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Research Update

Zynex, Inc.

Rating: Neutral

Juan Noble

ZYXI $0.18 (ZYXI: OTC)

November 12, 2014

	2012A	2013A	*2014E*	*2015E*
Total revenues (in millions)	$40.0	$21.7	***$12.4***	***$14.9***
Earnings (loss) per share	$0.05	($0.23)	***($0.24)***	***($0.07)***

52 - Week range	$0.51 – $ 0.06	Fiscal year ends:	December
Shares outstanding as of Nov. 4, 2014	31.3 million	Revenue/share (ttm)	$0.39
Approximate float	13 million	Price/Sales (ttm)	0.5X
Market Capitalization	$5.6 million	Price/Sales (2015)E	0.4X
Tangible Book value as of Sept 30, 2014	NA	Price/Earnings (ttm)	NA
Price/Book	NA	Price/Earnings (2015)E	NA

Zynex, Inc., based in Lone Tree, Colorado, manufactures a line of electrotherapy devices that relieve pain while reducing reliance on drugs, and speeds rehabilitation and recovery of i mobility. The company also produces diagnostic devices and distributes electrotherapy systems manufactured by others. A substantial portion of revenue is recurring – device rentals and the sale of electrodes and batteries sent to patients using rented or purchased units.

Key Investment Considerations:

Reiterating Neutral investment rating.

ZYXI has rationalized its product line and sharply reduced operating expenses. Sales appear to be stabilizing, potentially enabling the company to begin a revenue growth recovery in 2015 even if the outlook remains difficult due to reduced demand and more restrictive insurance reimbursement.

Revenue has fallen sharply during the past two years, reflecting a drop in demand stemming from broad reductions in Medicare reimbursements for medical devices, Medicare's curtailment of reimbursement for TENS use for relief of chronic lower back pain, and physician uncertainty over the impact of the Patient Protection and Affordable Care Act (PPACA).

We project some recovery in demand which should reverse the decline in revenue and narrow losses in 2015 but the process of regaining profitability could be a lengthy one.

For 2014 we project a loss of ($0.24) per share, including ($0.09) per share due to inventory write-offs, on revenue of $12.4 million. Previously we projected a 2014 loss of ($0.25) per share loss on revenue of $11.7 million. Our 2015 loss of ($0.07) per share is unchanged but we have raised our revenue estimate to $14.9 million from $14.4 million.

In 3Q14 *(results released Nov. 7, 2014)* ***Zynex earned a profit of $258,000, or $0.01 per share, on revenue of $4.4 million. We projected a loss of ($0.01) per share on revenue of $4 million. In the year-earlier quarter, the company lost ($0.02) per share on revenue of $5.2 million.***

See disclosures on pages 14 - 16

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Investment Recommendation

Reiterating Neutral investment rating.

ZYXI is trading at 0.4X trailing revenue vs. 6.4X (excluding outliers) for medical device stocks with market valuations of less than $250 million. The deep discount from the sector multiple arguably stems from ZYXI's stalled revenue growth, significant losses, and a difficult market. Prospects for a substantive recovery of growth momentum are still uncertain. The stock price has fallen sharply during the past year.

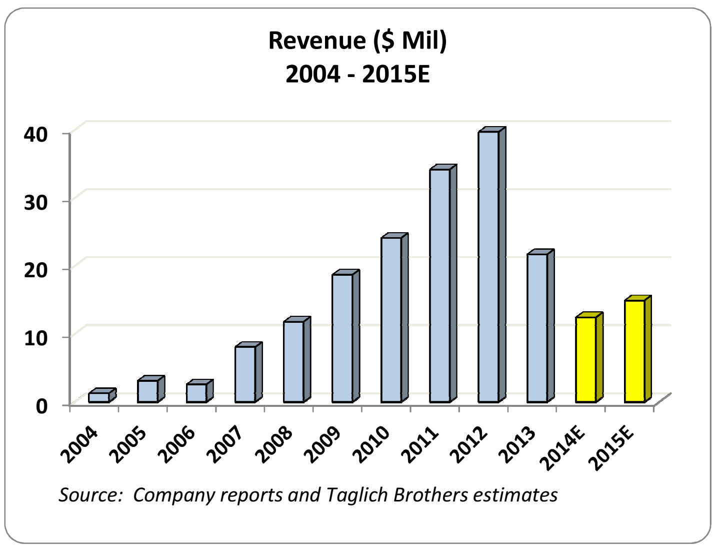
To the extent that Zynex can regain profitability by regaining sales growth and controlling its costs, the stock's valuation should improve. The company's revenue appears to be stabilizing. If investors begin to discount substantive revenue gain in 2015 the stock price should continue to recover from its recent lows.

Significant risks will persist. A recovery in the company's end markets is uncertain, as is Zynex's ability to secure adequate financing to support renewed revenue growth.

Overview

Zynex, Inc., headquartered in Lone Tree, Colorado, was founded in 1996 and became a publicly held company in 2004 through a reverse merger with a shell company. Zynex operated as a wholesaler of European-made electrotherapy devices until its first medical device was cleared by the Food and Drug Administration (FDA) in 1999. In 2003 Zynex's full line of electrotherapy devices and a stroke rehabilitation device were cleared by the FDA. In 2008 some of its major products were cleared for marketing in Europe.

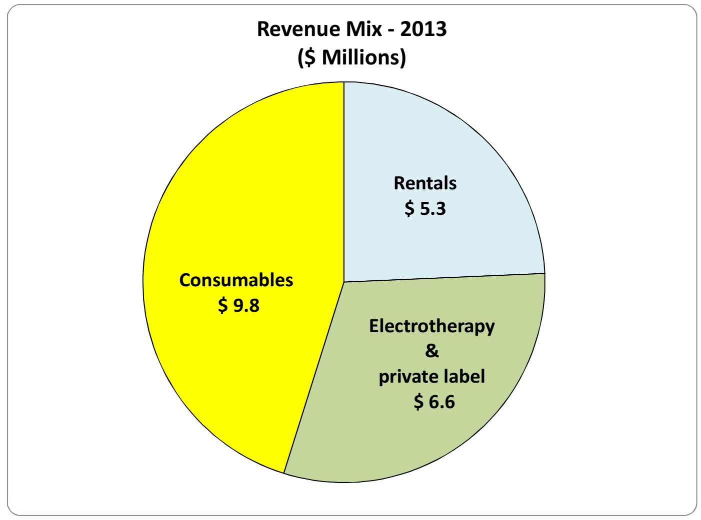
Zynex manufactures a line of neuromodulator devices that reduce reliance on drugs and promotes rehabilitation and increased mobility. Zynex's non-invasive transcutaneous electrical nerve stimulation systems have been used to treat pain ranging from mild persistent problems such as sore muscles to acute postoperative pain.



