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Home Diagnostics (Nasdaq/HDIX)

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BUY **Q3 OK; 2009 revised downward**

Home Diagnostics manufactures and markets diabetes testing supplies

Investment Highlights

1) Home Diagnostics (HDIX) reported solid **operating results** for their Q3/2009 last week, earning \$0.17 per share on revenues of \$34.5 million, down from \$0.22 on revenues of \$35.6 million (a decrease of 3% year-over-year). These results were slightly below our estimates of \$34.9 million in revenues and above our \$0.16 in earnings per share. Revenues, although down vis-à-vis last year, were 6% above the prior quarter. The rebound in revenues was led by increases in retail channel sales of 8%, international sales of almost 20% and mail order sales of 14%, offset by a decrease in distribution segment sales of 17%, a similar pattern shown since the start of this year. Gross margins took a step back, however, falling to 51.8% from 60.8% in the prior year and 53.0% in the prior quarter. Lower pricing in the distribution and mail order sectors and a lower meter-to-strip ratio as the new product line was rolled-out factored into the lower margins for the quarter. We had forecast that margins in Q3 would have been closer or even better than margins from the prior quarter. A continued emphasis on overhead cost savings helped lower S, G & A costs, down to \$11.6 million versus \$13.4 million one year ago, and combined with a lower tax rate this was enough to bring earnings per share in slightly above our expectations.

2) **While Q3/09 results were in-line or even above expectations**, Company management guided financial results for the year as a whole downward following the earnings report, to revenues in the range of \$126-\$127 million and earnings per share in the range of \$0.30-\$0.32. Our estimates had been revenues of \$130.3 million, or an increase of 5% year-over-year, and earnings per share of \$0.36 versus \$0.43 in the prior year. The primary reason given for the shortfall was the difficult market conditions, particularly in the distribution sector, as the handful of large medical distributions tighten inventories even more this fall. We are adjusting our estimates for the fourth quarter for Home Diagnostics to \$34.7 million in revenues (down from \$38.1 million) and \$0.15 per share in earnings, down from \$0.19. Despite the

Current Price **\$6.04**

Price Target **\$10.00**

Estimates	F2007A	F2008A	F2009E
Sales(\$mil)	\$115.6	\$123.6	\$126.5
1Q	28.1	25.1	24.6 A
2Q	28.1	33.4	32.7 A
3Q	31.7	35.6	34.5 A
4Q	27.8	29.5	34.7 E
Prev. Rev. Estimate (\$ mil.)			\$130.3
EPS	\$0.49	\$0.43	\$0.32
1Q	0.13	0.01	(0.10) A
2Q	0.09	0.14	0.11 A
3Q	0.27	0.22	0.17 A
4Q	0.01	0.06	0.15 E
Previous EPS Estimate			\$0.36
P/E (x)	12.3	13.9	18.8
EBITDA/Share	\$0.92	\$0.88	\$0.77
EV/EBITDA (x)	5.3	5.6	6.3
Stock Data			
52-Week Range			\$4.41-\$7.81
Shares Outstanding (mil.)			17.6
Market Capitalization (mil.)			\$106.4
Enterprise Value (mil.)			\$86.4
Debt to Capital (6/09)			0.5%
Book Value/Share (6/09)			\$6.18
Price/Book			1.0 x
Average Trading Volume (3-Month)			22,000
Insider Ownership			40.5%
Institutional Ownership			45.2%
Short interest			300,000
Dividend / Yield			\$0.00/0.0%



Price target and ratings changes over the past 3 yrs:
Initiated - July 15, 2009 - Price Target \$10.00

downward revision, Q4/09 results represent a very strong rebound from the prior year fourth quarter, when the tough times began for the industry, with revenues projected to increase 17% and EPS more than double. We are projecting gross margins for Q4 to stay level with those of Q3/09 at 52.0%, slightly better than the same period last year. The fourth quarter is seasonally a slow one for Home Diagnostics following a very active fall season.

3) We are also **revising our estimates for 2010**, to revenues of \$135.9 million, up 7.5% year-over-year, and to \$0.45 per share in earnings, down from our previous levels of \$0.65 but still a very strong 50% increase from 2009 estimates of \$0.32 per share. Our projections include strong revenue growth in all sectors except for distribution (flat), with slight improvements in gross margins to 53%, and steady overhead costs (38% of sales) as compared with this year. We are also assuming R&D expenses to remain stable at a little over 6% of sales. Health care reform next year could also be a major factor in sales and pricing, especially in the Medicare/Medicaid/"private option" arenas, although it is still too early to project this effect, if any, for 2010.

