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INSTITUTIONAL RESEARCH

Healthcare & Biotechnology

UPDATE REPORT

Endologix, Inc. (ELGX)

New Products in Q4 2008/Q1 2009 Should Lead to Major Increase in Revenues and CF B/E in 2009

BUY

September 3, 2008

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Current Price

\$2.77

Target Price

\$5.50

Investment Highlights:

1. Endologix, Inc. continues to gain traction with its Powerlink System endoluminal stent graft (ELG) for the minimally invasive treatment of abdominal aortic aneurysms (AAA) with Q2 revenues increasing 48% Y/Y to \$9.3 million and 11% sequentially.
2. New management reduces 2008 revenue outlook to \$37 to \$40 million from \$39 to \$43 million.
3. Given the reduction in revenues, partially offset by the recent FDA approval of ELGX's own manufacturing of ePTFE (expanded Polytetrafluoroethylene) will have in 2008, management now estimates it will be cash flow positive in the first half of 2009, not in Q4 2008 as previously projected.
4. **Large, Underserved Market:** \$300 million in the U.S., the AAA market is expected to grow to \$600 million on a world wide basis by 2009.
5. **Milestones:** Compelling long-term clinical data continues to mount; additional cases for the treatment of thoracic aortic dissection with the Powerlink Dissection Stent System (DSS); commercial rollout of Visiflex SurePass Delivery System; approval of the Powerlink in Japan.

Stock Data

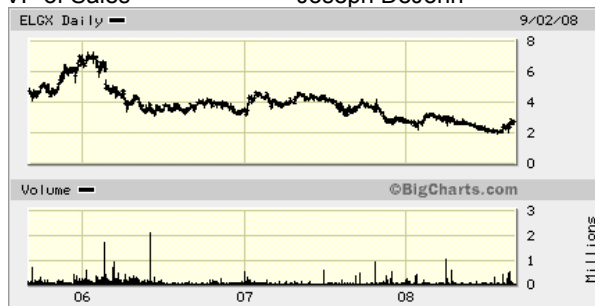
52-Week Range	\$1.96-4.19
Shares Outstanding (Mill)	43.0
Market Capital. (\$Mill)	\$120.0
Average Daily Volume	77,138
Book Value/Share	\$0.66
Price/Book	4.1x
Cash / Securities (\$Mill)	\$5.6
Cash/Share	\$0.13
Insider Ownership	6.6%
Institutional Ownership	76.6%
Debt (\$Mill)	\$0
Dividend/Yield	N/A
Short Interest (\$Mill) / %	\$0.8 / 8.0.7%

Estimates	2007	2008E	2009E
Sales	\$27.2	\$37.1	\$48.0
EPS	(\$0.36)	(\$0.30)	(\$0.15)
Net Inc. (Loss) (\$Mill)	(\$15.0)	(\$12.6)	(\$6.4)

See last page for important disclosures and analyst certification.

Management

CEO & Pres	John McDermott
CFO	Robert J. Krist
VP of Sales	Joseph DeJohn



Price target and ratings changes over the past 3 years:
Initiated May 22, 2007 – Buy – Price Target \$5.50

**Endologix Reports Q2 Revenues In-Line But Per Share Loss Greater than Expected
Revenue Guidance Revised Downward to \$37 to \$40 million from \$39 to \$43 million
Company Remains Takeover Candidate**