The company's neuromuscular electrical stimulation (NMES) systems are used mainly by physical therapists to treat victims of trauma, stroke, or incidents that degrade muscle function, enabling stroke or spinal injury victims to regain lost mobility, functionality, speech, and memory. Revenue increased sharply, growing threefold in the three years through 2012 but plummeted in the wake of tighter reimbursement restrictions in 2013.

Revenue growth stalled abruptly on curtailment of Medicare reimbursement for TENS in treating chronic lower back pain, and uncertainty over the impact of the Patient Protection and Affordable Care Act (PPACA). In 2013, hardware sales and rental revenue fell sharply. The company aims to regain growth momentum partly through the sale of diagnostic devices unaffected by significant reimbursement cuts and the launch of a line of topical and transdermal pain creams for the treatment of inflammation, peripheral neuropathy, headaches and other ailments. But in light of Zynex's current sales mix, the recovery process could be a lengthy one.

In addition to its own products, Zynex distributes private labeled electrical stimulation devices, electrodes and batteries produced by other US manufacturers. A substantial portion of revenue is recurring. Rentals and electrodes and batteries sold to patients using either rental or purchased units account for three-quarters of revenue.



Zynex's products are either purchased or rented on a monthly basis, mainly by patients, health care providers and distributors. Health insurers that cover patients generally determine, based on the anticipated time the device will be used, if devices will be rented or purchased. More than half of the company's revenue consists of sales to patients covered by private health insurance plans. Patients also include Medicare and Medicaid beneficiaries. Returned rental units are refurbished and made available for future rentals. Rental margins and margins on consumables, typically around 80%, range significantly higher than the 50% margins on device sales.

In the US, which accounts for most of its sales, the company sells its medical devices through a sales force that includes independent sales representatives. Overseas, Zynex has distributors in Canada, Australia, Southeast Asia, the United Arab Emirates, the Netherlands, and Germany. An international sales manager oversees distributors covering Asia and the Middle East.

Strategy

Zynex is reevaluating the strategy for Zynex Medical, its largest business. The company has rationalized its product line, narrowing it down essentially to NexWave, a TENS pain therapy device, InWave, an incontinence therapy device, and NeuroMove, a stroke rehabilitation device. The rest of the product line, which formerly included other TENS systems and neurodiagnostic devices, has been discontinued. All inventory relating to discontinued products was written off in 2Q14. To diversify away from electrotherapy products, which are based largely on aging technology and tend to be priced as commodities, Zynex started compounding and selling topical and transdermal pain creams in early 2014. Pain creams contributed $713,000 to revenue in the first nine months of 2014.

To attenuate the impact of a sharp decline in revenue, Zynex reduced its staff, cutting annual employee costs by $7 million, and renegotiated its lease, potentially reducing annual rent expense by $1 million.

Most of the company's technology – TENS was developed 30 years ago – is not patent protected. To keep its product knowledge proprietary, Zynex internally develops software for all of its products. All products are tested in-house to ensure quality and patient safety, and reduce the cost of warranty expenses.

Outlook

With the aging of the population, the prevalence of age-related disease – cancer, cardiovascular disorders, stroke, diabetes, and degenerative spinal disorders – is expected to rise significantly, increasing the demand for pharmaceutical- and device-based therapy. Technological advances in device design, as seen earlier in cardiac rhythm management, coronary revascularization devices, spinal implants, orthopedic prostheses, and neuromodulation systems, should also drive the growth in demand.

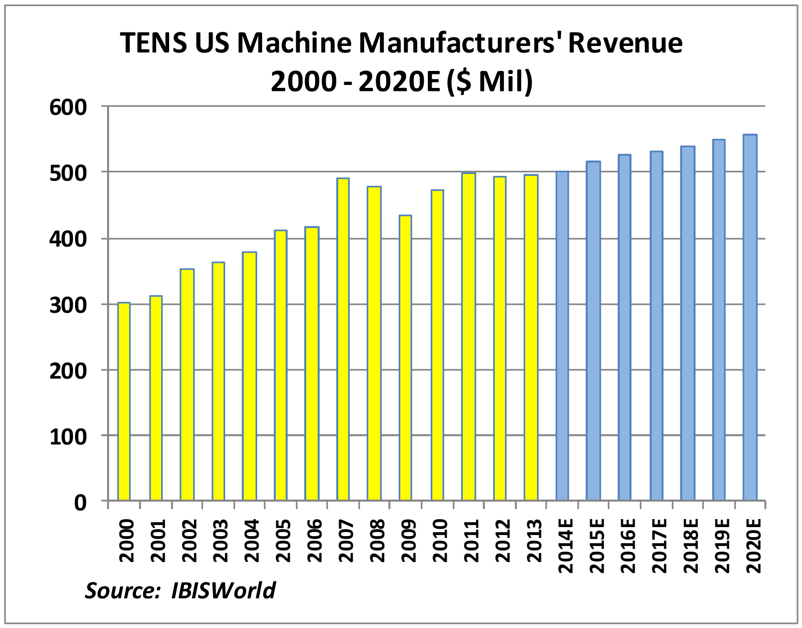
Gains could potentially be offset in part by more stringent regulatory 510(k) review mandated by the Food and Drug Administration Reform Act of 2012, and pressure on pricing and industry profits as the PPACA goes into effect. Sections of the law that require all medical device manufacturers to pay 2.3% of the sales price of a device may be repealed or amended in budget negotiations in a Republican dominated Congress.

