



# INSTITUTIONAL RESEARCH

## Healthcare & Biotechnology

### INITIATION REPORT

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January 31, 2011

## Synergetics USA, Inc. (Nasdaq/SURG)

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**BUY**                      **SURG-ing ahead**

*Synergetics USA provides surgical instruments for ophthalmology and neurology*

### Investment Highlights

1) Despite recording just steady revenues over the past two fiscal years while restructuring its neurology business, Synergetics USA (Synergetics) has **increased its net income and earnings per share, improved gross margins through a richer product mix, expanded operating cash flow**, while at the same time streamlining and optimizing its R&D expenditures. Share prices have followed suit upward, but with more revenue and earnings growth forecasted for the remainder of this fiscal year (ending July 2011) and next (July 2012) we anticipate that **SURG shares will continue their upward climb** over the next 12-18 months.

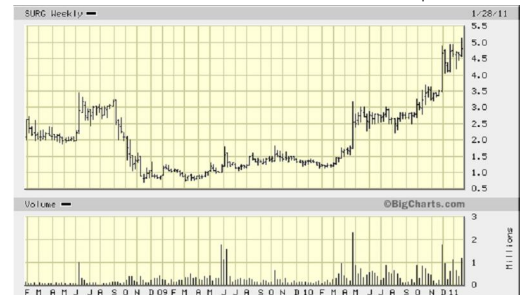
2) In addition to the aforementioned positive operating cash flow, Synergetics has also **bolstered its balance sheet** through a series of wise patent litigation settlements and product line divestitures, including ones with larger companies such as Alcon and Stryker, increasing cash on hand to over \$18 million (nearly \$0.75 per share) from almost zero and reducing long-term debt outstanding more than 50% since the end of fiscal 2009 just eighteen months ago. With a much stronger balance sheet, Synergetics can now **focus on growth through potential acquisitions or product in-licensing**, in addition to its more traditional organic growth through new product introductions.

3) Even without a major acquisition or merger since 2005's combination of Synergetics and Valley Forge, the Company has managed to **grow internally through its R&D efforts**. We expect these R&D programs to continue to bear fruit for Synergetics, including innovative new programs such as one recently signed with Retinal Solutions focused on pediatric **patients, new disposable instrumentation products, a next generation electrosurgical generator**, and more **extensive new marketing partnerships** with old (Codman & Shurtleff, Stryker) and new (Alcon) clients alike.

**Current Price \$4.60**

**Price Target \$6.25**

Estimates	F2009A	F2010A	F2011E
<b>Sales(\$000s)</b>	<b>\$52,965</b>	<b>\$52,075</b>	<b>\$52,576</b>
1Q October	12,246	12,146	12,076 A
2Q January	13,652	13,014	12,500 E
3Q April	13,161	13,859	13,500 E
4Q July	13,906	13,056	14,500 E
Prev. Rev. Estimate (\$000s)			
<b>EPS (diluted)</b>	<b>\$0.07</b>	<b>\$0.16</b>	<b>\$0.15</b>
1Q October	0.03	0.02	0.03 A
2Q January	0.02	0.04	0.03 E
3Q April	0.02	0.06	0.04 E
4Q July	0.00	0.04	0.05 E
Previous EPS Estimate			
P/E (x)	70.7	28.4	30.4
EBITDA/Share	\$0.20	\$0.33	\$0.33
EV/EBITDA (x)	19.9	12.1	12.2
<b>Stock Data</b>			
52-Week Range			\$1.15-\$5.14
Shares Outstanding (mil.)			24.9
Market Capitalization (mil.)			\$114.4
Enterprise Value (mil.)			\$99.7
Debt to Capital (10/10)			7.9%
Book Value/Share (10/10)			\$1.85
Price/Book			2.5 x
Average Trading Volume (3-Month)			131,000
Insider Ownership			22.0%
Institutional Ownership			12.7%
Short interest			53,800
Dividend / Yield			\$0.00/0.0%



Price target and ratings changes over the past 3 yrs:  
Initiated - January 31, 2011 - Buy - Price Target \$6.25

Please find Important Disclosures beginning on Page 8.

