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Research Report – Update

Investors should consider this report as only a single factor in making their investment decision.

Catasys, Inc.

Speculative Buy

John Nobile
April 17, 2018

CATS $4.85 — (NASDAQ)

	2016A	2017A	2018E	2019E
Revenues (millions)	$7.1	$7.7	$18.0	$22.5
Earnings (loss) per share	$(1.95)	$(0.99)	$(0.73)	$(0.59)

52-Week range	$14.00 – $3.30	Fiscal year ends:	December
Common shares out as of 3/2/18	15.9 million	Revenue per share (TTM)	$0.56
Approximate float	4.7 million	Price/Sales (TTM)	8.7X
Market capitalization	$77 million	Price/Sales (FY2019)E	4.1X
Tangible book value/share	$0.06	Price/Earnings (TTM)	NMF
Price/tangible book value	NMF	Price/Earnings (FY2019)E	NMF

Catasys, headquartered in Los Angeles, California, provides specialized behavioral health management and integrated treatment services to health plans through its proprietary OnTrak program. OnTrak utilizes proprietary analytics, artificial intelligence and telehealth in integrating medical and psychosocial treatments with care coaching in a 52-week outpatient program. OnTrak is designed to improve a member's health while lowering costs to the insurer where behavioral health conditions are causing or exacerbating medical conditions.

Key investment considerations:

Reiterating Speculative Buy rating and raising twelve-month price target to $7.50 per share from $5.30 based on strong revenue growth to 2019.

Our rating reflects strong revenue growth through our forecast horizon due to increased member enrollment in CATS' OnTrak program.

Catasys' enrollment increased 31% in 2017. Catasys' outreach pool of eligible members increased to 30,000 at the beginning of March 2018, 20% higher than at the end of 2017.

In January 2018, Catasys expanded OnTrak to Illinois with the fourth largest health insurance plan in the country, representing the second state with this customer.

In February 2018, the company launched the enrollment of OnTrak in Tennessee with a top 10 health insurer, representing the fourth national health plan to launch OnTrak.

For 2018, we project revenue more than doubling to $18 million (unchanged from prior report) from $7.7 million due to the approximate four-fold increase in Catasys' pool of eligible members in 2017. We increased our loss projection to $(0.73) per share from $(0.58) due to higher general and administrative expenses.

For 2019, we project a 25% increase in revenue to $22.5 million from $18 million due to increased billings from a growing pool of eligible members. We project a loss of $(0.59) per share.

CATS reported (March 7, 2018) 4Q17 revenue decreased 19.9% to $3 million. The net loss was $(0.17) per share versus a loss of $(0.16) per share. Excluding one-time items and changes in warrant and derivative liabilities, the 4Q16 net loss was $(0.12) per share. We projected 4Q17 revenue of $3 million and a net loss of $(0.09) per share.

****Please view our disclosures on pages 13 - 15.***

Recommendation and Valuation

We are reiterating our Speculative Buy rating on Catasys, Inc. and raising our twelve-month price target to $7.50 per share from $5.30 based on strong revenue growth to 2019.

Our rating reflects strong revenue growth through our forecast horizon due to increased member enrollment in CATS' OnTrak program. Catasys' enrollment increased 31% in 2017. Catasys' outreach pool of eligible members increased to 30,000 at the beginning of March 2018, 20% higher than at the end of 2017.

In January 2018, Catasys expanded OnTrak to Illinois with the fourth largest health insurance plan in the country, representing the second state with this customer. In February 2018, the company launched the enrollment of OnTrak in Tennessee with a top 10 health insurer, representing the fourth national health plan to launch OnTrak.

Shares of CATS trade at a trailing twelve month P/S ratio of 8.7X while the healthcare services industry trades at a trailing twelve month P/S ratio of 18.5X (Reuters). We believe CATS' discount to the industry could be due to the failure of the market to recognize the significant growth potential of CATS over our forecast period.

We applied the current multiple of 8.7X to our FY19 sales per share projection of $1.17, discounted to account for execution risk, to obtain a year-ahead value of approximately $7.50 per share.

