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Zacks Small - Cap Research

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Electromed Inc (ELMD-NASDAQ)

ELMD: Q3 Another Solid Quarter. Moving Recommendation to Outperform.

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	5/12/2011
Current Price (05/13/11)	$3.51
Target Price	**$5.50**

OUTLOOK

$6 million raised through an August 2010 IPO is being put to work expanding the size of the sales force and increasing marketing. The impact has been immediate with sales through the first 9 months of 2011 up 32%. Revenue growth should remain strong as ELMD continues this strategy, benefitting from increased adoption of HFCWO therapy in the U.S.

Gaining operating leverage will be key to accelerated EPS growth, although not likely to materialize until 2012. We are moving our price target from $4.00 to $5.50 and our recommendation from Hold to Outperform.

SUMMARY DATA

52-Week High	**$4.35**
52-Week Low	**$2.94**
One-Year Return (%)	**N/A**
Beta	**-0.03**
Average Daily Volume (sh)	**7,110**
Shares Outstanding (mil)	**8**
Market Capitalization ($mil)	**$28**
Short Interest Ratio (days)	**0.74**
Institutional Ownership (%)	**5**
Insider Ownership (%)	**42**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**N/A**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using TTM EPS	**23.4**
P/E using 2011 Estimate	**23.4**
P/E using 2012 Estimate	**19.5**
Zacks Rank	**3**

Risk Level	**N/A,**
Type of Stock	**Small-Blend**
Industry	**Med Instruments**
Zacks Rank in Industry	**36 of 50**

ZACKS ESTIMATES

Revenue
(in '000 of $)

	Q1 (Sep)	Q2 (Dec)	Q3 (Mar)	Q4 (Jun)	Year (Jun)
2010	3,228 A	3,223 A	4,229 A	3,624 A	14,304 A
2011	4,165 A	4,686 A	5,199 A	4,614 E	18,691 E
2012					22,060 E
2013					25,385 E

Earnings per Share

	Q1 (Sep)	Q2 (Dec)	Q3 (Mar)	Q4 (Jun)	Year (Jun)
2010	$0.05 A	$0.01 A	$0.08 A	$0.01 A	$0.15 A
2011	$0.02 A	$0.04 A	$0.06 A	$0.03 E	$0.15 E
2012					$0.18 E
2013					$0.26 E

Zacks Projected EPS Growth Rate - Next 5 Years % **23**

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Q3 2011 Financial Results…

Electromed reported financial results for the fiscal third quarter ending March 31, 2011 on May 12, 2011. For the second straight quarter the company beat our estimates on both the top and bottom lines. While the company does not provide revenue or earnings guidance, management's comments on the conference call may indicate that they have no reason to believe revenue momentum will stall anytime soon. We have made some slight upwards adjustments to our revenue estimates for Q4 2010 and beyond.

Revenue
Q3 revenue of $5.2 million was up 23% y-o-y (+11% sequentially) and consisted of $4.7 million (+26% y-o-y) from the Homecare segment, $143k (-46% y-o-y) from International and $367k (+56% y-o-y) from Government/Institutional.

Homecare sales continue to be driven by growth in the size of the sales force (3 reps added in the current quarter) and while not definitive, also potentially from share gains against competitors. Expansion of the sales force has almost certainly afforded deeper penetration of SmartVest into already well established (CF, bronchiectasis) indications. This strategy has clearly been successful for Electromed and we expect the company will continue to add additional sales reps for at least the next 12 months. As newly hired reps become more productive, operating expense leverage should widen and a greater percentage of revenue should flow to the bottom line.

	Q3 2010	Actual Q3 2011	Y-o-Y Change	Zacks Est Q3 2011	Actual +/- Zacks est.
Homecare	$3,727.0	$4,689.0	25.8%	$4,432.0	5.8%
International	$267.0	$143.0	-46.4%	$205.0	-30.2%
Gov't / Instit.	$235.0	$367.0	56.2%	$220.0	66.8%
	$4,229.0	**$5,199.0**	**22.9%**	**$4,857.0**	**7.0%**

Total revenue came in 7% better than our estimate, driven by 6% better Homecare and 67% better Gov't/Institutional segment sales, partially offset by 30% lower than modeled International sales. As Homecare accounts for about 90% of total sales, this segment (31% y-o-y growth for the first 9 months of 2011) continues to be the major driver of Electromed's revenue growth.

