

## Zynex Inc

(ZYXI-OTC)

**ZYXI: Ancillary Businesses Begin Making Material Revenue Contribution**

<b>Current Recommendation</b>	<b>Neutral</b>
Prior Recommendation	Outperform
Date of Last Change	08/08/2012
Current Price (05/13/14)	\$0.35
<b>Target Price</b>	<b>\$0.40</b>

**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. Electrotherapy revenue finally looks to be stabilizing and incremental sales coming from ancillary businesses. Longer-term upside to our model could come from pipeline and new services business. Liquidity is very tight, is a concern and needs to be addressed

**SUMMARY DATA**

52-Week High	\$0.51
52-Week Low	\$0.20
One-Year Return (%)	-2.27
Beta	0.67
Average Daily Volume (sh)	10,118

Shares Outstanding (mil)	31
Market Capitalization (\$mil)	\$10
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 (%)	21.7
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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<b>Risk Level</b>	<b>High,</b>
<b>Type of Stock</b>	<b>Small-Blend</b>
<b>Industry</b>	<b>Med Products</b>

**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	3,167 A	3,172 E	3,627 E	3,862 E	13,828 E
2015					15,947 E
2016					17,669 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	-\$0.05 A	-\$0.03 E	-\$0.02 E	-\$0.02 E	-\$0.11 E
2015					-\$0.09 E
2016					-\$0.07 E

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

## **Q1 2014 Results: Revenue May Finally Be Close To Stabilizing, Ancillary Biz Contributing...**

Zynex reported financial results for the first quarter ending March 31, 2014. While revenue fell about 6% from Q4 2013 and was slightly below our estimate, there are reasons to believe that revenue may be close to stabilizing.

As a reminder, Q4 2013 was a blood-bath with revenue dropping 35% from Q3 as the weakness experienced in the first nine months of the year due to recent changes in reimbursement was seemingly compounded in the final quarter. As Q1 has historically (aside from Q1 2013 which was unusual due to the reimbursement changes) been a relatively soft quarter in terms of revenue for Zynex due to insurance deductible resets, the 6% sequential decline in revenue may be indicative of sales finally beginning to stabilize (albeit at a relatively very low level compared to the last several years). Another glimpse of hope in that regard is that the company's latest ancillary business, the pain cream compounding pharmacy, accounted for approximately 4% of total revenue in Q1.

As we have noted in prior updates, due to the recent Medicare reimbursement changes to TENS (which we believe most private insurers adopted), Zynex will have to rely much more heavily on growing their ancillary businesses and services as well as international markets for the electrotherapy products in order to maximize sales growth. As a result of the changes implemented by CMS (which also includes required patient-to-physician face time and competitive bidding) in November 2013 ZYXI stopped accepting Medicare (however, we note that Medicare reimbursement had historically accounted for less than 10% of ZYXI's revenue).

With the pain cream business already accounting for ~4% of total sales and which, per the earnings call, has continued to show strong growth throughout April, these complementary revenue sources now appear to be making a material contribution. The company also noted that their NeuroDiagnostics (sleep apnea products) business has recently started to make a more relevant contribution.

And while revenue came in just shy of our estimate, both gross margins and operating expenses were significantly better than what we had been expecting. Gross margin was ~55% in Q4 (excluding write-down in inventory) but jumped back up to the high 60% in Q1 - compared to our 53% estimate. Operating expenses, which ZYXI began to slash in 2H 2013, came down by about \$1M from Q4 2013 to \$3.5M, compared to our \$4.3M estimate. The net result was operating loss about \$1.2M better than our estimate. While we think ZYXI will need to continue to further trim operating expenses in order to minimize net losses (on the Q1 call management noted further cuts have already been made during Q2) and conserve cash resources, the company has clearly been diligent on addressing this issue. We have since made adjustments to our GM (up) and operating expense (down) estimates.

### **Revenue**

Q1 revenue of \$3.2M fell 59% yoy, was down 6% sequentially and was about 7% lower than our \$3.4M estimate. Rental revenue was approximately \$735k, down 56% yoy (up 11% sequentially) and in-line with our \$711k estimate. Equipment sales fell 47% yoy (~flat sequentially) to \$1.1M, inline with our \$1.1M number. Consumables fell 69% yoy (-23% sequentially) to \$1.2M and were about 19% below our \$1.5M estimate. Meanwhile, revenue from pain creams accounted for approximately 4%, or \$125k, of total revenue - this is incremental revenue as the pain cream compounding business was just launched over the last several months.

While the sequential flattening of rentals and equipment sales is somewhat encouraging, we continue to have concern about consumables sales declining 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**

Q1 gross margin came in at 68.5%, compared to 71.4% in the comparable prior year period. Despite the 59% decrease in revenue yoy which resulted in less to cover the fixed portion of COGS, we think gross margin held up relatively well and was clearly much better than our 53% estimate. We have since made upward revisions to our GM estimates in future periods. While we think Billing and Consulting business as well as the compounding pharmacy businesses may provide greater margins, contribution from these businesses may not be hugely significant for the near-to-mid term. We think as these businesses grow, this will be positively reflected in widening of gross margins.