4) Home Diagnostics **continued to make investments in its plant** expansion in the third quarter, despite the industry doldrums, and is on track to complete the tripling of capacity by sometime mid next year. Although there will be a strong component of lower costs embedded in the facility expansion, and growth in sales to the retail (primarily Wal-Mart), mail order (Liberty Medical and managed care providers) and international markets (primarily Europe) will also help fill up the new plant, we can't help but wonder if Company management does not have something dramatic in mind for accelerated growth next year. New initiatives could be large **manufacturing outsourcing** contracts (especially moving production back from overseas) or even an **acquisition or two**, either of new, related products or perhaps a whole test strip product line from a large pharma that has tired of this competitive market. Home Diagnostics still has plenty of financial resources with which to complete its facilities expansion or make an acquisition, with over \$22 million in the bank and no long-term debt, and operating cash flow estimated at a positive \$13-\$15 million more next year.

Conclusion

Home Diagnostics has established itself as a well-rounded, innovative, and profitable participant in the high-growth diabetes testing market, despite going toe-to-toe with industry heavyweights. Shares have held steady this year despite the market rebound, as the Company continues its investment in new programs and new capacity, even while earnings suffer a bit versus last year. Still, even with overall economic and government reimbursement uncertainty, the incidence and acuity of diabetes is growing in the US, and HDIX's innovative and cost-saving product line should fare extremely well in 2010 and beyond, once this year's investments are complete. Thanks to a strong balance sheet and weak stock price, Home Diagnostics has been able to complete its share re-purchase program, which will boost earnings per share, particularly in 2010. Therefore, we are maintaining our BUY rating on this under-valued stock with a 12-18 month price target of \$10, still below the IPO price and at reasonable multiples of 1.6X book value per share and 22X estimated earnings for next year of \$0.45 per share.

Stock Valuation/Comparables

Home Diagnostics' shares currently trade at a discount to our list of comparable medical supply and distribution stocks based on last year's actual earnings, although the shares now trade at a premium to comparables based on this year's earnings estimates. (See Table 1 below) All current valuation metrics still pale when compared with those of recent buy-outs, such as 2007's purchase of PolyMedica (Liberty Medical's parent) by Medco Health, at a time of more favorable market conditions. Longer-term, however, we retain faith in the strength of the diabetes market and Home Diagnostics' strategic position within this market, and thus we believe that the inherent value of Home Diagnostics is much higher than current trading levels, up to 22X 2010E estimated earnings of \$0.45, or \$10 per share.

Risk Factors

The diabetes market, like many healthcare areas, is heavily dependent on **Federal Medicare reimbursement** for Senior Citizens, which could be subject to a competitive bidding process as early as 2010. This market is also subject to **FDA approvals**, as well as recent low-cost Asian entrants and a number of larger, well-heeled competitors which could put pressure on prices, if desired. Finally, the FDA has been meeting with a number of manufacturers of blood glucose meters, including the Company, to discuss safety concerns related to the use of the **GDH-PQQ enzyme** by certain patients undergoing other treatments containing maltose or its derivatives. The Company continues to have positive meetings with the FDA regarding the development of a mitigation plan related to the use of the new TRUEtest strips, which contain the enzyme, in the small population of patients receiving maltose-based therapies.

Catalysts/Investor Timeline

- 1) Progress of capacity expansion of US plant –ongoing in 2009; completed validation by mid-2010
- 2) Follow-up meetings with FDA regarding GDH-PQQ enzyme mitigation plan – H2/2009
- 3) New US retail partners; international distribution JVs; potential acquisitions – 2009-10

Table 1. Medical Supply Distribution and Mail Order Comparable Company Analysis

Company	Symbol	Price	Shares	Market Cap	Calendar Year		Revenues	Calendar Year		Price/Revs	Earnings	Notes
			(millions)	(\$Millions)	EPS '08A	EPS '09E	2009E	P/E '08A	P/E '09E	2009E	Growth	
Medco Health	MHS	\$60.64	473.7	28,725.2	2.33	2.82	59,630	26.0	21.5	0.48	21.0%	Purchased PolyMedica in late 2007
Henry Schein	HSIC	\$50.63	90.2	4,566.8	2.96	3.21	6,430	17.1	15.8	0.71	8.4%	
McKesson	MCK	\$62.58	268.0	16,771.4	3.87	4.54	10,700	16.2	13.8	1.57	17.3%	
Owens & Minor	OMI	\$41.83	41.2	1,723.4	2.44	2.59	8,070	17.1	16.2	0.21	6.1%	Sold Diabetes business to Medco Liberty in '09
Express Scripts	ESRX	\$85.30	274.7	23,431.9	3.10	3.42	23,840	27.5	24.9	0.98	10.3%	Buying WellPoint's PBM
PSS Worldwide	PSSI	\$20.55	59.4	1,220.7	0.92	1.19	2,080	22.3	17.3	0.59	29.3%	
Average								21.0	18.2	0.76	15.4%	
Home Diagnostics	HDIX	\$6.04	17.6	106.4	0.43	0.32	126	13.9	18.8	0.84	-26.0%	Also manufacturer
<i>Discount/(Premium)</i>								33.9%	-3.1%	-11.2%		
Recent Private Transactions												
PolyMedica	PLMD	\$53.00	23.4	1,240.2	2.15	2.35	800	24.7	22.6	1.55	9.3%	Reflects Medco Buy-out in late 2007