Business

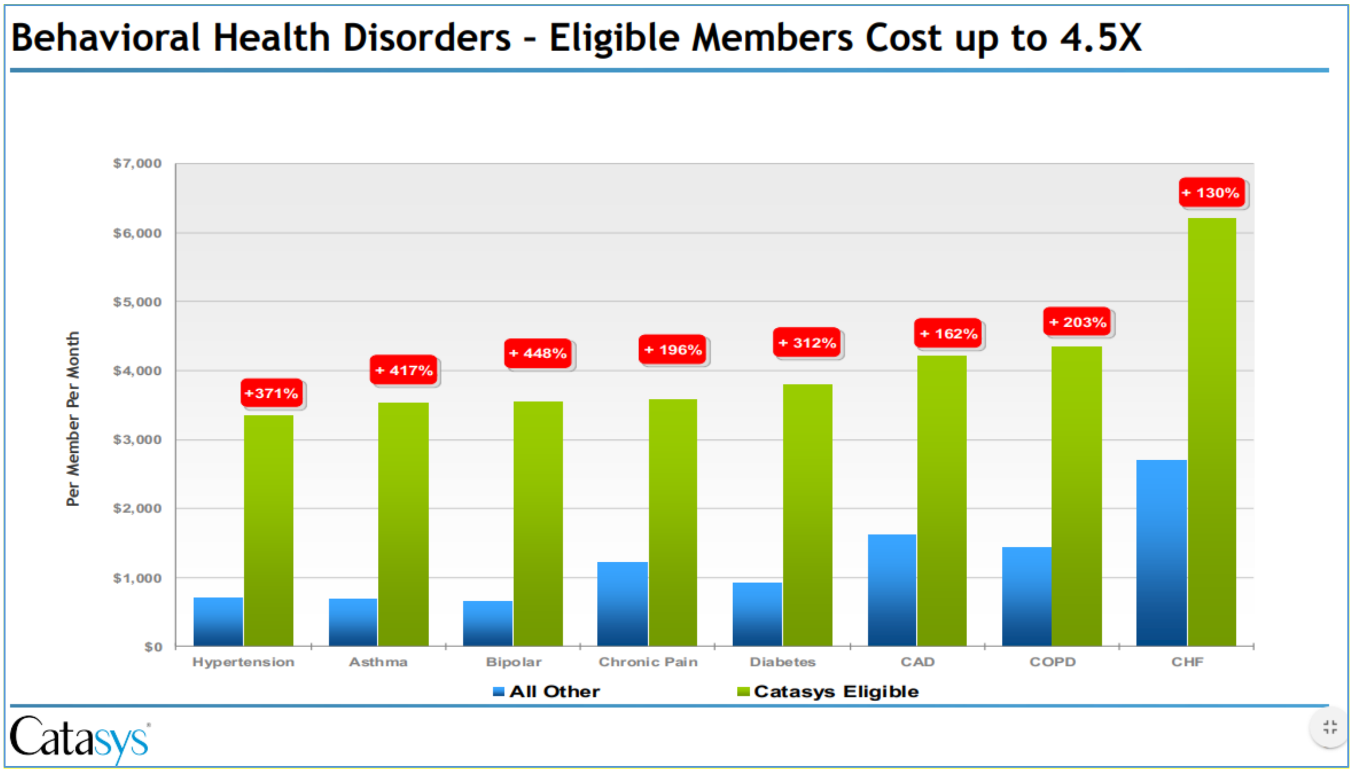
Catasys, headquartered in Los Angeles, California, provides specialized behavioral health management and integrated treatment services to health plans through its proprietary OnTrak™ solution. OnTrak utilizes proprietary analytics, artificial intelligence and telehealth in integrating medical and psychosocial treatments with care coaching in a 52-week outpatient program. OnTrak is designed to improve a member's health while lowering costs to the insurer where behavioral health conditions are causing or exacerbating medical conditions.

After initially focusing on members with substance use disorders (substance use disorders occur when the recurrent use of alcohol and/or drugs causes clinically and functionally significant impairment, such as health problems, disability, and failure to meet major responsibilities at work, school, or home), the company expanded OnTrak to assist members with anxiety and depression disorders. Catasys currently operates in Florida, Georgia, Illinois, Kansas, Kentucky, Louisiana, Massachusetts, Missouri, New Jersey, North Carolina, Oklahoma, Pennsylvania, South Carolina, Tennessee, Texas, Virginia, West Virginia and Wisconsin. The company's services are provided to commercial (employer funded), managed Medicare Advantage, and managed Medicaid and duel eligible (Medicare and Medicaid) populations. The Tier-1 health insurance companies that the company has signed contracts with can be seen in the chart at right.

Source: Catasys Presentation

OnTrak

Catasys' OnTrak program consists of identifying, engaging, enrolling and treating passive, care avoidant, high cost members. The chart below shows how eligible members' costs can be up to 4.5X higher when compared to members without behavioral health disorders. The chart indicates that a person suffering from bipolar disorder and is eligible for OnTrak, costs the insurance company approximately $3,500 per month. A typical member that suffers from bipolar disorder but does not exhibit a behavioral health disorder, costs an insurance company approximately $600 per month.



Catasys assists health plans in identifying members who may be appropriate for enrollment into OnTrak. The company then engages and enrolls targeted members into its program through direct mailings and by telephone, and referral through health plan sources. After enrollment, Catasys' contracted network of providers provide treatments utilizing integrated medical and psychosocial treatments, including the company's proprietary OnTrak therapy modules for anxiety, depression, and substance use disorders to help members develop improved coping skills and find a recovery support network. Throughout the treatment process, care coaches work directly with members to keep them engaged in treatment by enhancing motivation, minimizing lapses, and enabling lifestyle modifications consistent with the recovery goals. The company periodically reports clinical and financial outcome metrics to its customers (insurance companies) to demonstrate the extent of the program's value.

