

Zynex Inc (ZYXI-OTC)**ZYXI: Has Revenue Finally Bottomed?**

Current Recommendation	Neutral
Prior Recommendation	Outperform
Date of Last Change	08/08/2012
Current Price (03/27/14)	\$0.36
Target Price	\$0.40

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 over the last few periods. Longer-term upside to our model could come from pipeline and new services business.

SUMMARY DATA

52-Week High	\$0.60
52-Week Low	\$0.20
One-Year Return (%)	-18.97
Beta	0.68
Average Daily Volume (sh)	17,915

Shares Outstanding (mil)	31
Market Capitalization (\$mil)	\$11
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 (%)	27.8
Earnings Per Share (%)	16.8
Dividend (%)	N/A

P/E using TTM EPS	N/A
P/E using 2014 Estimate	N/A
P/E using 2015 Estimate	- N/A

Zacks Rank	N/A
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Risk Level	High,
Type of Stock	Small-Value
Industry	Med Products

ZACKS ESTIMATES**Revenue**

(in '000 of \$)

	Q1	Q2	Q3	Q4	Year
	(Mar)	(Jun)	(Sep)	(Dec)	(Dec)
2013	7,668 A	5,472 A	5,191 A	3,353 A	21,684 A
2014	3,396 E	3,673 E	3,900 E	4,135 E	15,103 E
2015					16,802 E
2016					18,621 E

Earnings per Share

	Q1	Q2	Q3	Q4	Year
	(Mar)	(Jun)	(Sep)	(Dec)	(Dec)
2013	-\$0.01 A	-\$0.06 A	-\$0.02 A	-\$0.15 A	-\$0.23 A
2014	-\$0.06 E	-\$0.04 E	-\$0.03 E	-\$0.03 E	-\$0.15 E
2015					-\$0.12 E
2016					-\$0.09 E

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

Q4 2013 Financial Results: Revenue Falls 68% YOY, 35% Sequentially

Zynex reported financial results for the fourth quarter ending December 31, 2013. Q4 revenue dropped dramatically from the prior period, was down over 68% from the yoy comparable quarter and was at the lowest level since Q3 2008. The weakness experienced in the first nine months of the year due to recent changes in reimbursement seemed to have been compounded in the final quarter of 2013 with revenue falling 35% from Q3. While we had expected revenue to continue to be impacted by CMS's June 2012 decision to no longer reimburse for TENS in the treatment of chronic lower back pain, the sequential decrease from Q3 to Q4 was more significant than we had anticipated, particularly as management indicated on the Q3 call (early November) that orders in the Zynex Medical division had begun to stabilize. We have since made further significant downward revisions to our forecasted revenue for 2014 as well for our out years in our model. While management indicated on the Q4 call that they now believe they have reached a bottom in terms of quarterly revenue and are now seeing signs of some increasing demand in their core electrotherapy business, we believe reimbursement challenges will remain a stiff headwind to growth of this business.

Despite making significant downward revisions to our estimates over the prior two reporting periods, Q4 revenue still came in well below our number. Most of the miss related to revenue from equipment rentals (as opposed to product sales). With the recent dramatic decline in revenue, ZYXI has been implementing cost-containment strategies which has resulted in meaningfully lower SG&A spend, although operating expenses have not come down nearly as rapidly as revenue has. We expect the company will need to further trim operating expenses in the coming year in order to minimize net losses. Gross margin in Q4 was dismal at just 25% - this compares to 78% for all of 2013 and a 69% average through the first nine months of 2013. However, excluding a ~\$1.0M inventory write-down which ZYXI recorded in Q4, gross margin would have been ~55%.

While we continue to expect that the electrotherapy business will remain the major contributor to revenue for the foreseeable future, if Q4 really did mark a low-point in terms of revenue for ZYXI, we think the top-line can see positive growth from the company's various ancillary business lines, products and services – none of which made a meaningful contribution in 2013. Management noted that their NeuroDiagnostics division (sleep products) contributed just 2% of total revenue in 2013 but about 10% in Q4. This segment, along with their newly launched non-sterile compounding pharmacy (which will focus on various prescription pain creams) and billing/consulting business may offer more growth potential in 2014 and beyond than the domestic electrotherapy products segment. And while we do not envision the domestic electrotherapy products business to hold much growth potential in the absence of a reversal of CMS's reimbursement policies, ZYXI's recent greater emphasis on international markets may offer an opportunity to spark additional growth for their TENS products. We have now included a contribution from these ancillary businesses and services in our model.

