Zacks Small-Cap Research

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Zynex Inc (ZYXI-OTC)

ZYXI: Reimbursement Issues, Moving Rec to Neutral

Current Recommendation	**Neutral**
Prior Recommendation	Outperform
Date of Last Change	08/08/2012
Current Price (08/08/13)	$0.39
Target Price	**$0.50**

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 have made significant downward revisions to our model following 2 straight disappointing qtrs. Longer-term upside to our model could come from pipeline and new services business, which we have yet to model.

SUMMARY DATA

52-Week High	**$0.82**
52-Week Low	**$0.35**
One-Year Return (%)	**-50.00**
Beta	**0.37**
Average Daily Volume (sh)	**10,008**
Shares Outstanding (mil)	**31**
Market Capitalization ($mil)	**$12**
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 (%)	**31.3**
Earnings Per Share (%)	**16.8**
Dividend (%)	**N/A**
P/E using TTM EPS	**7.2**
P/E using 2013 Estimate	**N/A**
P/E using 2014 Estimate	**N/A**
Zacks Rank	**N/A**

Risk Level **Above Avg.,**
Type of Stock **Small-Blend**
Industry **Med Products**

ZACKS ESTIMATES

Revenue
(in '000 of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2012	8,944 A	10,026 A	10,102 A	10,594 A	39,666 A
2013	7,668 A	5,472 A	5,599 E	5,574 E	24,313 E
2014					24,792 E
2015					25,862 E

Earnings per Share

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2012	$0.01 A	$0.02 A	$0.01 A	$0.01 A	$0.05 A
2013	-$0.01 A	-$0.06 A	-$0.04 E	-$0.03 E	-$0.14 E
2014					-$0.07 E
2015					-$0.03 E

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

Q2 2013 Financial Results: *Revenue Drops 45% on Reimbursement Issues*

Zynex reported financial results for the second quarter ending June 30, 2013 on August 8th. For the second straight quarter, results were a significant disappointment and the disappointment in Q2 was much worse than Q1. We think the numbers in Q2 validate our concerns that we expressed over the past few quarters that reimbursement, or a reduction thereof, could be a major risk. On the Q1 call management had guided towards 2013 full-year revenue of $38MM - $42MM and EPS of $0.04 - $0.08 but has clearly backed way off of those numbers and seems to be pointing to reimbursement issues as the main reason. In July ZYNX announced that they were revising their 2013 guidance to "significantly less than anticipated" and expects now to generate a net loss for the year.

Following the hugely disappointing numbers in Q2 and little in the way of confidence that the reimbursement picture will materially improve or that the company's newly launched initiatives (Billing and Consulting) and new partnerships will contribute meaningful in the near-term, we have made substantial downward revisions to our model and per share price target. We are also moving our recommendation from Outperform to Neutral.

While we think ZYXI's new initiatives (and potentially pipeline products such as the blood monitoring device) can contribute in the mid-to-long term, we will model little in contribution from these sources until there's more evidence of the real potential of these business, partnerships and products. 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). While management noted on the Q2 call that they have already begun to trim their expense base (reduction in headcount and fixed expenses, including a reduction in current year building lease), in order to return to profitability in the current reimbursement environment and with narrowing gross margins, we believe operating expense cuts may necessitate more extreme measures.

Revenue of $5.5 million fell 45% yoy and was well below our $10.1 million estimate. Rental revenue was $1.6 million, down 33% yoy and below our $2.0 million (-18%) estimate. Equipment sales were even weaker, falling 65% yoy while consumables fell 36%. The drop in consumables sales is of particular concern 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. Q2 was the first quarter of a decrease in consumables sales since at least 2009 and this may be a harbinger of what's ahead for the Zynex Medical electrotherapy business unless the reimbursement picture meaningfully improves. 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 $1.6 million (-33% y-o-y) in rentals and $3.8 million (-50% y-o-y) in product sales. The equipment portion of product sales was about $1.7 million (68%) lower than our estimate, which accounted for about 57% of the difference between our estimated total revenue ($10.1 million) and actual total revenue ($5.5 million).