The more immediate threat to Zynex's growth outlook stems from the curtailment of Medicare reimbursement. A June 2013 decision memorandum from CMS determined that "TENS is not reasonable and necessary for the treatment of CLBP under section 1862(a)(1)(A) of the Social Security Act." That decision directly affects TENS device manufacturers. High-end neuromodulation device manufacturers such as Medtronic and St. Jude Medical (see Competition) have not experienced as severe an impact as Zynex has. But the EMPI business of DJO Global, a large TENS manufacturer, has suffered more significant revenue declines that either Medtronic or St. Jude Medical.

In April 2013 Medicare payments for services to physicians were reduced by 2% as part of the automatic spending cuts in Federal spending mandated by the Budget Control Act of 2011. These cuts were temporarily deferred in December 2013 and planned Medicare cuts for 2014 were deferred by Congress in March 2014. In June 2013 CMS announced its proposal to reduce reimbursements for home healthcare by 3.5% annually from 2014 to 2017.

<u>Neromodulation Devices</u> This $2.6 billion segment of the US medical device market encompasses a wide range of devices that intervene in neural pathways to reduce pain and disorders stemming from illness and trauma that have impaired the central nervous system in some fashion. The neuromodulation segment includes electrotherapeutic devices, which apply an electrical impulse to an affected part of the anatomy.

TENS systems are distinct from neuromdulation systems which deliver therapeutic effect via devices implanted in the brain or major nerve systems. TENS devices and the other systems sold by ZYNEX are transdermal delivery systems.



The US TENS market grew an average of 7.1% a year between 2000 and 2007. The industry's average annual growth from 2007 through 2013 was essentially flat, a rate that masks declines in 2008 and 2009. By IBISWorld's estimates, the US market for TENS in 2014 will total $502 million. Broad reductions in Medicare coverage for durable medical equipment (which include medical devices) and new limitations on Medicare reimbursement for chronic lower back pain are likely to curtail usage of TENS devices, particularly in the home health market. By IBISWorld estimates, the US TENS market will grow less than 2% a year through 2020.

Competition

Zynex's competitors include large broad-line medical device manufacturers with substantial neurostimulation businesses, including Medtronic, which reported a 5% rise in nine-month (ending January 2014) neuromodulation revenue to $1.4 billion million. St. Jude Medical's 2013 neuromodulation revenue was $426 million, essentially flat compared to 2012.

DJO Global's Recovery Science business reported 2013 revenue of $313 million, down 6% from 2022. In 2012 the Recovery Science business' revenue dropped 7.5% due in part to changes in reimbursement for certain products in DJO's EMPI business. EMPI's product line consists in large part of TENS devices.

Aside from the larger competitors in this industry segment, there are more than 60 US manufacturers of electrotherapy devices, most of which carry a wide variety of products sold to the physical therapy market. IBISWorld's TENS market data imply an average annual revenue of around $8 million per TENS manufacturer.

Competition is based on price, which is important to patients, clinicians and insurers. As all TENS devices perform the same function, based on largely dated technology, and are produced by a large number of manufacturers, they increasingly trade as commodities. Differentiating technology can also be an advantage. Despite limited potential for innovation in TENS devices, manufacturers try to differentiate their products. TENS systems are commonly differentiated by being bundled with another pain management modality, just as Zynex combines TENS with NMS and IF. Product innovations may make systems easier for untrained patients to use at home, or be mainly cosmetic, but in a commoditized market, novel features can underlie a slight competitive edge even if they do not enhance functionality.

2014 Third Quarter and Nine-Month Results

	Quarter ending Sep 30:			'14 vs. '13	**Nine Mos. ending Sep 30:**		
($ Thousands)	**2014A**	***2014E***	**2013A**	%+/-	**2014**	**2013**	%+/-
Revenue							
Rental	389	*899*	1,284	(70%)	1,713	4,606	(63%)
Sales	4,015	*3,149*	3,907	3%	7,208	13,725	(47%)
Total revenue	4,404	*4,048*	5,191	(15%)	8,921	18,331	(51%)
Cost of revenue							
Rental	172	*279*	257	(33%)	575	956	(40%)
Sales	1,211	*1,071*	1,289	(6%)	2,976	4,664	(36%)
Inventory write-off					2,655		
Total	1,383	*1,349*	1,546	(11%)	6,206	5,620	10%
Gross profit	3,021	*2,698*	3,645	(17%)	2,715	12,711	(79%)
SG&A expenses	2,609	*3,441*	4,713	(45%)	9,012	16,699	(46%)
Operating income (loss)	*412*	*(742)*	(1,068)	NM	(6,297)	(3,988)	NM
Interest expense	(169)	*(83)*	(136)	24%	(471)	(480)	(2%)
Other income (expense)	25			NM	34	72	NM
Pretax income	268	*(825)*	(1,204)	NM	(6,734)	(4,396)	NM
Income tax		*330*	455	NM		1,610	NM
Income before minority int	268	*(495)*	(749)		(6,734)	(2,786)	
Minority interest in earnings	(10)	*10*	11	NM	10	28	
Net income	258	*(485)*	(738)	NM	(6,724)	(2,758)	NM
Average shares outstanding	31,216	*33,500*	31,148		31,186	31,148	
Earnings (loss) per share	0.01	*(0.01)*	(0.02)	NM	(0.22)	(0.09)	NM
Margin Analysis							
Gross margin	68.6%	66.7%	70.2%		30.4%	69.3%	
Rental	44.2%	31.0%	20.0%		66.4%	79.2%	
Sales	30.2%	34.0%	33.0%		58.7%	66.0%	
SG&A	59.2%	85.0%	90.8%		101.0%	91.1%	

Source: Company reports and Taglich Brothers estimates

In 3Q14, Zynex earned a profit of $258,000, or $0.01 per share, on revenue of $4.4 million. 3Q revenue includes $1.6 million in sales that were deferred in the prior quarter as a consequence of insufficient funding to finance inventory. Revenue for the quarter included $390,000 in sales of topical and transdermal pain creams.