And notwithstanding the recent cost-containment measures, 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). During the first half of 2013 ZYXI began trimming their expense base (reduction in headcount and fixed expenses, including a reduction in current year building lease) – this was clearly evident as operating expenses fell by more than \$1.4M from Q2 to Q3 and came down another ~\$270k in Q4. Management noted on the Q4 call that they will continue to evaluate expense levels and indicated that further cuts will be made depending on the levels of future revenue. In our opinion, there will likely be a need to trim expenses further given what we expect will be another difficult year in terms of revenue for Zynex in 2014.

Q4 revenue of \$3.4 million fell 68% yoy, was down 35% sequentially and was about 36% lower than our \$5.2 million estimate. Rental revenue was \$664k, down 69% yoy (-48% sequentially) and about 55% lower than our \$1.5 million estimate. Equipment sales fell 71% yoy (-44% sequentially) with consumables falling 66% (-18% sequentially). As we first noted with Q2 2013 earnings, consumables revenue showing a substantial decline is particularly 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 businesses, products and services (NeuroDiagnostics, Billing and Consulting, pain creams) to pick up the slack.

Gross Margin

Q4 gross margin came in at 24.8% and was impacted by both the dramatic drop in revenue (with less to cover the fixed-cost portion) as well as the aforementioned ~\$1.0M write down in inventory which was recorded in COGS. Excluding the write-down, GM would have been about 55% which is still significantly weaker than the historical

average of approximately 75% - 80%. While we think Billing and Consulting business as well as the compounding pharmacy businesses may provide greater margins, there may not be much in the way of relative revenue contribution from these in the near-to-mid term. As such, and with our expectations of only very modest growth in the electrotherapy products business, we have made some significant downward revisions to our modeled gross margins as well. We model gross margins to expand with increases in revenue contribution from the other higher margin segments.

Net Income / EPS

Net income and EPS were (\$4.5)M and (\$0.15), compared to our (\$833)k and (\$0.03) estimates. The difference coming from both the big miss on the top-line and crimped gross margins.

Cash

Zynex exited 2013 with \$323k in cash and equivalents, down slightly from \$468k at the end of Q3. Despite the substantial net GAAP loss of \$4.5M in Q4 and \$7.3M for the full year (included in this is \$300k and \$1.3M, respectively in non-cash write down of inventory), cash used in operating activities was actually an inflow of \$294k in Q4 and was a fairly modest outflow of \$382k for the full year. Cash flow from operations in 2013 benefitted from a \$4.7M reduction in A/R as well as \$1.3M in deferred rent.

As of the end of Q3 the company had no availability left under its revolving line of credit. Management did not disclose availability under the line on the Q4 call but did note that, assuming that they can deliver on their operational plans in 2014, that the existing line will be sufficient to meet their funding needs. However, we think that the company may need to look for an additional funding source in the near-term given that we do not expect significant growth in 2014, a significant fixed-cost base (including lease payments on the HQ building which will now be cash pay and no longer deferred) which limits how much operating expenses can be cut, and the current modest cash balance.

Guidance

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

OUTLOOK: *Healthcare Reform / Reimbursement Changes SERIOUSLY Impacted 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 2013 which we think validated our concerns that we expressed in late 2012 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 but we have now incorporated a contribution from the ancillary products and services including the Billing/Consulting business, NeuroDiagnostics and the compounding pharmacy (pain creams). On the Q4 call management noted that they are putting further development of their blood monitoring device on hold - as we had yet to incorporate any contribution from this in our model, the decision to mothball (for now) further development does not affect our estimates. We continue to think the ancillary businesses and services as well as international markets for the electrotherapy products hold the most promise for reigniting revenue growth. Zynex recently penned distribution agreements in Russia and China which will help expand their international electrotherapy business footprint. And as noted, management mentioned that NeuroDiagnostics (sleep apnea products) was a material contributor to revenue in Q4 - this business may add further to the top-line in 2014 and beyond.

