	**Small-Growth**
Industry	**Med-Biomed/Gene**
Zacks Rank in Industry	**N/A**

ZACKS ESTIMATES

Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2011	8.8 A	10.5 A	11.3 A	12.9 A	43.5 A
2012	15.2 A	15.6 A	14.2 A	14.5 E	59.5 E
2013					72.0 E
2014					85.0 E

Earnings per Share
(EPS is operating earnings before non recurring items)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2011	-$0.02 A	-$0.01 A	-$0.00 A	$0.00 A	-$0.03 A
2012	$0.01 A	$0.01 A	-$0.02 A	$0.01 E	-$0.01 E
2013					$0.03 E
2014					$0.07 E

Zacks Projected EPS Growth Rate - Next 3 Years % **150**

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WHAT'S NEW

Revenue Continued to Grow in 3Q12 despite Negative TC Grandfather Clause Impact

On October 31, NeoGenomics (NGNM) reported financial results for fiscal 3Q12 ended September 30, 2012.

Revenue for 3Q12 was $14.2 million, a 26% increase over third quarter 2011 revenue. Test volume increased by 42%. As a result of the expiration of the Medicare Technical Component (TC) Grandfather Clause on June 30th, average price per test declined 12% from 3Q11 and 7% sequentially from 2Q12, in-line with the Company's previous guidance on this issue. The Company estimates that this regulatory change resulted in a reduction in revenue of approximately $1.3 million during the quarter.

Gross profit in 3Q12 increased to $5.9 million, a 16% increase from 3Q11. The decrease in average price per test from 3Q2011 was partially offset by a 6% improvement in average cost per test during this period. As a result, gross profit margin decreased to 41.5% in the third quarter 2012 from 44.8% in the third quarter of 2011.

Total operating expenses for 3Q12 were $6.6 million, a 31% increase from 3Q11, primarily as a result of a $0.68 million increase in R&D expenditures related to new test development, as well as incremental personnel, commissions, and bad debt expense related to the increased test volume. Third quarter G&A expenses included approximately $170,000 in one-time expenses related to the company's move into a larger laboratory facility in Irvine California. Research and Development expenses included approximately $177,000 of incremental stock-based compensation expense due to the rise in the Company's stock price from the second quarter to the third quarter.

Net loss for 3Q12 was $0.98 million, or ($0.02) per share, versus a net loss of $0.14 million, or ($0.00) per share in 3Q11. Despite the net loss, adjusted EBITDA improved 22% to $842,000 vs. $693,000 in the prior year.

Balance sheet remains strong. As of September 30, 2012, NeoGenomics had $2.3 million in cash with little debt. The Company also has approximately $3.8 million line of credit backed by accounts receivables. The Company will return to profitability in first quarter of 2013. There is no need for further financing in our view.

Management Did a Great Job to Minimize the Impact of TC Grandfather Clause Expiration

We are very pleased to see another quarter of strong financial performance by NeoGenomics, especially under the negative impact of the TC Grandfather Clause during the quarter.

As a reminder, NeoGenomics announced previously that the Company expects the expiration of the TC Grandfather Clause to impact the Company beginning in the third quarter.

Effective as of July 1st, NeoGenomics is required to bill hospitals for the technical component of certain tests performed on behalf of Medicare in-patients and out-patients, whereas previously the Company was allowed to bill Medicare directly for such services if they were provided to hospitals that were "grandfathered" under the regulations.

About 80% of NeoGenomics' lab tests are billed off the physician fee schedule with the remainder billed off the clinical lab fee schedule. Lab tests billed off the physician fee schedule usually have two separable billing components: the **technical component** consisting of sample treatment and testing, and the **professional component** for interpretation of the test results.

As a result of the TC Grandfather Clause expiration, average price per test in 3Q12 declined 12% compared to that in 3Q11. However, despite the negative impact, total revenue in 3Q12 still increased 26% year by year. This was achieved by 42% increase in test volume in 3Q12. Both revenue and test volume growth were achieved when the Company had to redirect the focus of its sales force over the last few months to prepare clients for the expiration of the TC Grandfather Clause on July 1st rather than acquiring new clients. The Company has also made big progress in increasing the productivity and efficiency of its lab operations.