3Q revenue dropped 15% to $4.4 million. Excluding sales that were deferred in 2Q, revenue declined 46% due to a drop in customer orders, sale force reductions and the impact of healthcare reform.

The decline in revenue (excluding sales deferred in 2Q) was led, in dollar terms, by a 62% decline in equipment and consumables sales to $2.4 million. Rental revenue also fell sharply, dropping 70% to $389,000.

Gross profit for 3Q fell 17% to $3 million as revenue declined and the gross margin narrowed to 68.6% from 70.2% due mainly to reduced overhead coverage.

Operating expenses dropped 45% to $2.6 million due to staff reductions, lower sales commissions, reduced rent, and lower professional fees and travel expenses. Due to a sharp decrease in operating expenses Zynex earned 3Q operating income of $412,000 vs. an operating loss of $1.1 million in the year-earlier quarter.

Interest expense increased 24% to $169,000 due to a 300 basis point interest rate increase stemming from noncompliance with loan covenants.

In the first nine months of 2014, ZYXI lost $6.7 million, or ($0.22) per share, on revenue of $8.9 million. Excluding a $2.7 million 2Q inventory write-off, the company incurred a nine-month loss of ($0.13) per share vs. a loss of ($0.09) per share on revenue of $18.3 million in the first nine months of 2013. Nine-month revenue dropped 51% due to a decline in orders.

Nine-month gross profit, excluding the effect of a $2.7 million inventory write-off, dropped 58% to $3.6 million, a consequence of the decline in revenue and gross margin compression to 60.2% from 69.3% stemming from reduced overhead coverage.

SG&A expenses dropped 46% to $6 million, reflecting reductions in staff, lower commissions and rent, and a drop in professional fees, office and travel expenses. The operating loss for the first nine months of 2014 widened to $6.3 million from $4 million, a consequence of sharply reduced gross profit.

Interest expense was largely flat. Bank borrowing was reduced but the interest charged by the bank increased by 300 basis points due to noncompliance with loan covenants.

Finances In 3Q14 Zynex cash earnings of $765,000 were partly offset by a $457,000 increase in working capital stemming mainly from a reduction in deferred revenue. Cash of $308,000 from operations and proceeds from the sale of equipment covered repayment on the revolving line of credit, increasing cash by $8,000 to $319,000 at the end of the quarter.

For the first nine months of 2014, the company burned cash of $3.6 million but reduced working capital by $4.6 million mainly through reductions in receivables, inventory, prepayments and income taxes receivable. Cash from operations of $1 million, proceeds from the sale of equipment and changes in rental assets fell slightly short of repayment of bank loans and capital lease obligations. Cash dropped by $4,000 to $319,000 as of September 30, 2014.

Credit Facility Zynex has an asset-backed revolving credit facility with Triumph Community Bank that matures on December 19, 2014. The Triumph agreement contains certain customary restrictive and financial covenants for asset-backed credit facilities. As of September 30, 2014, $4.5 million was outstanding under the loan agreement. As the company was in default and under demand for accelerated payments, no further borrowing was available.

Borrowings bear interest at the default interest rate. As of September 30, 2014, the effective interest rate was 11% (6.75% interest rate plus 3% additional default interest rate and 1.25% fees). The loan agreement requires monthly interest payments in arrears on the first date of each month.

As of September 30, 2014, Zynex was not in compliance with the minimum debt service coverage ratio requirement for the quarter ended March 31, 2014 and certain other alleged defaults. The bank notified the Zynex that it would no longer make additional loans and was exercising its default remedies, including, among others, accelerating the repayment of all outstanding obligations under the loan agreement and collecting the company's bank deposits to apply towards the outstanding obligations.

Zynex and the bank are negotiating the terms of an accelerated repayment of the amounts outstanding under the agreement and the bank has continued to make additional loans to the company. However, the bank could potentially discontinue such additional loans and/or may not agree on a repayment plan acceptable to the company. If the bank insists on immediate repayment, the company could be forced into insolvency proceedings. Zynex is seeking new lenders or investors to replace its current borrowing arrangements.

Projections

Operations Revenue is well below ZYXI's 2012 peak of almost $40 million; in 3Q14, the company's run rate was approximately $11 million, excluding deferred 2Q revenue recognized in 3Q. Our projections reflect expectations for some recovery of demand as revenue stabilizes, possibly by 4Q14.

For 2014 we project a loss of $7.7 million, or ($0.24) per share, on revenue of $12.4 million. Excluding the effect of a 2Q inventory write-off, we project a 2014 loss of ($0.16) per share. Previously we projected, including an inventory write of $2.7 million, a loss of $8.2 million, or ($0.25) per share, on revenue of $11.7 million. Excluding that write-off, our previous estimate was ($0.23) per share. Our revenue projection was revised to reflect 3Q14 results and a slight increase in our 4Q14 revenue estimate. Revenue for 2014 will drop an estimated 43% and the gross profit will fall to $5 million ($7.7 million excluding inventory write-offs).

Operating expenses should decrease 40% to $12.7 million due to further reductions in sales commissions, the full-year impact of a $7 million reduction in annual personnel expenses, and a reduction in rent. Excluding the effect of inventory write-off, the operating loss for the year should narrow to $5 million from $7.6 million. So long as collections and inventory turnover do not deteriorate, average borrowings should stabilize, but higher rates will increase interest expense by 25% to $759,000. The net loss for the year will widen to $7.7 million from $7.3 million.

For 2015 we project a loss of $2.4 million, or ($0.07) per share, on revenue of $14.9 million. We previously projected a loss of $2.2 million, or ($0.07) per share, on revenue of $14.4 million. The changes in our estimates reflect an increase in our revenue projection. A modest recovery in demand should increase revenue by an estimated 20%, improving gross margins as overhead coverage improves.

Our 2015 revenue estimates are based in large measure on Zynex's ability to secure a significantly larger credit facility. Our loan projections for 2015 are significantly higher than the company's current loan limits. Without a larger credit line, Zynex will not be able to fund the receivables and inventory needed to support the levels of revenue that we forecast.

