

OCT/BB: CMHM

August 15, 2008

**Rating:** Speculative Buy  
(Unchanged)

**Recent Price:** \$2.50  
(8/14/08)

**Price Target:** \$5.00  
(Unchanged)

## Conmed Healthcare Management, Inc.

Healthcare Services; Corrections

### MARKET DATA

52-Week High/Low	\$3.70 - \$1.30
Ave. Daily Volume (6-mos.)	19 K
Shares Outstanding	12.0 M
Inside Ownership	25.8%
Institutional Ownership	52%
Float	9.0 mln
Short Interest (% of float)	<1%

Conmed Healthcare Management is a provider of healthcare services at county and municipal correctional facilities in the continental U.S. The Company has contracts for thirty-one county sites in five states, caring for over 15,000 detainees. Services include medical and behavioral healthcare for all inmates as well as record keeping and compliance functions. Conmed is headquartered in Hanover, Maryland and maintains an Internet presence at [www.conmed-inc.com](http://www.conmed-inc.com).

### FINANCIAL DATA

Market Capitalization	\$30.0 M
- Cash & Equivalents	\$ 7.3 M
+ Long-term Debt	\$ -0- M
Enterprise Value	\$22.7 M
Book Value	\$14.3 M
Working Capital	\$ 5.9 M
Dividend Yield	Nil

Balance sheet figures as of 3/31/08

### HIGHLIGHTS

- **Strong Top-line.** Conmed reported a net loss of \$494,000 or \$0.04 per share on a record \$9.0 million in sales in the second quarter 2008.
- **Positive Cash Flow.** Operations generated \$668,000 in cash during the quarter, bringing total cash flow from operations to \$668,000 in 1H08.
- **Increased Revenue Run-rate.** Following the award of a \$19.0 million contract with Pima County in Arizona for comprehensive medical and behavior health services, the Company estimates its annual revenue run-rate is now \$48.0 million per year.
- **Updated Earnings Model.** After the 2Q08 update our model reflects a net loss of \$1.2 million or \$0.10 per share on \$38.8 million in sales for the year 2008. Our estimate for cash flow from operations for the year is unchanged at \$2.4 million.
- **Rating.** We reiterated our Speculative Buy rating on Conmed stock based on the stock's current valuation parameters and our belief that Conmed's prospects for top-line growth and profitability are stronger than ever.
- **Outlook.** The stock seems to be one of the best kept secrets on Wall Street. Continued strong year-over-year comparisons and the addition of new business should gain investor attention.

	SALES	NET EARN	CFO	EPS
2007P*	\$26.1	(\$1.7)	\$1.7	(\$0.16)
1Q08A	\$ 7.8	(\$0.6)	\$0.4	(\$0.05)
2Q08A	\$ 9.0	(\$0.5)		(\$0.04)
3Q08E	\$10.0	(\$0.1)		(\$0.01)
4Q08E	\$12.0	\$0.0		\$0.00
FY08E	\$38.8	(\$1.2)	\$2.4	(\$0.10)
FY09E	\$53.0	\$1.2	\$3.7	\$0.10

Dollars in millions, except EPS; Fiscal year ends Dec.  
\*2007 results shown pro forma for calendar year 2007

### VALUATION

Price/Sales	0.9 X
Price/CFO	15.0 X
Price/Trailing 12-mo. Earnings	Neg
Price/Book Value	2.1 X
Consensus EPS Estimate 2008	NA
Forward PE	NA
Consensus EPS Estimate 2009	NA
Forward PE	NA

**Lead Analyst:** Debra Fiakas, CFA  
212-400-7519  
[dfiakas@crystalequityresearch.com](mailto:dfiakas@crystalequityresearch.com)

**PLEASE READ THE IMPORTANT DISCLOSURES AND DISCLAIMER ON PAGES 6 AND 7 OF THIS REPORT.**

## SUMMARY

Conmed Healthcare posted record \$9.0 million revenue in the June 2008 quarter, blowing past our estimate for \$8.3 million in sales. Even though higher than normal medical costs gouged gross profits, the Company still reached breakeven cash earnings in the quarter.

