Siena Market Line
2nd week of October 2015

IRIDEX Corporation

NasdaqGM:IRIX

Analyst: Coralie Cornern
Sector: Healthcare

BUY

Price Target: $12.29

Key Statistics as of 10/15/2015

Market Price:	$8.13
Industry:	Medical Appliances & Equipment
Market Cap:	$81.19 M
52-Week Range:	$6.41-11.28
Beta:	0.68

Thesis Points:

- Ophtalmology is a growing market
- Strong financial position, low debt and share repurchase program
- Overreaction to previous quarter poor performance

Company Description:

IRIDEX Corporation was founded in 1989 and is headquartered in Mountain View, California. The company develops, manufactures, markets, sells, and services medical laser systems and associated instrumentation for the treatment of the sight-threatening eye diseases. IRIDEX also operates for the otolaryngology market with its laser systems to perform stapedectomy. The company offers a wide variety of laser consoles, and ophthalmic delivery devices. They serves ophthalmologists, research and teaching hospitals, government installations, surgical centers, hospitals, and office clinics. Their equipment helps treating very common yet fatal human (and animal) disorders such as glaucoma or Diabetic Macular Edema or all other kind of retinal diseases. IRIDEX also provides solutions to enhance physicians' performance and results on patients. It sells and markets its products through a direct sales force in the United States, as well as through independent distributors internationally. The company was formerly known as IRIS Medical Instruments, Inc. until they went public in 1996.

Thesis

IRIDEX Corporation is among the leading companies in terms of developing, manufacturing, and marketing laser based medical systems. After selling its aesthetics business to Acera in 2012 for approximately $5.1 million, IRIDEX strategy is to focus solely on its ophthalmology business which is the company's core strength as the firm managed to generate net income from its ophthalmology operations in each of the past five years. Ophthalmology is a growing market mainly due to the aging of the population but also due to the widespread of obesity that leads to diabetes. Diabetes causes several eye diseases such as Diabetic Retinopathy, Diabetic Macular Edema (DME) but also cataract and Glaucoma. These diseases are mostly non curable but treatable. This means that people who have glaucoma are going to be treated their whole life. It also mean that demand for IRIDEX laser products is very unlikely to fall. Except for the last quarter, the company is showing growth. As of July 2015, the company recorded $12.2 Million in cash, with a total of $31.9 Million in current assets. The liabilities are $7.9 Million and has almost no noncurrent liabilities ($0.9Million), which leaves IRIDEX room to grow. Moreover the 8.27% Return on invested capital, which is higher than the company's Weighted average cost of capital (8.17%) shows that IRIDEX is creating value. The biotech is currently undervalued after a stock price drop in July due to disappointing earnings. Indeed, net loss for the second quarter of 2015 was $700,000 compared to the prior year period. This decrease is not due to a fall in demand but to supply chain difficulties.
A buy of IRIDEX Corporation is therefore recommended with a one-year target price of $12.29. Currently trading at $8.13, it has an upside potential of 51.16%.

Product Mix and Diversification

IRIDEX Corporation is providing products to healthcare professionals. Although they are mainly producing for the ophthalmology market, they respond to two different needs. On one side they have laser delivery devices, which are used to optimize physicians' view and maximize therapeutic capabilities. These are called consumables and account for 60% of the company's revenue. Those lasers are high quality premium products, of which prices are not public and need to be inquired. William Moore, CEO of the company actually declare that IRIDEX was currently shaping their business model to increase the sale of consumables. On most of these lasers, the MicroPulse™ technology, for which they were granted a US patent in 2010 is incorporated. "MicroPulse allows the tissue to cool between laser pulses, minimizing or preventing tissue damage. Treatment risks are reduced or eliminated, with increased patient comfort than with conventional, continuous-wave laser treatment." IRIDEX also sells laser devices which are surgical instruments used to treat patients directly rather than just improving their diagnostic or treatment. These are durable delivery devices and account for the remaining 40% of the revenue stream. One of their best and highest level surgical probe is the Adjustable and intuitive XR probe, that provides full coverage of peripheral retina without removing probe from the eye. Other than this one they have seven other different kinds of retinal surgical probes.