Source: Dawson James Securities; Thomson Analytics

Home Diagnostics, Inc.
Consolidated Statements of Operations
 (in \$000, except EPS)

FYE December	2002	2003	2004	2005	2006	2007	1Q08 (March)	2Q08 (June)	3Q08 (Sept)	4Q08 (Dec)	2008	1Q09 (March)	2Q09 (June)	3Q09 (Sept)	4Q09E (Dec)	2009E	2010E
Net sales	72,399	73,709	85,082	100,165	112,628	115,601	25,120	33,356	35,565	29,542	123,582	24,602	32,654	34,500	34,700	126,455	135,900
Cost of Sales	29,464	29,400	35,570	41,149	44,287	45,556	10,532	13,470	13,935	14,409	52,346	13,018	15,339	16,616	16,700	61,673	63,900
Gross profit	42,935	44,309	49,512	59,017	68,341	70,046	14,588	19,886	21,629	15,133	71,237	11,583	17,315	17,884	18,000	64,783	72,000
Operating expenses:																	
Sell. gen. & admin.	24,048	22,581	29,022	37,259	42,603	46,826	11,871	13,699	13,399	12,480	51,448	12,109	12,574	11,594	11,600	47,877	51,600
Research & dev.	6,366	5,990	5,713	6,526	8,230	8,928	2,357	2,427	2,036	1,816	8,635	1,884	1,971	2,051	2,300	8,206	8,600
Total	30,414	28,571	34,734	43,785	50,833	55,754	14,228	16,125	15,435	14,295	60,083	13,992	14,545	13,645	13,900	56,083	60,200
Income before taxes	12,521	15,738	14,778	15,232	17,508	14,291	361	3,761	6,194	838	11,153	(2,409)	2,770	4,239	4,100	8,700	11,800
Other income (expense)	(3,578)	(3,482)	(11,119)	(3,318)	(2,818)	(1,275)	(199)	320	149	285	555	170	33	(21)	(20)	162	800
Pre-tax income	8,943	12,256	3,659	11,914	14,690	13,016	162	4,080	6,343	1,123	11,708	(2,239)	2,803	4,218	4,080	8,862	12,600
Income taxes	4,067	4,323	1,692	5,982	4,380	3,388	(559)	1,397	1,809	(582)	2,064	(540)	907	1,302	1,500	3,169	4,700
Net income	4,876	7,933	1,966	5,932	10,309	9,628	721	2,683	4,534	1,704	9,644	(1,699)	1,896	2,916	2,580	5,693	7,900
EPS - basic	\$0.35	\$0.57	\$0.14	\$0.43	\$0.74	\$0.54	\$0.04	\$0.15	\$0.26	\$0.10	\$0.54	(\$0.10)	\$0.11	\$0.17	\$0.15	\$0.33	\$0.46
EPS - diluted	\$0.35	\$0.56	\$0.14	\$0.39	\$0.59	\$0.49	\$0.04	\$0.14	\$0.24	\$0.09	\$0.51	(\$0.10)	\$0.11	\$0.17	\$0.15	\$0.32	\$0.45
EPS - before tax benefit							\$0.01	\$0.14	\$0.22	\$0.06	\$0.43	(\$0.10)	\$0.11	\$0.17	\$0.15	\$0.32	\$0.45
Shares out - basic	13,783	13,815	13,815	13,740	14,811	17,952	17,899	17,841	17,610	17,483	17,708	17,326	16,876	16,894	16,950	17,012	17,000
Shares out - diluted	13,989	14,068	14,061	15,078	17,373	19,573	18,997	18,918	18,792	18,303	18,752	17,326	17,620	17,616	17,650	17,553	17,700
Key Ratios:																	
Sales growth		1.8%	15.4%	17.7%	12.4%	2.6%	-10.6%	18.9%	12.2%	6.4%	6.9%	-2.1%	-2.1%	-3.0%	17.5%	2.3%	7.5%
Gross margin	59.3%	60.1%	58.2%	58.9%	60.7%	60.6%	58.1%	59.6%	60.8%	51.2%	57.6%	47.1%	53.0%	51.8%	52.0%	51.2%	53.0%
S,G & A/Sales	33.2%	30.6%	34.1%	37.2%	37.8%	40.5%	47.3%	41.1%	37.7%	42.2%	41.6%	49.2%	38.5%	33.6%	33.5%	37.9%	38.0%
R & D/Sales	8.8%	8.1%	6.7%	6.5%	7.3%	7.7%	9.4%	7.3%	5.7%	6.1%	7.0%	7.7%	6.0%	5.9%	6.5%	6.9%	6.3%
Tax Rate	45.5%	35.3%	46.3%	50.2%	29.8%	26.0%	N/A	34.2%	28.5%	N/A	17.6%	N/A	32.4%	30.9%	37.0%	35.8%	37.0%
Cash Flow/Share	\$0.70	\$0.91	\$0.49	\$0.82	\$0.90	\$0.75	\$0.10	\$0.21	\$0.31	\$0.16	\$0.77	-\$0.03	\$0.18	\$0.23	\$0.21	\$0.59	\$0.73
EBITDA/Share	\$0.99	\$1.22	\$0.61	\$1.22	\$1.17	\$0.92	\$0.07	\$0.28	\$0.40	\$0.13	\$0.88	-\$0.06	\$0.23	\$0.31	\$0.30	\$0.77	\$0.99