We reiterated our Speculative Buy rating on Conmed stock based on the stock's current valuation parameters and our belief that Conmed's prospects for top-line growth and profitability are stronger than ever. Due to a robust business pipeline and what we see as solid execution, has been able to Conmed report robust revenue growth and improved margins over the last year. Although unexpected medical expenses could lead to earnings variance in any given quarter, we believe that risk is more than priced into the stock at current levels.

## SECOND QUARTER 2008 RESULTS

Conmed reported a net loss of \$494,000 or \$0.04 per share on \$9.0 million in sales in the second quarter 2008. This compares to our estimate for a net loss of \$373,000 or \$0.03 per share. The Company booked \$4.0 million in new business during the quarter, some of which contributed to the top-line before quarter end. Revenue increased 50% over the prior-year quarter, due to the addition of new contracts (\$2.2 million) over the last year, expansion of services under existing contracts (\$496,939) and prices increases (\$285, 196).

Gross margin in the quarter was 16.6%, well below the 18.8% earned in the first quarter and the year-ago quarter. Medical costs increased relative to sales due to higher than normal hospitalization expenses recorded at one facility during the quarter. During the second quarter earnings conference call management indicated there were an unusual number of inmates at one facility that required extended hospitalization. No long-term or persistent trend is expected.

Operating expenses totaled \$2.0 million in the quarter, resulting in a net operating loss of \$534,000. Excluding amortization expenses of \$530,000 and stock-based compensation of \$150,598, we estimate cash operating earnings were \$147,000. SG&A totaled \$1.5 million or 16.7% of total sales, compared to 20.3% in the previous quarter and 19.7% in the prior-year quarter.

Operations generated \$668,000 in cash during the quarter, bringing total cash flow from operations to \$668,000 in the first six months of 2008.

Cash on the balance sheet declined slightly over the last three months to \$7.3 million after using cash for capital investments and payments on loans. Working capital remained at \$5.9 million.

## UPDATED EARNINGS MODEL

We updated our earnings model to reflect second quarter 2008 results, but made no other changes to our earnings model. Following the award of a \$19.0 million two-year contract with Pima County in Arizona for comprehensive medical and behavior health services, the Company estimates its revenue run rate is now \$48.0 million per year. Guidance for revenue in the year 2008 is "near \$40.0 million," implying \$23.2 million in sales in the second half of the year. Although our earnings model reflects a slightly lower level, we are maintaining our sales estimates at \$22.0 million in 2H08.

We also left our cost and expense assumptions unchanged despite the 2Q08 up tick in medical expenses. We believe the second quarter medical expenses were more aberration than trend. Our profit margin assumption for each of the next two quarters falls short of the 20.0% level targeted by the Company. In our view, the 20% level is a reasonable goal as the business ramps and economies of scale in purchasing supplies and negotiating ancillary services. However, we believe it will take several more months to realize the benefits through new supplier and service provider agreements.

Our updated model now reflects a net loss of \$1.2 million or \$0.10 per share on \$38.8 million in sales for the year 2008. Our estimate for cash flow from operations for the year is unchanged at \$2.4 million.

Our estimate for 2009 sales is \$53.0 million, based on business already under contract and anticipated pricing increases, inmate population increases and expansion of services. During the earnings conference call management indicated that the Company is responding to requests for proposals by local governments involving \$15.0 million to \$25.0 million in contract value. Conmed is focused on the southwest, northwest and northern Atlantic regions where the Company has already established platforms. Typical contract size is in the range of 500 to 1,500 inmates. Based on the recent pace of contract awards, we believe it is more likely than not that at least some of the Company's business development efforts will produce new relationships, providing upside to our current estimates.