In the latest news, the company announced on October 6th that they added a new eye pressure diagnostic device to their portfolio called tonometer, designed specifically for glaucoma. They partnered with Revenio Group, the corporation who invented the tonometer to ally the tonometer, which monitors intra-ocular pressure to their Cyclo G6 to create a minimally invasive approach of slowing the disease down, it also includes the MicroPulse Technology. Sixty million people are afflicted with glaucoma worldwide so being able to sell this brand new effective and durable option to treat glaucoma is going to add to the company's competitive advantages. Indeed, following the first results shown patients tested with G6, the results were amazing. A woman was tested in Ohio with an intra-ocular pressure (IOP) of 38 and a massive pain, taking heavy medication. After being treated with G6 IOP reduced to 23 in the first day and she felt much better and was reduced of pain from the pressure in her eye. Doctors are also witnessing improvements in their success rate in IOP reduction. The Cyclo G6 system is definitely a growth catalyst. During the last earning call, IRIDEX' CFO and COO mentioned that a new glaucoma probe with illumination

(Containing illumination fiber) was currently sitting with the FDA. It is quite hard to forecast how long the process is going to take but as they are just waiting for the clearance from the illumination concept, managers are believing they could get it shortly. This could again be a catalyst for revenue's growth.

Other than its wide range of ophthalmologic consumable and surgical instrument, IRIDEX offers two different types of ENT lasers that many otologists in the United States use to perform stapedectomy. Finally, IRIDEX offers a range of ophthalmoscopes, probes, and other laser devices to treat animal eye disorders.

Most of IRIDEX' devices are patented. The patents' carrying value as of January 2015 was $120 thousand. The company logically relies on a combination of patents, trade secret, copyright and other intellectual property contracts to remain competitive.

Porter's Five Forces

The bargaining power of suppliers can be classified as relatively high. IRIDEX Corporation has reliable sources in their supply chain, however, since they operate in a very specific area of the healthcare sector, it is not easy to switch suppliers. The problems the company had in its supply chain during Q2 are relatively frequent for this kind of manufacturing companies and can be solved by hiring engineers and experts in the particular field to detect and solve the problem.

The bargaining power of customers on the other hand is low. IRIDEX has the competitive advantage to offer very high quality products, either consumable or durable, that are better than what the competition is offering. Some of their products, such as the Cyclo G6 are unique, the MicroPulse technology also is patented and IRIDEX is the only company to offer this technology. The company does not have to fear a loss in customer numbers, but should rather expect an increase since Cyclo G6 is only at its debut.

The threat of new competitors is low. IRIDEX Corporation holds patents that will protect their products and technologies. The barriers to entry as well as the learning curve are high in the ophthalmology lasers sector. Potential competitors would spent tremendous amount of time and money trying to compete with products such as Cyclo G6 or technologies such as MicroPulse.

The threat of substitute products is extremely low. Today, physicians are willing to use the best technology to better treat or easily diagnose their patients. There is for now no substitutes to retinal surgical instruments or laser delivery services. The only real danger would be another company coming up with a cure for glaucoma.

Management

IRIDEX Corporation is managed by William Moore than serves as Chairman of the board of directors but also as CEO and President of the company. Mr. Moore also currently serves on the board of directors of Natus Medical Incorporated, a public company he co-founded in 1990 and for which he served as CEO until 1993. Natus is also in the Medical Appliances & Equipment industry but does not work for the ophthalmology market. William Moore started as a President of IRIDEX in 2007 and has a very broad and extensive experience in the healthcare sector. However it never is optimal to have the same person, regardless of his or her experience, serving different positions. In this case, William Moore widely contributed to the growth of the company. Since he was appointed CEO in 2012, profit margin rose from 7% to 23% in the period ending in January 2015. Moreover, investors very much like Moore's input in the company and its future strategy of a heavier mix on the consumables to capital equipment. In the last earnings call William Moore announced that the CFO of the company, James Mackaness was resigning. He added that the individual took part in creating tremendous value for the company's shareholders, and that he would continue to serve in the CFO/COO role until the end of August. Even though the CEO mentioned in August that the company was already searching for a world class CFO to "fill Mackaness' shoes", there still has not been any announcement about a new CFO joining the company. As of today, the company's management structure is worrying. Still, there has not been any major stock price decrease since the CFO left the company and the company anticipates an increase in sales for the next quarter and re confirmed its strategy of increasing margins.

