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Zacks Small - Cap Research

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Electromed Inc (ELMD-AMEX)

ELMD: 2012 Full-Year Results. Trading Below Book Value Offers Downside Protection.

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	5/12/2011
Current Price (09/27/12)	$1.43
Target Price	**$4.00**

OUTLOOK

The slower than anticipated pace in net growth of the sales force has hampered revenue growth and resulted in the last 3 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. This hopefully bodes well for a resurgence of growth in the size of the sales force and directly related growth in revenue and earnings. New international distributors could spark more growth overseas - although the domestic business will likely remain 90%+ of total revenue. 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	**$4.49**
52-Week Low	**$1.43**
One-Year Return (%)	**-40.99**
One-Year Return (%)	**-56.06**
Beta	**0.20**
Average Daily Volume (sh)	**5,941**
Shares Outstanding (mil)	**8**
Market Capitalization ($mil)	**$12**
Short Interest Ratio (days)	**0.49**
Institutional Ownership (%)	**4**
Insider Ownership (%)	**37**
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	**70.2**
P/E using 2013 Estimate	**10.7**
P/E using 2014 Estimate	**6.3**
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	4,975 E	5,312 E	5,536 E	5,321 E	21,144 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	$0.02 E	$0.04 E	$0.04 E	$0.04 E	$0.14 E
2014					$0.24 E
2015					$0.30 E

Zacks Projected EPS Growth Rate - Next 4 Years % **33**

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Q4 2012 Financial Results

Electromed reported financial results for the fiscal 2012 fourth quarter ending June 30, 2012 on September 24th. Revenue disappointed relative to our estimates for the third straight quarter. The company again cited adverse reimbursement factors for the lackluster revenue while also noting that this is despite the fact that the number of prescriptions continues to grow. As has been noted in the past, reimbursement amount for SmartVest can differ among third-party payers (most notably between Medicare and private payers) as can the reimbursable diagnoses. Although ELMD does not disclose the proportion of prescriptions related to Medicare claims (which are generally reimbursed at a lower rate and have longer collection times compared to private payers), the implication is that this is a meaningful amount.

As we initially noted in our Q3 update, another contributor to revenue underperforming our expectations is the slower net growth of the size of the sales force - while ELMD is still adding headcount, the pace has been slower than management had previously expected (in early fiscal 2012 ELMD guided towards 27 - 30 reps by fiscal year-end), at least some of which is likely a result of the turnover in Q2. In addition, there's a learning curve for newly hired reps which means there is typically some lag between the date of hire and when reps reach optimum productivity. Nonetheless, the delay in growing the sales force seems to be a significant impediment to revenue and earnings growth. ELMD notes in the Q4 earnings release that they currently have 22 sales reps, which is actually down from the 23 that they had about 12 months ago (and compares to 21 at 3/30/12 and 22 in mid-May 2012), but plan to add 6 to 8 more reps by the end of fiscal 2013 (6/30/2013).

ELMD has taken a very discerning approach to adding headcount in areas of the country that offer the most opportunity for growth (i.e. the most bang for the buck). Factors such as population density as well as the local insurance reimbursement environment have both been components used to guide their domestic expansion strategy. Electromed has been similarly discriminating relative to experience, ability and certification (i.e. most are respiratory therapists) when it comes to hiring its sales staff. While this strategy has helped optimize sales efficiency, the process has clearly taken longer to implement than initially expected. In August 2012 ELMD announced the hiring of an experienced Director of Sales to facilitate the identification of high-opportunity territories and the hiring of qualified sales people to service those areas. This hopefully bodes well for a resurgence of growth in the size of the sales force and directly related growth in revenue and earnings.

Revenue
Q4 revenue of $4.58 million was down almost 8% y-o-y (down 4% sequentially) and consisted of $4.17 million (-10% y-o-y) from the Homecare segment, $153k (+43% y-o-y) from International and $259k (+9% y-o-y) from Government/Institutional.