With this distraction now behind, the Company has returned its full focus to growth and performance. NeoGenomics expects to overcome the impact from this regulatory change within a few quarters through aggressive cost savings, productivity improvements, new product introductions, and continued growth in each of its core laboratories.

Summary of Quarterly Performance

($, 000's)	3Q10	4Q10	1Q11	2Q11	3Q11	4Q11	1Q12	2Q12	3Q12
Total Revenue	**8,708**	**8,755**	**8,805**	**10,466**	**11,320**	**12,893**	**15,160**	**15,611**	**14,202**
% Growth	19.3%	12.3%	4.6%	23.3%	30.0%	47.3%	72.2%	49.2%	25.5%
Gross Margin	**44.7%**	**44.6%**	**43.9%**	**44.5%**	**44.8%**	**45.2%**	**47.1%**	**47.2%**	**41.5%**
SG&A as a % of Revenue	56.3%	51.0%	52.0%	45.6%	44.5%	42.3%	38.2%	38.4%	40.6%
Net Income (Loss)	**($1,198.0)**	**($377.0)**	**($893.0)**	**($293.0)**	**($143.0)**	**$152.0**	**$603.0**	**$839.0**	**($975.0)**
Diluted EPS	($0.03)	($0.01)	($0.02)	($0.01)	($0.00)	$0.00	$0.01	$0.01	($0.02)
Adjusted EBITDA	($398.0)	($97.0)	$29.0	$483.0	$693.0	$1,055.0	$1,775.0	$1,943.0	$842.0
Test Volume	**14,477**	**14,349**	**15,396**	**18,358**	**19,978**	**22,557**	**26,932**	**28,846**	**28,315**
% Growth	29.4%	12.9%	9.6%	26.9%	38.0%	57.2%	74.9%	57.1%	41.7%
Average Price/Test	602.00	610.00	572.00	570.00	567.00	571.59	562.89	541.20	501.58
% Growth	-7.7%	-0.5%	-4.7%	-2.9%	-5.8%	-6.3%	-1.6%	-5.1%	-11.5%

Summary of Annual Performance

$, 000's	2007	2008	2009	2010	2011	2012E	2013E	2014E	2015E
Total Revenue	11,505	20,015	29,469	34,371	43,484	59,473	72,000	85,000	110,000
% Growth	78.0%	74.0%	47.2%	16.6%	26.5%	36.8%	21.1%	18.1%	29.4%
Gross Margin	52.0%	53.3%	51.6%	45.9%	44.7%	44.8%	43.8%	44.1%	45.5%
SG&A as a % of Revenue	79.3%	57.7%	57.5%	54.5%	45.6%	39.4%	36.8%	35.3%	31.8%
Net Income (Loss)	(3,380.0)	(1,383.0)	(2,243.0)	(3,303.0)	(1,177.0)	(391.0)	1,400.0	3,700.0	10,850.0
Diluted EPS	(0.11)	(0.04)	(0.06)	(0.09)	(0.03)	(0.01)	0.03	0.07	0.19
Adjusted EBITDA	(1,017.0)	809.0	103.0	(566.0)	2,134.0	1,109.0	2,900.0	5,200.0	12,350.0
Annual Test Volume Growth	63.7%	56.4%	39.1%	25.5%	33.1%	47.7%	45.0%	40.0%	37.0%

Innovation and New Product Development is an Ongoing Process at NGNM

On September 13, 2012, NGNM announced it has begun using a new proprietary software that it developed for reading and interpreting Fluorescent in Situ Hybridization (FISH) digital data. The company will use this software to further automate certain FISH analyses in its own laboratories and will consider sub-licensing it to other providers. The Company also announced that it has applied for a utility patent on this methodology and the related software.