Operating expenses should drop 2% to $12.5 million, reflecting the limits of the ability to take more costs out of the business. The operating loss will narrow to an estimated $2.6 million from $7.6 million. But interest expense will almost double to $1.5 million, reflecting higher borrowings and interest rates comparable to those charged by the company's current lender.

Finances We project 2014 cash burn of $4.2 million, offset by a $4.4 reduction in working capital as receivables and inventory decrease significantly due to the drop in revenue, partly offset by reductions in payables and accruals. Cash of $147,000 from operations and cash gains from the sale equipment and changes in rental inventory will be offset repayments on bank loans and capital lease payments, increasing cash by $18,000 to $341,000 at the end of 2014.

For 2015, we project cash burn of $1 million and a $742,000 increase in working capital due to an increase in receivables. An additional $2 million in borrowing should cover cash of $1.8 million used in operations, capital expenditures and payments on capital leases, increasing cash by $36,000 to $377,000 at the end of 2015.

Zynex's Electrical Nerve Stimulation Technology and its Product Line

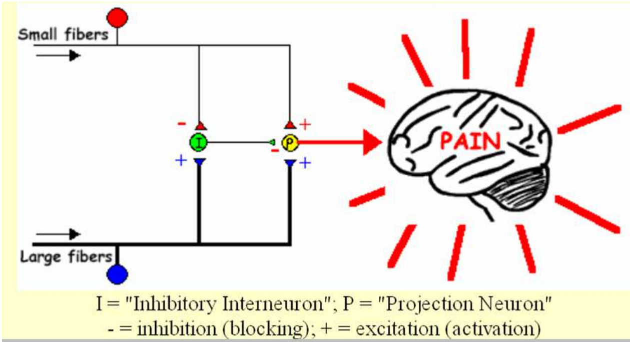
Zynex's principal products include pain management, rehabilitation and incontinence therapy devices, some of them bundled in combination systems. Single-use supplies such as electrodes and batteries account for a sizable proportion of revenue.

Electrotherapy devices are generally small, portable (hand-held in many cases), and relatively inexpensive. The TENS unit illustrated at right (not a Zynex product) is fairly typical. There are TENS systems that retail on the Internet for as little as $30.

Pain Management Electrical stimulation systems, also known as neurostimulation devices, range from Medtronic's PrimeAdvanced® and Restore™ implantables to the ubiquitous TENS (transcutaneous electrical nerve stimulation) system. TENS reduces pain by electrically stimulating nerve fibers that interfere with pain signals and by stimulating the production of pain-relieving endomorphins. Common pain relief applications for TENS include back and neck, RSD (complex regional pain syndrome), arthritis, shoulder pain, neuropathies, and other acute and chronic pain.

TENS therapy is delivered through a small, external portable battery-powered generator from which electrical impulses are coursed through electrodes placed on the skin, either directly over the painful area or at certain points along the nerve pathway.

The mechanism of action of TENS is explained by the gate-control theory (Melzack and Wall, 1965), illustrated at the right, as follows: in the absence of stimuli, both large and small nerve fibers are quiet and the inhibitory interneuron (I) blocks the signal in the projection neuron (P) that connects to the brain. The "gate is closed", so there is no pain sensed.



Source: Eric H. Chudler

With non-painful stimuli, mainly the large nerve fibers are activated. Activation of the large nerve fibers also activates the projection neuron (P), but it also activates the inhibitory interneuron (I) which then blocks the signal in the projection neuron (P) that connects to the brain. The gate remains closed so there is no pain sensed.

With pain stimulation, small nerve fibers become active, activating the projection neurons (P) and blocking the inhibitory interneuron (I). Because activity of the inhibitory interneuron is blocked, it cannot block the output of the projection neuron that connects with the brain. So the gate is "open", and the brain senses pain. TENS aims to stimulate the large diameter nerve fibers, closing the gate and reducing pain.

The sensation produced by the electrical stimulation appears to "override" the pain messages and may stimulate the body to produce its own natural morphine-like substance, which minimizes pain.

Since it was developed more than 30 years ago TENS has been used to treat almost every type of pain, from mild persistent problems such as sore muscles to acute postoperative pain. Its most common use, however, has been in the treatment of chronic low-back pain, an application in which the American Academy of Neurology now says TENS is ineffective. Whether TENS suppresses or overrides pain signals, stimulates production of natural pain relieving chemicals, or is merely a placebo effect, it has provided pain relief in many cases. Its broad acceptance is based in part on its benign side effects profile. TENS is non-addictive, non-sedative, and can be used indefinitely without the problems associated with prolonged use of some pain medications.

Rehabilitation Neuromuscular electrical stimulation (NMES) systems deliver electrical impulses to the surface over targeted muscles through electrodes. These electrical impulses cause muscles to contract as a form of exercise or physical therapy. NMES is used mainly by physical therapist to treat victims of trauma, stroke, or incidents that degrade muscle function. NEMS is also to diagnose the performance of nerves and muscles, and measure improvement after treatment.

NEMS is used in cases of chronic neuromuscular disorders such as cerebral palsy, spina bifida, club foot and some nonprogressive myopathies. It is also applied to healthy muscle to strengthen or maintain muscle mass during periods of enforced inactivity, increase range of motion, improve voluntary muscle control, and temporarily reduce spasticity.

Risks

In our view, these are the principal risks underlying the stock:

Regulatory/Legal Zynex's devices must be cleared for US marketing by the FDA, mostly through the 510(k) review process, a relatively low regulatory hurdle that requires the company to demonstrate that a product under review is substantially equivalent to a similar device on the market (predicate device) before 1976. Devices sold in in the European Union (EU) must be CE (Conformite Europeenne) marked, showing that it meets EU health, safety, and environmental requirements.

The Patient Protection and Affordable Care Act (PPACA) of 2010, which must be fully implemented by 2019, contains provisions that will increase pressure on pricing and require medical device manufacturers to pay fees on their sales. Adverse proposals by the Medicare system could cripple near-term growth.

Intervening Technnology Zynex's technology is protected by trademarks and trade secrets, rather than patents. While the company keeps it software proprietary by developing and maintaining it internally, competitors could potentially develop more effective devices.