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

	Actual Q4 2011	Actual Q4 2012	Y-o-Y Change	Zacks Est Q4 2012	Actual +/- Zacks est.
Homecare	$4,609.0	$4,169.0	-9.5%	$4,869.0	-14.4%
International	$107.0	$153.0	43.0%	$135.0	13.3%
Gov't / Instit.	$237.0	$259.0	9.3%	$250.0	3.6%
	$4,953.0	**$4,581.0**	**-7.5%**	**$5,254.0**	**-12.8%**

Total revenue came in about 13% less than our estimate, despite International and Gov't/Institutional sales coming in slightly better than our numbers. 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 seems to be paying dividends (we note, while Int'l sales fell 10% for the full year, they were up 14% over the final 9 months of fiscal 2012).

Gross Margin
GM came in at 70.4% compared to our 73.5% 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.

Operating Expenses
Excluding approximately $400k in severance costs related to the retirement of Bob Hansen, SG&A came in at about $2.8 million, or 60.5% of sales, compared to our 59.2% estimate. Similar to Q2 and Q3 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. ELMD continues to invest in support infrastructure and personnel - mostly customer service, reimbursement and billing - activities which are essential to growth of the business. As we've noted in the past, we expect these fixed expenses in SG&A to be leverageable as revenue grows - but in the case of the past three quarters where revenue falls short, these expenses are highlighted and crimp the bottom line.

R&D expense was $215k in Q4, well below our $305k estimate. We continue to model R&D expense at low-to-mid single digit % of revenue.

Net Income / EPS
Excluding severance expense, net income and EPS were approximately $120k and $0.01, compared to our $248k and $0.03 estimates.

Cash
Electromed exited fiscal Q4 with $1.70 million in cash and equivalents, compared to $1.39 million at the end of Q3. Cash from operating activities was an inflow of $506k in the most recent quarter, which benefitted from a $241k reduction in A/R. Stripping out the increase in working capital, cash from operating activities was an inflow of $286k. For the 12 months ending 6/30/2012 cash used operating activities was $1.17 million and was an inflow of $1.09 million ex-changes in working capital. As we've noted in the past, the increase in working capital (particularly A/R) is reflective of the long collections times characteristic of the industry.

Along with the cash balance there's about $3.1 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. Assuming A/R continues to grow at the recent pace (A/R grew ~$1.3MM in fiscal 2012) and capex uses on average another ~$210k/quarter (capex was ~$850k in fiscal 2012), cash balance plus short-term borrowing capacity represents about 27 months worth of operating cash (includes capex and monthly principal payments) - this assumes ELMD continues to successfully roll over the bank loans. If, when and how much cash ELMD may need to raise to fund growth of the business (mostly working capital) will depend on a number of things including timing of A/R collections and capex and inventory investments. Raising capital is not a near-term need, however and we do not view this as a significant concern.

Valuation and Recommendation
We now look for revenue of $21.1 million (implying growth of ~8%) in fiscal 2013, down from $23.3 million prior to Q4 results. Our 2013 EPS estimate has moved from $0.21 to $0.14. The downward revision to our 2013 estimates as well as our out-years mostly reflects the delay in building the sales force. Management is guiding for 28 to 30 reps to be onboard 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 $0.24 in 2014, and $0.38 to $0.30 in 2015. With the close of fiscal 2012, we now model out to year 2016 (EPS estimate of $0.38).

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 $0.38 in 2016, implying a five-year (2011 - 2016) CAGR of 23%. Based on a 1.3 PE/G, ELMD should trade at about 30x 2013 EPS or ~ $4.00/share. The stock currently trades at about $1.50. We think the stock trades significantly below fair value with market value now below book value (stock currently trades at ~0.8x 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.

FINANCIAL STATEMENTS

INCOME STATEMENT — Electromed Inc.