## Conclusion

Since new top management took over at Synergetics USA two years ago, the Company has bolstered its balance sheet, settled pending patent litigation favorably, streamlined manufacturing processes and product lines, increased revenues, net income, and gross margins, and certainly caught the eye of the investment public. Still, perhaps due to its smaller size or the relative newness of its management team, Synergetics' shares continue to trade at a discount to its industry peers based on several valuation metrics, and we feel that as the Company and its stock become more well known and as the Company continues to advance its growth strategies, the shares will continue to appreciate, and thus we are initiating coverage on SURG with a BUY rating and 12-18 month price target of \$6.25 per share, or approximately 25X estimated earnings of \$0.25 for next fiscal year (with 15% revenue growth forecast).

## Company Business

Synergetics USA is a leading supplier of precision microsurgical devices for ophthalmology and neurosurgery. The Company was formed in 2005 with the combination of Valley Forge Scientific and Synergetics, Inc. and began trading under the symbol "SURG" in that year. The Company's headquarters is in O'Fallon, Missouri, outside St. Louis, with additional manufacturing facilities in King of Prussia, Pennsylvania, near Philadelphia. Synergetics' sales by medical area for fiscal 2010 (ending July) in \$000s were as follows:

	<u>FYE July,</u>
Net sales by segment	<u>2010</u>
Ophthalmic	\$31,689
Neurology	8,175
Marketing partners	4,204
OEM (Codman, Stryker & Iridex)	7,878
Other	<u>129</u>
Total	\$52,075

In fiscal 2010, Synergetics transitioned much of its neurological device business from a direct sales force to one using marketing partners, specifically, Codman & Shurtleff (a division of Johnson & Johnson) and Stryker Corporation. The Company's product lines focus upon precision engineered, microsurgical, hand-held instruments and the delivery of various energy modalities for the performance of less invasive microsurgery including: (i) laser energy, (ii) ultrasonic energy, (iii) radio frequency energy for electrosurgery and lesion generation and (iv) visible light energy for illumination, and where applicable, simultaneous infusion (irrigation) of fluids into the operative field. In addition, Synergetics provides certain devices on an OEM basis to Codman, Stryker, and Iridex, and most recently following a patent litigation settlement in April 2010, the Company has licensed certain ophthalmology products and devices to Alcon on a co-exclusive basis.

## Intellectual Property

Synergetics owns 38 US patents and multiple pending patents, the oldest of which was issued in 1994 and none of which expire before 2012. The Company's patents are employed in most of their product lines, and most recently Synergetics won a \$32 million patent litigation settlement against Alcon Laboratories related to two patents revolving around vitrectomy machines used in vitreoretinal surgery.

## Recent Results

Synergetics reported excellent financial results for their fiscal first quarter ending October 31<sup>st</sup>, 2010, in mid-December. In the quarter, the Company recorded \$12.1 million in sales and net income of \$633,000 or \$0.03

per share. This compares with sales of \$12.1 million also in the prior year period and net income of \$542,000 or \$0.02 per share. Last year's results, however, included \$444,000 in sales of the Omni product line, since sold to Stryker, and a transition in neurological sales from internal to marketing partners. Positive developments during Q1/2011 were increases in ophthalmic sales of 6% and OEM sales of 9%. Also positive factors in Q1/2011 results were an improvement in product mix, with higher margin disposables accounting for 83% of total product sales. This factor helped improve gross margins to 58.2% from 56.1% in the prior year period. Combined with lower sales and marketing expense, due in part from cost reduction measures but also due to the switch to marketing partners, as well as lower interest expense from reduced long-term debt outstanding, Synergetics was able to increase net income and EPS year-over-year in Q1/2011. Cash flow during the quarter was approximately \$1.2 million, much of which went to increase inventory in anticipation of the new marketing agreement with Alcon among other factors.

### **Balance Sheet and Operating Cash Flow**

Synergetics held \$18.5 million in cash and equivalents on its balance sheets as of the most recent quarter end (October 31<sup>st</sup>), offset by approximately \$3.8 million in long-term debt, specifically notes payable to the estate of a former director for a patented device, a settlement obligation for Iridex Corporation, and a revenue bond dating from 2002 for improvements to the Company's O'Fallon manufacturing facility. Synergetics has been cash flow positive for the past several years and is expected to be so again this and next fiscal year, thus the Company would not appear to need additional capital in the near future.