Reimbursement Applications for reimbursement are subject to disputes or reversal after review of the billings in question, and the sums refunded have been largely immaterial. Potential for refunds underlies some revenue uncertainty. One private health insurance carrier accounted for 7% of net accounts receivable as of December 31, 2013. If this carrier proved to be especially problematical, reimbursements might be lost or delayed.

Liquidity ZYXI may be unable to obtain additional borrowing sufficient to finance its working capital. Our projections for 2014 and 2015 reflect bank loans that exceed the line's current limits. If the company is unable to negotiate higher borrowing capacity, revenue growth recovery may not be achieved.

Interest Rates When the Federal Reserve raises interest rates, the company's borrowing costs would increase. Higher interest rates are also likely to dampen market performance.

Competition The market for electrotherapy devices is fragmented and highly competitive. TENS and interferential current technologies have been on the market for more than 30 years and these devices increasingly tend to trade as commodities with limited pricing flexibility.

Concentration of stock ownership Thomas Sandgaard owns 58% of ZYXI shares. This concentration of ownership gives him disproportionate influence over management actions, potentially leading to decisions that may not be in the best interest of the stockholders at large.

Microcap Concerns Shares of ZYXI have risks common to the stocks of other microcap (which we define as market capitalizations of $250 million or less) companies. These risks often underlie stock price discounts from the valuations of larger-capitalization stocks. Liquidity risk, typically caused by small trading floats and very low trading volume, can lead to large spreads and high volatility in stock price. The company has approximately 13 million shares in the float. Average daily volume is 16,000 shares.

Miscellaneous Risks The company's financial results and equity values are subject to other risks and uncertainties known and unknown, including but not limited to competition, operations, financial markets, regulatory risk, and/or other events. These risks may cause actual results to differ from expected results.

Balance Sheets
($ 000)
2011A –2015E

	2011A	2012A	2013A	3Q14A	2014E	2015E
ASSETS						
Current assets						
Cash + equivalents	789	823	323	319	341	377
Accts receivable	10,984	12,224	7,033	4,460	4,482	5,378
Inventory	4,556	6,160	5,002	2,483	1,716	1,664
Prepaid expenses	293	243	346	37	161	194
Deferred tax asset	1,384	1,855	72	72	72	72
Income tax receivable				219		
Other	42	57	928			
Total	18,048	21,362	13,704	7,590	6,771	7,685
Fixed assets (net)	3,422	3,851	2,891	1,833	1,935	1,509
Deposits	170	171	400	3	15	15
Deferred financing fees	145	98	48			
Intangibles		203	178	142	137	117
Goodwill		251				
TOTAL ASSETS	21,785	25,936	17,221	9,568	8,858	9,326
LIABILITIES AND EQUITY						
Current liabilities						
Line of credit	3,289	5,906	5,820	4,541	5,500	7,500
Notes & other obligations - curr	131	144	92	82	35	35
Accts pay	2,189	2,057	2,743	2,745	2,293	2,426
Accruals	2,276	1,430	926	869	435	437
Income taxes payable	1,567	2,164	96			
Deferred rent	296	371	7			
Deferred revenue				109	200	200
Contingencies - curr		21		4		
Total	9,748	12,093	9,684	8,350	8,463	10,598
Notes & other obligations (less curr)	258	114	150	78	64	8
Deferred rent	1,156	785	2,454	2,845	2,800	2,800
Deferred tax liability	483	786	72	72	72	72
Warranty liability		20	13	12	12	12
Contingencies - less curr		83				
Shareholders' equity	10,140	12,055	4,848	(1,789)	(2,553)	(4,164)
TOTAL LIABILITIES AND EQUITY	21,785	25,936	17,221	9,568	8,858	9,326

Source: Company reports and Taglich Brothers estimates

Annual Income Statements
($ 000)
2011A –2015E

	2011A	2012A	2013A	2014E	2015E
Revenue					
Rental	9,892	8,917	5,270	2,111	1,693
Sales	24,256	30,749	16,414	10,299	13,201
Total	34,148	39,666	21,684	12,411	14,894
Cost of revenue					
Rental	1,842	1,283	1,373	691	503
Sales	5,529	7,487	6,767	4,027	4,488
Inventory write-off				2,655	
Total	7,371	8,770	8,140	7,373	4,991
Gross profit	26,777	30,896	13,544	5,038	9,902
SG&A expenses	23,676	28,159	21,144	12,677	12,485
Operating income (loss)	3,101	2,737	(7,600)	(7,639)	(2,583)
Interest income	1	3			
Interest expense	(460)	(435)	(607)	(759)	(1,486)
Other income (expense)	2	31	77	34	
Pretax income (loss)	2,644	2,336	(8,130)	(8,365)	(4,069)
Income tax (benefit)	(1,080)	(788)	790	652	1,628
Net income before minority int			(7,340)	(7,713)	(2,441)
Minority interest in earnings			39	20	40
Net income (loss)	1,564	1,548	(7,301)	(7,693)	(2,401)
Average shares outstanding	30,978	31,222	31,152	31,827	33,375
Earnings (loss) per share	0.05	0.05	(0.23)	(0.24)	(0.07)
Margin Analysis					
Gross margin - total	78.4%	77.9%	62.5%	40.6%	66.5%
Rental	81.4%	85.6%	73.9%	67.3%	70.3%
Sales	77.2%	75.7%	58.8%	60.9%	66.0%
SG&A	69.3%	71.0%	97.5%	102.1%	83.8%
Operating income	9.1%	6.9%	NA	NA	NA
Pretax income	7.7%	5.9%	NA	NA	NA
Net income	4.6%	3.9%	NA	NA	NA

