Zacks Small-Cap Research

August 22, 2011
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AUXILIO, Inc. (AUXO-OTC)

AUXO: Initiating Coverage - OUTPERFORM

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	08/21/2011
Current Price (08/19/11)	$0.72
Six- Month Target Price	**$2.00**

OUTLOOK

AUXILIO is the only health care exclusive, vendor neutral Managed Print Services (MPS) firm that provides document production management strategies, services and solutions to hospitals throughout the United States. AUXILIO's continuous workflow improvement solutions enable hospitals and health systems to reduce costs and waste in their operational and clinical functions by managing the process of document production between printing and copying equipment and technology. AUXILIO should see a tail wind in its top and bottom-line growth given the Health Information Technology federal mandates; the fact that hospitals are seeking efficiencies to reduce the cost of health care to the public, and because of increasing reductions in Medicare reimbursements. A recent strategic relationship with Sodexo, a leading provider of integrated facilities management services in North America, has been renewed and should nearly double the sales force. We see value in the shares.

SUMMARY DATA

52-Week High	**$0.94**
52-Week Low	**$0.64**
One-Year Return (%)	**N/A**
Beta	**-0.02**
Average Daily Volume (sh)	**3,810**
Shares Outstanding (mil)	**19**
Market Capitalization ($mil)	**$14**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**N/A**
Insider Ownership (%)	**14**
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 2011 Estimate	**N/A**
P/E using 2012 Estimate	**N/A**
Zacks Rank	**2**

Risk Level	**Moderate**
Type of Stock	**Growth**
Industry	**Outsourcing**

ZACKS ESTIMATES

Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2010	3.69 A	3.58 A	3.97 A	4.15 A	15.40 A
2011	4.68 A	4.80 A	4.90 E	5.00 E	19.38 E
2012					22.25 E

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

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2010	$0.00 A	-$0.02 A	-$0.01 A	-$0.05 A	-$0.08 A
2011	-$0.04 A	-$0.03 A	-$0.03 E	-$0.03 E	-$0.13 E
2012					-$0.06 E

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KEY POINTS

- No other Managed Print Services company has its entire business dedicated to solving cost-cutting and waste reduction issues in the document production process within the health care industry.
- Vendor neutral status means negotiating power for 'best equipment, lowest price' regardless of manufacturers' make or model for customers.
- Hospitals are under intense government and public scrutiny to do more with less or cut costs.
- Hospital IT departments are overburdened with federal electronic records mandates and are outsourcing for support services.
- There are approximately 5,795 hospitals in the United States, representing a large market opportunity.
- A partnership agreement with Sodexo gives the firm the inside track on its portfolio of over 1,300 hospitals.

OVERVIEW

AUXILIO, Inc. provides fully-outsourced Managed Print Services (MPS) exclusively to the health care industry throughout the United States. The company is vendor neutral and provides full-time, on-site and trained customer service and technical service representatives that execute customized document management solution programs that are risk-free with guaranteed savings. The company is headquartered out of Mission Viejo, CA.

AUXILIO's vendor neutral position ensures maximum savings and efficiencies by enabling the company to work with a wide range of print-related equipment vendors. Its vendor neutral positioning enables it to offer each of its customers the proper hardware solutions based on need, use and quality.

Furthermore, AUXILIO's risk-free program assumes all costs related to a customer's print environment with no upfront costs, and AUXILIO guarantees savings up to 30 percent for customers at fixed rates that generate service fees for the company. The company's utilization model includes all expenses related to the production of the document, including services, supplies, equipment, finance charges and labor.

Through its validated and proven methodology, proprietary database of information and highly-skilled staff expertise in MPS in hospitals since 2004, AUXILIO performs strategic, operational and financial assessment analyses at the customers' premises and is able to forecast savings and waste reduction. AUXILIO is able to assist hospitals and health systems in reducing expenses by creating manageable, standardized and dependable document management programs.

AUXILIO is the first and only MPS provider in the U.S. dedicated exclusively to the health care industry and hospitals. Its comprehensive and single focus on hospitals provides AUXILIO with a deeper understanding of the cultural and urgent care environment of hospitals, thereby providing its customers with heightened performance levels of caregiver service and satisfaction.

