Siena Market Line
1st week of November 2015

Span-America Medical Systems Inc.

NasdaqGM:SPAN

Analyst: Coralie Cornern
Sector: Healthcare

BUY

Price Target: $33.74

Key Statistics as of 10/29/2015

Market Price:	$18.10
Industry:	Medical Appliances and Equipment
Market Cap:	$52.60 M
52-Week Range:	$16.44-$21.62
Beta:	0.13

Thesis Points:

- Share repurchase Program and raise in quarterly dividends
- Strong financial position, 100% equity composition
- Broad product portfolio with continuous products innovation

Company Description:

Span-America Medical Systems Inc. was founded in 1970 and is headquartered in Greenville, South Carolina. It manufactures and distributes various therapeutic support surfaces and related products for the medical, consumer, and industrial markets in the United States and Canada. It operates through two segments, Medical and Custom Products. The Medical segment offers various medical products consisting of polyurethane foam mattress overlays, non-powered and powered therapeutic support surfaces, patient positioners, medical beds, and tables and related in-room furnishings, as well as seating, skin care, and fall protection products to acute care hospitals, long-term care facilities, and home health care providers. The Custom Products segment provides consumer bedding products comprising convoluted and contour-cut mattress overlays, and specially designed pillows for the consumer bedding market; and engineered industrial products, including engineered foam products that are used in various markets, such as automotive, packaging, durable goods, electronics, and water sports equipment industries. The company went public in July 1983.

Thesis

Span-America Medical Systems Inc. provides medical, consumer, and industrial markets with polyurethane foam based surfaces for the prevention and treatment of pressure ulcers. Pressure ulcers are all kind of injuries to skin and underlying tissue resulting from prolonged pressure on the skin. Span has a very large portfolio of product, mostly patented, that management is willing to improve regularly. Innovation and improvements are key to Span. The company is in a very strong financial position with cash on hand and a hundred percent equity structure. Furthermore, the CEO announced in last earning calls a raise in quarterly dividends. Adding that to the repurchase program announced on 2nd October, it is clear that management believes that the company is currently undervalued. Moreover, the latest ROIC/WACC ratio was 2.78x which shows that Span is creating value.

A buy of Span-America Medical Systems Inc.is therefore recommended with a one-year target price of $33.77. Currently trading at $18.10, it has an upside potential of 92.27%.

Product Portfolio

Span America is providing products to healthcare professionals as well as to private users through retailers. The company develops manufactures and markets beds, surfaces, seating, positioners, skin care fall protections and furniture. Most of their product are polyurethane foam based. Span's medical sales including mainly therapeutic support surfaces, Medical bed frames and patient positioners accounted for 76% of their total sales end of 2014. The 24% remaining is the custom products segment that includes consumer bedding and industrial products. The company product line include several patented medical technologies. Those patented products are continually improved year on year. The Pressure Guard technology for example was first acquired in 1993 and was polyurethane foam shell and static air cylinders to form a replacement mattress that incorporates the comfort and pressure relieving features of both mattress overlays and more sophisticated dynamic mattresses. This design has been upgraded several times and was the base of today's Pressure Guard, which is an industry-leading air therapy powered solution providing alternating pressure and lateral

rotation in one surface. Many of the patented technology that Span created, such as the Pressure Guard but also Span-Aids (patient positioner) or TerryFoam comfort products are designed for long term care, either hospice, home or rehab care. Another part of Span's long term care business is M.C Healthcare. Span acquired M.C in 2011 to add medical bedframes to their portfolio. Span decided to maintain M.C Healthcare as the name of the subsidiary. The demand for medical bedding as well as seating products is unlikely to fall in the future. Indeed, the population is aging and has increased access to Health insurance, which should create further demands for span products in the future. Another factors corroborating that demand will remain stable is that there will always be people in need of medical bedding or custom foam products to improve their life conditions; for example tetraplegic and paraplegic young people are to use those kind of products, which provide lateral rotation their whole life in order to improve blood circulation. Span America's newest product is called Encor, and is a long term care premium bed that offers superior fall prevention, staff protection and protection from shearing, which has been driving sales up the last quarter and should continue to gain momentum among Span's customer.

Porter's Five Forces

The bargaining power of suppliers can be classified as relatively low. Span's basic raw materials are in adequate supply and are available from many suppliers at competitive prices. This implies a high level of competition among suppliers which acts to reduce prices.