	2012 A	Q1E	Q2E	Q3E	Q4E	2013 E	2014 E	2015 E	2016
Home Care Revenue	$17,959.0	$4,616.8	$4,844.5	$5,043.3	$4,868.7	$19,373.4	$22,913.1	$25,463.3	$28,060.6
% of total revenue	*92.0%*	*92.8%*	*91.2%*	*91.1%*	*91.5%*	*91.6%*	*91.7%*	*91.5%*	*90.9%*
y-o-y growth	*3.5%*	*-10.0%*	*12.7%*	*15.7%*	*16.8%*	*7.9%*	*18.3%*	*11.1%*	*10.2%*
International Revenue	$547.0	$149.3	$185.9	$177.2	$165.0	$677.3	$906.2	$1,134.5	$1,496.9
% of total revenue	*2.8%*	*3.0%*	*3.5%*	*3.2%*	*3.1%*	*3.2%*	*3.6%*	*4.1%*	*4.8%*
y-o-y growth	*-10.0%*	*303.4%*	*-3.2%*	*7.4%*	*7.8%*	*23.8%*	*33.8%*	*25.2%*	*31.9%*
Gov't / Institutional Revenue	$1,018.0	$209.0	$281.5	$315.6	$287.3	$1,093.4	$1,171.1	$1,216.8	$1,328.7
% of total revenue	*5.2%*	*4.2%*	*5.3%*	*5.7%*	*5.4%*	*5.2%*	*4.7%*	*4.4%*	*4.3%*
y-o-y growth	*-2.9%*	*-0.5%*	*-6.2%*	*26.7%*	*10.9%*	*7.4%*	*7.1%*	*3.9%*	*9.2%*
Net Sales	$19,524.5	$4,975.0	$5,312.0	$5,536.0	$5,321.0	$21,144.0	$24,990.4	$27,814.6	$30,886.2
YOY Growth	*2.7%*	*-7.5%*	*10.9%*	*16.0%*	*16.2%*	*8.3%*	*18.2%*	*11.3%*	*11.0%*
Cost of product sales	$5,392.4	$1,338.3	$1,381.1	$1,509.7	$1,447.3	$5,676.4	$6,522.5	$7,176.2	$7,876.0
Gross Income	$14,132.1	$3,636.7	$3,930.9	$4,026.3	$3,873.7	$15,467.6	$18,467.9	$20,638.5	$23,010.2
Gross Margin	*72.4%*	*73.1%*	*74.0%*	*72.7%*	*72.8%*	*73.2%*	*73.9%*	*74.2%*	*74.5%*
SG&A	$12,614.5	$3,164.1	$3,155.3	$3,186.5	$3,059.6	$12,565.5	$14,294.5	$15,659.6	$16,956.5
% SG&A	*64.6%*	*63.6%*	*59.4%*	*57.6%*	*57.5%*	*59.4%*	*57.2%*	*56.3%*	*54.9%*
R&D	$911.3	$228.9	$239.0	$238.0	$223.5	$929.4	$949.6	$1,029.1	$1,081.0
% R&D	*4.7%*	*4.6%*	*4.5%*	*4.3%*	*4.2%*	*4.4%*	*3.8%*	*3.7%*	*3.5%*
Operating Income	$606.3	$243.8	$536.5	$601.8	$590.6	$1,972.7	$3,223.8	$3,949.7	$4,972.7
Operating Margin	*3.1%*	*4.9%*	*10.1%*	*10.9%*	*11.1%*	*9.3%*	*12.9%*	*14.2%*	*16.1%*
Interest income, net	($168.7)	($36.0)	($32.0)	($28.0)	($24.0)	($120.0)	($25.0)	$25.0	$50.0
Pre-Tax Income	$437.6	$207.8	$504.5	$573.8	$566.6	$1,852.7	$3,198.8	$3,974.7	$5,022.7
Taxes (benefit)	$251.0	$79.0	$191.7	$218.0	$215.3	$704.0	$1,215.5	$1,510.4	$1,908.6
Tax Rate	*57.4%*	*38.0%*	*38.0%*	*38.0%*	*38.0%*	*38.0%*	*38.0%*	*38.0%*	*38.0%*
Net Income	$186.6	$128.8	$312.8	$355.7	$351.3	$1,148.7	$1,983.2	$2,464.3	$3,114.1
Net Margin	*1.0%*	*2.6%*	*5.9%*	*6.4%*	*6.6%*	*5.4%*	*7.9%*	*8.9%*	*10.1%*
EPS	$0.02	$0.02	$0.04	$0.04	$0.04	$0.14	$0.24	$0.30	$0.38
YOY Growth	*-83.0%*	*-47.5%*	*1175.6%*	*274.2%*	*-296.7%*	*515.9%*	*71.9%*	*25.0%*	*26.4%*
Diluted Shares O/S	8,119	8,115	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.**