Clinical and financial outcomes from the OnTrak program have been promising. OnTrak enrolled members have achieved an average gross cost reduction of more than 50% for the year after enrollment compared to the twelve months prior to enrollment.

The company receives approximately $6,500 per enrolled member. New customer launches take approximately 12 months to ramp up to a 20% yearly enrollment rate of eligible members.

Catasys' Markets

According to a report by the advisory firm Stout, substance use disorders are a significant contributor to high healthcare costs. Stout cited the Substance Abuse and Mental Health Services Administration as saying that excessive substance use and substance use disorders are costly to the nation due to lost productivity, healthcare, and crime. Addressing the impact of substance use alone is estimated to cost Americans more than $600 billion each year. Stout's belief is that behavioral companies can help reduce these costs by preventing hospital readmissions via mental health and substance use disorder treatment programs. This is why insurance companies are engaging Catasys' OnTrak program.

Catasys is focused on insurance company members with behavioral health conditions such as substance use disorders, anxiety and depression. Members with these behavioral health disorders average higher medical costs for covering health insurance providers and many of these high costs members do not seek treatment.

Substance Use Disorders – Substance use disorders caused by the recurrent used of alcohol or other drugs (or both) can significantly impair a person and result in health problems, disability, and failure to meet major responsibilities at work, school, or home.

According to the Substance Abuse and Mental Health Services Administration's National Survey on Drug Use and Health (NSDUH), approximately 20.1 million people in the US aged 12 or older had a substance use disorder in 2016, including 15.1 million people who had an alcohol use disorder and 7.4 million people who had an illicit drug use disorder. Among the 7.4 million people aged 12 or older who had an illicit drug use disorder, the most common disorders were for marijuana (4 million people) and prescription pain relievers (1.8 million people). In 2016, smaller numbers of people had disorders related to their use of cocaine, methamphetamines, and heroin or prescription stimulants.

Approximately one out of 10 people with a substance use disorder seeks treatment.

Anxiety – IBISWorld reports that mental illness affects an estimated 44.7 million or 18.3% of adults in the US each year and primarily includes anxiety, mood and psychotic disorders.

Anxiety includes panic disorder, agoraphobia (an abnormal fear of being in crowds, public places, or open areas), social phobia, generalized anxiety, post-traumatic stress, obsessive-compulsive stress, and adult separation anxiety. Sufferers generally feel anxiety toward events in the future and fear current situations.

Approximately one out of three people with an anxiety disorder seeks treatment.

Depression – Major depressive episodes (MDE) are generally characterized by changes in mood, thought, or behavior and are generally defined as being in a depressed mood for two weeks or more, and a loss of interest or pleasure in everyday activities, accompanied by other symptoms such as feelings of emptiness, hopelessness, anxiety, worthlessness, guilt and/or irritability, as well as changes in appetite, problems concentrating, remembering details or making decisions, and thoughts of or attempts at suicide.

According to the Substance Abuse and Mental Health Services Administration, 12.8% of adolescents aged 12 to 17 (3.1 million adolescents) had MDE in 2016 and 9% of adolescents (2.2 million adolescents) had an episode with severe impairment. Thus, adolescents who had an episode with severe impairment represented more than two thirds (70.5%) of adolescents in 2016 with MDE.

In 2016, 6.7% of adults aged 18 or older (16.2 million adults) had at least one MDE and 4.3% of adults (10.3 million adults) had an MDE with severe impairment. Adults who had an MDE with severe impairment represented nearly two thirds (64%) of adults who had an MDE in 2016.

Approximately two out of 10 people who suffer from depression seek treatment.

Competition

Catasys operates in highly competitive markets. The company competes with other healthcare management service organizations, care management and disease management companies. Those competing organizations include managed behavioral health organizations (MBHOs) that manage behavioral health benefits, perform utilization reviews, provide case management and patient coaching, and pay their network of providers for behavioral health services delivered. Most of Catasys' competitors are significantly larger and have greater financial, marketing and other resources than the company.

Competitors include companies such as AbleTo and Health Integrated that offer coaching, social media, and in the case of Health Integrated, more comprehensive products to address the costs of members with substance dependence and other behavioral health conditions. The company believes that its ability to offer customers an outcomes based comprehensive and integrated solution, including the utilization of innovative medical and psychosocial treatments and engagement methodologies, along with its network of treatment providers, will enable Catasys to compete effectively. However, there can be no assurance that the company will not encounter more effective competition in the future.