### **Outlook/Growth Drivers**

Synergetics' historical profitability is expected to continue for the Company's Q2/2011 quarter (ending January 2011); we are forecasting that the Company will earn \$0.03 per share or net income of \$860,000 on revenues of \$12.5 million, very similar to results for Q2/2010 of \$13.0 million in revenues and net income of \$877,000 or \$0.04 per share, but higher than results for last quarter as the Company continues its transition to marketing partners in the neurology area. Results are estimated to be reported in March. Expected to lead growth in the second quarter are the same factors evident in the first quarter of this fiscal year, including higher OEM sales and Ophthalmic sales, especially an increased proportion of disposable sales. We are also forecasting gross margins to continue to improve over last year's levels, due to better product mix and cost-saving measures implemented over the past 12- 24 months, and combined with the Company's stronger balance sheet these factors will contribute to solid earnings for Q2/2011.

For the fiscal year 2011 as a whole (ending in July 2011), we are forecasting that Synergetics will accrue \$52.6 million in sales, an increase of 1% year-over-year, and net income of \$3.8 million, or \$0.15 per share, very close to results for last fiscal year after factoring out several one-time gains in fiscal 2010. For the year as a whole, growth is forecasted to come from higher sales of ophthalmic products, and higher OEM/marketing partners' revenues, including the initiation in the second half of the fiscal year (April and July 2011 quarters) of ophthalmology products sold by Alcon under the distribution agreement signed last year.

For fiscal 2012, we are forecasting that the Company will return to a more normalized annual revenue growth rate of 15%, helping boost estimated revenues to \$60.5 million for the fiscal year and net income to \$6.4 million or \$0.25 per share. Expected to lead positive results are shipments of new products in the ophthalmology area, shipments to marketing partners (especially Alcon), higher gross margins continuing a trend since 2008, and additional improvements in operating metrics thanks to economies of scale and other cost-savings measures accomplished in the past two years.

## Management

**David Hable** joined the Company as President, Chief Executive Officer and Director in January 2009 after prior experience in the medical device industry with Afferent, ONI Medical Systems, and Johnson & Johnson, including its Codman & Shurtleff subsidiary. **Kurt Gamp** has served as Chief Operating Officer and a director of the Company since 2005, after prior experience with Valley Forge, a predecessor to Synergetics. Also joining the Company in 2005 after prior experience with Valley Forge was **Jerry Malis, MD**, currently Chief Scientific Officer and a director. **Pamela Boone** joined the Company in 2005 as Chief Financial Officer after previous financial management experience at Maverick Tube Corporation. **Jason Stroisch**, with 15 years experience in the medical device industry, serves as Vice President, Marketing, while **Michael Fanning**, with 20 years in sales and management, serves as Vice President, Sales. Outside directors include **Robert H. Dick**, Chairman of the Board, formerly with Codman & Shurtleff and several investment banking firms; **Lawrence Cardinale**, a 35-year veteran of the medical manufacturing industry; **Guy Guarch**, a former executive with C.R. Bard; and **Juanita Hinshaw**, currently CEO of H&H advisors, a financial advisory firm.

## Stock Valuation/Comparables

We have compiled a six-stock comparison group for Synergetics, including several stocks in the ophthalmology field such as Alcon (NYSE/ACL/Not Rated) and Iridex (Nasdaq/IRIX); two companies which provide devices for neurological applications, Cyberonics (Nasdaq/CYBX/Not Rated) and Integra Life Sciences (Nasdaq/IART/Not Rated); and lastly two firms which provide general surgical instrumentation, including Conmed (Nasdaq/CNMD/Not Rated) and Covidien (NYSE/COV/Not Rated) through its Valleylab subsidiary. Table 1 below outlines price/revenues for 2010E, price/book value and price/earnings ratios for 2010E and 2011E for Synergetics and six comparable surgical device companies.

Based on valuation metrics including price/earnings for calendar 2010 and 2011, price/revenue for 2010, and price/book, Synergetics' shares can be considered undervalued by as much as 25%-35% in several aspects, including price/revenues and price/book, perhaps reflecting a stock market oversight related to the Company's recently improved balance sheet, which to some extent reduced revenue growth and net margins in the short term. Thus, we are recommending that investors purchase these shares with an 12-18 month price target of \$6.25, or 3.3X book value, 28X next year's estimating calendar earnings per share of \$0.22, and 3.0X estimated revenues for 2010.