The proprietary software, which is based upon a sophisticated machine learning technology known as **Support Vector Machine (SVM),** allows users to read and interpret specific types of FISH images more accurately and more quickly. Laboratory technologists and professionals can train different algorithms for specific types of FISH images, and a library of files for reading and interpreting various FISH probes can be easily compiled for general use in any FISH laboratory that has a sublicense to the SVM technology. The software can read and interpret most forms of digital FISH data acquired manually or by an automated system.

NeoGenomics has validated and is currently implementing a laboratory developed test using the new software to read ALK rearrangement FISH tests, and plans to expand its use for other FISH probes. FISH testing for ALK rearrangement is currently performed manually and only 50 cells are counted by most laboratories. This new computer-aided system enables a significantly higher number of cells to be counted and allows for increased accuracy and reduced subjectivity from case to case. ALK testing is very important for selecting appropriate therapy for lung cancer patients. The Company expects a modest incremental reimbursement associated with ALK testing in this initial application of SVM technology, because it will enable the use of computer assisted FISH CPT codes for billing.

NGNM is the first laboratory in the world to use SVM technology to assist in reading and interpreting ALK FISH data.

On July 18, 2012, NeoGenomics announced that it has validated and launched 20 new molecular assays thus far in 2012 and that it expects to validate another 15-20 molecular assays by the end of 2012. NeoGenomics also added over 60 immunohistochemistry (IHC) antibodies to its menu in 2012, and the Company is in the process of rolling out a new digital pathology imaging platform. These investments are beginning to fuel growth in its molecular and IHC volumes, and allowed each of these laboratories to turn profitable in the second quarter for the first time. In addition, the Company recently introduced 10-color Flow Cytometry, which makes the Company one of only a few labs to offer this service on a broad scale.

NeoGenomics also announced that it is in the process of launching a series of new NeoTYPE™ Cancer Profile Panels in conjunction with this significantly expanded molecular testing menu. These NeoTYPE™ Panels are specifically designed to detect cancer-related genetic mutations in patients that have failed their first line therapies in order to assess which additional types of treatments may be effective.

The first NeoTYPE™ Panels will provide comprehensive molecular profiles of certain solid tumor cancers, but the Company expects to offer additional NeoTYPE™ Panels for hematopoietic cancers in the future. Each NeoTYPE™ Panel will profile the molecular abnormalities in a cancer by using high throughput, highly reliable Sanger sequencing and will use ancillary FISH testing if deemed necessary. These NeoTYPE™ Panels are specifically designed to help physicians better plan the therapeutic approach for their cancer patients as well as help determine if a patient would be a good candidate for one of the many new cancer therapeutics that are currently in clinical trials. The initial NeoTYPE™ Panels are based on sequencing combinations of the following 10 oncogenes: TP53, KRAS, NRAS, PIK3CA, BRAF, EGFR, c-KIT, IDH1, IDH2 and DNMT3A, however, additional oncogenes may be added or substituted depending on the type of cancer being targeted in each panel. The initial NeoTYPE™ Solid Tumor Profiles are:

- NeoTYPE™ Breast Tumor Profile

- NeoTYPE™ Colorectal Tumor Profile
- NeoTYPE™ Gastric Tumor Profile
- NeoTYPE™ Lung Tumor Profile
- NeoTYPE™ Solid Tumor (Other) Profile

The launch of new products is important to NeoGenomics as these new products will be growth driver and provide sustainable growth for the Company in the long run. NeoGenomics now has one of the most advanced molecular testing labs in the United States.

The development of the software and the new product launch is indicative of management commitment to offer innovative solutions and uncompromising quality for cancer testing. We believe innovation and new product development is an ongoing process at NeoGenomics, which provides long term growth driver for the Company in our view.

VALUATION AND RECOMMENDATION

Since we initiated coverage of NeoGenomics in early October 2011, price has appreciated 167% as of this writing. We maintain our Outperform rating on NeoGenomics (NGNM) and reiterate our 12-month price target of $4.0 per share.