4Q and 2017 Financial Results

<u>*4Q17*</u> – Revenue decreased 19.9% to $3 million. The net loss was $2.7 million or $(0.17) per share versus a net loss of $1.5 million or $(0.16) per share. Excluding one-time items and changes in warrant and derivative liabilities, the 4Q16 net loss was $1.1 million or $(0.12) per share. We projected 4Q17 revenue of $3 million and a net loss of $1.4 million or $(0.09) per share.

The decrease in revenue was primarily due to a larger portion of billings being subject to deferred revenue. Partly offsetting the revenue decline was a 31% increase in enrolled members.

Cost of revenue increased 57.5% to $2 million which resulted in a gross margin of 33.1% compared to 66% in the year ago period. The increase in cost of revenue was primarily due to more members being treated and the addition of staff to manage the increase in enrolled members.

General and administrative expenses increased 58.1% to $3.7 million reflecting staff increases in order to manage service contracts and an increasing number of enrolled members.

Interest expense decreased to $1,000 from $1.2 million in 4Q16.

<u>*2017*</u> – Revenue increased 9.1% to $7.7 million. The net loss was $13.6 million or $(0.99) per share versus a net loss of $17.9 million or $(1.95) per share. Excluding one-time items and changes in warrant and derivative liabilities, the 2017 net loss was $14 million or $(1.02) per share versus a net loss of $11.8 million or $(1.29) per share in 2016.

The increase in revenue was primarily due to more members enrolled in the company's programs.

Cost of revenue increased 36.9% to $6.4 million while gross margins decreased to 17.2% from 34% in 2016. The increase in cost of revenue was primarily due to more members being treated and the addition of staff to manage the increase in enrolled members.

General and administrative expenses increased 33.6% to $11.8 million primarily due to costs associated with managing an increasing number of enrolled members.

Interest expense decreased to $3.4 million from $5.4 million. The year-ago expense was related to the value of warrants issued for convertible debentures in 2016, as well as the amortization of the debt discount on the debentures. The convertible debentures were either converted or paid in full in April 2017.

Liquidity - As of December 31, 2017, the company had $4.8 million cash, a current ratio of 1, no debt, and 14% of assets are financed by equity.

Cash used in operations in 2017 was $7.4 million consisting of a $9.3 million cash burn and a $1.9 million decrease in working capital. The decrease in working capital was primarily due to an increase in deferred revenue.

Cash used in investing consisted primarily of $448,000 of capital expenditures. Cash provided by financing of $11.7 million consisted primarily of proceeds from the issuance of common stock offset in part by the repayment of debt. Cash increased by $3.9 million to $4.8 million at December 31, 2017.

In March 2017, Catasys entered into amendments with the holders of certain outstanding warrants to eliminate certain anti-dilution provisions in such warrants, which resulted in a warrant liability of $5.3 million on the balance sheet as of December 31, 2016. The elimination of the anti-dilution provision resulted in the write-off of $6.2 million of the warrant liability as of December 31, 2017.

In January 2017, Catasys entered into a subscription agreement with Acuitas, pursuant to which the company received gross proceeds of $1.3 million in consideration of the issuance of an 8% Series B convertible debenture due March 31, 2017 and five-year warrants to purchase shares of the company’s common stock at an exercise price of $5.10 per share. In April 2017, Catasys used the net proceeds from a public offering of common stock ($15 million gross proceeds) to repay the loan including interest of $1.3 million.

The company has issued warrants to purchase common stock from February 2012 to June 2017. Some of the warrants are being accounted for as liabilities in accordance with FASB accounting rules due to anti-dilution provisions in some warrants that protect the holders from declines in the stock price. For 2017 and 2016, Catasys recognized a gain of $1.8 million and $2.1 million, respectively, related to the revaluation of its warrant liabilities.

In April 2017, convertible debentures that were originally issued in July 2015 were converted into approximately 2.4 million shares of common stock and the derivative liability was written off. For 2017 and 2016, the company recognized a gain of $132,000 and a loss of $5.8 million, respectively, related to the revaluation of derivative liabilities.

Economic Outlook

In January 2018, the IMF raised its global economic growth estimate to 3.9% for both 2018 and 2019, up from 3.7% in October 2017. The upward revision reflects increased global economic growth momentum and the positive impact expected from approved US tax policy changes in 2017 that go into effect in 2018.

The IMF raised its economic growth estimate for the US to 2.7% in 2018 and 2.5% in 2019, up from its earlier (October 2017) growth forecast of 2.3% for 2018 and 1.9% for 2019. The upward revision reflects stronger than expected US economic activity in 2017, higher projected external demand, and the positive economic impact from 2018 tax policy changes, in particular the reduction in corporate tax rates and the temporary allowance for full expensing of investments.

The third estimate of US GDP growth (released on March 28, 2018) showed the US economy grew at an annual rate of 2.9% in 4Q17, down from 3.2% growth in 3Q17. The 4Q17 US GDP growth estimate primarily reflects increases in consumer spending, business investment, exports, housing investment, and government spending. These contributions were partly offset by declines in private inventory investment.