## Risk Factors

**We believe an investment in Synergetics involves the following risks:**

- **FDA and regulatory risks** – Synergetics is subject to regulatory review for its ongoing research and development activities, principally the US Food and Drug Administration's 510(k) application process. In addition, the manufacture and assembly of the Company's surgical devices and related disposable products are subject to ongoing oversight and regulation, and any negative correspondence from the FDA could have an adverse effect on the ongoing operations of the Company. Synergetics, however, has a strong track with the FDA, which should be a positive factor in future regulatory relations.
- **Reliance on marketing and OEM partners** — A significant portion of the Company's revenues are received through the marketing efforts of distribution and OEM partners, especially and increasingly in the neurology market. There can be no assurance that the Company's current partners will remain financially healthy or even if they do so, they will continue to place an emphasis on the marketing of the Company's products. However, Synergetics strives to maintain good relations with its partners as well as keep its

products up to date and competitive, thus creating an incentive for its partners to continue to expend energy on marketing Synergetics' products.

- **Need to defend patents and other intellectual property** – Synergetics currently holds 38 US patents on its products and devices, some of which expire as soon as 2012. Although the Company has successfully defended its patents in the past, in some cases against much larger companies, Synergetics may need to again defend its patents in the US and overseas in the future, and there can be no assurance these defenses will be successful.
- **Competitive Markets** – The Company competes in both the ophthalmology and neurology markets with a number of other manufacturers, some of which represent much larger companies, including Alcon, Iridex, Bausch & Lomb, the Valleylab division of Covidien, B. Braun Medical, and Integra Life Sciences. Even though Synergetics and its partners (all of which are larger than the Company) have successfully competed in their respective marketplaces in the past, there can be no assurance that they will continue to do so in the future.

**Table 1. Surgical Device (Neuro/Ophthalmic) Industry Comparable Company Analysis**

Company	Symbol	Price	Shares (millions)	Market Cap (\$Millions)	Book Value	Calendar Year		Revenues (\$Millions)		Calendar Year		Price/Revs Price/Book Earnings		Growth	Notes
						EPS '10E	EPS '11E	2010E	P/E '10	P/E '11E	2010E	Value			
Alcon	ACL	\$162.86	301.9	\$49,167.4	\$22.28	\$7.67	\$8.47	\$ 7,130.0	21.2	19.2	6.90	7.31	10.4%	Surgical equipment and pharmaceuticals	
Conmed	CNMD	\$26.11	28.1	\$733.7	\$20.62	\$1.30	\$1.43	718.0	20.1	18.3	1.02	1.27	10.0%	Devices for minimally invasive surgery	
Covidien	COV	\$47.47	495.2	\$23,507.1	\$18.13	\$3.56	\$3.96	11,240.0	13.3	12.0	2.09	2.62	11.2%	Medical devices subsidiary Valleylab	
Cyberonics	CYBX	\$32.75	28.0	\$917.0	\$5.69	\$1.14	\$1.20	191.0	28.7	27.3	4.80	5.76	5.3%	Neurological stimulators	
Integra Life Science:	LART	\$46.38	28.3	\$1,312.6	\$16.19	2.78	2.99	731.0	16.7	15.5	1.80	2.86	7.6%	Neurological and also orthopedic devices	
Index	IRIX	\$4.02	9.0	\$36.2	\$2.05	0.22	0.31	42.0	18.3	13.0	0.86	1.96	40.9%	Ophthalmology and also aesthetic medicine	
<b>Average</b>										19.7	17.5	2.91	3.63	14.2%	
Synergetics USA	SURG	\$4.60	24.9	\$114.4	\$1.85	0.16	0.22	\$ 51.5	28.0	20.8	2.22	2.49	34.7%	Neurosurgery and ophthalmic devices	