- While the second quarter met our expectations at the top line with revenues only \$200,000 below our estimate, expenses were greater than we had anticipated and the new CEO, John McDermott, has taken the opportunity to reign in the revenue forecast for the remainder of 2008. **Revenue guidance was revised downward to \$37 to \$40 million from \$39 to \$43 million. We have also revised our 2009 revenue forecast to \$48 million from our previous estimate of \$52 million.** This would still represent a 30% Y/Y increase from our revised 2008 revenue forecast of \$37 million.
- More disconcerting to us is the fact that the **sales force still seems in turmoil with discontent by management for the productivity of the current cadre of sales professionals.** To rectify this, the company implementing several initiatives. In July, the company announced the appointment of Joseph A. DeJohn as Vice President of Sales. DeJohn brings more than 20 years of sales management experience in the medical device industry, including serving in senior positions in the peripheral vascular device division at C.R. Bard Corporation where he worked with John McDermott.
- Management also announced that based on newly acquired AAA hospital data it is evaluating sales territories with the goal of optimizing its territorial structure. Additionally, beginning in the current quarter management announced a new sales compensation plan that puts greater emphasis on per-territory sales increases. McDermott also expressed concern about a higher than acceptable sales rep turnover which he proposes to fix by increasing training for which the company has hired a dedicate sales training manager with significant AAA experience.
- Although we can sympathize with management's desire to send a fully trained "senior" sales force into the field, we are forced to reduce our expectations for both 2008 and 2009 revenue forecasts which results in a delay in the company reaching cash flow neutrality and eventual profitability. Cash flow neutrality will now occur, according to management, in the first half of 2009 instead of late 2008. Our analysis suggests it could occur in the second quarter of 2009.
- Endologix, Inc. continues to gain strong traction with its Powerlink System endoluminal stent graft (ELG) for the minimally invasive treatment of abdominal aortic aneurysms (AAA) with Q2 revenues increasing 48% Y/Y to \$9.3 million and up 11% on a sequential basis. Both rates of increase exceeded first quarter results which were an increase of 33% Y/Y and 5% sequentially. However, **given the lower limit of the revised guidance, we would suggest that Q3 revenues could be flat on a sequential basis at around \$9.5 million (up 32% Y/Y) and Q4 revenues would then come in at about \$10 million (up 25% Y/Y).**
- ELGX reported a loss of \$3.8 million or \$0.09 per share, greater than our \$0.05 per share loss estimate. The difference was attributed by management to be, higher legal expenses, expenses associated with the CEO transition and the expected launch of two new products in late 2008 (a 34 millimeter aortic cuff) and early 2009 (a simpler and more intuitive delivery system).
- Gross margin in the quarter was 72.6% up from 58.2% in the same period a year ago. Being able to manufacture its own ePTFE is estimated by management to be capable of increasing gross

margin by 1,500 to 1,800 basis points. Approximately 1500 basis points have been realized already with small incremental improvements possible over subsequent quarters.

- Despite some greater than normal turnover in its sales force, it now numbers 50, approximately the same number as last quarter.
- The company is involved in three clinical trials that could increase the potential market for EVAR patients by as much as 20%. These include studies that will include larger neck devices, longer devices and devices to treat iliac aneurysms.
- It has been our long held belief that once ELGX was able to demonstrate the competitiveness (and perhaps superiority) of its technology and that it could achieve sales traction it would become a likely acquisition candidate. We believe that while the evidence has been mounting that the company can be successful in establishing a sales force capable of achieving sequential sales increases on a consistent basis, the maturation and productivity of the sales force has always been an issue for Endologix. **Although recent sales initiatives and the reduction in revenue guidance give us pause, we believe it is better for new management to address these issues than it would be to ignore them.**
- Moreover, we believe that constant improvements in the delivery system which make it easier and faster for surgeons to perform this less invasive procedure will lead to greater adoption of the Powerlink. Incorporating the Visiflex SurePass Delivery System, to what is still the only one piece, FDA approved, AAA endoluminal stent, results in a very attractive product in our opinion. Certainly these facts, along with the dramatic improvement in gross margin that will result from the conversion of purchasing ePTFE from an outside vendor to self manufacturing, should not indefinitely escape the notice of strategic players in the endovascular space.
- **On a takeout, we believe ELGX could garner a price of at least \$5.50 based on a multiple of 2009 revenues of 5X. We are maintaining our investment recommendation at BUY,** and continue to believe current shareholders should maintain positions because we believe ELGX still represents a very attractive takeover opportunity by a major company in the vascular arena.

RISKS

We believe a BUY position with ELGX involves the following risks:

- **Clinical Indications** – ELGX continues to explore technology upgrades such as the Visiflex SurePass Delivery System. The Visiflex SurePass is the Company’s next generation delivery device that allows physicians continued guidewire access to the contralateral limb of the unibody Powerlink ELG device. Additional indications for use of its current technologies include thoracic aortic dissection patient with the Company’s Powerlink Dissection Stent System (DSS). The Powerlink DSS, a variant of the Powerlink technology without the ePTFE graft cover, is being used as an investigational device in the European Union and is not currently available in the United States. Its inability to discover and commercialize these new applications and product improvements could relegate revenue growth to high single digits. While ELGX has a competitive product line with many innovative devices, the abdominal aortic aneurysm market is highly competitive and the requirement for innovation and new clinical indications is enormous. A set-back or delay in such an initiative would negatively impact the company.
- **Regulatory** – ELGX relies on all of its products receiving approval from the Food and Drug Administration. The company currently has several products under development that must go through the approval process prior to commercial availability. Any delay will negatively impact the company.
- **Litigation**—From time to time ELGX is engaged in litigation that is normal for the medical device industry. At the present time the company is not engaged in any major outstanding legal. However, the outcome of potentially unknown litigation could have an adverse impact on ELGX.
- **Reimbursement** – Since many of the patients receiving ELGX’s products are elderly, there is significant governmental reimbursement, especially through Medicare and some from private insurance. Although endovascular treatment of AAA is economically appealing relative to open surgery, changes in reimbursement could have a negative effect on revenues.
- **Competition** – The AAA device industry is highly competitive, from both private and public companies.
- **Sector Rotation** – ELGX is a medical device company and is often held in a portfolio with other device companies. A material event affecting one company many times affects the entire group.

ENDOLOGIX, INC.															
Quarterly Earnings Model 2007E-2009E															
Fiscal Year Ends December 31															
(\$ millions, except per share)															
	Mar-07	Jun-07	Sep-07	Dec-07	2007	Mar-08	Jun-08	Sep-08	Dec-08	2008	Mar-09	Jun-09	Sep-09	Dec-09	2009
Product Revenue	\$6.3	\$6.3	\$6.6	\$8.0	\$27.2	\$8.3	\$9.3	\$9.5	\$10.0	\$37.1	\$11.0	\$12.0	\$12.0	\$13.0	\$48.0
License Revenue			\$0.6				\$0.0								
Total Revenue			\$7.2				\$9.3								
Gross Margin	59.6%	58.2%	59.6%	63.8%		69.6%	72.5%	74.0%	75.0%	75.0%	75.0%	75.0%	75.0%	75.0%	75.0%
Gross Profit	\$3.8	\$3.7	\$4.7	\$5.1	\$17.3	\$5.8	\$6.7	\$7.0	\$7.5	\$27.0	\$8.3	\$9.0	\$9.0	\$9.8	\$36.0
R & D	1.6	1.5	1.6	1.7	6.4	1.5	1.8	1.6	1.6	6.5	1.6	1.6	1.6	1.6	6.4
S & M	5.2	4.7	4.8	5.5	20.2	5.8	6.1	6.1	6.4	24.4	6.7	7.0	7.0	7.3	28.0
G & A	1.6	1.4	1.6	1.7	6.4	2.3	2.6	2.0	2.0	8.9	2.0	2.0	2.0	2.0	8.0
Op. Inc.	\$ (4.6)	\$ (3.9)	\$ (3.3)	\$ (3.8)	\$ (15.6)	\$ (3.8)	\$ (3.8)	\$ (2.7)	\$ (2.5)	\$ (12.8)	\$ (2.1)	\$ (1.6)	\$ (1.6)	\$ (1.2)	\$ (6.4)
Int. Inc./Other	0.2	0.2	-0.1	0.2	0.6	0.1	0.1								
Net Inc.	(4.4)	(3.7)	(3.4)	(3.5)	(15.0)	(3.7)	(3.8)	(2.7)	(2.5)	(12.6)	(2.1)	(1.6)	(1.6)	(1.2)	(6.4)
Dep. & Amort.	0.5	0.5	0.6	0.6	2.2	0.4	0.7	0.7	0.7	2.5	0.7	0.7	0.7	0.7	2.8
Op. Cash Flow	\$ (4.1)	\$ (3.4)	\$ (2.7)	\$ (3.2)	\$ (13.4)	\$ (3.4)	\$ (3.1)	\$ (2.0)	\$ (1.8)	\$ (10.3)	\$ (1.4)	\$ (0.9)	\$ (0.9)	\$ (0.5)	\$ (3.6)
SFAS 123R	\$ 0.5	\$ 0.5	\$ 0.5	\$ 0.6	\$ 2.1	\$ 0.6	\$ 0.5	\$ 0.5	\$ 0.5	\$ 2.1	\$ 0.5	\$ 0.5	\$ 0.5	\$ 0.5	\$ 2.0
Net Cash Flow	\$ (3.6)	\$ (2.9)	\$ (2.2)	\$ (2.6)	\$ (11.3)	\$ (2.8)	\$ (2.6)	\$ (1.5)	\$ (1.3)	\$ (8.2)	\$ (0.9)	\$ (0.4)	\$ (0.4)	\$ 0.1	\$ (1.6)
Shares Out.	42.7	42.7	42.9	42.9	42.8	43.0	42.976	42.9	42.9	42.9	42.9	42.9	42.9	42.9	42.9
EPS	\$ (0.11)	\$ (0.09)	\$ (0.08)	\$ (0.08)	\$ (0.36)	\$ (0.09)	\$ (0.09)	\$ (0.06)	\$ (0.06)	\$ (0.30)	\$ (0.05)	\$ (0.04)	\$ (0.04)	\$ (0.03)	\$ (0.15)
Net CF/Share	\$ (0.08)	\$ (0.07)	\$ (0.05)	\$ (0.06)	\$ (0.25)	\$ (0.07)	\$ (0.06)	\$ (0.03)	\$ (0.03)	\$ (0.19)	\$ (0.02)	\$ (0.01)	\$ (0.01)	\$ 0.00	\$ (0.04)
John M. Putnam, CFA															
Dawson James Securities, Inc.															