Quarterly Comparisons

	Balance Sheets (in \$Millions)		Quarterly Comparisons (in \$Millions)					
	12/31/08	9/30/09	(March)	(June)	(Sept)	(Dec)	Total	
Assets:			Revenues (in \$Millions)					
Cash and equivalents	\$30.4	\$22.1	2005	20.2	26.7	29.5	23.7	100.2
Accounts receivable	18.7	22.3	2006	27.2	28.5	30.1	26.9	112.6
Inventory	17.1	18.6	2007	28.1	28.1	31.7	27.8	115.6
Other current	7.1	8.2	2008	25.1	33.4	35.6	29.5	123.6
Total current	73.3	71.2	2009E	24.6	32.7	34.5	34.7	126.5
Property & equip, net	31.5	36.7	Earnings per Share					
Goodwill & other	36.5	36.4	2005	0.05	0.10	0.18	0.10	0.43
TOTAL ASSETS	\$141.3	\$144.3	2006	0.10	0.13	0.45	0.04	0.70
			2007	0.14	0.10	0.29	0.01	0.54
Liabilities:			2008	0.04	0.14	0.24	0.09	0.51
Accounts payable	7.7	8.7	2009E	(0.10)	0.11	0.17	0.15	0.32
Accrued expenses	21.5	21.1						
Other	0.0	0.0						
Total current	29.3	29.8						
Other long-term	0.0	1.9						
Stockholders' equity	112.1	112.6						
TOTAL LIAB. & EQ	\$141.3	\$144.3						

Operating Statistics (In \$Millions, except EPS)	December 2004	December 2005	December 2006	December 2007	December 2008	December 2009E
Revenues by Segment						
Retail	\$18,929.0	\$20,502.0	\$25,118.5	\$25,959.0	\$29,072.8	\$32,000.0
Domestic Distribution	42,481.0	53,340.0	63,092.1	61,068.6	60,433.1	57,000.0
Mail Service	15,697.0	16,159.0	13,095.1	14,048.0	19,274.0	21,000.0
International	7,975.0	10,164.0	11,322.7	14,525.7	14,802.5	16,500.0
Total	\$85,082.0	\$100,165.0	\$112,628.4	\$115,601.3	\$123,582.4	\$126,500.0

Source: Dawson James Securities, Inc. estimates; Company documents

Important Disclosures:

Price Chart:



Price target and ratings changes over the past 3 years:

Initiated - July 15, 2009 – \$6.48 - Price Target \$10.00

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Ratings Distribution	Company Coverage		Investment Banking	
	# of Companies	% of Total	# of Companies	% of Totals
Speculative Buy	5	31%	5	100%
Strong Buy	0	0%	0	0%
Buy	8	50%	2	25%
Neutral	3	19%	2	67%
Sell	0	0%	0	0%
Sell Short	0	0%	0	0%
Under Review	0	0%	0	0%
Restricted	0	0%	0	0%
Total	16	100%	9	56%

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