AUXO has retained 100 percent of its hospital partnerships since its launch and currently has a national portfolio of 42 hospitals and manages nearly 700 facilities that consist of affiliated clinical, corporate and administrative support offices. Along the same lines, a recent strategic relationship with Sodexo, a leading

provider of comprehensive service solutions, promotes AUXILIO's Managed Print Services and leverages Sodexo's customer pipeline by providing crucial, C-suite access to over 1,300 U.S. hospitals in the $22 billion market in which AUXILIO competes.



Looking closer at the agreement on May 19th 2011, AUXLIO and Sodexo announced an expanded marketing alliance that will enhance their partnership and deepen the market reach of AUXILIO's MPS program into the U.S. health care industry. The new agreement comes after the successful implementation of the existing agreement that led to four new MPS contracts in 2010.

Sodexo will more than double its investment in AUXILIO's sales resources and marketing efforts to bolster its unique health care exclusive, vendor neutral MPS model deeper into Sodexo's 1,300 hospital portfolio. In exchange, AUXILIO will provide Sodexo with direct equity in the company through the issuance of restricted stock and certain performance based equity and cash commissions based on sales and growth achievements.

Customer Type	Size	Cash Flows
Single	One Single Facility	$15,000 to $50,000 per month
Mid-Size	medium hospital with small clinics attached	$50,000 to $100,000 per month
Large	Large hospital or several facilities	$100,000 to $400,000 per month

Backdrop of growth in MPS

Hospitals are paper intensive businesses. A typical 525-bed hospital will create roughly 35 million documents each year and expend about $1.5 million to print, copy, fax and scan each piece. This cost results in a high proportion of their annual budgets spent on printing and document handling — an estimated nine percent, according to the National Health Service in 2010. The inefficiencies are tremendous in the print environment as there is routinely a fragmented array of printers, scanners and multi-function devices; no management or centralized cost center; an over-burdened staff, and inefficient workflow processes that adversely affect the quality of health care provided to patients.

Enter Managed Print Services (MPS). Hospital management teams, (CEOs, CFOs, and CIOs) across America are seeking best practices and change management techniques to reduce their carbon footprint and to be more accountable and transparent to their boards, stakeholders and the public They are turning to MPS as one of the few remaining areas where they can capture considerable savings (as much as 20 to 30 percent) and efficiencies to improve workflow processes, as well as gain employee productivity and satisfaction, all while reducing waste and making the transition to electronic health records less costly and painful. According to estimates by Photizo Group, the growth of MPS by 2012 will have a carbon reduction impact equivalent to taking 304,000 cars off the road and saving enough energy to power 230,000 homes for a year.

The question today is often not if your hospital should implement MPS, but how best to implement MPS to over-achieve desired results. Creating fundamental, sustainable transformation in workflow processes requires a comprehensive change in a hospital's operations and culture.

EMR Mandate

With its exclusive focus on the health care industry, the Healthcare Information Technology (HITECH) portion of the American Recovery and Reinvestment Act of 2009 (ARRA) offers AUXILIO a unique growth opportunity. The ARRA was initiated with the intent to stimulate the U.S. economy by providing nearly $800 billion in spending and tax cuts. The HITECH portion of the bill includes nearly $20 billion of reimbursement incentives to those providers achieving "Meaningful Use" for the implementation of an Electronic Medical Record System.

The funding is per-physician and hospital or health system and is based on either Medicare or Medicaid charges. Eligible physicians can receive up to $44,000 in incentive payments under the Medicare provision or up to $63,750 under the Medicaid provision. The funding began in May 2011 for those who achieve Stage 1 "Meaningful Use". It is expected that Medicare will begin applying penalties to hospitals and physicians who fail to adopt an Electronic Medical Record System starting in 2015.

Solutions that maximize interoperability of hardware and EHR software across the enterprise and improve workflow processes in a hospital's print environment are vital to the successful implementation of electronic records management. The world renowned ECRI Institute in 2010, identified four steps to EHR implementation success, the first one advised to 'map out the existing workflow and clinical data flow at your organization,' which is precisely the service AUXILIO's MPS program performs.

AUXILIO's unshared position as the only managed print service provider in the U.S. dedicated exclusively to the health care industry provides a greater opportunity for hospitals to tap into HITECH incentives by bringing its unique expertise and knowledge in assisting customers in the preparation of electronic records management and the complex compliance requirements of the 'meaningful use' criteria federal mandates.

