

Synergetics USA, Inc. (Nasdaq/SURG)

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BUY **Q1/12 results solid; Lower to Neutral on reaching price target**

Synergetics USA provides surgical instruments for ophthalmology and neurology

Investment Highlights

1) Synergetics reported solid financial results for their Q1/12 quarter (ending October) earlier this month, including revenues of \$13.5 million, an increase of 11.8% year-over-year, and earnings per share of \$0.05 versus \$0.03 one year ago, before charges of \$0.02 per share for a loss from discontinued operations in Q1/2012. Our estimates had been \$14.0 million in sales (a 15.9% increase) and earnings per share of \$0.05. Company management had pre-announced financial results in mid-November. Sales growth was led by growth in both ophthalmic and neurosurgical product segments, especially new products such as the VersaPACK launched last fiscal year and other disposable products. Disposable products such as procedural kits, laser probes, cannulas and ultrasonic tips, which typically carry a higher gross margin, accounted for 82% of first quarter sales, and helped boost total gross margins to 58.6% in Q1/2012 from 58.2% in the prior year period. Thanks to higher sales volumes and tight cost controls, Synergetics was able to increase its net income and earnings per share in Q1/2012, continuing a positive trend first started in fiscal 2009. The Company earned approximately \$1.7 million in operating cash flow in the first quarter, and cash and investments on hand at October 31st were \$13.7 million, offset by only \$900,000 in long-term debt.

2) Company management did not provide financial guidance for the upcoming second quarter of fiscal 2012 (ending January 2012). However, in a subsequent earnings conference call it was noted that there was a great deal of interest in several new products for the vitrectomy market shown at the October American Academy of Ophthalmology conference, and also that in the fiscal second quarter Synergetics expects to reduce a temporary increase in backorders experienced late in the fiscal first quarter. Bearing these factors in mind, as well as considering the results of the most recent quarter, we are adjusting our estimates for Synergetics slightly for this fiscal year, to revenues of \$62.8 million (from \$63.8 million), representing an

Current Price \$7.34

Price Target \$7.00

Estimates	F2010A	F2011A	F2012E
Sales(\$000s)	\$52,075	\$55,845	\$62,805
1Q October	12,146	12,076	13,505 A
2Q January	13,014	13,278	14,900 E
3Q April	13,859	14,695	16,600 E
4Q July	13,056	15,796	17,800 E
Prev. Rev. Estimate (\$000s)			\$63,800

EPS (diluted)	\$0.16	\$0.22	\$0.28
1Q October	0.02	0.03	0.03 A
2Q January	0.04	0.05	0.06 E
3Q April	0.06	0.07	0.09 E
4Q July	0.04	0.08	0.10 E
Previous EPS Estimate			\$0.28
P/E (x)	45.3	32.6	26.7

EBITDA/Share	\$0.33	\$0.41	\$0.52
EV/EBITDA (x)	20.7	16.5	13.2

Stock Data	
52-Week Range	\$4.11-\$7.50
Shares Outstanding (mil.)	25.1
Market Capitalization (mil.)	\$184.5
Enterprise Value (mil.)	\$171.7
Debt to Capital (10/11)	1.7%
Book Value/Share (10/11)	\$2.11
Price/Book	3.5 x
Average Trading Volume (3-Month)	160,000
Insider Ownership	8.4%
Institutional Ownership	20.8%
Short interest	900,000
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
 Updated - October 18, 2011 - Buy - Price Target \$7.00
 Updated - December 28, 2011 - Lower to Neutral

increase of 12.5% over fiscal 2011, and earnings per share of \$0.30 before the recent charge of \$0.02 for discontinued operations, as compared with our previous estimate of \$0.28 and earnings per share of \$0.22 in fiscal 2011. Results in fiscal 2012 are projected to be boosted by increased sales, improved gross margins, and also from a lower-than-expected tax rate.