VALUATION

We model negative EPS through 2017 (the out-year in our model). Our valuation methodology is based on book value. We use a 2.5x book value multiple which puts fair value at approximately \$0.40. We are maintaining our Neutral rating.

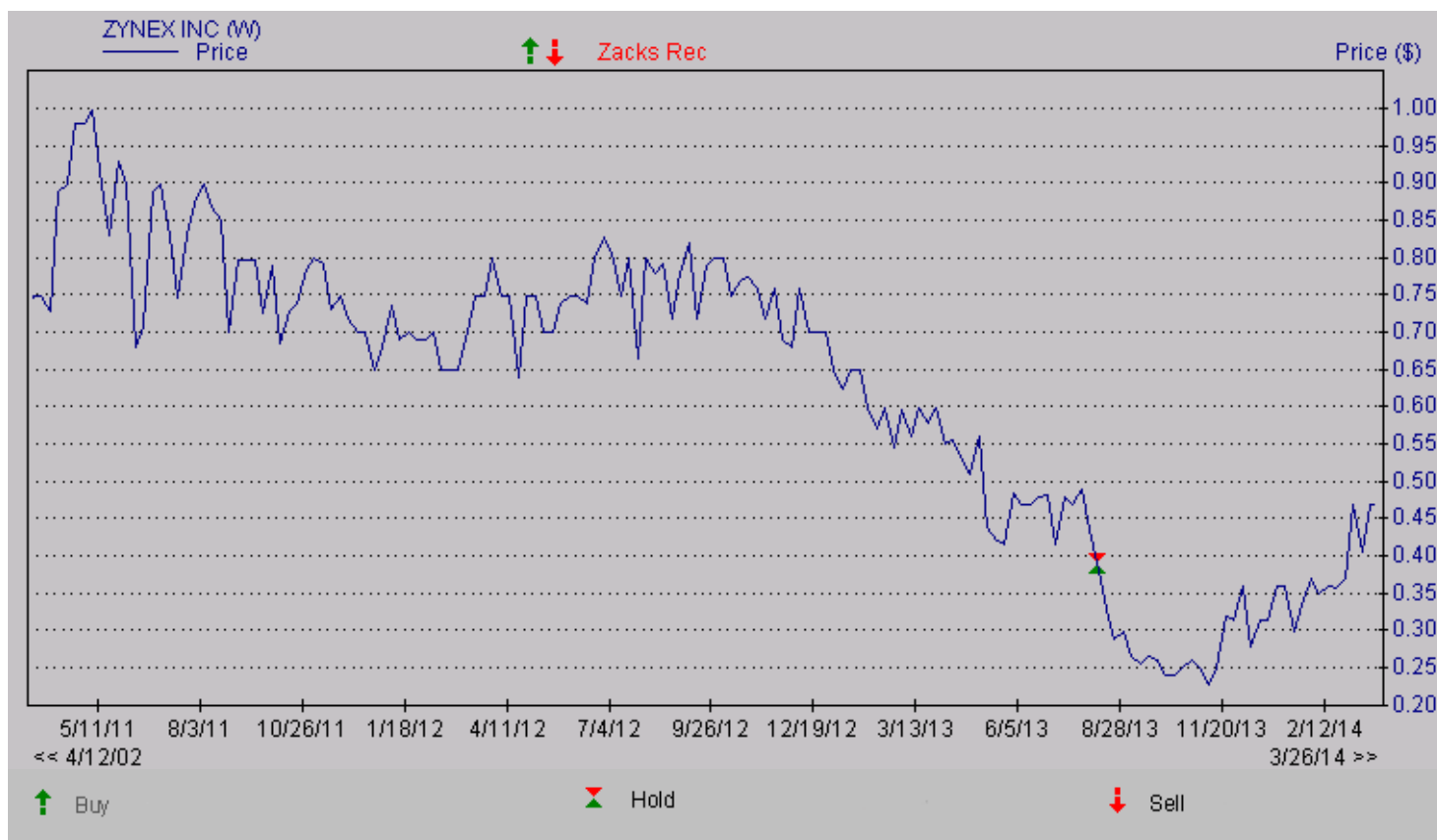
FINANCIAL MODEL

Zynex Inc.