AUXILIO is able to assist its customers in electronic records management preparation by solving device connectivity issues from department to department, facility-to-facility, and person-to-person, and uses its trained full-time, on-site teams to support hospital staff in the design and application of practical solutions to software that are customized and standardized.

Typical Customer Case Study

Let's look at a hospital with three campuses that has approximately 1,000 beds and averages five million documents per month at an average cost of $0.045 per document. (This assumes a 60% printer/fax 40% copier split) The problem before the assessment is that no one owns the process. It is a bad mix of dysfunction and under-utilized technology. Through a combination eliminating multiple vendor invoices and bringing the system together in a centralized managed process, AUXILIO can manage entire process for $0.035 per document which represents a 20% discount. This translates to savings to the hospital of $43,000 per month or $2.6 million over the life of the contract. (Assumes a three-five year contract) That savings could improve if the firm is able to reduce the total documents produced per month. The revenue for AUXILIO in this case is projected at $170,000 per month. On a margin basis, most projects take several months to be profitable before settling in at around 20%.

Combine this type of cost saving potential with the fact that most hospitals are reeling from Medicare cuts and you have a powerful business model. In a white paper on www.healthaffairs.org, Author James Robinson illustrates how hospitals respond to Medicare payment shortfalls. The study presents empirical evidence that faced with shortfalls between Medicare payments and projected costs, hospitals in concentrated markets focus on raising prices to private insurers, while hospitals in competitive markets focus on cutting costs.



Opportunity

The potential for growth as the only exclusive MPS provider to the health care industry is enormous. There are approximately 5,795 hospitals in the United States of which only 42are current clients. The Sodexo partnership opens the company up to over 1,300 potential new customers, which the firm has direct access to and the inside track to its C-suite. Four Sodexo contracts were signed in 2010. They include the Johns Hopkins Health System (made up of over 100 clinical and administrative support facilities and five hospitals) Palisades Medical Center, St. Joseph's in Yonkers and New York Hospital Queens. AUXILIO's three year goal is to have 80 hospitals with an average of 300-500 beds each with three-five year contracts.

Beyond the obvious huge number of potential hospitals, the health care industry in general is set to take on a greater and greater piece of the GDP pie given the aging baby boom generation. According to the American Hospital Association (AHA), the over-65 population will nearly triple between 1980 and 2030 as a result of the aging Baby Boomers, adding new demands and challenges on an already stressed-out health system.

The first Boomers will turn 65 this year and, more than 37 million of them - six out of 10 - will be managing more than one chronic condition by 2030. Also by 2030:

- 14 million Boomers will be living with diabetes - that's one out of every four Boomers.
- Almost half of the Boomers will live with arthritis and that number peaks to just over 26 million in 2020.
- More than one out of three Boomers - over 21 million - will be considered obese.

As patients live with multiple chronic diseases, demand for services will increase. The number of physician visits has been increasing for all adults, up 34 percent over the last decade, and this trend is expected to continue. By 2020, Boomers will account for four in 10 office visits to physicians. Over the next 20 years, Boomers will make up a greater proportion of hospitalizations as they live longer but with multiple complex conditions.

INDUSTRY OUTLOOK

Our outlook for the business services industry is positive. Companies in this broadly characterized industry provide consulting, information and data, information technology (IT), marketing, payment processing, staffing, and other outsourcing services to businesses. The industry is generally tied to the economy, and is related to growth in business spending. Most firms in this industry have straightforward business models that generate healthy cash flows, low debt levels, and negligible dividend payouts. Firms in this industry are wide-ranging in terms of size, market share, and geographic reach.

INDUSTRY POSITION

AUXILIO operates in a highly competitive market in which the majority of competition comes from the large photocopy/multi-functional digital device manufacturers such as Xerox, Canon, Konica Minolta, Ricoh and Sharp. Smaller competitors are also found in a number of regional and local equipment dealers and distributors in the communities that the hospitals serve. In addition, in-house departments perform some of the functions the firm seeks to outsource.

AUXILIO is entirely focused on the health care industry. No other vendor/service provider has its entire business dedicated to solving issues within the health care industry.