Conclusion

Synergetics' shares have performed very well this year, responding to strong earnings growth and positive marketing developments and have exceeded both our initial price target of \$6.25 and our most recent increased price target of \$7.00. However, SURG shares now carry much higher valuation metrics of 28X this calendar year's estimated earnings, 22X next year's (calendar 2012) estimated earnings, 3.5X book value, and 3.1X estimated revenues for this calendar year, compared with 17X 2011 EPS, 15X 2012 EPS, 3.5X book value, and 2.7X estimated 2011 calendar year revenues for the industry group. These metrics are considerably higher or level with similar metrics for our comparable company group, (see section below) many of whose members have seen little or no share appreciation this year. Thus, we are lowering our rating on SURG shares to Neutral, preferring to take profits at this time and wait for lower price re-entry points or until such a time as comparable companies in this industry display improved valuation metrics.

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/NR); 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.

Based on valuation metrics including price/earnings for calendar 2011 and 2012, price/revenue for 2011, and price/book (through April 2011 buy-out for Alcon), Synergetics' shares can be considered fully valued in certain aspects, specifically price/book, and over-valued in terms of other metrics such as price/earnings and price/revenues. Thus, we are lowering our rating on SURG shares as these have reached our price target and current valuation metrics for the Company are too high vis-à-vis other stocks in this area to warrant a higher price target.

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 2011E	Price/Book Value	Earnings Growth	Notes
						EPS '11E	EPS '12E	2011E	2012E	P/E '11E	P/E '12E				
Alcon	ACL	\$167.99	301.9	\$50,716.2	\$22.28	\$8.32	\$9.00	\$ 7,800.0	20.2	18.7	6.50	7.54	8.2%	Surgical equipment and pharmaceuticals	
Conmed	CNMD	\$25.88	28.1	\$727.2	\$20.62	\$1.43	\$1.65	739.3	18.1	15.7	0.98	1.26	15.4%	Devices for minimally invasive surgery	
Covidien	COV	\$45.84	495.2	\$22,700.0	\$18.13	\$3.92	\$4.29	11,530.0	11.7	10.7	1.97	2.53	9.4%	Medical devices subsidiary Valleylab	
Cyberonics	CYBX	\$34.12	28.0	\$955.4	\$5.69	\$1.20	\$1.40	210.0	28.4	24.4	4.55	6.00	16.7%	Neurological stimulators	
Integra Life Science	IART	\$31.60	28.3	\$894.3	\$16.19	\$2.93	\$3.27	798.2	10.8	9.7	1.12	1.95	11.6%	Neurological and also orthopedic devices	
Iridex	IRIX	\$3.65	9.0	\$32.9	\$2.05	\$0.28	\$0.32	44.0	13.0	11.4	0.75	1.78	14.3%	Ophthalmology and also aesthetic medicine	
Average									17.0	15.1	2.65	3.51	12.6%		
Synergetics USA	SURG	\$7.34	25.1	\$184.5	\$2.11	0.26	0.34	\$ 58.9	28.2	21.6	3.13	3.48	30.8%	Neurosurgery and ophthalmic devices	

Source: Dawson James Securities, Thomson Financial Network

Risk Factors

In addition to normal economic and market risk factors that impact most equities and the common risks shared by Synergetics with other companies in the industry, we believe an investment in SURG 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.
- **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.
- **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.
- **Acquisition availability** – Synergetics has achieved growth in the past through acquisitions, most notably the merger with Valley Forge Scientific in 2005. Recently, Company management has expressed interest in becoming more active in the acquisition market, citing the Company’s strong financial position and completion of integration of Valley Forge Scientific. However, Synergetics is competing with a number of larger and more aggressive acquirers in the medical device industry, and there can be no assurance that the Company will be able to find, close and successfully integrate suitable acquisition candidates in the future.