Gov't/Institutional has also experienced recent significant revenue growth (+89% for the first nine months of 2011), although this segment's sales can be somewhat volatile on a short-term basis so it may be too early to conclude that this upward trajectory will continue for the longer-term. This will be something to keep an eye on as the company heads into the new fiscal year.

Gross Margin
GM came in at 71.2% compared to our 74% estimate. GM is also somewhat variable on a short-term basis (was 72.1% in Q1 and 75.6% in Q2), largely due to referral mix and related average reimbursement rates (not all insurance reimburses at the same rate).

Operating Expenses
Operating expenses were almost dead-on where we had them modeled. SG&A came in at $2.76 million versus our $2.74 million estimate, while R&D was $272k versus our $228k estimate. We continue to expect operating expenses as a percent of sales to be slightly higher in fiscal 2011 compared to the prior year as a result of head count additions and marketing initiatives. We think Electromed can begin to squeeze leverage from these “investments” during 2012 as newly hired sales reps become more seasoned and productive.

Net Income / EPS
Net income of $488k was 39% better than our $350k estimate. EPS came in at $0.06, $0.02 ahead of our $0.04 estimate. Net income and EPS benefitted from a lower than modeled income tax rate (24% actual versus 40%) as

a result of realization of R&D tax credits in the quarter. Going forward, this is expected to return the historical norm of 35% - 40%.

Cash
Electromed exited the quarter with $3.95 million in cash and equivalents, compared to $5.16 million at 12/31/10. Cash used in operating activities was $1.04 million, but stripping out a $1.70 million increase in working capital including $1.38 million increase in A/R), operating cash flow was positive $654k. We see no concern with the increase in A/R as long collection times are very typical of the industry and can cause intermittent spikes in A/R. Cash position remains strong and along with cash from operations and piecemeal draws on the revolver should provide sufficient flexibility to weather any quarterly variability in working capital needs.

Valuation and Recommendation

We are raising our price target on ELMD due to a combination of moving our 2011 EPS estimate from $0.13 prior to Q3 results to $0.15 currently and comparable valuations moving higher since our last update. We are also moving our investment recommendation from Hold to Outperform due to the discrepancy between ELMD's current share price ($3.51) and our new target ($5.50).

We continue to value Electromed using Hill-Rom's long-term PE/G ratio as a comparable. Hill-Rom's long-term PE/G currently sits at 1.64 (up from 1.32 since our last update on ELMD). We model ELMD to post EPS of $0.34 in 2014, implying four-year CAGR of 22.4%. Backing this growth rate into the 1.64 PE/G results in a near-term P/E multiple of 37x. We look for ELMD to earn $0.15/share in fiscal 2011 which values the company at approximately $5.50 per share.

FINANCIAL STATEMENTS

INCOME STATEMENT — Electromed Inc.