	2013 A	Q1E	Q2E	Q3E	Q4E	2014 E	2015 E	2016 E	2017 E
Total Revenues	\$21,684.0	\$3,396.0	\$3,672.6	\$3,900.0	\$4,134.6	\$15,103.2	\$16,802.6	\$18,620.6	\$19,959.9
<i>YOY Growth</i>	-45.3%	-55.7%	-32.9%	-24.9%	23.3%	-30.3%	11.3%	10.8%	7.2%
Cost of Revenues	\$8,140.0	\$1,614.4	\$1,668.2	\$1,689.3	\$1,782.7	\$6,754.6	\$6,770.1	\$7,210.6	\$7,384.1
Gross Income	\$13,544.0	\$1,781.7	\$2,004.4	\$2,210.6	\$2,351.9	\$8,348.6	\$10,032.4	\$11,410.0	\$12,575.8
<i>Gross Margin</i>	62.5%	52.5%	54.6%	56.7%	56.9%	55.3%	59.7%	61.3%	63.0%
SG&A	\$21,144.0	\$4,315.0	\$4,018.0	\$3,954.0	\$3,857.0	\$16,144.0	\$15,858.0	\$16,244.0	\$16,527.0
<i>% SG&A</i>	97.5%	127.1%	109.4%	101.4%	93.3%	431.1%	76.6%	73.5%	72.0%
Operating Income	(\$7,600.0)	(\$2,533.3)	(\$2,013.6)	(\$1,743.4)	(\$1,505.1)	(\$7,795.4)	(\$5,825.6)	(\$4,834.0)	(\$3,951.2)
<i>Operating Margin</i>	-35.0%	-74.6%	-54.8%	-44.7%	-36.4%	-51.6%	-34.7%	-26.0%	-19.8%
Interest income, net	(\$607.0)	(\$135.0)	(\$140.0)	(\$145.0)	(\$150.0)	(\$570.0)	(\$820.0)	(\$900.0)	(\$1,100.0)
Other income	\$77.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$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	(\$8,130.0)	(\$2,668.3)	(\$2,153.6)	(\$1,888.4)	(\$1,655.1)	(\$8,365.4)	(\$6,645.6)	(\$5,734.0)	(\$5,051.2)
Taxes	(\$790.0)	(\$933.9)	(\$753.8)	(\$660.9)	(\$579.3)	(\$2,927.9)	(\$2,259.5)	(\$1,949.6)	(\$1,717.4)
<i>Tax Rate</i>	9.7%	35.0%	35.0%	35.0%	35.0%	140.0%	34.0%	34.0%	34.0%
Net Income	(\$7,301.0)	(\$1,734.4)	(\$1,399.9)	(\$1,227.4)	(\$1,075.8)	(\$5,437.5)	(\$4,386.1)	(\$3,784.5)	(\$3,333.8)
<i>YOY Growth</i>	-571.6%	470.5%	-18.9%	63.9%	-76.2%	-25.5%	-19.3%	-13.7%	-11.9%
<i>Net Margin</i>	-33.7%	-51.1%	-38.1%	-31.5%	-26.0%	-36.0%	-26.1%	-20.3%	-16.7%
EPS	(\$0.23)	(\$0.06)	(\$0.04)	(\$0.03)	(\$0.03)	(\$0.15)	(\$0.12)	(\$0.09)	(\$0.08)
<i>YOY Growth</i>	-572.7%	470.0%	-31.0%	39.5%	-79.8%	-34.2%	-23.7%	-20.1%	-16.2%
Diluted Shares O/S	31,152	31,175	36,580	36,600	36,650	35,251	37,250	40,230	42,290

Brian Marckx, CFA

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