	June 30, 2012	June 30, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,702,435	$ 4,091,739
Accounts Receivable	10,850,859	9,593,105
Inventories	2,392,416	1,855,957
Prepaid expenses and other current assets	359,583	371,257
Income tax receivable	340,744	-
Deferred income taxes	656,000	722,000
Total current assets	16,302,037	16,634,058
Property and equipment, net	3,170,014	2,807,082
Finite-life intangible assets	1,174,033	1,235,828
Deferred common stock offering costs	-	-
Other assets	274,940	191,964
Total assets	$ 20,921,024	$ 20,868,932
LIABILITIES		
Current liabilities:		
Revolving line of credit	$ 1,768,128	$ 1,768,128
Current maturities of long term debt	254,020	438,267
Accounts payable	749,985	733,621
Accrued compensation	636,995	868,229
Warranty reserve	610,000	444,096
Other accrued liabilities	151,558	161,166
Income tax payable	-	-
Total current liabilities	4,170,686	4,413,507
Long term debt, less current	1,390,003	1,582,102
Deferred income taxes	280,000	167,000
Total liabilites	5,840,689	6,162,609
Commitments and contingencies		
STOCKHOLDERS' EQUITY		
Common stock	81,143	81,005
Additional paid-in capital	12,959,136	12,794,368
Retained earnings	2,040,056	1,853,450
Common stock subscription receivable for shares o/s of 48,500	-	(22,500)
Total stockholders' equity	15,080,335	14,706,323
Total liabilities and stockholders' equity	$ 20,921,024	$ 20,868,932