	2010 A	Q1A	Q2A	Q3A	Q4E	2011 E	2012 E	2013 E	2014 E
Home Care Revenue	$13,109.0	$3,803.0	$4,246.0	$4,689.0	$4,256.0	$16,994.0	$20,152.0	$23,120.0	$25,810.0
% of total revenue	*91.6%*	*91.3%*	*90.6%*	*90.2%*	*91.7%*	*90.9%*	*91.4%*	*91.1%*	*90.9%*
y-o-y growth	*12.5%*	*29.5%*	*39.5%*	*25.8%*	*25.1%*	*29.6%*	*18.6%*	*14.7%*	*11.6%*
International Revenue	$647.0	$159.0	$199.0	$143.0	$170.0	$671.0	$778.0	$1,020.0	$1,250.0
% of total revenue	*4.5%*	*3.8%*	*4.2%*	*2.8%*	*3.7%*	*3.6%*	*3.5%*	*4.0%*	*4.4%*
y-o-y growth	*-29.6%*	*-21.3%*	*172.6%*	*-46.4%*	*61.9%*	*3.7%*	*15.9%*	*31.1%*	*22.5%*
Gov't / Institutional Revenue	$548.0	$203.0	$241.0	$367.0	$215.0	$1,026.0	$1,130.0	$1,245.0	$1,340.0
% of total revenue	*3.8%*	*4.9%*	*5.1%*	*7.1%*	*4.6%*	*5.5%*	*5.1%*	*4.9%*	*4.7%*
y-o-y growth	*27.7%*	*128.1%*	*127.4%*	*56.2%*	*82.2%*	*87.2%*	*10.1%*	*10.2%*	*7.6%*
Net Sales	$14,303.8	$4,165.4	$4,685.5	$5,199.0	$4,641.0	$18,691.0	$22,060.0	$25,385.0	$28,400.0
YOY Growth	*10.0%*	*29.0%*	*45.4%*	*23.0%*	*28.1%*	*30.7%*	*18.0%*	*15.1%*	*11.9%*
Cost of product sales	$3,707.5	$1,161.9	$1,145.4	$1,495.5	$1,281.0	$5,083.8	$5,945.0	$6,680.0	$7,250.0
Gross Income	$10,596.3	$3,003.5	$3,540.2	$3,703.5	$3,360.0	$13,607.1	$16,115.0	$18,705.0	$21,150.0
Gross Margin	*74.1%*	*72.1%*	*75.6%*	*71.2%*	*71.5%*	*72.8%*	*73.1%*	*73.7%*	*74.5%*
SG&A	$8,199.4	$2,557.3	$2,778.4	$2,759.5	$2,657.3	$10,752.5	$12,552.1	$13,911.0	$15,279.2
% SG&A	*57.3%*	*61.4%*	*59.3%*	*53.1%*	*57.3%*	*57.5%*	*56.9%*	*54.8%*	*53.8%*
R&D	$601.0	$198.4	$218.7	$272.3	$241.3	$930.7	$1,103.0	$1,269.3	$1,420.0
% R&D	*4.2%*	*4.8%*	*4.7%*	*5.2%*	*5.2%*	*5.0%*	*5.0%*	*5.0%*	*5.0%*
Operating Income	$1,796.0	$247.8	$543.0	$671.7	$461.4	$1,923.9	$2,459.9	$3,524.8	$4,450.8
Operating Margin	*12.6%*	*5.9%*	*11.6%*	*12.9%*	*9.9%*	*10.3%*	*11.2%*	*13.9%*	*15.7%*
Interest income, net	($263.4)	($59.7)	($53.2)	($38.1)	($40.0)	($191.0)	($70.0)	$0.0	$120.0
Pre-Tax Income	$1,532.5	$188.1	$489.9	$633.6	$421.4	$1,733.0	$2,389.9	$3,524.8	$4,570.8
Taxes (benefit)	$599.0	$76.0	$198.0	$146.0	$168.6	$588.6	$955.9	$1,409.9	$1,828.3
Tax Rate	*39.1%*	*40.4%*	*40.4%*	*23.0%*	*40.0%*	*34.0%*	*40.0%*	*40.0%*	*40.0%*
Income before non-control interest	$933.5	$112.1	291.9	487.6	252.8	$1,144.4	$1,433.9	$2,114.9	$2,742.5
Margin	*6.5%*	*2.7%*	*6.2%*	*9.4%*	*5.4%*	*6.1%*	*6.5%*	*8.3%*	*9.7%*
Income to non-controlling interest	$17.2	$0.0	0.0	0.0	0.0	$0.0	$0.0	$0.0	$0.0
% of total	*1.8%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*
Net Income	$916.3	$112.1	$291.9	$487.6	$252.8	$1,144.4	$1,433.9	$2,114.9	$2,742.5
Net Margin	*6.4%*	*2.7%*	*6.2%*	*9.4%*	*5.4%*	*6.1%*	*6.5%*	*8.3%*	*9.7%*
EPS	$0.15	$0.02	$0.04	$0.06	$0.03	$0.15	$0.18	$0.26	$0.34
YOY Growth	*-32.3%*	*-70.8%*	*523.0%*	*-22.6%*	*183.1%*	*-2.6%*	*21.2%*	*46.6%*	*29.7%*
Diluted Shares O/S	6,115	7,003	8,116	8,113	8,120	7,838	8,100	8,150	8,150