	Actual Q2 2012	Actual Q2 2013	Y-o-Y Change	Zacks Est Q2 2013	Actual +/- Zacks est.
Consumables	$4,010	$2,572	-35.9%	$4,167	-38.3%
Equipment Sales	$3,579	$1,257	-64.9%	$3,885	-67.6%
Total Product Sales	$7,589	$3,829	-49.5%	$8,052	-52.4%
Rental Revenue	$2,437	$1,643	-32.6%	$2,000	-17.9%
	$10,026	**$5,472**	**-45.4%**	**$10,052**	**-45.6%**

Gross Margin

Gross margin at 65.6% continues to come in very soft and was much weaker than even Q1, which was 71.4% and had been the lowest of any quarter since Q4 2009. The 65.6% GM in Q2 is the lowest since at least 2006 and was well below our 80.1% estimate. Both rental and product sales margins were relatively weak which we think also has to do with reimbursement issues as well as the recently implemented 2.3% medical device tax. 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 current year (management noted on the call that Billing and Consulting contributed less than 1% of total revenue in Q2).

Net Income / EPS
Net income and EPS were ($1.7) million and ($0.06) compared to our $529k and $0.02 estimates. The difference a combination of the top-line miss, lower gross margin and higher SG&A as a percentage of sales.

Cash
Zynex exited Q2 with $445k in cash and equivalents, down from $681k at the end of Q1. Cash from operating activities was an inflow of $8 which benefitted from $1.3 million in A/R collections and a $433k increase in A/P. We think the credit line is nearly fully tapped which also may introduce greater liquidity concerns although management indicated on the Q2 call that they believe they can manage their liquidity situation.

Guidance
Unlike previous earnings releases management did not provide specific revenue and EPS guidance with the Q2 earnings release or on the call, although as noted, the July announcement calls for a net loss in the current year and significantly lower revenue than previous guidance of $38MM - $42MM.

OUTLOOK: *Healthcare Reform / Reimbursement Changes SERIOUSLY Effecting Revenue and Margins…*

We have made significant downward revisions to our model following the substantially disappointing numbers in Q2 which we think validates 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. 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 contribution from the new Billing and Consulting business if and when it's appropriate.

VALUATION

With the downward revisions, we now model negative EPS through 2016 (the out-year in our model) which renders our previous valuation methodology (PE/G) inappropriate. Instead we use a 1.5x book value multiple which puts fair value at approximately $0.50. We are moving our price target from $1.20/share to $0.50/share and moving our recommendation from Outperform to Neutral.

FINANCIAL MODEL

Zynex Inc.

