

Zynex Inc

(ZYXI-OTC)

ZYXI: Q3 Mostly In-Line, Beat on EPS

| | |
|-------------------------------|----------------|
| Current Recommendation | Neutral |
| Prior Recommendation | Outperform |
| Date of Last Change | 08/08/2012 |
| Current Price (11/07/13) | \$0.25 |
| Target Price | \$0.45 |

OUTLOOK

Both revenue and gross margins have taken a big hit in the electrotherapy business, which remains the bulk of ZYXI revenue. It's now obvious that recent healthcare reform measures and changes to reimbursement are the culprit - something we had been concerned about. ZYXI will now have to have a more determined focus on diversifying revenue sources and reducing exposure to third-party reimbursement. New product launches, a new medical billing and consulting segment, and collaborations may now be where the growth opportunities exist - but may not materialize for some time. Another key to maximize EPS is controlling op expenses, which has been an issue for Zynex. We made significant downward revisions to our model following Q2. Longer-term upside to our model could come from pipeline and new services business.

SUMMARY DATA

| | |
|---------------------------|--------|
| 52-Week High | \$0.76 |
| 52-Week Low | \$0.20 |
| One-Year Return (%) | -66.67 |
| Beta | 0.60 |
| Average Daily Volume (sh) | 37,881 |

**Above Avg.,
Small-Blend
Med Products**

| | |
|-------------------------------|-----|
| Shares Outstanding (mil) | 31 |
| Market Capitalization (\$mil) | \$8 |
| Short Interest Ratio (days) | N/A |
| Institutional Ownership (%) | 0 |
| Insider Ownership (%) | N/A |

| | |
|----------------------|--------|
| Annual Cash Dividend | \$0.00 |
| Dividend Yield (%) | 0.00 |

| | |
|-------------------------------|------|
| 5-Yr. Historical Growth Rates | |
| Sales (%) | 30.1 |
| Earnings Per Share (%) | 16.8 |
| Dividend (%) | N/A |

| | |
|-------------------------|-----|
| P/E using TTM EPS | N/A |
| P/E using 2013 Estimate | N/A |
| P/E using 2014 Estimate | N/A |

| | |
|------------|-----|
| Zacks Rank | N/A |
|------------|-----|

ZACKS ESTIMATES

Revenue

(in '000 of \$)

| | Q1 | Q2 | Q3 | Q4 | Year |
|------|---------|----------|----------|----------|----------|
| | (Mar) | (Jun) | (Sep) | (Dec) | (Dec) |
| 2012 | 8,944 A | 10,026 A | 10,102 A | 10,594 A | 39,666 A |
| 2013 | 7,668 A | 5,472 A | 5,191 A | 5,211 E | 23,542 E |
| 2014 | | | | | 23,099 E |
| 2015 | | | | | 24,136 E |

Earnings per Share

| | Q1 | Q2 | Q3 | Q4 | Year |
|------|-----------|-----------|-----------|-----------|-----------|
| | (Mar) | (Jun) | (Sep) | (Dec) | (Dec) |
| 2012 | \$0.01 A | \$0.02 A | \$0.01 A | \$0.01 A | \$0.05 A |
| 2013 | -\$0.01 A | -\$0.06 A | -\$0.02 A | -\$0.03 E | -\$0.12 E |
| 2014 | | | | | -\$0.07 E |
| 2015 | | | | | -\$0.03 E |

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

Q3 2013 Financial Results: *Slight Miss on Revenue But GM, Cost Reductions Result in EPS Beat*

Zynex reported financial results for the third quarter ending September 30, 2013 on November 11th. For the second straight quarter revenue was at a relatively depressed level as a result of recent changes to reimbursement that have had a fairly dramatic negative impact on Zynex's top line, which we had previously warned was a serious concern of ours. Following a significant sequential plunge in revenue from Q1 to Q2 we made substantial downward adjustments to our modeled revenue when we felt it was clear that our concerns relative to potential reimbursement issues had become a reality. This was also the impetus for moving our investment recommendation from Outperform to Neutral.

Q3 revenue came in only slightly below our revised number, with almost all of the 7% miss related to rental revenue (as opposed to product sales). Importantly, operating expenses fell 23% from Q2 (sequentially) with revenue only contracting 5% over the same period. Gross margin also ticked up 460 basis points from Q2. So while revenue continues to go in the wrong direction, management's efforts to cut costs along with GM holding up better than what we had expected, helped soften the blow to bottom line with EPS beating our number by \$0.02. Moreover, the company's earnings release (which was reiterated on the call) notes that orders for the Zynex Medical division have stabilized which, if that ends up being the case, we view as a real positive sign. Stabilized revenue in the core business along with incremental revenue growth coming from new product introductions, distribution arrangements and from the company's new Billing and Consulting business (which in aggregate contribute relatively little currently) means that revenue may be at or close to bottoming at the \$5.2 million level posted in Q3.