Source: Dawson James Securities, Thomson Financial Network

**Synergetics USA, Inc.**  
**Consolidated Statements of Income**  
 (In 000s, except per share data)

FYE July	2003	2004	2005	2006	2007	2008	2009	1Q10	2Q10	3Q10	4Q10	2010	1Q11	2Q11E	3Q11E	4Q11E	2011E	2012E
								October	January	April	July		October	January	April	July		July
Net sales	\$13,017	\$16,887	\$21,792	\$38,246	\$45,945	\$50,062	\$52,963	\$12,146	\$13,014	\$13,859	\$13,056	\$52,075	\$12,076	\$12,500	\$13,500	\$14,500	\$52,576	\$60,500
Cost of goods sold	4,483	6,514	8,289	14,238	18,943	20,100	23,550	5,327	5,688	5,828	5,520	22,363	5,053	5,190	5,600	6,020	21,863	24,500
Gross Profit	8,534	10,373	13,503	24,008	27,002	29,962	29,415	6,819	7,326	8,031	7,536	29,712	7,023	7,310	7,900	8,480	30,713	36,000
Operating Expenses:																		
Sales and marketing*	6,104	7,886	10,262	9,002	11,124	12,601	14,262	3,259	3,045	2,896	2,759	11,959	3,023	3,000	3,110	3,340	12,473	13,310
General and administrative*				8,347	11,776	9,499	9,030	2,019	2,045	2,204	2,617	8,885	2,252	2,190	2,300	2,470	9,212	9,680
Research and development	563	797	858	1,655	2,584	2,653	2,998	600	731	886	688	2,905	719	750	740	800	3,009	3,030
Operating income (loss)	1,866	1,690	2,383	5,004	1,518	5,209	3,125	941	1,505	2,045	1,472	5,963	1,029	1,370	1,750	1,870	6,019	9,980
Other (income) expense, net	243	176	186	503	945	1,106	755	140	129	(3,173)	42	(2,862)	55	50	50	50	205	100
Income (loss) before tax	1,623	1,514	2,198	4,501	573	4,103	2,370	801	1,376	5,218	1,430	8,825	974	1,320	1,700	1,820	5,814	9,880
Income tax expense (benefit)	532	421	740	1,420	(272)	1,440	725	258	499	1,909	425	3,092	341	460	600	640	2,041	3,460
Net income (loss)	1,091	1,094	1,458	3,081	845	2,663	1,595	542	877	3,309	1,005	5,733	633	860	1,100	1,180	3,773	6,420
Basic income per share	\$0.32	\$0.32	\$0.43	\$0.15	\$0.03	\$0.11	\$0.07	\$0.02	\$0.04	\$0.13	\$0.04	\$0.23	\$0.02	\$0.03	\$0.04	\$0.05	\$0.15	\$0.26
Diluted income per share	\$0.32	\$0.32	\$0.42	\$0.15	\$0.03	\$0.11	\$0.07	\$0.02	\$0.04	\$0.13	\$0.04	\$0.23	\$0.03	\$0.03	\$0.04	\$0.05	\$0.15	\$0.25
Basic shares outstanding	3,383	3,401	3,424	20,657	24,221	24,322	24,454	24,458	24,584	24,701	24,735	24,620	24,783	24,800	24,850	24,900	24,833	25,000
Diluted shares outstanding	3,393	3,414	3,443	20,821	24,405	24,475	24,495	24,497	24,615	24,740	24,828	24,670	24,862	24,900	24,950	25,000	24,928	26,100
* Selling, general & administrative expense prior to 2006																		
Key ratios:																		
Revenue growth	24.6%	29.7%	29.0%	75.5%	20.1%	9.0%	5.8%	-0.8%	-4.7%	5.3%	-6.1%	-1.7%	-0.6%	-3.9%	-2.6%	11.1%	1.0%	15.0%
Gross margin	65.6%	61.4%	62.0%	62.8%	58.8%	59.8%	55.5%	56.1%	56.3%	57.9%	57.7%	57.1%	58.2%	58.5%	58.5%	58.5%	58.4%	59.5%
Sales and marketing/sales	46.9%	46.7%	47.1%	23.5%	24.2%	25.2%	26.9%	26.8%	23.4%	20.9%	21.1%	23.0%	25.0%	24.0%	23.0%	23.0%	23.7%	22.0%
General & admin/sales				21.8%	25.6%	19.0%	17.0%	16.6%	15.7%	15.9%	20.0%	17.1%	18.6%	17.5%	17.0%	17.0%	17.5%	16.0%
R&D/sales	4.3%	4.7%	3.9%	4.3%	5.6%	5.3%	5.7%	4.9%	5.6%	6.4%	5.3%	5.6%	6.0%	6.0%	5.5%	5.5%	5.7%	5.0%
Depreciation & amortization	\$370	\$420	\$580	\$742	\$1,634	\$1,990	\$1,807	\$550	\$550	\$550	\$550	\$2,200	\$550	\$550	\$550	\$550	\$2,200	\$2,200
Tax Rate	32.8%	27.8%	33.7%	31.5%	N/A	35.1%	32.7%	32.3%	36.3%	36.6%	29.7%	35.0%	35.0%	35.0%	35.0%	35.0%	35.1%	35.0%
Cash Flow/share	\$0.43	\$0.44	\$0.59	\$0.18	\$0.10	\$0.19	\$0.14	\$0.04	\$0.06	\$0.07	\$0.06	\$0.24	\$0.05	\$0.06	\$0.07	\$0.07	\$0.24	\$0.33
EBITDA/share	\$0.66	\$0.62	\$0.86	\$0.28	\$0.13	\$0.29	\$0.20	\$0.06	\$0.08	\$0.10	\$0.08	\$0.33	\$0.06	\$0.08	\$0.09	\$0.10	\$0.33	\$0.47