Financials

Revenues were 42.8 million in 2014, representing a growth of 12% from 38.03 million in FY 2013.
Gross Margin slightly improved to 50.00% from 48.50% in FY 2013, while the Net Profit margin sky rocketed from 5.83% to 23.45% at the end of 2014, which is partly due to tax benefit.
Similarly to 2013, IRIDEX had $13.30 million cash on hand in 2014 which, secures reserves for future acquisitions (especially patent acquisition) and other growth opportunities. It will also be used for the company's repurchase of its stocks.
IRIDEX has almost no debt, their debt to equity ratio is 0.09x which grants the company an AAA rating as there is absolutely no risk that they will not be able to pay interest payment.
Before the deceiving second quarter of 2015, IRIDEX had ten previous quarters of record revenues. This is actually why the company decided to address the quality issues by reducing the production. Even though gross margin decreased 330 basis points in Q2 2015 compared to Q2 2014, there are opportunities for margins improvement now that the supply chain issue has been addressed and the consumable sales associated with the launch of the new Cyclo G6 system will start kicking in.

Overreaction to Q2 earnings

Since the last earning calls on the 8th June, IRIDEX Corporation's stock price declined by 9% from $8.70 to the current price of $8.13. The stock dropped to $6.51 before the Cyclo G6 was announced, but its price started to increase again right after the announcement. The Q2 disappointing results that led the stock price down were only due to supply chain issue, but not at all about demand as the company's CEO mentioned several times during the earning call. More precisely, there were issues with RFID antenna, a software glitch and a small motor malfunction. The company hired professional to address those issues and then implemented additional quality controls. William Moore is pretty confident that these kind of problems will not arise again. The market overreacted to Q2 results even though the demand for IRIDEX products was not impacted and competitors did not take business away from the company. Additionally, these kind of slight issues can often happen to manufacturing businesses without destroying value. The undervaluation of the stock added to the $12.2 Million in cash gave the opportunity to management to start a massive repurchase program.
They are planning on repurchasing up to $2 million worth of the company's common stock over the next 12 months.

Valuation

The valuation of IRIDEX Corporation is based on a proforma that values the company with a discounted cash flow model and focus on the company's return on invested capital. A summary of the outputs of the valuation is attached to this report and can be found on the last page. A 0.5% premium has been added to the market risk premium consisting of market premium and country risk premium. This 0.5% premium accounts mainly for the small chance of finding a durable cure to retina disease and especially glaucoma.
When valuing IRIDEX Corporation, a slow decay growth rate has been utilized to determine the speed of reversion toward long term stability as the company, together with the ophthalmology market is unlikely to quickly reach long term stability. There is not any analysts' estimates concerning IRIDEX growth but there are other appropriate way of predicting growth: The revenue growth rate for FY 2016 is based on the growth rate in the market for medical lasers, and is an adjusted average of market predictions. In the following years revenue growth has been set to decline year-over-year to reach a revenue growth for the long-term of 3%. Both Net and NOPAT margins are due to increase in the future. From 8.00% to 15.50% and 6.2% to 7.2% respectively in the long term. This seems logical as the company's strategy is to increase margins by 55% at least by using volume and cost reduction drivers but mainly by focusing their sales on consumables that carry better margins.

The below ratios further proves that IRIX is undervalued. The company is traded at lower levels than its competitors.

	IRIX	PEERS	Δ
EV/REV	1.67x	1.82x	8.74%
P/BV	1.50x	2.01x	33.81%

Finally, the Debt to Equity ratio impact on weighted average cost of capital is the same at the end of the explicit period than during the continuing period (8.4%) which shows very smooth and healthy growth. Following the assumptions used in the valuation model, the stock has an upside potential of 51.16% with a one year target of $12.29.