The bargaining power of customers on the other hand is medium. Span as quite a large number of competitors so clients have choices available and can decide to pay less for lowest quality products. The bargaining power of customer is measured as medium rather than low because when customer cherish one particular product they are likely to pay a premium for this product. Span has the competitive advantage of offering very high quality products. It is also mentioned in Span's annual report tan they have rapid delivery capabilities and responsiveness to customer requirements. Moreover, the firm offer customizable products which is another competitive advantage to meet customer demand. A lot of Span's products are

patented and therefore unique. The company does not normally have to fear a loss in customers' number, but it might be more difficult to gain new customers due to competition.

The intensity of existing rivalry is high as mentioned in the above paragraph. Most of Span's competitors have greater resources and are larger than them. But the Medical Appliances and Equipment industry is large which allows multiple firm to prosper without having to steal market share to each other. The threat of competition exist but is not the major concern of the company.

The threat of substitutes is low as customers cannot easily find other products that would meet their need.

The threat of new competitors is low. Span America holds patents that will protect their products and technologies. The barriers to entry as well as the learning curve are high. Potential competitors would spent tremendous amount of time and money trying to compete with already patented methods.

Management

James Ferguson joined the company in 1990 as a materials manager and is now CEO, President and Director of Span America Medical Systems. During his 25 years inside the company he serve as materials manager, plant manager, director of contract packaging and VP of operations before being appointed CEO in 1996. It is very valuable to have operation people serving as CEO, especially when they have been in a company for a long time as they would know the business perfectly. Thomas Henrion is the chairman, a member of compensation committee and a member of nominating committee of the company since 1996. He has been chosen for his extensive experience in several industry rather than for any expertise in Healthcare or Medical Appliances and Equipment industry. Henrion has more than 30 years of experience in executive management in corporate finance and investment field. Richard Coggins, CFO of the company joined in 1986 as a controller, just like Ferguson he occupied different position among Span before becoming CFO. The fact that the company is able to keep its senior executives and highly skilled employees over the years is a catalyst for the company's growth.

It has been announced the 2nd October 2015 that Span had repurchased 261,310 shares of its common stock

from Robert Johnston and his affiliate, The Jerry Zucker Revocable Trust, for $4.6 million. The decision of repurchasing has been made as management believe in the stock current undervaluation. Following this event, Johnston resigned from the board of directors as he does not own stocks in the company anymore.

Financials

2014 has been a deceiving year for the company has sales decreased 24% compared to 2013. The stock price therefore dropped after 2014 results. The poor performance was mainly due to the loss of a large retail customers in February that the company regained at the end of the same year. Before the deceiving year of 2014, Span had two years of record revenues and the company has been profitable for 25 years.

Last quarter showed solid sales and earnings. Even though it is compared to a weak year, last quarter performance were strong on an absolute basis too. Sales went up 19%, 13% increased for medical sales and 40% for custom sales. The growth in sales is a very healthy sign for the business as it was not driven by any large corporate orders as one could have believed. Earnings increased 155% compare to Q3 2014 driven by the higher sales volume and by a more profitable medical sales mix. During the last quarter, M.C Healthcare sales improved 39% and led the Gross Profit to increase 25%. The reason why the gross profit increased this much is because most of M.C's costs are fixed. Operating profit last quarter was up 130% compared to Q3 2014 thanks to the combination of increase in sales, more profitable sales mix and lowered rate of growth in operating expense.

Concerning the balance sheet, Span is in excellent shape as in previous years. The company has always had comfortable amount of cash on hand. The firm had $6.2 million on hand the latest quarter, recording a 10% decrease compared to last year due only to special dividends paid, those were the fifth special dividends, and 102nd consecutive quarterly dividend. Moreover, Span's CEO announced during the last earning call that the company was going to increase dividend from $0.15 to $0.16, which is a sign that management truly believes that Span is a growing, healthy firm and that

they are able to sustain this level of dividend.
It is important to note that the company does not have any debt, and absolutely no financial risk. A company

composed of one hundred percent equity is very attractive, especially when the company is managing its cash so well.

Bullish guidance from management

More than the share repurchase program and the dividend increase, the bullish guidance from management during the last earning call was very clear. Announcing increases only, CEO and CFO were both very confident about the future growth in Q4. Jim Ferguson declared that there were some opportunities for large corporate orders in the medical business that would add sales on top of the normal sales growth. Moreover, new products will be introduced in Q4 to further compete with the current competitors. One of them is the Topper Micro Environment manager, a patented pressure redistributing support surface.