Source: Zacks Investment Research — *Brian Marckx, CFA*

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BALANCE SHEET **Electromed Inc.**

	March 31, 2011	December 31, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	$ 3,952,032	$ 5,161,270
Accounts Receivable	9,232,544	7,848,776
Inventories	1,664,965	1,535,204
Prepaid expenses and other current assets	324,519	218,197
Deferred income taxes	514,000	514,000
Total current assets	15,688,060	15,277,447
Property and equipment, net	2,770,695	2,758,014
Finite-life intangible assets	1,255,235	1,284,299
Deferred common stock offering costs	-	-
Other assets	191,895	152,081
Total assets	$ 19,905,885	$ 19,471,841
LIABILITIES		
Current liabilities:		
Revolving line of credit	$ 1,268,128	$ 1,268,128
Current maturities of long term debt	435,793	408,206
Accounts payable	603,483	622,909
Accrued compensation	814,579	727,932
Warranty reserve	427,764	424,455
Other accrued liabilities	37,162	44,216
Income tax payable	-	99,592
Total current liabilities	3,586,909	3,595,438
Long term debt, less current	1,693,431	1,832,423
Deferred income taxes	145,000	145,000
Total liabilites	5,425,340	5,572,861
Commitments and contingencies		
STOCKHOLDERS' EQUITY		
Common stock	80,999	80,879
Additional paid-in capital	12,765,802	12,698,785
Retained earnings	1,689,244	12,011,816
Common stock subscription receivable for shares o/s of 48,500	(55,500)	(82,500)
Total stockholders' equity	14,480,545	13,898,980
Total liabilities and stockholders' equity	$ 19,905,885	$ 19,471,841