Benefits include

- Hospitals need only pay a single invoice.
- Not restricted to any single equipment vendor.
- AUXILIO maintains a daily connection with the hospital.
- Operate the print management process as a department in the hospital with full-time staff on-site.

RECENT NEWS

On August 15, 2011, AUXILIO, Inc., reported financial results for its fiscal 2011 second quarter, ended June 30, 2011. A solid quarter resulted in a 34 percent year over year increase in sales, with revenue expanding to $4.803 million from $3.587 million for the three months ended June 30, 2010.

AUXILIO's strength in second quarter revenues was primarily driven by new MPS contracts as well as the Company's recurring revenue base that reflects its 100 percent customer retention rate.

The Company has retained 100 percent of its hospital partnerships since its launch and currently has a national portfolio of 42 long-term contracts representing hospitals, health care systems and affiliated clinical and administrative support offices that consist of over 100 facilities.

AUXILIO reported a net loss of $569,696, falling $216,398 from a net loss of $353,298 for the second quarter of 2010.While year over year operating expenses increased by $208,857 or 18 percent, the year over year decrease in net income was primarily the product of a drop in gross margin.

Gross margin fell from 22 percent in the second quarter of 2010, down to 16.3 percent for the three months ended June 30, 2011. Margins were negatively impacted by increased costs associated with absorbing new customer's legacy contracts with third party vendors. It is important to note that as AUXILIO implements its programs, it attempts to improve upon these legacy contracts, therefore reducing costs over the term of the contract.

The Company continued to show significant strength and improvement in milestones as evidenced by new MPS contract sales, increased resources through a marketing alliance and improved presence in its current markets.

As previously mentioned AUXILIO was able to gain traction from the MPS contracts signed over the past 12 months including five new MPS contracts beginning in the fourth quarter of 2010.

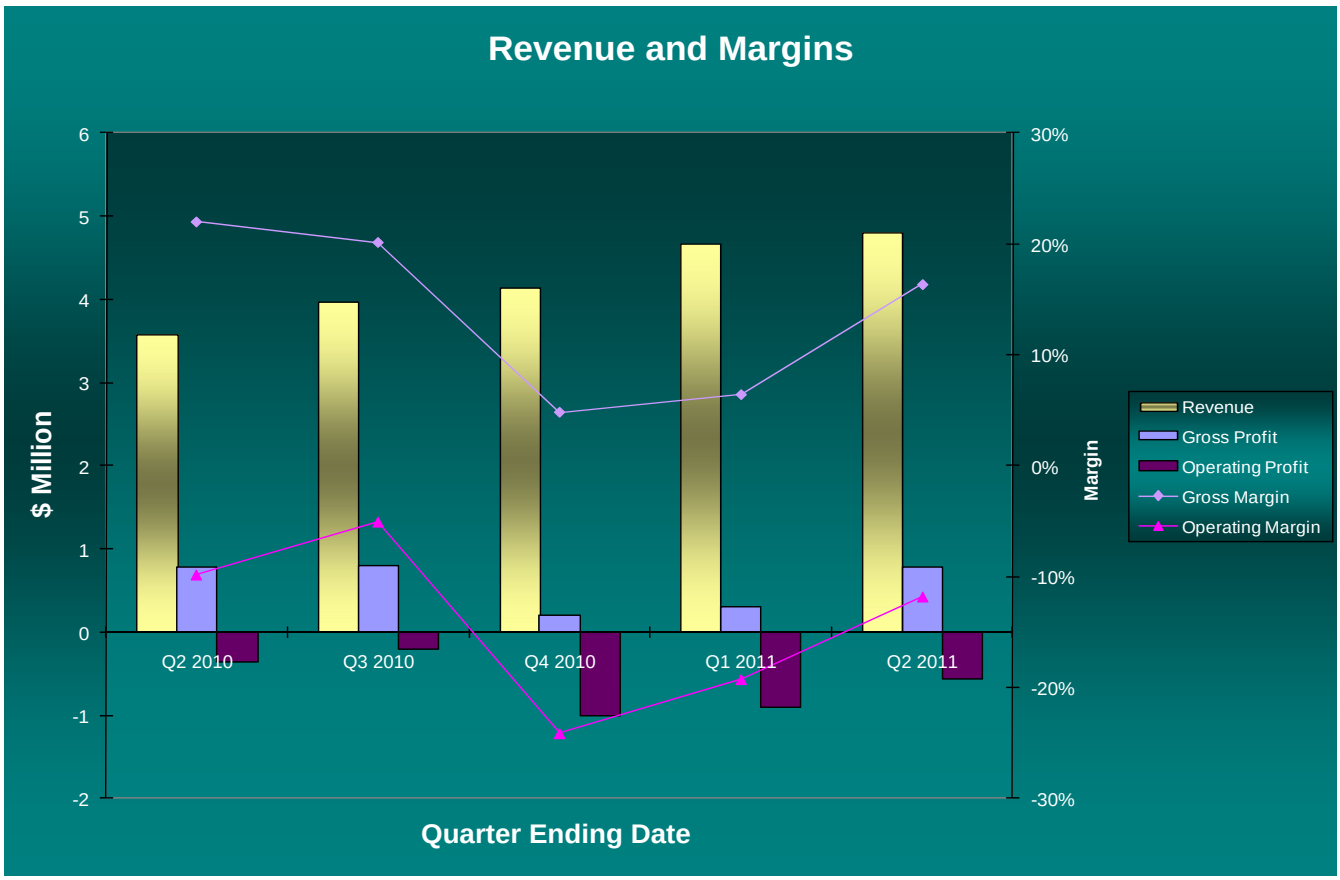
Similarly, it should be noted that the Company's improved sales efforts have recently resulted in AUXILIO closing six new recurring revenue contracts between March 2010 and December 2010.These new recurring revenue contracts were a monumental part of the improved strength in the Company's second quarter revenue growth.