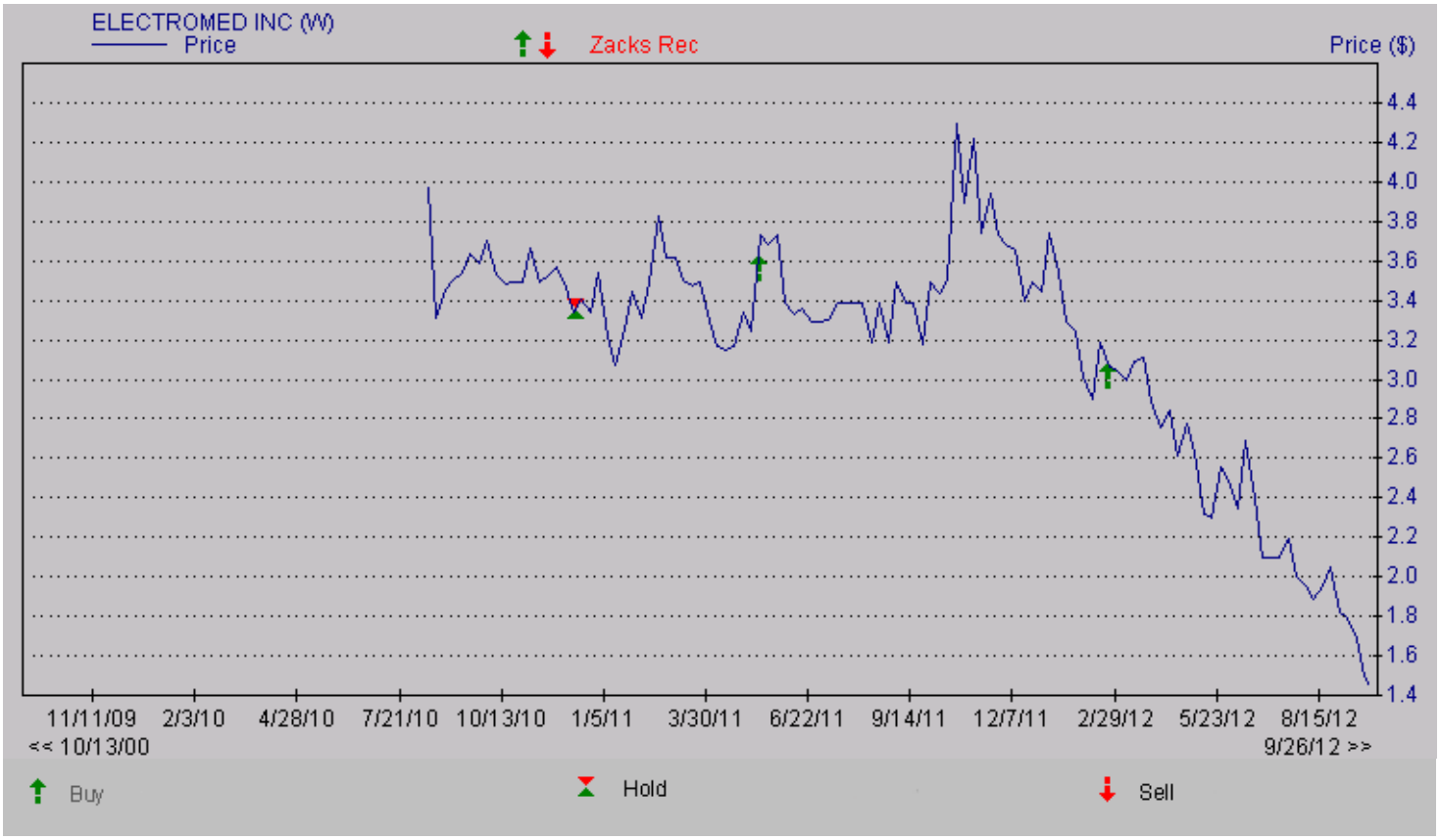
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CASH FLOW STATEMENT **Electromed Inc.**

	Fiscal Year Ending June 30, 2012	2011
Cash flows from operating activities:		
Net income	186,606	1,055,577
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	408,630	335,620
Amortization of finite-life intangible assets	123,996	113,850
Amortization of debt issuance costs	12,824	31,463
Share based compensation expense	135,605	156,169
Deferred income taxes	179,000	(186,000)
Loss on disposal of P&E	47,906	26,225
Issuance of common stock for services	-	-
Changes in operating assets and liabilities:		
Accounts receivable	(1,257,754)	(3,016,103)
Inventory	(536,459)	(385,182)
Prepaid expenses and other assets	(413,557)	(193,342)
Accounts payable and accrued liabilites	(58,574)	646,619
Net cash provided by operating activities	(1,171,777)	(1,415,104)
Cash flows from investing activities:		
Expenditures for P&E, net	(786,550)	(451,503)
Purchase of nonctonrolling interest in Electromed Financial, LLC	-	-
Expenditures for finite-life intangible assets	(62,201)	(659,210)
Net cash used in investing activities	(848,751)	(1,110,713)
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	(409,264)	(435,968)
Payments of deferred financing fees	(11,313)	(6,716)
Proceeds from stock issuance	-	6,363,713
Payments of deferred offering costs	-	-
Proceeds of warrant exercises	29,301	25,800
Expenditures of IPO	-	-
Income tax benefit related to exercise of stock warrants	-	-
Repurchase of common stock	-	-
Proceeds from subscription notes receivable	22,500	60,000
Net cash provided by (used in) financing activities	(368,776)	6,006,829
Net increase (decrease) in cash and cash equivalents	(2,389,304)	3,481,012
Cash and cash equivalents, beginning of period	4,091,739	610,727
Cash and cash equivalents, end of period	1,702,435	4,091,739

Electromed, Inc

HISTORICAL ZACKS RECOMMENDATIONS



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