Despite the potential for these other areas to spark (potentially significant) top-line and earnings growth over the long-term, as we have noted in the past, we will model relatively little in contribution from these sources until there's more evidence of the real potential of these business, partnerships and products.

And notwithstanding the significant sequential improvement in operating expenses, we also continue to remain concerned about the elevated expense base - something we have had an ongoing concern about for some time given the lack of operating leverage growth over the past years despite very substantial growth in revenue (through FY2012). Management noted on the Q2 call that they began trimming their expense base (reduction in headcount and fixed expenses, including a reduction in current year building lease) - which clearly benefitted Q3 earnings and cash. However, in the absence of a major uptick in revenue from ancillary sources (i.e. - ex-Zynex Medical) in order to return to profitability in the current reimbursement environment and with narrowing gross margins (relative to 2012 and before), we believe operating expense cuts may necessitate more extreme measures.

Revenue of \$5.2 million fell 49% yoy, was down 5% sequentially and was about 7% lower than our \$5.6 million estimate. Rental revenue was \$1.3 million, down 44% yoy (-22% sequentially) and about 19% lower than our \$1.6 million estimate. Equipment sales fell 48% yoy (+58% sequentially) with consumables falling 52% (-25% sequentially). As we first noted with Q2 earnings, consumables revenue showing a substantial decline is concerning as that was the one revenue source that had held up relatively well in the recent past due to consumables feeding a greater installed base. This puts that much more pressure on ZYXI's other business lines (NeuroDiagnostics, Billing and Consulting) to pick up the slack.

Revenue

Total revenue consisted of \$1.3 million (-44% y-o-y) in rentals and \$3.9 million (-50% y-o-y) in product sales. The equipment portion of product sales was about \$560k (39%) higher than our estimate while the consumables portion was about \$670k (26%) lower.

| | <u>Actual</u> <u>Q3 2012</u> | <u>Actual</u> <u>Q3 2013</u> | <u>Y-o-Y</u> <u>Change</u> | <u>Zacks Est</u> <u>Q3 2013</u> | <u>Actual +/-</u> <u>Zacks est.</u> |
|----------------------------|---------------------------------|---------------------------------|-------------------------------|------------------------------------|--|
| Consumables | \$4,018 | \$1,921 | -52.2% | \$2,589 | -25.8% |
| Equipment Sales | \$3,803 | \$1,986 | -47.8% | \$1,430 | 38.9% |
| Total Product Sales | \$7,821 | \$3,907 | -50.0% | \$4,019 | -2.8% |
| Rental Revenue | \$2,281 | \$1,284 | -43.7% | \$1,580 | -18.7% |
| | \$10,102 | \$5,191 | -48.6% | \$5,599 | -7.3% |

Gross Margin

Gross margin at 70.2% was considerably weaker than the year earlier period (78.1%) but was much better than our 66% estimate and improved from the 65.6% in Q2, which was the lowest since at least 2006. Both rental and product sales margins ticked up from Q2. While we think the Billing and Consulting business may provide greater margins, there may not be much in the way of revenue contribution from this business in the remainder of the current year (management noted on the call that Billing and Consulting contributed about 1% of total revenue in Q3).

Net Income / EPS

Net income and EPS were (\$749)k and (\$0.02) which compared favorably to our (\$1.3) million and (\$0.04) estimates. The difference coming from the slight top-line miss which was more than offset by stronger GM and lower operating expenses relative to our estimates.

Cash

Zynex exited Q3 with \$468k in cash and equivalents, roughly flat from the end of Q2. Cash from operating activities was an inflow of \$264k which benefitted from \$799k in A/R collections and from ZYXI being able to defer rent payments per the recently revised lease terms. ZYXI was also able to reduce the amount outstanding on the line of credit by about \$580k, although we think the credit line remains close to being fully tapped.

Guidance

As of the Q2 2013 earnings release management has not provided specific revenue and EPS guidance.

OUTLOOK: *Healthcare Reform / Reimbursement Changes SERIOUSLY Effecting Revenue and Margins. New products, distribution agreements and services revenue could spark incremental growth...*

We made significant downward revisions to our model following the substantially disappointing numbers in Q2 which we think validated our concerns that we expressed over the past few quarters that reimbursement, or a reduction thereof, could be a major risk. As a reminder, we had noted that additional risk was introduced from the Centers for Medicare & Medicaid Services (CMS) deciding in June 2012 that, effective immediately, they would no longer provide reimbursement for TENS for chronic low back pain. Only a relatively small percentage of Zynex's (we estimate it's less than 10%) revenue comes from Medicare and CMS's recent decision relates only to chronic low back pain - both of which we felt could help insulate the impact to Zynex. However, as Medicare reimbursement policies go, so often does private insurers. We felt that this, along with other recent healthcare reform and reimbursement changes, could negatively impact ZYXI's revenue and margins. Management had previously indicated that they did not see this as a major risk - however, we think it's now clear that this is seriously negatively impacting revenue and gross margins.