Valuation

The valuation of Span America 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 2% premium has been added to the market risk premium consisting of market premium and country risk premium due to the number and size superiority of competitors. Span is also selling in Canada (10.8% of sales) but the country has the same risk premium as the United States, which does not further impact the market risk.
When valuing Span America, a fast decay growth rate has been utilized to determine the speed of reversion toward long term stability as the company is likely to reach long term stability in a few years only. James Ferguson, the CEO, has been working for 25 years to help the company reach long term stability.
Another important assumption made in the proforma is that the company will not be able to significantly decrease its operating cost. The company is in the business since 1970, and the CEO has been present for 25 years so he probably knows the business and has already been able to negotiate with the suppliers. It is unlikely that management engage in cost cutting strategy.
There is not any analysts' estimates concerning Span growth so the industry average growth has been utilized to forecast growth rate for FY 2016. 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% in 2020.
Both Net and NOPAT margins are due to increase in the future. From 6.24% to 7.14% and 6.02% to 7.22% respectively in the long term.
The below ratios further proves that Span is undervalued. The company is traded at lower levels than its competitors.

	Span America	Peers	Δ
EV/Revenue	0.83x	2.04x	146%
EV/EBITDA	9.44x	11.14x	18%

Furthermore, the Debt to Equity impact on Weighted average cost of capital is almost the same (9.4% and 9.5%) at the end of the explicit period and at the beginning of the continuing period. This implies smooth and healthy growth for Span, which further justifies the used of an ROIC model for the valuation.
Following the assumptions used in the proforma, the stock has an upside potential of 92.27%, with a one year target price of $33.74.

Summary

Span-America Medical Systems Inc. is currently creating value as per their latest ROIC/WACC ratio of 2.78. Management is very confident in the firm's ability to further grow. One of the future growth catalyst is the fact that American and Canadian population is aging and getting heavier which should increase demand for Span product. Moreover Span management decided to repurchase 5% of its shares outstanding and increased its quarterly dividend. Those are very positive signals. The company has a strong and diversified patented product portfolio that is significantly better than competition.

Sources:

- Span America Medical Systems , 10-K
- Capital IQ
- Bloomberg
- Yahoo finance

- http://www.businesswire.com.
- http://www.ibisworld.com

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Span-America Medical Systems Inc.	span	Analyst	Current Price	Intrinsic Value	Target Value	Divident Yield	1-y Return: 92.27%	BULLISH
		Coralie Cornern	$17.88	$33.77	$33.74	4%		

General Info

Sector	Healthcare
Industry	Healthcare Equipment and Supplies
Last Guidance	August 8, 2015
Next earnings date	November 6, 2015

Market Data

Enterprise value	$47.28
Market Capitalization	$291,281.98
Daily volume	65.52
Shares outstanding	2.99
Diluted shares outstanding	3.00
% shares held by institutions	57.59%
% shares held by insiders	14.74%
Short interest	0.13%
Days to cover short interest	1.69
52 week high	$21.62
52-week low	$16.44
5y Beta	0.28
6-month volatility	35.02%

Peers	Market Cap.
Hill-Rom Holdings, Inc.	$2,965.87
Invacare Corporation	$603.93
Steris Corp.	$4,250.92
West Pharmaceutical Services, Inc.	$4,317.34
The Cooper Companies Inc.	$7,243.47
Alere Inc.	$3,943.51
Integra LifeSciences Holdings Corporatic	$2,141.50

Current Capital Structure

Total debt/Common Equity (LTM)	0.11
Cost of Borrowing (LTM)	0.00%
Estimated Cost of new Borrowing	2.63%
Altman's Z	8.80
Estimated Debt Rating	AAA
Current levered Beta	-0.42
LTM WACC	-0.11%

Management

Professional	Title	Comp. FY2012	Comp. FY2013	Comp. FY2014
Henrion, Thomas	Chairman, Member of Compensation Comm	$41,180	$43,600	$47,700
Ferguson, James	Chief Executive Officer, President and Directo	$397,420	$357,757	$338,616
Coggins, Richard	Chief Financial Officer, Chief Accounting Offi	$255,596	$232,528	$220,389
Shew, Clyde	Vice President of Medical Sales and Marketing	$266,962	$242,326	$230,347
Ackley, Robert	Vice President of Custom Products	$229,354	$207,837	$195,188
O'Reagan, James	Vice President of Research & Development ar	$213,497	$192,308	$182,861