AUXILIO was able to increase its presence in current markets by expanding relationships with Saint Alphonsus Health System in Idaho, Saint Joseph's Medical Center of Yonkers in New York and MemorialCare Health System in Southern California.

Along the same lines, in July 2011, the Company signed a three-year contract with Holy Cross Hospital in Maryland. Other promising accomplishments during the second quarter included the securing of an expanded marketing alliance with Sodexo, a leading provider of comprehensive service solutions.

It important to note that the progress made during the second quarter was based on current sales force efforts and that AUXILIO expects the expanded relationship with Sodexo to further advance sales progress as well as expand the ability to attract and sign new customer contracts.

The strategic relationship with Sodexo promotes AUXILIO's managed print solutions and leverages Sodexo's customer pipeline by providing crucial, C-suite access to over 1,300 U.S. hospitals in the $22 billion market in which the firm competes.



VALUATION

Several factors point to AUXILIO growing faster than the overall industry.

- The cost saving nature of the business combined with the fact that hospitals are under pressure to cut costs.
- The aging population which will require more health care assets.
- The fact that AUXILIO remains the only Managed Print Services Company has its entire business dedicated to the health care industry.
- The partnership agreement with Sodexo gives the firm the inside track on its portfolio of over 1,300 hospitals.

Investors should be aware that signing new clients and realizing immediate profits do not go hand and in hand. Contracts signed in 2010 provide a microcosm into how cash flows are affected by new business. During the latter part of 2010, AUXILIO signed five new long-term customer contracts. As such, its results only represent a small portion of the revenue related to these new contracts but recognized many of the costs related to starting up an account, such as commissions, travel, recruiting and “onboarding” of new employees and other upfront costs. In addition, AUXILIO assumes the customer's legacy contracts with third party vendors when it signs a new account and absorbs related costs at the beginning of the relationships. However, after a period of time, AUXILIO is able to favorably restructure the contracts. As a result of these factors, the company’s gross and operating margins are negatively impacted, but are expected to improve over the life of the contracts. These factors are symptomatic of a service model, and as such, AUXILIO expects for them to continue as the business grows and new contracts are added.

To value the firm we assume AUXILIO takes a moderate share of the market over the next ten years and then grows at the rate of the economy after that.

The intrinsic value is essentially a sum of the company's future earnings, minus any long-term debt. Dividing the intrinsic value by the number of shares outstanding yields an intrinsic stock price. We used the following inputs:

- A 10-year period with an earnings growth rate of 15% and a discount rate of 11.43%.
- A continuing period assumed to go on forever, with earnings growing at 3% and a discount rate of 9.87%.