## **VALUATION AND OUTLOOK**

Our target price remains \$5.00 over the next twelve months. This assumes CMHM shares are fairly valued at 25.0 times and 16.2 times our 2008 and 2009 estimates for cash flow from operations, respectively. Our target valuation appears to eliminate the discount we suspect is currently attributed to the stock for potential variability in quarter results. We note that the risk of measurable variance in profit margins due to unusual medical expenses will diminish as the patient population is increased and diversified through the addition of new contracts. In our view, as the business builds and risk of variance diminishes, the stock merits a higher valuation.

The stock seems to be one of the best kept secrets on Wall Street. Continued strong year-over-year comparisons and the addition of new business should gain investor attention. If achieved, the swing to profitability in the fourth quarter 2008 and positive cash flow generation we expect in the coming quarters should trigger a revaluation of the stock. Once investors understand the business model and growth opportunity in detention health care, we expect to see a firming in valuation metrics.

***Additional information is available upon request.***

**Table I: Historical and Projected Sales and Expenses**

Dollars in Thousands	2006	1Q07	2Q07	3Q07	4Q07	2007	1Q08	2Q08	3Q08E	4Q08E	2008E	2009E
Total revenue	16,777	5,551	5,969	6,965	7,588	26,073	7,836	8,995	10,000	12,000	38,831	53,000
Direct costs												
Salaries, wages & benefits	8,377	2,745	3,093	3,645	4,170	13,653	4,114	4,606	5,250	6,300	20,270	27,825
Medical expenses	4,859	1,614	1,506	1,850	1,723	6,693	2,017	2,643	2,600	3,120	10,380	13,780
Other operating expenses	641	210	247	240	209	906	233	255	300	360	1,148	1,590
Direct costs	13,877	4,569	4,846	5,735	6,102	21,252	6,364	7,504	8,150	9,780	31,798	43,195
Gross profit	2,900	982	1,123	1,230	1,486	4,821	1,472	1,491	1,850	2,220	7,033	9,805
Operating expenses:												
Selling, general & administrative	1,809	959	1,178	1,106	1,300	4,543	1,589	1,495	1,500	1,680	6,264	7,010
Depreciation & amortization	40	501	572	521	499	2,093	499	530	555	555	2,139	1,240
Total operating expenses	1,849	1,460	1,750	1,627	1,799	6,636	2,088	2,025	2,055	2,235	8,403	8,250
Operating income (loss)	1,051	(478)	(627)	(397)	(313)	(1,815)	(616)	(534)	(205)	(15)	(1,370)	1,555
Other income (expense)												
Interest income	10	60	84	85	84	313	66	41	60	60	227	200
Interest expense	(7)	-	-	(3)	(4)	(7)	(2)	(2)	(2)	(2)	(8)	(3)
Total other income (expense)	3	60	84	82	80	306	64	39	58	58	219	197
Income (loss) before income taxes	1,054	(418)	(543)	(315)	(233)	(1,509)	(552)	(495)	(147)	43	(1,151)	1,752
Provision for income taxes (benefit)	-	(123)	(168)	291	162	162	-	-	-	-	-	578
Net income (loss)	1,054	(295)	(375)	(606)	(395)	(1,671)	(552)	(495)	(147)	43	(1,151)	1,174
Net EPS (loss)	na	\$ (0.09)	\$ (0.03)	\$ (0.05)	\$ (0.03)	\$ (0.16)	\$ (0.05)	\$ (0.04)	\$ (0.01)	\$ 0.00	\$ (0.10)	\$ 0.10
Weighted shares outstanding, diluted	na	3,440	11,833	11,937	11,900	10,300	11,989	12,024	12,000	12,000	12,003	12,000

\* 2006 results are shown pro forma as if the January 2007 reverse merger had occurred at the beginning of 2006.

\*\* 2007 results are shown pro forma for the calendar year, reflecting a combination of reported results for the Conmed predecessor for January 1 through January 26, 2007 and the Conmed successor for January 27 through December 31, 2007.

\*\*\* 2007 quarterly EPS figures do not sum due to the anti-dilutive effects of share issuances during the year.