Projections

<u>Basis for forecast</u> – We anticipate strong revenue growth through our forecast horizon due to increased member enrollment in CATS' OnTrak program.

Catasys' enrollment increased 31% in 2017. Catasys' outreach pool of eligible members increased to 30,000 at the beginning of March 2018, 20% higher than at the end of 2017.

In January 2018, Catasys expanded OnTrak to Illinois with the fourth largest health insurance plan in the country, representing the second state with this customer. In February 2018, the company launched the enrollment of OnTrak in Tennessee with a top 10 health insurer, representing the fourth national health plan to launch OnTrak.

<u>*FY18*</u> – We project revenue more than doubling to $18 million from $7.7 million due to the approximate four-fold increase in Catasys' pool of eligible members in 2017. We project a net loss of $13 million or $(0.73) per share. Our revenue projection is unchanged from our prior report but we increased our net loss projection from $10 million or $(0.58) per share due primarily to higher general and administrative expenses which are reflected in 4Q17 results.

We project gross profit increasing to $2.5 million from $1.3 million with gross margins decreasing to 14% from 17.2% as the company continues to invest in staffing to support additional contracts.

We project G&A expenses increasing by $3.6 million to $15.4 million in order to support the rapid growth in OnTrak members. G&A expense margins should decrease to 85.6% from 153.1%.

We project no interest expense due to the conversion and payoff of debt that occurred in 2017. The company should pay minimal to no taxes due to its large amount of net operating loss carry forwards ($235 million as of December 31, 2017).

We project CATS' will use $9.7 million cash from operations from an $11.5 million cash burn offset in part by a $1.8 million decrease in working capital due primarily to an increase in accounts payable. The company's cash used in operations and capital expenditures should necessitate a $10 million raise from the issuance of common stock, increasing cash by $25,000 to $4.8 million at December 31, 2018.

<u>*FY19*</u> – We project a 25% increase in revenue to $22.5 million from $18 million due to increased billings from a growing pool of eligible members. We project a net loss of $11.5 million or $(0.59) per share.

We project gross profit increasing to $5.6 million from $2.5 million with gross margins increasing to 25% from 14%.

We project G&A expenses increasing by $1.6 million to $17 million in order to support the rapid growth in OnTrak members. G&A expense margins should decrease to 75.6% from 85.6%.

We project no interest expense and the company paying only minimal taxes due to its large amount of net operating loss carry forwards.

We project CATS' will use $10 million cash from operations primarily from its cash burn. The company's cash used in operations and capital expenditures should necessitate a $7 million raise from the issuance of common stock, decreasing cash by $3.2 million to $1.7 million at December 31, 2019.

Risks

In our view, these are the principal risks underlying the stock.

Going concern – Catasys has been unprofitable since its inception in 2003 and expectations are for continued operating losses and negative cash from operations for the remainder of 2018. These conditions raise substantial doubt as to the company's ability to continue as a going concern.

No assurance of growing acceptance of OnTrak – The company's ability to achieve further acceptance for its OnTrak program is dependent on its ability to contract with a sufficient number of third party payors and to demonstrate financial and clinical benefits from those agreements. If Catasys is unable to secure sufficient contracts for its OnTrak program or if the program does not demonstrate the expected level of clinical improvement and cost savings, it is unlikely that OnTrak will be able to achieve widespread market acceptance.

Competition **-** The healthcare business in general, and the behavioral health treatment business in particular, are highly competitive. Catasys competes with other healthcare management service organizations, care management and disease management companies, other specialty healthcare and managed care companies, and healthcare technology companies that offer treatment and support of behavioral health on-line and on mobile devices. Most of the company's competitors are significantly larger and have greater financial, marketing and other resources than Catasys. There can be no assurance that the company will be able to effectively compete.

Regulations **-** Healthcare companies are subject to extensive and complex federal, state and local laws and regulations. Catasys' failure to comply with applicable healthcare laws and regulations could adversely impact its business operations.

Insider ownership – Approximately 61% of CATS' outstanding common stock is beneficially owned Acuitas Group Holdings, LLC, whose sole managing member is CATS' Chairman and CEO, Terren Peizer. As a result, Peizer is expected to significantly influence the election of CATS' Board of Directors and the outcome of matters submitted by stockholders. Peizer's interest may not always be in the best interest of other stockholders

Liquidity risk **-** Shares of Catasys have risks common to those of the microcap segment of the market. Often these risks cause microcap stocks to trade at discounts to their peers. The most common of these risks is liquidity risk, which is typically caused by small trading floats and very low trading volume and can lead to large spreads and high volatility in stock price. There are 4.7 million shares in the float and the average daily volume is approximately 56,000 shares.

Miscellaneous risk **-** The company's financial results and equity values are subject to other risks and uncertainties including competition, operations, financial markets, regulatory risk, and/or other events. These risks may cause actual results to differ from expected results.