Source: Company reports and Taglich Brothers estimates

Quarterly Income Statements
($ Thousands)
2013A - 2015E

	1Q13A	2Q13A	3Q13A	4Q13A	**2013A**	1Q14A	2Q14A	3Q14A	4Q14E	**2014E**	1Q15E	2Q15E	3Q15E	4Q15E	**2015E**
Revenue															
Rental	1,679	1,643	1,284	664	**5,270**	735	589	389	398	**2,111**	404	442	408	438	**1,693**
Sales	5,989	3,829	3,907	2,689	**6,624**	2,432	760	4,015	3,092	**10,299**	3,040	3,192	3,413	3,556	**13,201**
Total revenue	7,668	5,472	5,191	3,353	**11,894**	3,167	1,349	4,404	3,491	**12,411**	3,444	3,634	3,821	3,994	**14,894**
Cost of revenue															
Rental	301	398	257	417	**1,373**	135	268	172	116	**691**	121	128	127	127	**503**
Sales	1,890	1,485	1,289	2,103	**6,767**	862	903	1,211	1,051	**4,027**	1,034	1,085	1,160	1,209	**4,488**
Inventory write-off							2,655			**2,655**					
Total	2,191	1,883	1,546	2,520	**8,140**	997	3,826	1,383	1,167	**7,373**	1,155	1,213	1,287	1,336	**4,991**
Gross profit	5,477	3,589	3,645	833	**3,754**	2,170	(2,477)	3,021	2,324	**5,038**	2,289	2,420	2,534	2,658	**9,902**
SG&A expenses	5,833	6,153	4,713	4,389	**7,580**	3,456	2,947	2,609	3,665	**12,677**	3,283	3,242	2,479	3,482	**12,485**
Operating income (loss)	(356)	(2,564)	(1,068)	(3,556)	**(3,826)**	(1,286)	(5,424)	412	(1,341)	**(7,639)**	(994)	(821)	56	(824)	**(2,583)**
Interest expense	(130)	(214)	(136)	(127)	**(607)**	(158)	(144)	(169)	(288)	**(759)**	(327)	(368)	(389)	(402)	**(1,486)**
Other income (expense)	(6)	78		5	**77**		9	25		**34**					
Pretax income	(492)	(2,700)	(1,204)	(3,678)	**(4,356)**	(1,444)	(5,559)	268	(1,630)	**(8,365)**	(1,321)	(1,190)	(333)	(1,226)	**(4,069)**
Income tax (benefit)	182	973	455	(820)	**790**				652	**652**	528	476	133	490	**1,628**
Net income before minority interest	(310)	(1,727)	(749)	(4,498)	**(3,566)**	(1,444)	(5,559)	268	(978)	**(7,713)**	(793)	(714)	(200)	(735)	**(2,441)**
Minority interest in earnings	6	11	11	11	**39**	14	6	(10)	10	**20**	10	10	10	10	**40**
Net income (loss)	(304)	(1,716)	(738)	(4,487)	**(3,527)**	(1,430)	(5,553)	258	(968)	**(7,693)**	(783)	(704)	(190)	(725)	**(2,401)**
Average shares outstanding	31,148	31,148	31,148	31,163	**31,152**	31,171	31,171	31,216	33,750	**31,827**	33,000	33,250	33,500	33,750	**33,375**
Earnings (loss) per share	(0.01)	(0.06)	(0.02)	(0.14)	**(0.11)**	(0.05)	(0.18)	0.01	(0.03)	**(0.24)**	(0.02)	(0.02)	(0.01)	(0.02)	**(0.07)**
Margin Analysis															
Gross margin	71.4%	65.6%	70.2%	24.8%	**31.6%**	68.5%	(183.6%)	68.6%	66.6%	**40.6%**	66.5%	66.6%	66.3%	66.5%	**66.5%**
Rental	85.6%	82.1%	75.8%	80.0%	**37.2%**	73.9%	81.6%	54.5%	55.8%	**71.0%**	67.3%	70.0%	71.0%	69.0%	**71.0%**
Sales	68.4%	61.2%	67.0%	21.8%	**(2.2%)**	64.6%	(18.8%)	69.8%	66.0%	**60.9%**	66.0%	66.0%	66.0%	66.0%	**66.0%**
SG&A	76.1%	112.4%	90.8%	130.9%	**63.7%**	109.1%	218.5%	59.2%	105.0%	**102.1%**	95.3%	89.2%	64.9%	87.2%	**83.8%**

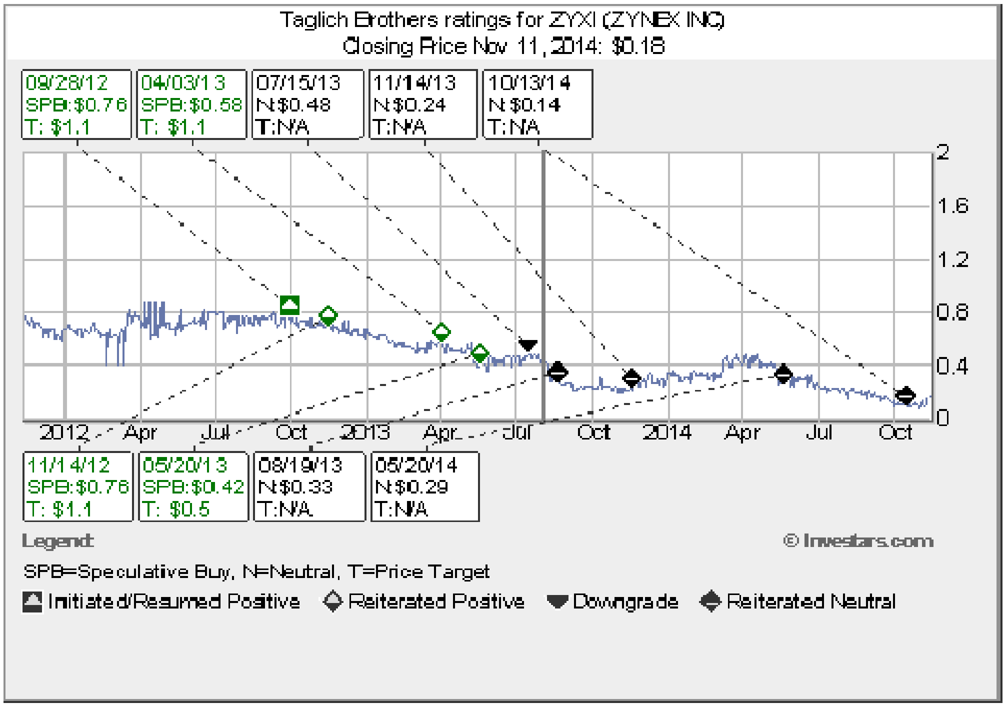
Source: Company reports and Taglich Brothers estimates