### **Net Income / EPS**

Net income and EPS were (\$1.4)M and (\$0.05), compared to our (\$1.7)M and (\$0.06) estimates.

## **Cash**

Zynex exited Q1 with \$189k in cash and equivalents, down from \$323 at 2013 year-end. Despite the \$1.4M net loss, cash used in operating activities was only \$3k. Cash flow from operations benefitted from \$357k in deferred rent and a \$741k decrease in A/R.

As of 3/31/2014 \$5.6M was drawn on the line of credit and no significant borrowing availability. At least one covenant has been tripped. ZYXI noted that they are in discussions with the lender (Doral) regarding waiver of the covenant. As we first noted in our March update, we think that the company will 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 modest cash balance.

## **Guidance**

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

## **OUTLOOK**

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). Management recently noted that they were 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. With pain creams contributing about 4% of total revenue in Q1 and showing continued strong growth in Q2, these complementary revenue sources now appear to be making a material contribution. The recent growth in the pain creams and NeuroDiagnostics revenue is a clear positive in terms of returning ZYXI to top-line growth. In addition, we could see the international electrotherapy business begin to make a more significant impact on total revenue as the company recently penned distribution agreements in Russia and China.

The company has also made important and substantial progress in trimming expenses. SG&A fell from \$5.8M in Q1 2013 to \$4.5M in Q4 2013 to \$3.5M in Q1 2014. Management noted on the Q1 call that additional cuts have been made during Q2. The company expects to 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.

The liquidity situation will need immediate attention - the company has been successful in the past with negotiating terms with its lenders - although continued success in that regard that will not necessarily address their operating funding needs. As noted, we expect the company will be looking to raise capital from other sources.

## **VALUATION**

We model negative EPS through 2017 (the out-year in our model). Our valuation methodology is based on book value. We use a 3.0x book value multiple which puts fair value at approximately \$0.40. We are maintaining our Neutral rating.