Past Earning Surprises

	Revenue	EBITDA	Norm. EPS	Standard Error of "Surprise"
Last Quarter	-17.65%	0.00%	-61.76%	18.37%
Last Quarter-1	-8.46%	0.00%	-11.76%	3.50%
Last Quarter -2	-6.19%	0.00%	-26.67%	8.06%
Last Quarter -3	0.00%	0.00%	0.00%	0.00%
Last Quarter -4	0.00%	0.00%	0.00%	0.00%
Standard error	3.3%	0.0%	11.5%	4.32%
Standard Error of Revenues prediction	3.3%			
Imputed Standard Error of Op. Cost prediction	NM			
Imputed Standard Error of Non Op. Cost predictio	11.5%			

Industry Outlook (Porter's Five Forces)

Bargaining Power of Suppliers (88th Percentile), Bargaining Power of Customers (43th Percentile), Intensity of Existing Rivalry (67th Percentile), Threat of Substitutes (67th Percentile), Threat of New Competition (100th Percentile), and Overall (88th Percentile).

Proforma Assumptions

Convergence Assumptions

All base year ratios linearly converge towards the Peers ratios over an explicit period of 8 years

General Assumptions

Money market rate (as of today)	0.32%
Risk-Free rate (long term estimate)	2.92%
Annual increase (decrease) in interest rates	0.1%
Marginal Tax Rate	37.5%
Country Risk Premium	7.5%

Forecast Year	Revenue Growth Forecast	Revenue ($) Forecast
LTM		$59.61
FY2015	1.8%	$60.69
FY2016	2.4%	$62.14
FY2017	2.7%	$63.82
FY2018	2.9%	$65.64
FY2019	2.9%	$67.56
FY2020	3.0%	$69.56
FY2021	3.0%	$71.63
FY2022	3.0%	$73.78
FY2023	3.0%	$75.99
FY2024	3.0%	$78.26
Continuing Period	3.0%	$80.61

Items' Forecast Assumptions

	Base year (LTM)	Convergence period (Peers)	Adjustment per year
Operating Cash/Rev.	0.00%	0.00%	0.0%
NWV/Rev.	15.55%	20.16%	0.4%
NPPE/Rev.	7.85%	26.32%	1.5%
Dpr/NPPE	12.09%	15.75%	0.3%
NOPAT MARGIN	6.02%	12.06%	0.5%
Op. Exp./Rev.	90.68%	90.00%	-0.1%
SBC/Rev.	0.04%	0.96%	0.1%
Rent Exp./Rev.	0.63%	1.51%	0.1%
R&D/Rev.	1.90%	3.54%	0.1%
E&D/Rev.	0.00%	0.00%	0.0%
SG&A/Rev.	24.92%	30.64%	0.5%
ROIC	13%	16.19%	0.23%
EV/Rev.	0.83x	1.54x	0.06x
EV/EBITA	9.44x	7.98x	-0.12x
Debt/Equity	11%	747%	61.3%
Unlevered beta	-0.40	0.80	0.10
Dividends/REV	3%	1%	-0.1%

Other Assumptions

Tobin's Q	80%
Excess cash reinvestment	Money market rate
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%, 7.5%, 5.665%)
Country risk premium	Triangular (2.91%, 3%, 3.09%)
Intrinsic value σ(ε)	$0.38
1-year target price σ(ε)	$0.10

Valuation

Forecast Year	ROIC	WACC	Invested Capital	Implied Enterprise Value	Net Claims on Assets and Dilution Costs	Shares Outstanding	Price per Share
LTM	13.5%	-0.1%	$25.21	$86.94	-$1.42	2.99	$33.73
FY2015	14.3%	0.7%	$27.28	$86.04	-$2.66	2.99	$33.84
FY2016	13.7%	1.5%	$29.73	$86.07	-$1.91	2.99	$33.54
FY2017	12.9%	2.4%	$32.44	$86.98	-$1.87	2.99	$33.56
FY2018	12.1%	3.2%	$35.38	$88.72	-$0.77	2.99	$33.61
FY2019	11.4%	4.0%	$38.50	$91.31	$0.43	2.99	$33.85
FY2020	10.7%	4.7%	$41.80	$94.82	$1.70	2.99	$34.30
FY2021	10.1%	5.5%	$45.28	$99.31	$2.93	2.99	$34.99
FY2022	9.5%	6.3%	$48.94	$104.91	$4.43	2.99	$36.65
FY2023	9.1%	9.2%	$50.34	$111.53	$4.05	2.99	$38.50
FY2024	9.1%	9.3%	$51.79	$118.78	$3.64	2.99	$40.51
Continuing Period	16.2%	9.4%	$60.06				

Monte Carlo Simulation Results

The 3σ(ε)-adjusted intrinsic value is $33.77; the 3σ(ε)-adjusted target price is $33.74; 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