	2012 A	Q1A	Q2A	Q3E	Q4E	2013 E	2014 E	2015 E	2016 E
Rental revenue	$8,917.0	$1,679.0	$1,643.0	$1,580.0	$1,625.0	$6,527.0	$6,574.0	$6,785.0	$6,892.0
YOY Growth	*-9.9%*	*-18.6%*	*-32.6%*	*-30.7%*	*-24.0%*	*-26.8%*	*0.7%*	*3.2%*	*1.6%*
Consumable sales	$16,479.4	$3,911.0	$2,572.0	$2,588.6	$2,561.1	$11,632.7	$11,170.0	$11,332.6	$11,328.7
YOY Growth	*27.0%*	*2.3%*	*-35.9%*	*-35.6%*	*-44.6%*	*-29.4%*	*-4.0%*	*1.5%*	*0.0%*
Equipment sales	$14,269.6	$2,078.0	$1,257.0	$1,430.0	$1,388.0	$6,153.0	$7,048.0	$7,744.0	$8,417.0
YOY Growth	*26.5%*	*-32.0%*	*-64.9%*	*-62.4%*	*-63.8%*	*-56.9%*	*14.5%*	*9.9%*	*8.7%*
Product sales revenue	$30,749.0	$5,989.0	$3,829.0	$4,018.6	$3,949.1	$17,785.7	$18,218.0	$19,076.6	$19,745.7
YOY Growth	*26.8%*	*-13.0%*	*-49.5%*	*-48.6%*	*-53.3%*	*-42.2%*	*2.4%*	*4.7%*	*3.5%*
Total Revenues	$39,666.0	$7,668.0	$5,472.0	$5,598.6	$5,574.1	$24,312.7	$24,792.0	$25,861.6	$26,637.7
YOY Growth	*16.2%*	*-14.3%*	*-45.4%*	*-44.6%*	*-47.4%*	*-38.7%*	*2.0%*	*4.3%*	*3.0%*
Cost of Revenues	$8,770.0	$2,191.0	$1,883.0	$1,906.3	$1,874.4	$7,854.7	$8,434.9	$8,809.7	$9,088.5
Gross Income	$30,896.0	$5,477.0	$3,589.0	$3,692.3	$3,699.7	$16,458.0	$16,357.2	$17,052.0	$17,549.1
Gross Margin	*77.9%*	*71.4%*	*65.6%*	*66.0%*	*66.4%*	*67.7%*	*66.0%*	*65.9%*	*65.9%*
SG&A	$28,159.0	$5,833.0	$6,153.0	$5,492.2	$5,156.0	$22,634.2	$19,486.5	$18,620.4	$18,113.6
% SG&A	*71.0%*	*76.1%*	*112.4%*	*98.1%*	*92.5%*	*93.1%*	*78.6%*	*72.0%*	*68.0%*
Operating Income	$2,737.0	($356.0)	($2,564.0)	($1,799.9)	($1,456.3)	($6,176.2)	($3,129.4)	($1,568.4)	($564.5)
Operating Margin	*6.9%*	*-4.6%*	*-46.9%*	*-32.1%*	*-26.1%*	*-25.4%*	*-12.6%*	*-6.1%*	*-2.1%*
Interest income, net	($432.0)	($130.0)	($214.0)	($160.0)	($160.0)	($664.0)	($400.0)	$0.0	$50.0
Other income	$31.0	($6.0)	$78.0	$8.0	$8.0	$88.0	$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)	($1,951.9)	($1,608.3)	($6,752.2)	($3,529.4)	($1,568.4)	($514.5)
Taxes	$788.0	($182.0)	($973.0)	($663.6)	($546.8)	($2,365.5)	($1,200.0)	($533.3)	($174.9)
Tax Rate	*33.7%*	*37.0%*	*36.0%*	*34.0%*	*34.0%*	*35.0%*	*34.0%*	*34.0%*	*34.0%*
Net Income	$1,548.0	($304.0)	($1,727.0)	($1,288.3)	($1,061.5)	($4,386.8)	($2,329.4)	($1,035.2)	($339.5)
YOY Growth	*-0.9%*	*-195.0%*	*-465.1%*	*-459.8%*	*-367.4%*	*-383.4%*	*-46.9%*	*-55.6%*	*-67.2%*
Net Margin	*3.9%*	*-4.0%*	*-31.6%*	*-23.0%*	*-19.0%*	*-18.0%*	*-9.4%*	*-4.0%*	*-1.3%*
EPS	$0.05	($0.01)	($0.06)	($0.04)	($0.03)	($0.14)	($0.07)	($0.03)	($0.01)
YOY Growth	*-1.7%*	*-194.7%*	*-466.3%*	*-459.5%*	*-366.6%*	*-383.1%*	*-48.1%*	*-55.8%*	*-67.7%*
Diluted Shares O/S	31,222	31,148	31,148	31,350	31,375	31,255	31,950	32,150	32,600