Consolidated Balance Sheets
(in thousands $)

	2015A	2016A	2017A	2018E	2019E
Cash and cash equivalents	916	851	4,779	4,804	1,652
Receivables	590	1,052	511	1,192	1,490
Prepaid and other	575	420	366	366	366
Total current assets	2,081	2,323	5,656	6,362	3,508
Net property, plant and equipment	412	410	612	579	555
Deposits	387	371	336	336	336
Total assets	**2,880**	**3,104**	**6,604**	**7,277**	**4,399**
Accounts payable	753	870	980	2,373	2,588
Accrued compensation and benefits	1,703	2,089	1,177	2,745	3,432
Deferred revenue	1,683	1,525	2,914	2,914	2,914
Other accrued liabilities	682	575	578	578	578
Short-term debt	-	9,796	-	-	-
Short-term derivative liability	-	8,122	-	-	-
Total current liabilities	4,821	22,977	5,649	8,610	9,511
Deferred rent and other	198	117	25	25	25
Long-term debt	3,662	-	-	-	-
Capital leases	66	31	2	2	2
Long-term derivative liability	2,348	-	-	-	-
Warrant liabilities	509	5,307	30	30	30
Total liabilities	**11,604**	**28,432**	**5,706**	**8,667**	**9,568**
Total stockholders' equity	**(8,724)**	**(25,328)**	**898**	**(1,390)**	**(5,169)**
Total liabilities & stockholders' equity	**2,880**	**3,104**	**6,604**	**7,277**	**4,399**

Source: Company filings and Taglich Brothers' estimates

Income Statements for the Fiscal Years Ended
(in thousands $)

	2015A	2016A	2017A	2018E	2019E
Revenue	2,705	7,075	7,717	18,000	22,500
Cost of revenue	2,433	4,670	6,391	15,475	16,875
Gross profit	272	2,405	1,326	2,525	5,625
General and administrative	9,049	8,838	11,811	15,400	17,000
Depreciation and amortization	122	141	246	233	224
Operating income (loss)	(8,899)	(6,574)	(10,731)	(13,108)	(11,599)
Other income	64	106	132	120	120
Interest expense	(2,590)	(5,354)	(3,409)	-	-
Loss on debt extinguishment	(195)	(2,424)	-	-	-
Loss on conversion of note	-	-	(1,356)	-	-
Loss on issuance of common stock	-	-	(145)	-	-
Change in fair value of warrant liability	11,665	2,093	1,778	-	-
Change in fair value of derivative liability	(2,761)	(5,774)	132	-	-
Income before taxes	(7,214)	(17,927)	(13,599)	(12,988)	(11,479)
Income tax	9	9	6	-	-
Net Income / (Loss)	(7,223)	(17,936)	(13,605)	(12,988)	(11,479)
EPS	(1.07)	(1.95)	(0.99)	(0.73)	(0.59)
Shares Outstanding	6,729	9,179	13,751	17,900	19,300
Margin Analysis					
Gross margin	10.1%	34.0%	17.2%	14.0%	25.0%
SG&A	334.5%	124.9%	153.1%	85.6%	75.6%
Operating margin	(329.0)%	(92.9)%	(139.1)%	(72.8)%	(51.6)%
Net margin	(267.0)%	NMF	(176.3)%	(72.2)%	(51.0)%
Tax rate	(0.1)%	(0.1)%	0.0%	0.0%	0.0%
Year / Year Growth					
Total Revenues		161.6%	9.1%	133.3%	25.0%

Source: Company filings and Taglich Brothers' estimates

Quarterly Income Statements 2017A - 2019E
(in thousands $)