**Balance Sheets**

	(S000s)	
Assets:	7/31/10	10/30/10
Cash and equivalents	\$18,669	\$18,519
Accounts receivable, net	9,056	9,132
Inventories	11,891	13,421
Prepaid expenses & other	1,450	1,188
Total current	41,066	42,260
Property & equip., net	8,044	8,044
Goodwill & intangibles	23,913	23,767
Other	72	72
<b>TOTAL ASSETS</b>	<b>\$73,095</b>	<b>\$74,143</b>
Liabilities:		
Accounts payable	\$1,800	\$1,844
Accrued expenses	3,035	3,348
Long-term debt - current portion	1,514	1,523
Total current	\$6,349	\$6,715
Long-term debt	939	784
Revenue bonds payable	1,612	1,583
Deferred revenue & taxes	19,969	19,894
Total long-term liabilities	22,520	22,261
Stockholders' equity	44,226	45,167
<b>TOTAL LIAB &amp; EQ</b>	<b>\$73,095</b>	<b>\$74,143</b>

**Quarterly Earnings Comparisons**

	October	January	April	July	Total
<b>Revenues (in \$Mill)</b>					
2004					\$16,887
2005					21,792
2006					38,246
2007	9,906	11,353	11,482	13,203	45,945
2008	10,469	11,636	13,500	14,457	50,062
2009	12,246	13,652	13,161	13,906	52,965
2010	12,146	13,014	13,859	13,056	52,075
2011E	12,076	12,500	13,500	14,500	52,576
<b>Earnings per Share (fully diluted)</b>					
2004					\$0.32
2005					0.42
2006					0.15
2007	0.02	0.01	0.00	0.02	0.03
2008	0.02	(0.00)	0.05	0.05	0.11
2009	0.03	0.02	0.02	0.00	0.07
2010	0.02	0.04	0.06	0.04	0.16
2011E	0.03	0.03	0.04	0.05	0.15

**Net sales by category**

	2004	2005	2006	2007	2008	2009	2010	2011E
Net sales by segment								
Ophthalmic	\$14,061	\$17,752	\$22,709	\$24,522	\$28,019	\$29,981	\$31,689	\$33,000
Neurology	2,826	4,040	6,745	10,241	12,925	13,968	8,175	2,500
Marketing partners							4,204	8,000
OEM (Codman, Stryker & Inides)			8,005	10,266	8,347	8,538	7,878	8,500
Other			787	916	772	478	129	580
Total	\$16,887	\$21,792	\$38,246	\$45,945	\$50,063	\$52,965	\$52,075	\$52,580
Net sales by Geographic area								
Domestic	\$13,462	\$16,384	\$30,090	\$35,214	\$35,838	\$36,047	\$35,417	\$35,800
International	3,425	5,408	8,156	10,731	14,225	16,918	16,658	16,780
Total	\$16,887	\$21,792	\$38,246	\$45,945	\$50,063	\$52,965	\$52,075	\$52,580

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

## Important Disclosures:

### Price Chart:



### Price target and ratings changes over the past 3 years:

Initiated – January 31, 2011 – Price Target \$6.25

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Ratings Distribution	Company Coverage		Investment Banking	
	# of Companies	% of Total	# of Companies	% of Totals
Buy	17	74%	6	35%
Neutral	6	26%	4	67%
Sell	0	0%	0	0%
Total	23	100%	10	43%

**Information about valuation methods and risks can be found in the "STOCK VALUATION" and "RISK FACTORS" sections of this report.**

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