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

FYE July	2003	2004	2005	2006	2007	2008	2009	2010	1Q11	2Q11	3Q11	4Q11	2011	1Q12	2Q12E	3Q12E	4Q12E	2012E
									October	January	April	July		October	January	April	July	
Net sales	\$13,017	\$16,887	\$21,792	\$38,246	\$45,945	\$50,062	\$52,965	\$52,075	\$12,076	\$13,278	\$14,695	\$15,796	\$55,845	\$13,505	\$14,900	\$16,600	\$17,800	\$62,805
Cost of goods sold	4,483	6,514	8,289	14,238	18,943	20,100	23,550	22,363	5,053	5,544	6,148	6,376	23,121	5,589	6,110	6,560	7,030	25,289
Gross Profit	8,534	10,373	13,503	24,008	27,002	29,962	29,415	29,712	7,023	7,734	8,547	9,420	32,724	7,916	8,790	10,040	10,770	37,516
Operating Expenses:																		
Sales and marketing*	6,104	7,886	10,262	9,002	11,124	12,601	14,262	11,959	3,023	2,734	2,771	2,945	11,473	3,076	2,980	3,150	3,290	12,496
General and administrative*																		
Research and development	563	797	858	1,655	2,584	2,653	2,998	2,905	719	986	882	1,126	3,713	790	890	1,000	1,070	3,750
Operating income (loss)	1,866	1,690	2,383	5,004	1,518	5,209	3,125	5,963	1,029	1,838	2,467	2,958	8,292	1,512	2,390	3,230	3,650	10,782
Other (income) expense, net	243	176	186	503	945	1,106	755	(2,862)	55	140	15	(3)	207	388	50	70	90	598
Income (loss) before tax	1,623	1,514	2,198	4,501	573	4,103	2,370	8,825	974	1,698	2,452	2,961	8,085	1,124	2,340	3,160	3,560	10,184
Income tax expense (benefit)	532	421	740	1,420	(272)	1,440	775	3,092	341	378	809	918	2,446	353	740	1,000	1,120	3,213
Net income (loss)	1,091	1,094	1,458	3,081	845	2,663	1,595	5,733	633	1,320	1,643	2,043	5,639	771	1,600	2,160	2,440	6,971
Basic income per share	\$0.32	\$0.32	\$0.43	\$0.15	\$0.03	\$0.11	\$0.07	\$0.23	\$0.03	\$0.05	\$0.07	\$0.08	\$0.23	\$0.03	\$0.06	\$0.09	\$0.10	\$0.28
Diluted income per share	\$0.32	\$0.32	\$0.42	\$0.15	\$0.03	\$0.11	\$0.07	\$0.23	\$0.03	\$0.05	\$0.07	\$0.08	\$0.22	\$0.03	\$0.06	\$0.09	\$0.10	\$0.28
Basic shares outstanding	3,383	3,401	3,424	20,657	24,221	24,322	24,454	24,620	24,783	24,937	24,946	24,970	24,902	24,971	25,000	25,050	25,100	25,030
Diluted shares outstanding	3,393	3,414	3,443	20,821	24,405	24,475	24,495	24,670	24,862	25,074	25,109	25,138	25,035	25,137	25,300	25,350	25,400	25,297
* 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%	-1.7%	-0.6%	2.0%	6.0%	21.0%	7.2%	11.8%	12.5%	13.0%	13.0%	12.5%
Gross margin	65.6%	61.4%	62.0%	62.8%	58.8%	59.8%	55.5%	57.1%	58.2%	58.2%	58.2%	59.6%	58.6%	58.6%	59.0%	60.5%	60.5%	59.7%
Sales and marketing/sales	46.9%	46.7%	47.1%	23.5%	24.2%	25.2%	26.9%	23.0%	25.0%	20.6%	18.9%	18.6%	20.5%	22.8%	20.0%	19.0%	18.5%	19.9%
General & admin/sales				21.8%	25.6%	19.0%	17.0%	17.1%	18.6%	16.4%	16.5%	15.1%	16.6%	18.8%	17.0%	16.0%	15.5%	16.7%
R&D/sales	4.3%	4.7%	3.9%	4.3%	5.6%	5.3%	5.7%	5.6%	6.0%	7.4%	6.0%	7.1%	6.6%	5.8%	6.0%	6.0%	6.0%	6.0%
Depr. amort & stock-based comp.	\$370	\$420	\$580	\$742	\$1,634	\$1,990	\$1,807	\$2,200	\$550	\$510	\$520	\$520	\$2,100	\$570	\$570	\$570	\$570	\$2,280
Tax Rate	32.8%	27.8%	33.7%	31.5%	N/A	35.1%	32.7%	35.0%	35.0%	22.3%	33.0%	31.0%	30.3%	31.4%	31.5%	31.5%	31.5%	31.5%
Cash Flow/share	\$0.43	\$0.44	\$0.59	\$0.18	\$0.10	\$0.19	\$0.14	\$0.24	\$0.05	\$0.07	\$0.09	\$0.10	\$0.31	\$0.05	\$0.09	\$0.11	\$0.12	\$0.37
EBITDA/share	\$0.66	\$0.62	\$0.86	\$0.28	\$0.13	\$0.29	\$0.20	\$0.33	\$0.06	\$0.09	\$0.12	\$0.14	\$0.41	\$0.08	\$0.12	\$0.15	\$0.17	\$0.52