	3/17A	6/17A	9/17A	12/17A	2017A	3/18E	6/18E	9/18E	12/18E	2018E	3/19E	6/19E	9/19E	12/19E	2019E
Revenue	1,822	1,665	1,195	3,035	7,717	3,000	4,000	5,000	6,000	18,000	4,650	5,300	5,950	6,600	22,500
Cost of revenue	1,365	1,332	1,664	2,030	6,391	3,900	3,200	3,875	4,500	15,475	3,488	3,975	4,463	4,950	16,875
Gross profit	457	333	(469)	1,005	1,326	(900)	800	1,125	1,500	2,525	1,163	1,325	1,488	1,650	5,625
General and administrative	2,629	2,940	2,575	3,667	11,811	3,700	3,800	3,900	4,000	15,400	4,100	4,200	4,300	4,400	17,000
Depreciation and amortization	39	45	47	115	246	59	58	58	58	233	56	56	56	56	224
Operating income (loss)	(2,211)	(2,652)	(3,091)	(2,777)	(10,731)	(4,659)	(3,058)	(2,833)	(2,558)	(13,108)	(2,994)	(2,931)	(2,869)	(2,806)	(11,599)
Other income	14	14	16	88	132	30	30	30	30	120	30	30	30	30	120
Interest expense	(2,867)	(539)	(1)	(1)	(3,409)	-	-	-	-	-	-	-	-	-	-
Loss on debt extinguishment	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Loss on conversion of note	(926)	(430)	-	-	(1,356)	-	-	-	-	-	-	-	-	-	-
Loss on issuance of common stock	-	(145)	-	-	(145)	-	-	-	-	-	-	-	-	-	-
Change in fair value of warrant liability	(5,181)	6,950	(2)	11	1,778	-	-	-	-	-	-	-	-	-	-
Change in fair value of derivative liability	(10,596)	10,728	-	-	132	-	-	-	-	-	-	-	-	-	-
Income before taxes	(21,767)	13,926	(3,078)	(2,679)	(13,599)	(4,629)	(3,028)	(2,803)	(2,528)	(12,988)	(2,964)	(2,901)	(2,839)	(2,776)	(11,479)
Income tax	1	1	2	2	6	-	-	-	-	-	-	-	-	-	-
Net Income / (Loss)	(21,768)	13,925	(3,080)	(2,681)	(13,605)	(4,629)	(3,028)	(2,803)	(2,528)	(12,988)	(2,964)	(2,901)	(2,839)	(2,776)	(11,479)
EPS	(2.35)	0.97	(0.19)	(0.17)	(0.99)	(0.26)	(0.17)	(0.16)	(0.14)	(0.73)	(0.15)	(0.15)	(0.15)	(0.14)	(0.59)
Shares Outstanding	9,246	14,299	15,889	15,889	13,751	17,900	17,900	17,900	17,900	17,900	19,300	19,300	19,300	19,300	19,300
Margin Analysis															
Gross margin	25.1%	20.0%	(39.2)%	33.1%	17.2%	(30.0)%	20.0%	22.5%	25.0%	14.0%	25.0%	25.0%	25.0%	25.0%	25.0%
SG&A	144.3%	176.6%	215.5%	120.8%	153.1%	123.3%	95.0%	78.0%	66.7%	85.6%	88.2%	79.2%	72.3%	66.7%	75.6%
Operating margin	(121.4)%	(159.3)%	NMF	(91.5)%	(139.1)%	(155.3)%	(76.5)%	(56.7)%	(42.6)%	(72.8)%	(64.4)%	(55.3)%	(48.2)%	(42.5)%	(51.6)%
Net margin	NMF	836.3%	NMF	(88.3)%	(176.3)%	(154.3)%	(75.7)%	(56.1)%	(42.1)%	(72.2)%	(63.7)%	(54.7)%	(47.7)%	(42.1)%	(51.0)%
Tax rate	0.0%	0.0%	(0.1)%	-0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Year / Year Growth															
Total Revenues	150.3%	36.1%	(10.6)%	(19.9)%	9.1%	64.7%	140.2%	318.4%	97.7%	133.3%	55.0%	32.5%	19.0%	10.0%	25.0%

Source: Company filings and Taglich Brothers' estimates

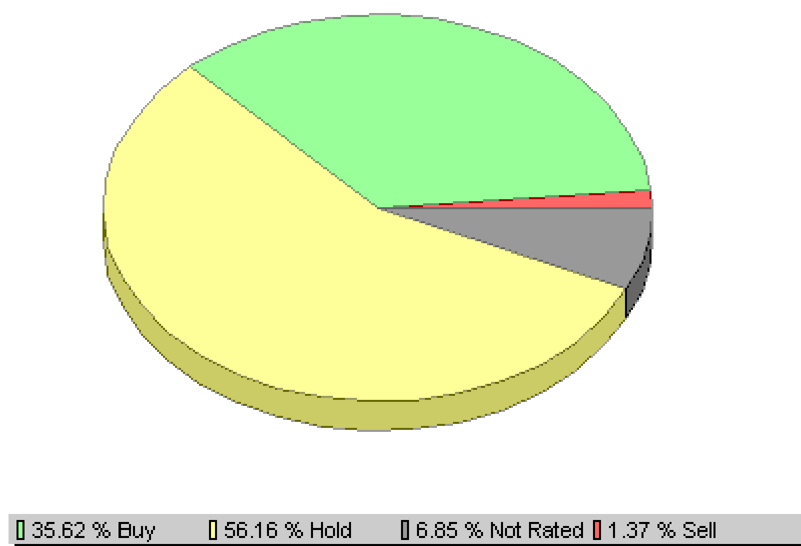
Statement of Cash Flows for the Periods Ended
(in thousands $)