We also used a relative valuation model of 1.5x sales using the same discount rates.

With these inputs we arrive at a target price of **$2.00.**

RISKS

- The majority of the competition in the health care industry market for Managed Print Services comes from the large photocopy/multi-functional digital device manufacturers such as Xerox, Canon, Konica Minolta, Ricoh and Sharp.

- AUXILIO's largest customers represent approximately 70% of revenues for the year ended December 31, 2010. While that should fall to less than 36% of revenue for 2011, the loss of any of these customers would hurt results.

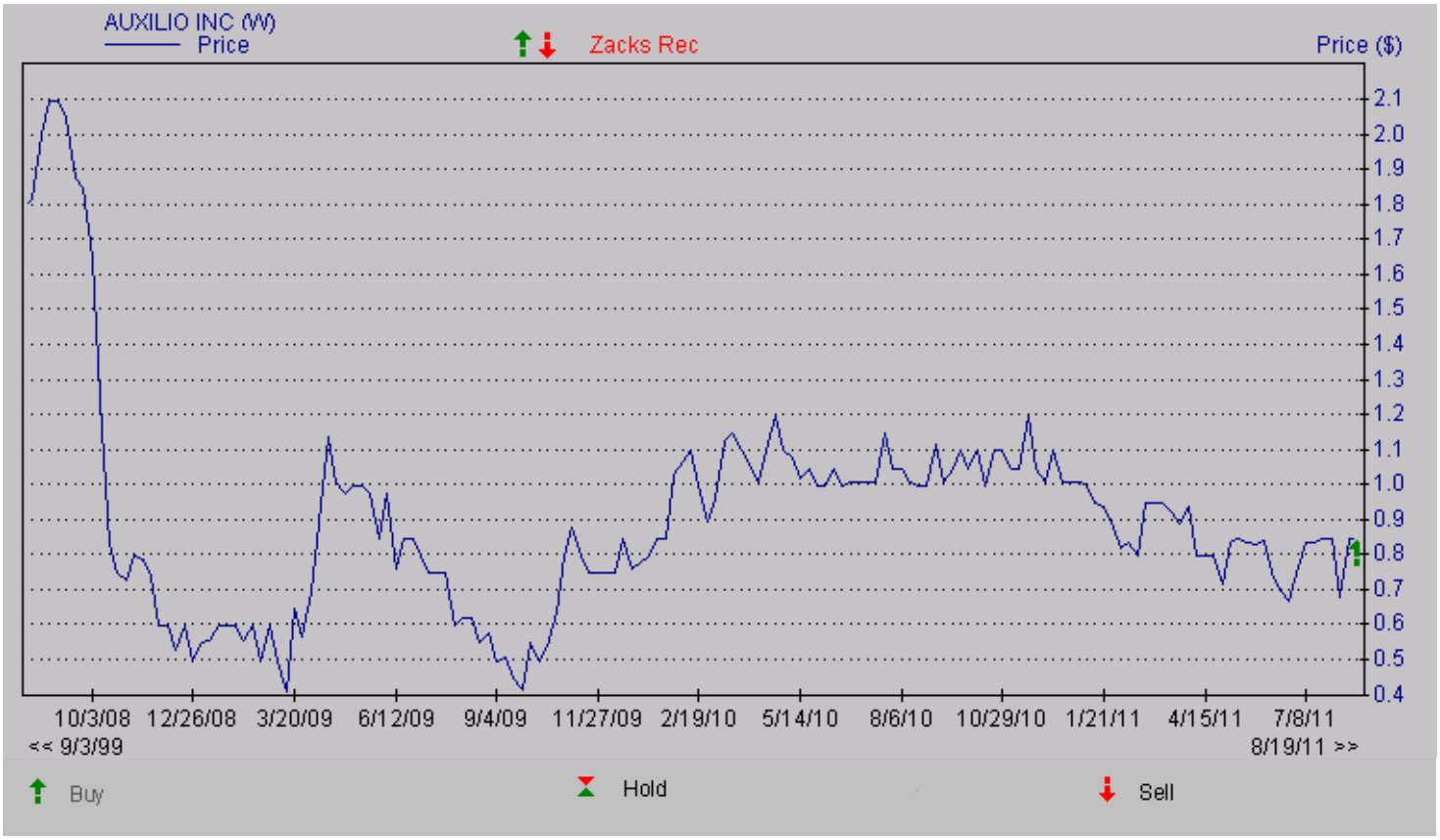
- The market for the firm's products and services is competitive and is likely to become even more competitive in the future. Increased competition could result in pricing pressures, reduced sales, reduced margins or the failure of products and services to achieve or maintain market acceptance.