Summary

The recent decline in stock price caused by negative results in Q2 led IRIDEX Corporation's stock to be undervalued. The stock proves to be a good investment as the market for ophthalmology is definitely growing. The investment has more upside than downside risk.
Moreover, IRIDEX Corporation has a healthy balance sheet, without debt, and capital available in order to further invest into the company. The cash available was also used by the company to repurchase large amount of their stocks, due to their current undervaluation. The company plans to further grow the margins but also further invest in innovation and if opportunities come up, in small acquisitions, technology investments and strategic relationships, or improve the pricing of the company's products. In the short-term, revenue, margins and stock price should be driven up by Cyclo G6 sales.

Sources:

- IRIDEX Corporation, 10-K
- Yahoo Finance
- Capital IQ
- Bloomberg
- http://www.IRIDEX.com/
- Seeking alpha
- Bbcresearch.com
- Strategy.com

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IRIDEX Corporation	irix	Analyst	Current Price	Intrinsic Value	Target Value	Divident Yield	1-y Return: 51.16%	BULLISH
		Coralie Cornern	$8.13	$11.08	$12.29	0%		

General Info	
Sector	Healthcare
Industry	Healthcare Equipment and Supplies
Last Guidance	August 6, 2015
Next earnings date	November 6, 2015
Market Data	
Enterprise value	$68.78
Market Capitalization	$77.79
Daily volume	0.02
Shares outstanding	10.00
Diluted shares outstanding	10.10
% shares held by institutions	21.62%
% shares held by insiders	4.12%
Short interest	0.09%
Days to cover short interest	0.32
52 week high	$11.28
52-week low	$6.41
5y Beta	0.70
6-month volatility	44.71%

Peers	Market Cap.
Ellex Medical Lasers Limited	$52.75
MGC Diagnostics Corporation	$29.36
Utah Medical Products Inc	$201.82
Misonix, Inc	$80.54
Bovie Medical Corporation	$53.57
Synergetics USA, Inc	$170.20
STAAR Surgical Company	$341.92
Anika Therapeutics Inc	$480.96
Carl Zeiss Meditec AG	$2,160.80

Current Capital Structure	
Total debt/Common Equity (LTM)	0.09
Cost of Borrowing (LTM)	0.00%
Estimated Cost of new Borrowing	0.00%
Altman's Z	8.14
Estimated Debt Rating	AAA
Current levered Beta	0.97
LTM WACC	8.17%

Management

Professional	Title	Comp. FY2012	Comp. FY2013	Comp. FY2015
Moore, William	Chairman of The Board, Chief Executive Offi	$208,643	$524,391	$0
Steckel, Ronald	Vice President of Operations	$373,037	$226,657	$0
Hardiman, Paul	Vice President of Regulatory & Compliance	$0	$0	$0
Buckley, Timothy	Vice President of Marketing & North America	$0	$0	$0
Rodgers, Stacie	Vice President of Human Resources	$0	$0	$0
Peartree, Kenneth	Vice President of Research & Development	$0	$0	$0

Past Earning Surprises

	Revenue	EBITDA	Norm. EPS	Standard Error of "Surprise"
Last Quarter	-0.30%	0.00%	150.00%	50.05%
Last Quarter-1	1.53%	0.00%	-25.00%	8.60%
Last Quarter -2	3.09%	0.00%	-16.67%	6.14%
Last Quarter -3	0.38%	0.00%	0.00%	0.13%
Last Quarter -4	6.24%	0.00%	25.00%	7.51%
Standard error	1.2%	0.0%	32.0%	10.39%
Standard Error of Revenues prediction	1.2%			
Imputed Standard Error of Op. Cost predictio	NM			
Imputed Standard Error of Op. Cost predictio	32.0%			

Proforma Assumptions

Convergence Assumptions

All base year ratios linearly converge towards the Sub-industry ratios over an explicit period of 10 years

General Assumptions	
Money market rate (as of today)	0.28%
Risk-Free rate (long term estimate)	2.94%
Annual increase (decrease) in interest rates	0.1%
Marginal Tax Rate	37.5%
Country Risk Premium	6.0%