Source: Company Reports and Crystal Equity Research Estimates

**Table II: Selected Measures of Historical and Projected Sales and Expenses**

Dollars in Thousands	2006	1Q07	2Q07	3Q07	4Q07	2007	1Q08	2Q08	3Q08E	4Q08E	2008E	2009E
Total revenue	16,777	5,551	5,969	6,965	7,588	26,073	7,836	8,995	10,000	12,000	38,831	53,000
Operating income (loss)	1,051	(478)	(627)	(397)	(313)	(1,815)	(616)	(534)	(205)	(15)	(1,370)	1,555
Net income (loss)	1,054	(295)	(375)	(606)	(395)	(1,671)	(552)	(495)	(147)	43	(1,151)	1,174
Net EPS (loss)	na	\$ (0.09)	\$ (0.03)	\$ (0.05)	\$ (0.03)	\$ (0.16)	\$ (0.05)	\$ (0.04)	\$ (0.01)	\$ 0.00	\$ (0.10)	\$ 0.10
Weighted shares outstanding, diluted	na	3,440	11,833	11,937	11,900	10,300	11,989	12,024	12,000	12,000	12,003	12,000
SELECTED MEASURES:												
Sales growth, yr/yr						55.4%					48.9%	36.5%
Net income growth, yr/yr						258.5%					31.1%	202.0%
EPS cont. oper. growth, yr/yr											40.9%	202.0%
Gross margin	17.3%	17.7%	18.8%	17.7%	19.6%	18.5%	18.8%	16.6%	18.5%	18.5%	18.1%	18.5%
Operating margin	6.3%	-8.6%	-10.5%	-5.7%	-4.1%	-7.0%	-7.9%	-5.9%	-2.1%	-0.1%	-3.5%	2.9%
Net margin	6.3%	-5.3%	-6.3%	-8.7%	-5.2%	-6.4%	-7.0%	-5.5%	-1.5%	0.4%	-3.0%	2.2%
Direct costs, % sales	82.7%	82.3%	81.2%	82.3%	80.4%	81.5%	81.2%	83.4%	81.5%	81.5%	81.9%	81.5%
Salaries, wages & benefits	49.9%	49.5%	51.8%	52.3%	55.0%	52.4%	52.5%	51.2%	52.5%	52.5%	52.2%	52.5%
Medical expenses	29.0%	29.1%	25.2%	26.6%	22.7%	25.7%	25.7%	29.4%	26.0%	26.0%	26.7%	26.0%
Other direct operating expenses	3.8%	3.8%	4.1%	3.4%	2.8%	3.5%	3.0%	2.8%	3.0%	3.0%	3.0%	3.0%
G&A expense, % sales	10.8%	17.3%	19.7%	15.9%	17.1%	17.4%	20.3%	16.6%	15.0%	14.0%	16.1%	13.2%
Effective tax rate	0.0%	29.4%	30.9%	-92.4%	-69.5%	-10.7%	0.0%	0.0%	0.0%	0.0%	0.0%	33.0%
EBITDA, \$\$	1,091					279					794	2,795
EBITDA margin	6.5%					1.1%					2.0%	5.3%

\* 2006 results are shown pro forma as if the January 2007 reverse merger had occurred at the beginning of 2006.

\*\* 2007 results are shown pro forma for the calendar year, reflecting a combination of reported results for the Conmed predecessor for January 1 through January 26, 2007 and the Conmed successor for January 27 through December 31, 2007.

\*\*\* 2007 quarterly EPS figures do not sum due to the anti-dilutive effects of share issuances during the year.

Source: Company Reports and Crystal Equity Research Estimates

## CRYSTAL EQUITY RESEARCH, LLC

Crystal Equity Research, LLC is an impartial research resource, providing coverage of small capitalization companies in selected industries. The firm provides research reports by subscription to institutional investors, supplies research consulting services to financial professionals and offers an issuer or agent sponsored research program for qualifying companies. Crystal Equity Research is a Registered Investment Advisor with the State of New York.