Our model continues to incorporate the assumption that the electrotherapy business provides the bulk of revenue and we still do not incorporate any contribution from the aforementioned blood monitoring device or any significant contribution from the new Billing and Consulting business - both of which could provide some upside to our model - particularly in the out-years. Zynex's recently penned distribution arrangements, including acting as distributor for certain sleep apnea devices also offer opportunity to spark additional revenue growth.

While our model does not incorporate any revenue contribution from the blood monitoring device as few details have been revealed about the device or the related development/trials, we will update our model when we are more comfortable with the chances of eventual regulatory approval and commercialization of this product as well as other products under development. We will also incorporate a more substantial contribution from the new Billing and Consulting business and distribution-related revenue if and when it's appropriate.

VALUATION

We model negative EPS through 2016 (the out-year in our model). Our valuation methodology is based on book value. We use a 1.5x book value multiple which puts fair value at approximately \$0.45. We are maintaining our Neutral rating.

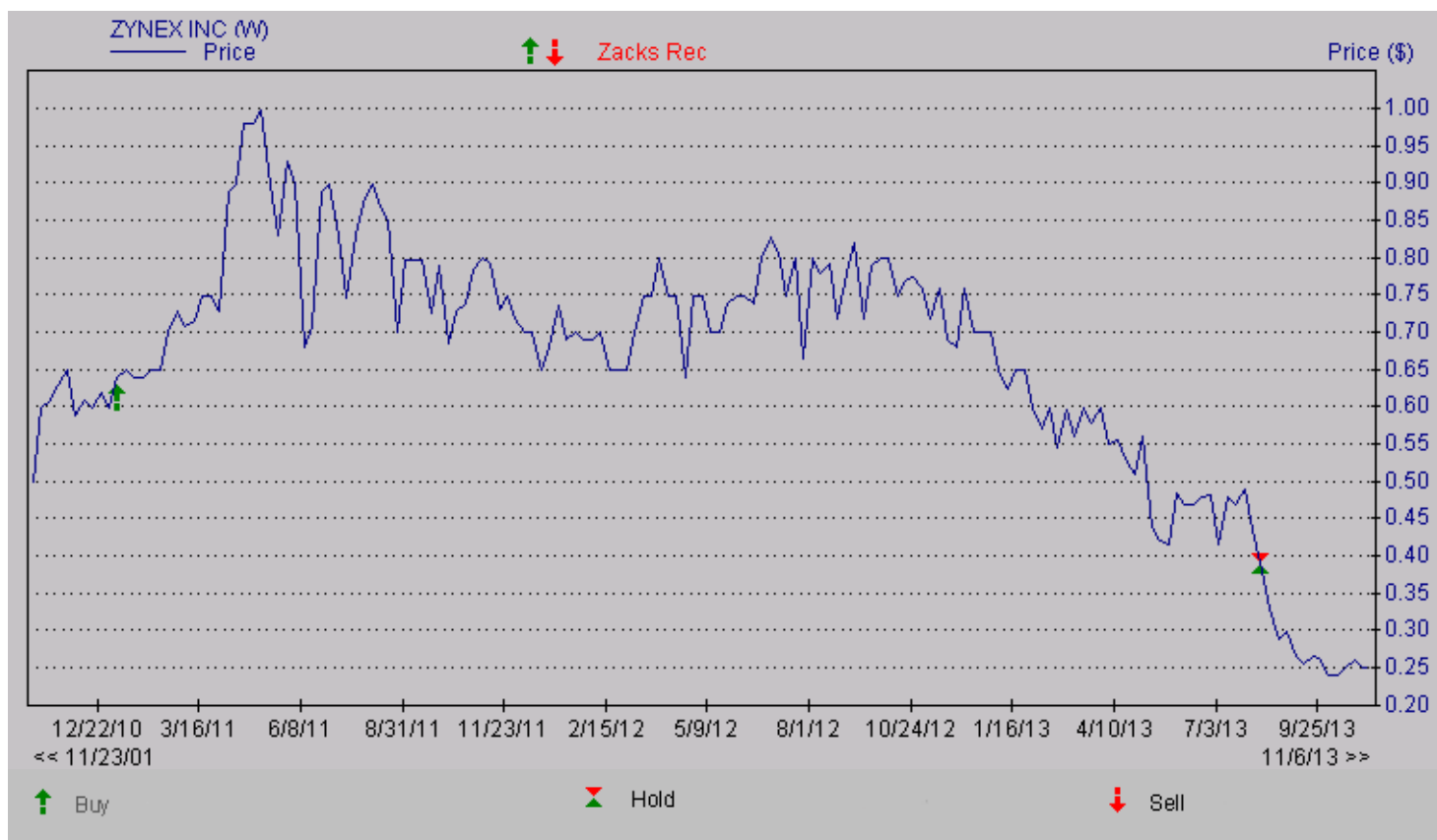
FINANCIAL MODEL

Zynex Inc.