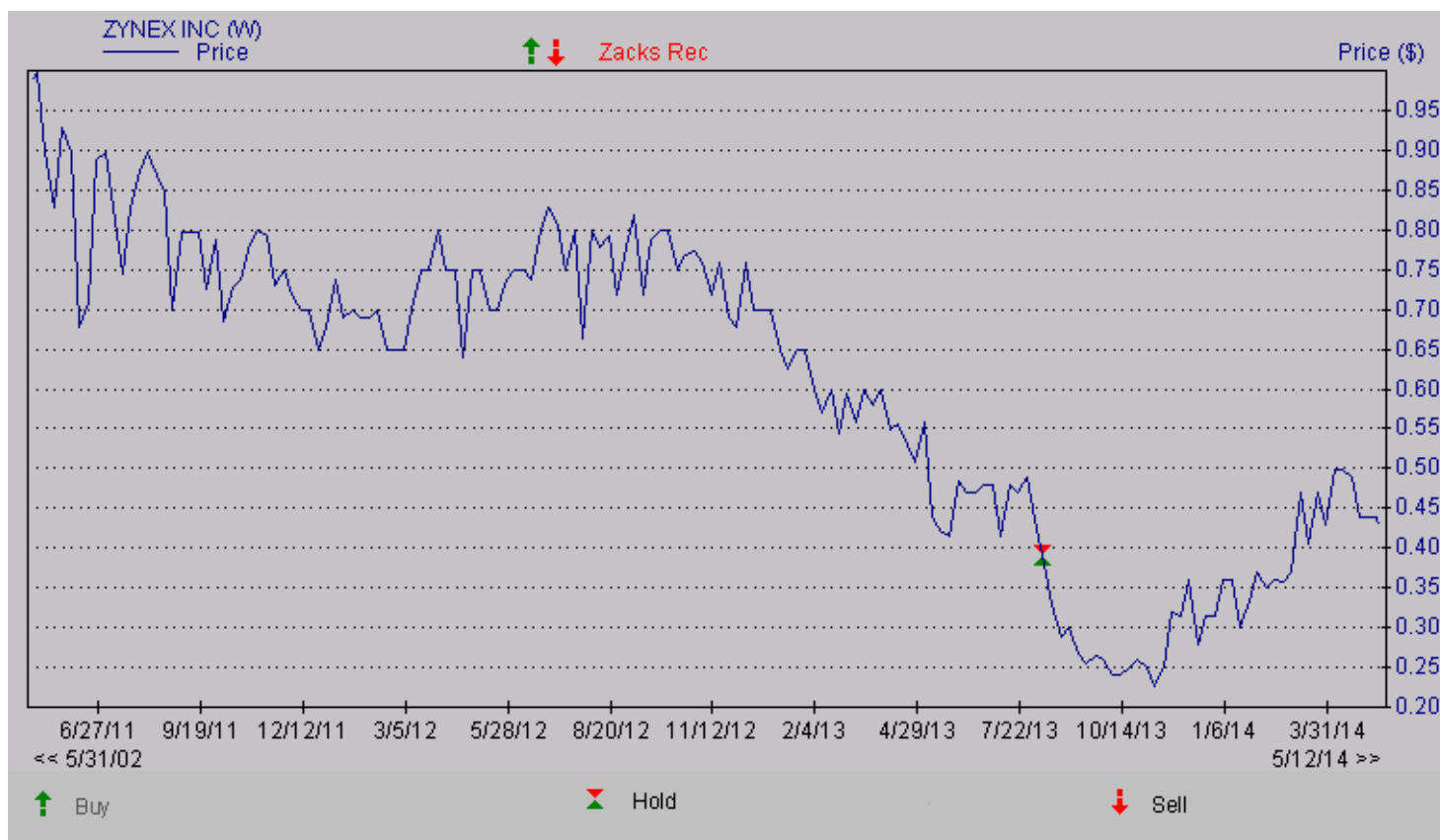
## FINANCIAL MODEL

### Zynex Inc.

	2013 A	Q1A	Q2E	Q3E	Q4E	2014 E	2015 E	2016 E	2017 E
<b>Total Revenues</b>	\$21,684.0	\$3,167.0	\$3,172.1	\$3,627.0	\$3,861.6	\$13,827.7	\$15,947.2	\$17,669.0	\$19,140.1
<i>YOY Growth</i>	-45.3%	-58.7%	-42.0%	-30.1%	15.2%	-36.2%	15.3%	10.8%	8.3%
<b>Cost of Revenues</b>	\$8,140.0	\$997.0	\$1,107.8	\$1,207.5	\$1,267.1	\$4,579.5	\$5,161.5	\$5,587.6	\$5,927.7
<b>Gross Income</b>	\$13,544.0	\$2,170.0	\$2,064.2	\$2,419.4	\$2,594.5	\$9,248.2	\$10,785.6	\$12,081.4	\$13,212.4
<i>Gross Margin</i>	62.5%	68.5%	65.1%	66.7%	67.2%	66.9%	67.6%	68.4%	69.0%
<b>SG&amp;A</b>	\$21,144.0	\$3,456.0	\$3,388.0	\$3,518.0	\$3,692.0	\$14,054.0	\$15,117.0	\$15,497.0	\$16,141.0
<i>% SG&amp;A</i>	97.5%	109.1%	106.8%	97.0%	95.6%	101.6%	94.8%	87.7%	84.3%
<b>Operating Income</b>	(\$7,600.0)	(\$1,286.0)	(\$1,323.8)	(\$1,098.6)	(\$1,097.5)	(\$4,805.8)	(\$4,331.4)	(\$3,415.6)	(\$2,928.6)
<i>Operating Margin</i>	-35.0%	-40.6%	-41.7%	-30.3%	-28.4%	-34.8%	-27.2%	-19.3%	-15.3%
<b>Interest income, net</b>	(\$607.0)	(\$158.0)	(\$160.0)	(\$160.0)	(\$160.0)	(\$638.0)	(\$820.0)	(\$900.0)	(\$1,100.0)
<b>Other income</b>	\$77.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0
<b>Gain on value of derivative liab</b>	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0
<b>Pre-Tax Income</b>	(\$8,130.0)	(\$1,444.0)	(\$1,483.8)	(\$1,258.6)	(\$1,257.5)	(\$5,443.8)	(\$5,151.4)	(\$4,315.6)	(\$4,028.6)
<b>Taxes</b>	(\$790.0)	\$0.0	(\$519.3)	(\$440.5)	(\$440.1)	(\$1,399.9)	(\$1,751.5)	(\$1,467.3)	(\$1,369.7)
<i>Tax Rate</i>	9.7%	35.0%	35.0%	35.0%	35.0%	140.0%	34.0%	34.0%	34.0%
<b>Net Income</b>	(\$7,301.0)	(\$1,430.0)	(\$964.5)	(\$818.1)	(\$817.4)	(\$4,029.9)	(\$3,399.9)	(\$2,848.3)	(\$2,658.9)
<i>YOY Growth</i>	-571.6%	370.4%	-44.2%	9.2%	-81.9%	-44.8%	-15.6%	-16.2%	-6.6%
<i>Net Margin</i>	-33.7%	-45.2%	-30.4%	-22.6%	-21.2%	-29.1%	-21.3%	-16.1%	-13.9%
<b>EPS</b>	(\$0.23)	(\$0.05)	(\$0.03)	(\$0.02)	(\$0.02)	(\$0.11)	(\$0.09)	(\$0.07)	(\$0.06)
<i>YOY Growth</i>	-572.7%	370.0%	-52.4%	-10.2%	-85.2%	-52.1%	-21.3%	-19.8%	-11.2%
<b>Diluted Shares O/S</b>	31,152	31,171	36,580	37,900	38,000	35,913	38,500	40,230	42,290

Brian Marckx, CFA

## HISTORICAL ZACKS RECOMMENDATIONS



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