NeoGenomics is an emerging leader in the genetic/molecular cancer testing market. The Company holds numerous competitive advantages over its competitors. We are especially impressed by the Company's fast turn-around times, tech-only reporting solution and state of the art laboratory information system (LIS), which are key elements that drive top line growth.

NeoGenomics has achieved strong financial performance. Revenue grew from $1.9 million in 2005 to $43.5 million in 2011, a tremendous 68.7% compound annual growth rate (CAGR) for the six-year period. We estimate revenue will further grow to $110 million in 2015, at a CAGR of 36% from 2012 to 2015.

We are also impressed by the Company's strong balance sheet, which is in contrast with most small cap biotech companies. NeoGenomics held $2.3 million in cash as of September 30, 2012 with little debt. With profitability at its fingertips, the Company should be able to focus on its long term strategic development plan without fearing short term cash strains.

We are optimistic about the strength of the Company's business model. Fundamentals remain strong for NGNM. Sales pipeline is strong. The Company is executing plans to gain further efficiencies. By growing its business, lowering its costs and driving innovation, NeoGenomics is becoming America's premier cancer testing laboratory.

Although price has appreciated about 167% since our initiation in early October 2011, there is still room for further price appreciation. Based on NeoGenomics strong fundamentals, we think the shares of NeoGenomics are still undervalued at current market price. Currently, NGNM is trading at about $2.80 per share which values the Company at $126 million in terms of market cap based on 45 million shares outstanding. This is still a deep discount compared to its peers. Based on our financial model, revenue will grow at 36% CAGR from 2012 to 2015. We think NGNM should trade at 30 x P/E multiple. If we use this P/E multiple, coupled with our estimated EPS of $0.19 in 2015, discounted at 20% for two years, we come up with a price target of $4.0 per share.

We think at this time, downside risk for NGNM is relatively low while upside potential is high. One short term potential catalyst is the possible upgrade of NGNM shares from current OTC trading to major exchange such as AMEX or NASDAQ. Management indicated that they are making progress to list

NGNM shares on either exchange. This upgrade will significantly increase the Company's visibility and attract institutional investors.

One wild card for NGNM valuation is that the Company may be an acquisition target for big players. The genetic/molecular industry is quite fragmented currently, but merger & acquisition activity is looming. We all know that big players like LabCorp and Quest Diagnostics are increasingly acquiring smaller players in this field. Qiagen NV, a research service company based in Netherland, entered into genetic/molecular testing market in 2007 by acquiring Digene Corp. Since then, Qiagen has been quite aggressive in acquisition of other small genetic/molecular testing companies.

In December 2010, GE Healthcare acquired NeoGenomics' largest competitor Clarient Inc. at 5.8 x EV/LTM Revenue. Clarient Inc. is similar to NeoGenomics in terms of business and operations and is NeoGenomics' largest competitor, therefore, Clarient is the closest comparable for NeoGenomics. With the increased activity in M&A in the industry, NGNM could be an easy target for acquisition. If acquired by big players, share price of NGNM may soar.