| | 2012 A | Q1A | Q2A | Q3A | Q4E | 2013 E | 2014 E | 2015 E | 2016 E |
|----------------------------------|------------|-----------|-------------|-------------|-------------|-------------|-------------|-------------|------------|
| Total Revenues | \$39,666.0 | \$7,668.0 | \$5,472.0 | \$5,191.0 | \$5,210.7 | \$23,541.7 | \$23,099.2 | \$24,135.7 | \$25,235.0 |
| <i>YOY Growth</i> | 16.2% | -14.3% | -45.4% | -48.6% | -50.8% | -40.7% | -1.9% | 4.5% | 4.6% |
| Cost of Revenues | \$8,770.0 | \$2,191.0 | \$1,883.0 | \$1,546.0 | \$1,646.7 | \$7,266.7 | \$7,101.0 | \$7,341.5 | \$7,639.8 |
| Gross Income | \$30,896.0 | \$5,477.0 | \$3,589.0 | \$3,645.0 | \$3,563.9 | \$16,274.9 | \$15,998.2 | \$16,794.3 | \$17,595.3 |
| <i>Gross Margin</i> | 77.9% | 71.4% | 65.6% | 70.2% | 68.4% | 69.1% | 69.3% | 69.6% | 69.7% |
| SG&A | \$28,159.0 | \$5,833.0 | \$6,153.0 | \$4,713.0 | \$4,689.6 | \$21,388.6 | \$18,964.5 | \$18,488.0 | \$18,169.2 |
| <i>% SG&A</i> | 71.0% | 76.1% | 112.4% | 90.8% | 90.0% | 90.9% | 82.1% | 76.6% | 72.0% |
| Operating Income | \$2,737.0 | (\$356.0) | (\$2,564.0) | (\$1,068.0) | (\$1,125.7) | (\$5,113.7) | (\$2,966.2) | (\$1,693.7) | (\$574.0) |
| <i>Operating Margin</i> | 6.9% | -4.6% | -46.9% | -20.6% | -21.6% | -21.7% | -12.8% | -7.0% | -2.3% |
| Interest income, net | (\$432.0) | (\$130.0) | (\$214.0) | (\$136.0) | (\$145.0) | (\$625.0) | (\$400.0) | \$0.0 | \$50.0 |
| Other income | \$31.0 | (\$6.0) | \$78.0 | \$0.0 | \$8.0 | \$80.0 | \$0.0 | \$0.0 | \$0.0 |
| Gain on value of derivative liab | \$0.0 | \$0.0 | \$0.0 | \$0.0 | \$0.0 | \$0.0 | \$0.0 | \$0.0 | \$0.0 |
| Pre-Tax Income | \$2,336.0 | (\$492.0) | (\$2,700.0) | (\$1,204.0) | (\$1,262.7) | (\$5,658.7) | (\$3,366.2) | (\$1,693.7) | (\$524.0) |
| Taxes | \$788.0 | (\$182.0) | (\$973.0) | (\$455.0) | (\$429.3) | (\$2,039.3) | (\$1,144.5) | (\$575.9) | (\$178.1) |
| <i>Tax Rate</i> | 33.7% | 37.0% | 36.0% | 37.8% | 34.0% | 36.0% | 34.0% | 34.0% | 34.0% |
| Net Income | \$1,548.0 | (\$304.0) | (\$1,727.0) | (\$749.0) | (\$833.4) | (\$3,619.4) | (\$2,221.7) | (\$1,117.8) | (\$345.8) |
| <i>YOY Growth</i> | -0.9% | -195.0% | -465.1% | -309.2% | -309.9% | -333.8% | -38.6% | -49.7% | -69.1% |
| <i>Net Margin</i> | 3.9% | -4.0% | -31.6% | -14.4% | -16.0% | -15.4% | -9.6% | -4.6% | -1.4% |
| EPS | \$0.05 | (\$0.01) | (\$0.06) | (\$0.02) | (\$0.03) | (\$0.12) | (\$0.07) | (\$0.03) | (\$0.01) |
| <i>YOY Growth</i> | -1.7% | -194.7% | -466.3% | -310.4% | -309.3% | -333.9% | -40.0% | -50.0% | -69.5% |
| Diluted Shares O/S | 31,222 | 31,148 | 31,148 | 31,148 | 31,375 | 31,205 | 31,950 | 32,150 | 32,600 |

Brian Marckx, CFA

HISTORICAL ZACKS RECOMMENDATIONS



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