## ANALYST

Debra Fiakas, CFA is a seasoned, credentialed investment professional with a diversified and successful track record as a research analyst and as an investment banker. Her decade-plus career includes solid experience in all aspects of the equity capital markets with particular emphasis on emerging growth companies operating in the technology sectors. Ms. Fiakas is also the principal member of Crystal Equity Research, LLC.

## ANALYST CERTIFICATION

The analyst who is primarily responsible for this research and whose name is listed first under Analysts above certifies that: 1) all of the views expressed in this research accurately reflect his or her professional views about any and all of the subject securities or issuers, and 2) no part of any of the analyst's compensation was, is or will be directly or indirectly related to the specific rating expressed by analyst in this research.

## CER REPORT RESEARCH UNIVERSE\*

Speculative Buy	4	80%	Unproved business model; catalysts exist to generate higher returns
Accumulate	1	20%	Long-term return potential above 10%; near-term catalysts may not exist
Hold	0	0%	Total return potential below 10%; an acceptable long-term holding
Sell	0	0%	Potential return greater than negative 10%; take profits or stem losses
Not Rated	0	0%	No rating
<b>Total</b>	<b>5</b>	<b>100%</b>	

\*Research universe categorized by rating only; Crystal Equity Research provides no investment banking services.

## HISTORICAL RECOMMENDATIONS AND TARGET PRICE: Conmed Healthcare Management

<u>Report</u>	<u>Date</u>	<u>Price</u>	<u>Rating</u>	<u>Target Price</u>
Initial	7/7/08	\$1.70	Speculative Buy	\$4.50
Update	7/25/08	\$2.05	Speculative Buy	\$5.00
Update	8/15/08	\$2.50	Speculative Buy	\$5.00

**DISCLOSURES**

<u>Name</u>	<u>Symbol: Exchange</u>	<u>Disclosures</u>
Conmed Healthcare Management, Inc.	CMHM: OCT/BB	D

**Disclosure Key**

- A A member or employee of Crystal Equity Research, LLC serves on the board of directors of the company.
- B A controlling member of Crystal Equity Research, LLC has a beneficial interest in the common stock of the company.
- C A person or persons preparing this report or an immediate family member of the preparer has a beneficial interest in the common stock of the company.
- D Crystal Equity Research, LLC received compensation for research coverage from the company or one of its agents. Subscription fees for CER Research Coverage are paid in advance in cash.
- E The company has a convertible issue outstanding.
- F The securities covered in this report can be optioned.
- G The securities covered in this report can be margined.

**ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST.** Inquiries may be made by telephone at **212-400-7519**, by electronic message to **info@crystalequityresearch.com** or by mail to **1040 Avenue of the Americas, Floor 24, New York, NY 10018**. Additional information about Crystal Equity Research is available at the firm's web site at **www.crystalequityresearch.com**.

---

The information and opinions in this report were prepared by Crystal Equity Research, LLC. The information herein is believed to be reliable and has been obtained from public sources believed to be reliable. We make no representation as to the accuracy or completeness of such information. Opinions, estimates and projections in this report constitute the current judgment of the author as of the date of the report and are subject to change without notice. We have no obligation to update, modify or amend this report or to otherwise notify a reader thereof in the event that any matter stated herein, or any opinion, projection, forecast or estimate set forth herein, changes or subsequently becomes inaccurate, or if research on the subject company is withdrawn.

This report is provided for informational purposes only. It is not to be construed as an offer to buy or sell or a solicitation of an offer to buy or sell any financial instruments or to participate in any particular trading strategy in any jurisdiction. Opinions and recommendations in our reports do not take into account individual investor circumstances, objectives, or needs and are not intended as recommendations of particular securities or strategies to particular investors. The recipients of our reports must make their own independent decisions regarding any securities mentioned in our reports.

Crystal Equity Research, LLC may receive compensation from the company or companies mentioned in this report or agents acting on their behalf. Please review the important disclosures in this report.

This report may not be reproduced, distributed or published by any person for any purpose without the prior written consent of Crystal Equity Research. Please cite source when quoting.

Copyright © 2007-2008 Crystal Equity Research, LLC.