	2015A	2016A	2017A	2018E	2019E
Net income (loss)	(7,223)	(17,936)	(13,605)	(12,988)	(11,479)
Depreciation & amortization	122	141	246	233	224
Amortization of debt discount and issuance costs	2,324	4,651	3,082	-	-
Loss on disposal of intangible assets	88	-	-	-	-
Loss on debt extinguishment	195	2,424	-	-	-
Warrants issued for services	168	-	252	-	-
Provision for doubtful accounts	10	47	590	590	590
Deferred rent	(44)	(70)	(81)	(81)	(81)
Share-based compensation	1,397	697	465	500	500
Common stock issued for services	172	235	181	200	200
Loss on conversion of convertible debentures	-	-	1,356	-	-
Loss on issuance of common stock	-	-	145	-	-
Loss on exchange of warrants	4,410	-	-	-	-
Fair value adjustment on warrant liability	(11,665)	(2,093)	(1,778)	-	-
Fair value adjustment on derivative liability	2,761	5,774	(132)	-	-
Cash earnings (loss)	(7,285)	(6,130)	(9,279)	(11,546)	(10,046)
Changes in assets and liabilities					
Receivables	(111)	(509)	(49)	(681)	(298)
Prepaid and other current assets	17	155	54	-	-
Deferred revenue	1,329	(158)	1,389	-	-
Accounts payable and other	882	916	517	2,486	394
(Increase) decrease in working capital	2,117	404	1,911	1,805	96
Net cash provided by (used in) operations	**(5,168)**	**(5,726)**	**(7,368)**	**(9,741)**	**(9,950)**
Purchases of properrty and equipment	(107)	(106)	(448)	(200)	(200)
Deposits and other assets	-	16	35	-	-
Net cash used in investing	**(107)**	**(90)**	**(413)**	**(200)**	**(200)**
Proceeds from the issuance of common stock and warrants	2,463	-	16,458	10,000	7,000
Proceeds from bridge loan	-	-	1,300	-	-
Proceeds from the issuance of convertible debt	5,910	300	-	-	-
Payments on convertible debt	(2,681)	-	(4,363)	-	-
Proceeds from the issuance of notes	-	5,505	-	-	-
Transaction costs	(185)	-	(1,667)	-	-
Capital lease obligations	(24)	(54)	(19)	(34)	(2)
Net cash provided by (used in) financing	**5,483**	**5,751**	**11,709**	**9,966**	**6,998**
Net change in cash	**208**	**(65)**	**3,928**	**25**	**(3,152)**
Cash - beginning of period	**708**	**916**	**851**	**4,779**	**4,804**
Cash - end of period	**916**	**851**	**4,779**	**4,804**	**1,652**

Source: Company filings and Taglich Brothers' estimates

Price Chart

Taglich Brothers' Current Ratings Distribution



Investment Banking Services for Companies Covered in the Past 12 Months		
Rating	#	%
Buy	**3**	**12**
Hold		
Sell		
Not Rated		

Important Disclosures

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I, John Nobile, the research analyst of this report, hereby certify that the views expressed in this report accurately reflect my personal views about the subject securities and issuers; and that no part of my compensation was, is, or will be, directly, or indirectly, related to the specific recommendations or views contained in this report.

Public companies mentioned in this report:

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Cray (NASDAQ: CRAY)
General Electric (NYSE: GE)
Goldman Sachs (NYSE: GS)
Humana (NYSE: HUM)

Meaning of Ratings

Buy – The growth prospects, degree of investment risk, and valuation make the stock attractive relative to the general market or comparable stocks.

Speculative Buy – Long term prospects of the company are promising but investment risk is significantly higher than it is in our BUY-rated stocks. Risk-reward considerations justify purchase mainly by high risk-tolerant accounts. In the short run, the stock may be subject to high volatility and could continue to trade at a discount to its market.

Neutral – Based on our outlook the stock is adequately valued. If investment risks are within acceptable parameters, this equity could remain a holding if already owned.

Sell – Based on our outlook the stock is significantly overvalued. A weak company or sector outlook and a high degree of investment risk make it likely that the stock will underperform relative to the general market.

Dropping Coverage – Research coverage discontinued due to the acquisition of the company, termination of research services, non-payment for such services, diminished investor interest, or departure of the analyst.

Some notable Risks within the Microcap Market

Stocks in the Microcap segment of the market have many risks that are not as prevalent in Large-cap, Blue Chips or even Small-cap stocks. Often it is these risks that cause Microcap stocks to trade at discounts to their peers. The most common of these risks is liquidity risk, which is typically caused by small trading floats and very low trading volume which can lead to large spreads and high volatility in stock price. In addition, Microcaps tend to have significant company specific risks that contribute to lower valuations. Investors need to be aware of the higher probability of financial default and higher degree of financial distress inherent in the microcap segment of the market.

From time to time our analysts may choose to withhold or suspend a rating on a company. We continue to publish informational reports on such companies; however, they have no ratings or price targets. In general, we will not rate any company that has too much business or financial uncertainty for our analysts to form an investment conclusion, or that is currently in the process of being acquired.