PROJECTED INCOME STATEMENT

INCOME STATEMENT ($ Millions)	Sep-10 Q3 10	Dec-10 Q4 10	Mar-11 Q1 11	Jun-11 Q2 11	Sep-11 Q3 11 E	FY 2008	FY 2009	FY 2010	FY 2011 E	FY 2012 E
REVENUE										
Net Revenue	**3.97**	**4.15**	**4.68**	**4.80**	**4.90**	**21.02**	**15.98**	**15.41**	**19.38**	**22.25**
Sequential Growth		*5%*	*13%*	*3%*	*2%*					
OPERATING EXPENSES										
Cost of Revenues	3.14	3.94	4.34	4.02	4.05	15.91	11.93	12.53	16.9	18.2
% of Revenue	*79.0%*	*95.0%*	*92.7%*	*83.7%*	*82.7%*					
Gross Profit -	**0.84**	**0.21**	**0.34**	**0.78**	**0.85**	**5.11**	**4.05**	**2.88**	**2.5**	**4.0**
Proforma Gross Margin	*21.0%*	*5.0%*	*7.3%*	*16.3%*	*17.3%*	*24.3%*	*25.3%*	*18.7%*	*12.8%*	*18.1%*
R&D + Engg	0.00	0.00	0.00	0.00	0.00	0.0	0.0	0.0	0.0	0.0
% of Revenue	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*0.0%*
SG&A	1.01	1.24	1.20	1.35	1.38	4.34	3.99	4.43	4.90	5.22
% of Revenue	*25.5%*	*29.9%*	*25.7%*	*28.1%*	*28.1%*	*20.7%*	*24.9%*	*28.7%*	*25.3%*	*23.5%*
GW Amort, Restructuring, other	-	-	-	-	-	*0.2*	-	-	-	-
% of Revenue										
Total Operating Expenses	1.01	1.24	1.20	1.35	1.38	4.54	3.99	4.43	4.90	5.22
% of Revenue	*25.5%*	*29.9%*	*25.7%*	*28.1%*	*28.1%*	*21.6%*	*24.9%*	*28.7%*	*25%*	*23%*
Operating Income -	**-0.18**	**-1.03**	**-0.86**	**-0.57**	**-0.52**	**0.57**	**0.06**	**(1.55)**	**-2**	**-1**
Operating Margin	*-4.5%*	*-24.9%*	*-18.3%*	*-11.8%*	*-10.7%*	*3%*	*0%*	*2%*	*-12%*	*-5%*
NON-OPERATING ITEMS										
Non operating Income/Expense	0	0	0	0	0	(0.62)	-0.1	0.01	0	0
% of Revenue	*-0.05%*	*-0.05%*	*-0.06%*	*-0.06%*	*-0.06%*	*-2.95%*	*-0.58%*	*0.04%*	*0.03%*	*0.02%*
Tax Provision	0.000	0.009	0.002	0.000	0.000	0.056	0.011	0.015	0.015	0.000
Net Income -	**-0.18**	**-1.04**	**-0.86**	**-0.57**	**-0.53**	**(0.10)**	**(0.04)**	**(1.56)**	**-2.4**	**-1.2**
Net Income Margin	*-4.5%*	*-25.1%*	*-18.4%*	*-11.9%*	*-10.8%*	*-0.5%*	*-0.3%*	*-4%*	*-13%*	*-5%*
EARNINGS PER SHARE										
EPS - Basic	-$0.01	-$0.05	-$0.04	-$0.03	-$0.03	-$0.01	$0.00	-$0.08	-$0.13	-$0.06
EPS - Diluted	-$0.01	-$0.05	-$0.04	-$0.03	-$0.03	-$0.01	$0.00	-$0.08	-$0.13	-$0.06

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