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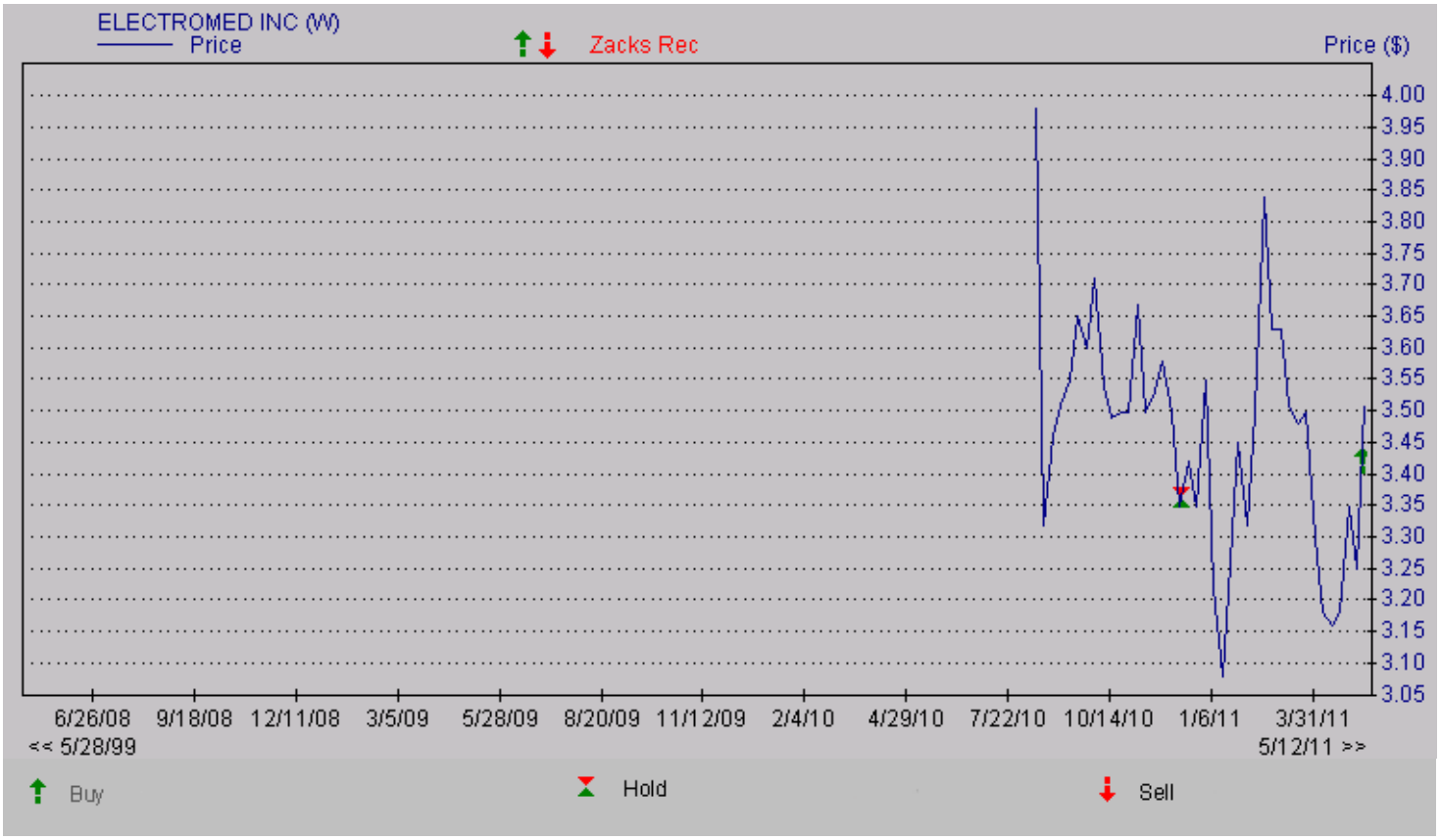
	Nine months March 31, 2011	2010
Cash flows from operating activities:		
Net income	$ 891,371	862,888
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	246,426	223,107
Amortization of finite-life intangible assets	83,848	34,323
Amortization of debt issuance costs	27,778	40,384
Share based compensation expense	129,396	125,846
Deferred income taxes	-	(153,000)
Loss on disposal of P&E	15,758	3,728
Issuance of common stock for services	-	22,500
Changes in operating assets and liabilities:		
Accounts receivable	(2,655,542)	(553,884)
Inventory	(194,190)	(74,612)
Prepaid expenses and other assets	(149,566)	(67,072)
Accounts payable and accrued liabilites	329,215	629,158
Net cash provided by operating activities	(1,275,506)	1,093,366
Cash flows from investing activities:		
Expenditures for P&E	(315,456)	(189,828)
Purchase of nonctonrolling interest in Electromed Financial, LLC	-	(125,000)
Expenditures for finite-life intangible assets	(648,616)	(509,162)
Net cash used in investing activities	(964,072)	(823,990)
Cash flows from financing activities:		
Payments on revolving line of credit	(500,000)	1,268,128
Proceeds from LT debt	-	2,520,000
Principal pymnts on LT debt inc. capital lease obligations	(327,113)	(3,543,933)
Payments of deferred financing fees	(6,717)	(75,780)
Proceeds from stock issuance	6,363,713	-
Proceeds of warrant exercises	24,000	73,332
Expenditures of IPO	-	(328,768)
Repurchase of common stock	-	(18,418)
Proceeds from subscription notes receivable	27,000	9,000
Net cash provided by (used in) financing activities	5,580,883	(96,438)
Net increase (decrease) in cash and cash equivalents	3,341,305	172,938
Cash and cash equivalents, beginning of period	610,727	361,916
Cash and cash equivalents, end of period	$ 3,952,032	534,854

Electromed, Inc

HISTORICAL ZACKS RECOMMENDATIONS



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