Balance Sheets

(\$000s)

Assets:	7/31/11	10/31/11
Cash and equivalents	\$18,399	\$13,743
Accounts receivable, net	11,242	10,436
Inventories	12,423	12,298
Prepaid expenses & other	1,753	2,122
Total current	43,817	38,599
Property & equip., net	8,964	8,825
Goodwill & intangibles	23,532	23,448
Other	4,997	4,799
TOTAL ASSETS	\$81,310	\$75,671
Liabilities:		
Accounts payable	\$1,567	\$1,906
Accrued expenses	9,966	3,524
Long-term debt - current portion	1,053	898
Total current	12,586	6,328
Long-term debt	0	0
Revenue bonds payable	0	0
Deferred revenue & taxes	18,060	17,827
Total long-term liabilities	18,060	17,827
Stockholders' equity	50,664	51,516
TOTAL LIAB & EQ	\$81,310	\$75,671

Quarterly Earnings Comparisons

	October	January	April	July	Total
Revenues (in \$Mill)					
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
2011	12,076	13,278	14,695	15,796	55,845
2012E	13,505	14,900	16,600	17,800	62,805
Earnings per Share (fully diluted)					
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
2011	0.03	0.05	0.07	0.08	0.22
2012E	0.03	0.06	0.09	0.10	0.28

Net sales by category

Net sales by segment	2004	2005	2006	2007	2008	2009	2010	2011	2012E
Ophthalmic	\$14,061	\$17,752	\$22,709	\$24,522	\$28,019	\$29,981	\$31,689	\$34,547	\$38,000
Neurology	2,826	4,040	6,745	10,241	12,925	13,968	8,175	1,571	500
Marketing partners							4,204	9,448	11,000
OEM (Codman, Stryker & Iridex)			8,005	10,266	8,347	8,538	7,878	10,007	12,900
Other		787	916	772	478	478	129	272	400
Total	\$16,887	\$21,792	\$38,246	\$45,945	\$50,063	\$52,965	\$52,075	\$55,845	\$62,800
Net sales by Geographic area									
Domestic	\$13,462	\$16,384	\$30,090	\$35,214	\$35,838	\$36,047	\$35,417	\$39,185	\$45,500
International	3,425	5,408	8,156	10,731	14,225	16,918	16,658	16,660	17,300
Total	\$16,887	\$21,792	\$38,246	\$45,945	\$50,063	\$52,965	\$52,075	\$55,845	\$62,800

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 – Buy - Price Target \$6.25
 Update – October 18, 2011 – Buy – Price Target \$7.00
 Update – December 28, 2011 – Lowered to Neutral

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Ratings Distribution	Company Coverage		Investment Banking	
	# of Companies	% of Total	# of Companies	% of Totals
Buy	15	63%	5	33%
Neutral	8	33%	5	63%
Sell	1	4%	0	0%
Total	24	100%	10	42%

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

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