PROJECTED INCOME STATEMENT

	2010A (Dec)	2011A (Dec)					2012E (Dec)					2013E (Dec)	2014E (Dec)	2015E (Dec)
$ in million except per share data	FYA	Q1	Q2	Q3	Q4	FYA	Q1	Q2	Q3	Q4E	FYE	FYE	FYE	FYE
Total Revenues	**$34.37**	**$8.81**	**$10.47**	**$11.32**	**$12.89**	**$43.48**	**$15.16**	**$15.61**	**$14.20**	**$14.50**	**$59.47**	**$72.00**	**$85.00**	**$110.00**
YOY Growth	16.6%	4.6%	23.3%	30.0%	47.3%	26.5%	72.2%	49.2%	25.5%	12.5%	36.8%	21.1%	18.1%	29.4%
CoGS	18.59	4.94	5.81	6.25	7.06	24.06	8.02	8.24	8.31	8.27	32.84	40.50	47.50	59.95
Gross Income	**$15.78**	**$3.87**	**$4.66**	**$5.07**	**$5.83**	**$19.43**	**$7.14**	**$7.37**	**$5.89**	**$6.23**	**$26.63**	**$31.50**	**$37.50**	**$50.05**
Gross Margin	45.9%	43.9%	44.5%	44.8%	45.2%	44.7%	47.1%	47.2%	41.5%	43.0%	44.8%	43.8%	44.1%	45.5%
SG&A	$18.75	$4.58	$4.77	$5.03	$5.46	$19.84	$5.79	$6.00	$5.77	$5.85	$23.40	$26.50	$30.00	$35.00
% SG&A	54.5%	52.0%	45.6%	44.5%	42.3%	45.6%	38.2%	38.4%	40.6%	40.3%	39.4%	36.8%	35.3%	31.8%
R&D	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.50	$0.53	$0.81	$0.75	$2.58	$2.60	$3.00	$3.50
% Other	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Operating Income	**($3.0)**	**($0.7)**	**($0.1)**	**$0.0**	**$0.4**	**($0.4)**	**$0.9**	**$0.8**	**($0.7)**	**($0.4)**	**$0.6**	**$2.4**	**$4.5**	**$11.6**
Operating Margin	-	-	-	0.4%	2.9%	-0.9%	5.7%	5.4%	-4.8%	-2.6%	1.1%	3.3%	5.3%	10.5%
Other Net	($0.3)	($0.2)	($0.2)	($0.2)	($0.2)	($0.8)	($0.3)	($0.3)	($0.3)	($0.2)	($1.0)	($1.0)	($0.8)	($0.5)
Pre-Tax Income	**($3.3)**	**($0.9)**	**($0.3)**	**($0.1)**	**$0.2**	**($1.2)**	**$0.6**	**$0.6**	**($1.0)**	**($0.6)**	**($0.4)**	**$1.4**	**$3.7**	**$11.1**
Income taxes(benefit)	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.2
Tax Rate	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	1.8%
Reported Net Income	**($3.3)**	**($0.9)**	**($0.3)**	**($0.1)**	**$0.2**	**($1.2)**	**$0.6**	**$0.6**	**($1.0)**	**($0.6)**	**($0.4)**	**$1.4**	**$3.7**	**$10.9**
YOY Growth	-	-	-	-	-	-64.4%	-	-	-	-475.0%	-	-458.1%	164.3%	193.2%
Net Margin	-	-	-	-	1.2%	-2.7%	4.0%	3.5%	-6.9%	-3.9%	-0.7%	1.9%	4.4%	9.9%
Diluted Shares Out	37.3	41.7	42.9	43.1	45.3	43.2	47.4	47.7	45.2	47.0	46.8	48.5	53.5	58.5
Reported EPS	**($0.09)**	**($0.02)**	**($0.01)**	**($0.00)**	**$0.00**	**($0.03)**	**$0.01**	**$0.01**	**($0.02)**	**($0.01)**	**($0.01)**	**$0.03**	**$0.07**	**$0.19**
One time charge	*$0.00*	*$0.00*	*$0.00*	*$0.00*	*$0.00*	*$0.00*	*$0.00*	*$0.00*	*$0.00*	*$0.00*	*$0.00*	*$0.00*	*$0.00*	*$0.00*
Non GAAP Net Income	**($3.3)**	**($0.9)**	**($0.3)**	**($0.1)**	**$0.2**	**($1.2)**	**$0.6**	**$0.6**	**($1.0)**	**($0.6)**	**($0.4)**	**$1.4**	**$3.7**	**$10.9**
Non GAAP EPS	**($0.09)**	**($0.02)**	**($0.01)**	**($0.00)**	**$0.00**	**($0.03)**	**$0.01**	**$0.01**	**($0.02)**	**($0.01)**	**($0.01)**	**$0.03**	**$0.07**	**$0.19**