Forecast Year	Revenue Growth Forecast	Revenue ($) Forecast
LTM		$41.43
FY2016	11.0%	$46.48
FY2017	10.2%	$52.29
FY2018	9.4%	$58.38
FY2019	8.6%	$64.75
FY2020	7.8%	$71.42
FY2021	7.0%	$78.41
FY2022	6.2%	$85.77
FY2023	5.4%	$93.53
FY2024	4.6%	$101.34
FY2025	3.8%	$109.14
Continuing Period	3.0%	$116.95

Items' Forecast Assumptions

	Base year (LTM)	Convergence period (Sub-industry)	Adjustment per year
Operating Cash/Rev.	0.00%	0.00%	0.0%
NWV/Rev.	30.60%	20.67%	-1.0%
NPPE/Rev.	2.60%	19.30%	1.7%
Dpr/NPPE	41.98%	21.30%	-2.1%
NOPAT MARGIN	8.00%	15.51%	0.8%
Op. Exp./Rev.	93.31%	76.43%	-1.7%
SBC/Rev.	2.55%	1.64%	-0.1%
Rent Exp./Rev.	1.45%	0.91%	-0.1%
R&D/Rev.	11.35%	8.00%	-0.3%
E&D/Rev.	0.00%	0.00%	0.0%
SG&A/Rev.	33.48%	30.78%	-0.3%
ROC	8%	11.78%	0.36%
EV/Rev.	1.67x	2.45x	0.08x
EV/EBITA	18.12x	9.86x	-0.83x
Debt/Equity	9%	64%	5.5%
Unlevered beta	0.92	0.77	-0.01
Cost of Borrowing	0%	5%	0.5%
Dividends/REV	0%	3%	0.3%

Other Assumptions

Tobin's Q	80%
Excess cash reinvestment	Cost of capital
Other claims on the firm's assets	$0.00

Capitalization

100% of all rent expenses are capitalized and amortized 'straightline' over 10 years
100% of all R&D expenses are capitalized and amortized 'straightline' over 10 years
E&P expenses are not capitalized
SG&A expenses are not capitalized

Valuation Focus

DCF Valuation	100%
Relative valuation	0%
Distress Valuation	0%

Monte Carlo Simulation Assumptions

Revenue Growth deviation	Normal (0%, 1%)
Operating expense deviation	Normal (0%, 1%)
Continuing Period growth	Triangular (5.335%, 6%, 5.665%)
Country risk premium	Triangular (2.91%, 3%, 3.09%)
Intrinsic value σ(ε)	$0.03
1-year target price σ(ε)	$0.03

Valuation

Forecast Year	ROC	WACC	Total Capital	Implied Enterprise Value	Other Claims on Assets and Dilution Costs	Shares Outstanding	Price per Share
LTM	8.1%	8.2%	$60.52	$117.64	$8.29	10.00	$10.84
FY2016	7.8%	8.2%	$65.76	$127.77	$8.03	10.00	$12.01
FY2017	8.4%	8.2%	$71.97	$138.91	$6.64	10.00	$13.32
FY2018	9.0%	8.2%	$79.25	$151.08	$6.35	10.00	$14.66
FY2019	9.6%	8.2%	$87.71	$164.36	$4.15	10.00	$16.18
FY2020	10.1%	8.2%	$97.53	$178.87	$2.30	10.00	$17.78
FY2021	10.5%	8.3%	$108.91	$194.77	$2.01	10.00	$19.40
FY2022	10.9%	8.3%	$122.12	$212.27	$2.05	10.00	$21.11
FY2023	11.2%	8.3%	$132.32	$226.44	$2.13	10.00	$22.64
FY2024	11.8%	8.3%	$143.11	$240.45	$0.00	10.00	$24.16
FY2025	12.4%	8.4%	$155.16	$254.78	$0.00	10.00	$25.55
Continuing Period	11.8%	8.4%	$154.00				

Monte Carlo Simulation Results

The 3σ(ε)-adjusted intrinsic value is $11.08; the 3σ(ε)-adjusted target price is $12.29; and the analysts' median target price is $0

Sensitivity Analysis

Revenue growth variations account for 95.9% of total variance
Risk premium's variations account for 2.5% of total variance
Operating expenses' variations account for 1.4% of total variance
Continuing period growth variations account for 0.2% of total variance