Annual Cash Flow Statements
($ 000)
2011A –2015E

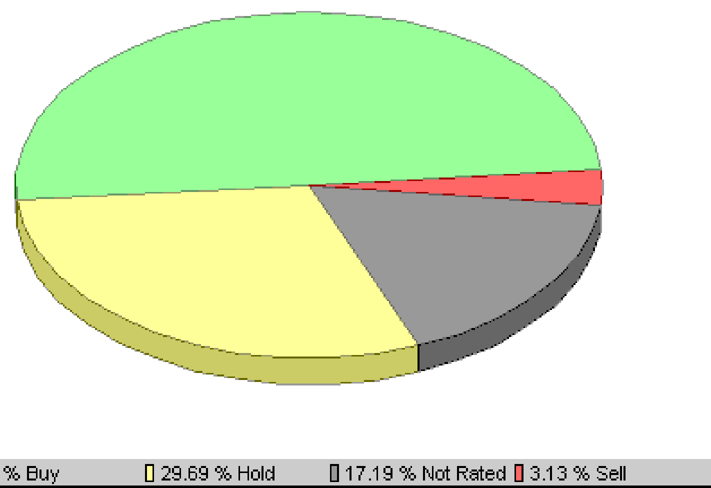
	2011A	2012A	2013A	3Q14A	2014E	2015E
Operating activities				(quarter only)		
Net Income	1,564	1,548	(7,340)	249	(7,702)	(2,401)
Depreciation/ amortization	806	864	708	149	583	600
Warranty expense				(1)	(1)	
Accretion of contingency consideration		(31)	(94)			
Provision for losses - accts rec	1,190	485	469	(74)	(776)	500
Amortization of intangibles		48	131	11	41	20
Impairment of goodwill			251			
Impairment of intangibles			160			
Amortization - financing fees	91	50	50		83	140
Stock based compensation - employees	267	166	133	19	99	100
Stock based compensation for services	79	20		23	23	
Provision for obsolete inventory	149	573	97	336	336	
Write-off of field inventory			1,340	(14)	2,655	
Deferred rent	(221)	(296)	1,299	34	391	
Deferred tax benefit	(295)	(168)	1,069			
Gain on asset disposal				33	33	
Cash burn/earned	3,630	3,259	(1,727)	765	(4,235)	(1,041)
accts rec	(4,865)	(1,725)	4,722	597	3,452	(897)
inventories	(1,046)	(2,070)	(279)	(214)	953	52
Prepayments	(148)	50	(103)	136	185	(32)
Income taxes receivable			(893)	152	674	
Deposits	3	(12)	(207)	44	44	
accts pay	876	(132)	686	(256)	(450)	133
accruals	724	(112)	(1,247)	283	(569)	2
deferred revenue				(1,187)	109	
income taxes payable	464	(137)	(1,334)	(12)	(17)	
Changes in working capital	(3,992)	(4,138)	1,345	(457)	4,382	(742)
Net cash from operations	(362)	(879)	(382)	308	147	(1,784)
Investing activities						
Cash paid for domain name		(18)				
Payment on contingency			(3)		(4)	
Capital expenditures/(sales of equip)			(644)	74	191	(100)
Cash paid for acquisition		(245)				
Change in rental equip/inventory	(1,267)	(1,321)	764	(44)	126	80
Net - investing activities	(1,267)	(1,584)	117	30	313	(20)
Financing activities						
Bank loan proceeds (repayments) - net	2,019	2,617	(86)	(335)	(320)	2,000
Deferred financing fees	(147)	(2)				
Payments - capital lease obligations	(104)	(131)	(149)	5	(122)	(160)
Proceeds - issuance of stock	48	13				
Net cash from financing	1,816	2,497	(235)	(330)	(442)	1,840
Net change in cash	187	34	(500)	8	18	36
Cash - beginning	602	789	823	311	323	341
Cash - ending	789	823	323	319	341	377

Source: Company reports and Taglich Brothers estimates

Price Chart



Taglich Brothers Current Ratings Distribution



Investment Banking Services for Companies Covered in the Past 12 Months

Rating	#	%
Buy	2	8
Hold	1	20
Sell		
Not Rated		

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Public companies mentioned in this report

ITT Corporation	(NYSE: ITT)	Qualmark	(OTC: QMRK)
Koninklijke Philips Electronics NV	(NYSE: PHG)	Siemens AG	(NYSE: SI)
Medtronic	(NYSE: MDT)	St. Jude Medical	(NYSE: STJ)

Meaning of Ratings

Buy – The growth prospects, degree of investment risk, and valuation make the stock attractive relative to the general market or comparable stocks.

Speculative Buy – Long term prospects of the company are promising but investment risk is significantly higher than it is in our BUY-rated stocks. Risk-reward considerations justify purchase mainly by high risk-tolerant accounts. In the short run, the stock may be subject to high volatility and could continue to trade at a discount to its market.

Neutral – Based on our outlook the stock is adequately valued. If investment risks are within acceptable parameters, this equity could remain a holding if already owned.

Sell – Based on our outlook the stock is significantly overvalued. A weak company or sector outlook and a high degree of investment risk make it likely that the stock will underperform relative to the general market.

Dropping Coverage – Research coverage discontinued due to the acquisition of the company, termination of research services, non-payment for such services, diminished investor interest, or departure of the analyst.

Some notable Risks within the Microcap Market

Stocks in the Microcap segment of the market have many risks that are not as prevalent in Large-cap, Blue Chips or even Small-cap stocks. Often it is these risks that cause Microcap stocks to trade at discounts to their peers. The most common of these risks is liquidity risk, which is typically caused by small trading floats and very low trading volume which can lead to large spreads and high volatility in stock price. In addition, Microcaps tend to have significant company specific risks that contribute to lower valuations. Investors need to be aware of the higher probability of financial default and higher degree of financial distress inherent in the microcap segment of the market.

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