Source: Company filings and Zacks Investment Research

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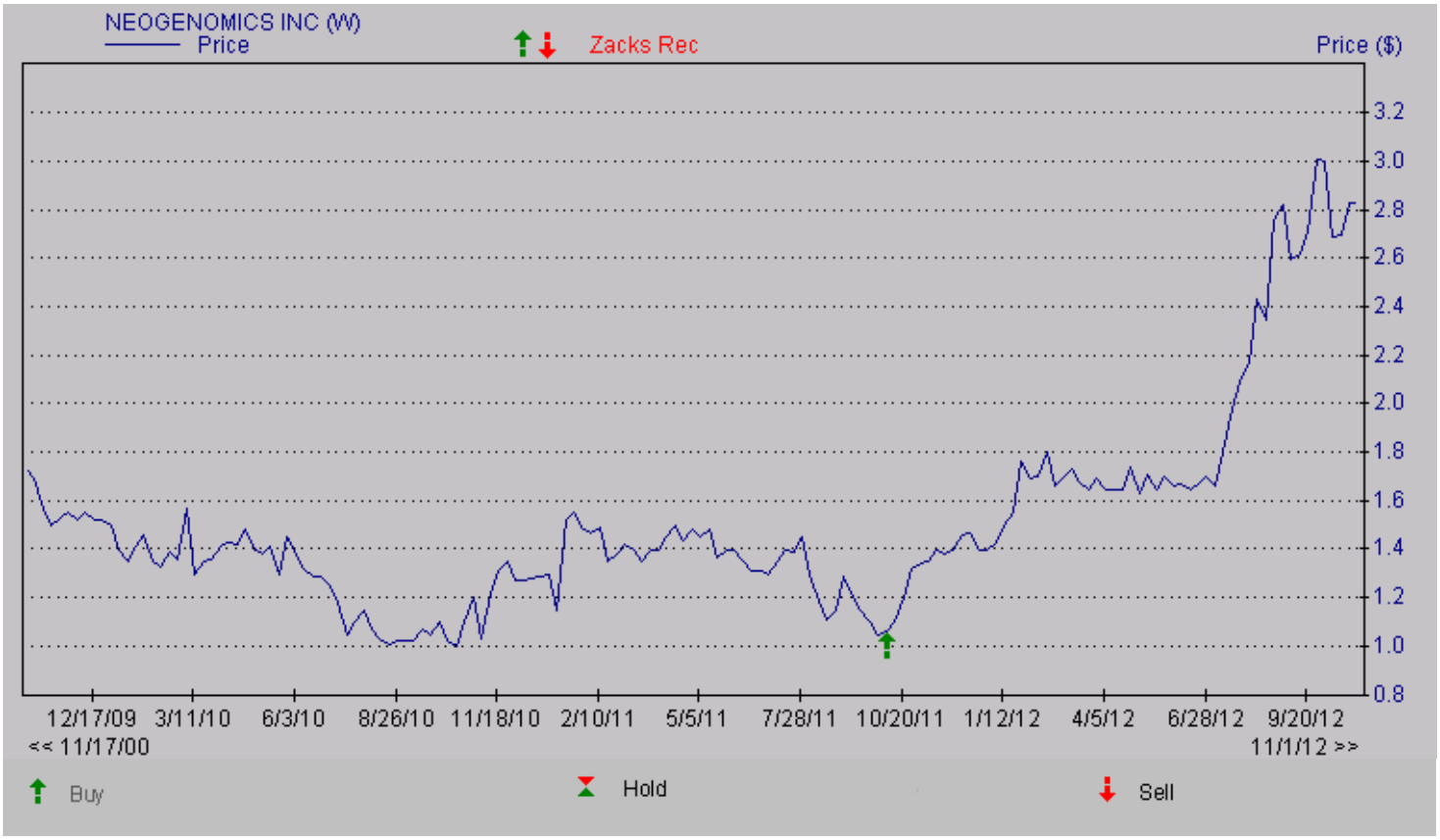
HISTORICAL ZACKS RECOMMENDATIONS



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