ENDOLOGIX, INC.
 CONDENSED CONSOLIDATED BALANCE SHEETS
 (In thousands, except share and par value amounts)
 (Unaudited)

	<u>June 30,</u> <u>2008</u>	<u>December 31,</u> <u>2007</u>
ASSETS		
Current assets:		
Cash and cash equivalents	\$5,602	\$ 8,728
Restricted cash equivalents	500	500
Accounts receivable, net of allowance for doubtful accounts of \$137 and \$100, respectively	4,967	4,527
Other receivables	11	234
Inventories	7,179	8,054
Other current assets	<u>308</u>	<u>581</u>
Total current assets	<u>18,567</u>	<u>22,624</u>
Property and equipment, net	3,487	3,771
Goodwill	4,631	4,631
Intangibles, net	8,211	8,913
Other assets	<u>104</u>	<u>104</u>
Total assets	<u>\$35,000</u>	<u>\$ 40,043</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	<u>\$5,006</u>	<u>\$ 4,259</u>
Total current liabilities	5,006	4,259
Long term liabilities	<u>1,077</u>	<u>1,109</u>
Total liabilities	<u>6,083</u>	<u>5,368</u>
Commitments and contingencies (Note 12)		
Stockholders' equity:		
Convertible preferred stock, \$0.001 par value; 5,000,000 shares authorized, no shares issued and outstanding	—	—
Common stock, \$0.001 par value; 60,000,000 shares authorized, 44,124,000 and 43,453,000 shares issued, respectively, and 43,629,000 and 42,958,000 shares outstanding, respectively	44	43
Additional paid-in capital	168,518	166,912
Accumulated deficit	(139,192)	(131,738)
Treasury stock, at cost, 495,000 shares	(661)	(661)
Accumulated other comprehensive income	<u>208</u>	<u>119</u>
Total stockholders' equity	<u>28,917</u>	<u>34,675</u>
Total liabilities and stockholders' equity	<u>\$35,000</u>	<u>\$ 40,043</u>

DISCLOSURES


Initiated May 22, 2007 – BUY – Price Target \$5.50

Analyst Certification: The analyst(s) whose name appears on this research report certifies that 1) all of the views expressed in this report accurately reflect his personal views about any and all of the subject securities or issuers discussed; and 2) no part of the research analyst's compensation was, is, or will be directly or indirectly related to the specific recommendations or views expressed by the research analyst in this research report; and 3) All Dawson James employees, including the analyst(s) responsible for preparing this research report, may be eligible to receive non-product or service specific monetary bonus compensation that is based upon various factors, including total revenues of Dawson James and its affiliates as well as a portion of the proceeds from a broad pool of investment vehicles consisting of components of the compensation generated by investment banking activities, including but not limited to shares of stock and/or warrants, which may or may not include the securities referenced in this report.

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Ratings Distribution	Company Coverage		Investment Banking	
	# of Companies	% of Total	# of Companies	% of Totals
Speculative Buy	7	28%	4	57%
Strong Buy	3	12%	1	33%
Buy	11	44%	0	0%
Neutral	3	12%	2	67%
Sell	1	4%	0	0%
Sell Short	0	0%	0	0%
Under Review	0	0%	0	0%
Restricted	0	0%	0	0%
Total	25	100%	7	28%

Information about valuation methods and risks can be found in the “STOCK VALUATION” and “RISKS” sections of this report.

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