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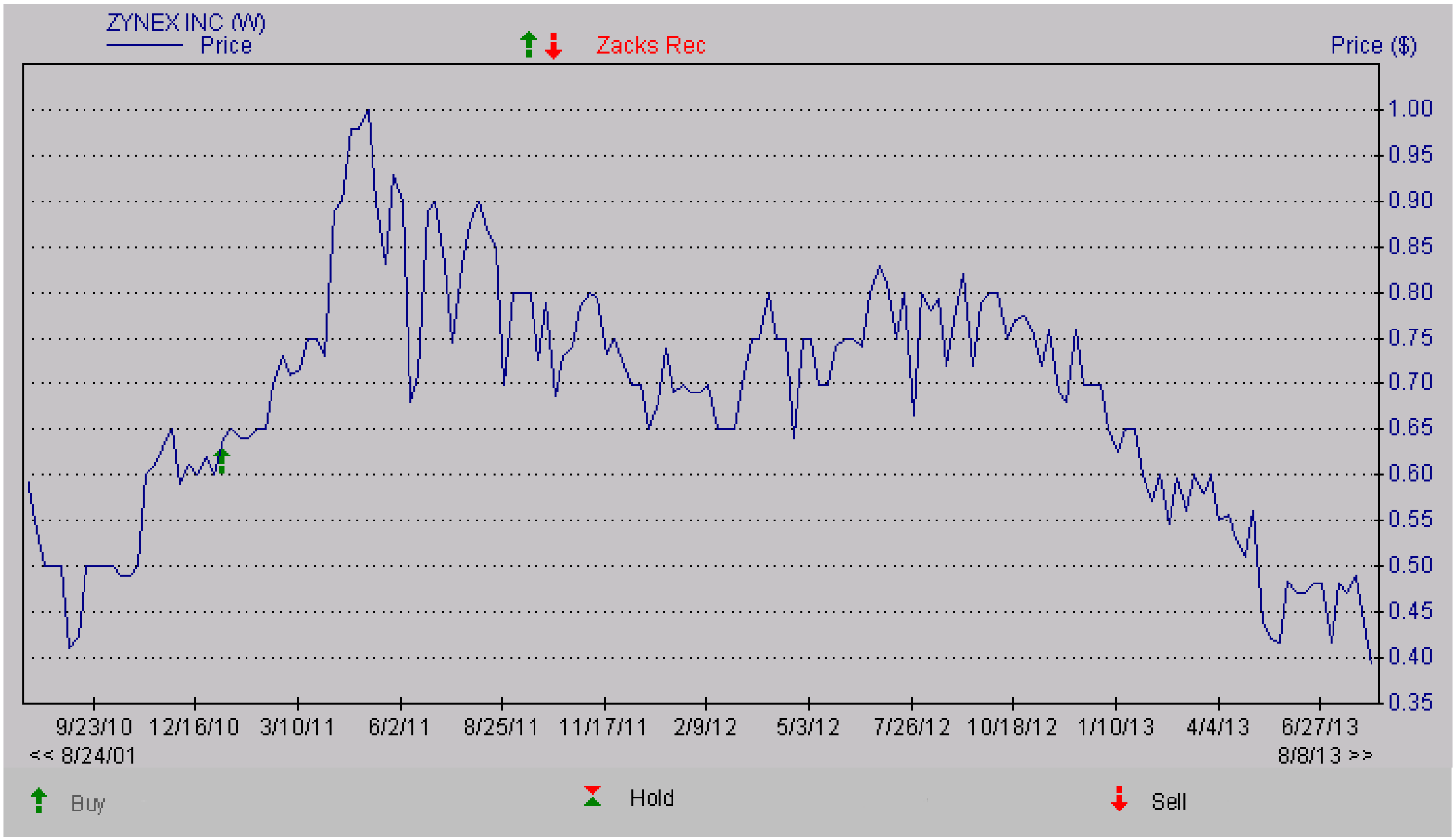
HISTORICAL ZACKS RECOMMENDATIONS



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