

CONM: NYSE AMEX

Update

November 13, 2009

Rating: **Accumulate**
(Unchanged)

Recent Price: **\$3.09**
(11/12/09)

Price Target: **\$5.25**
(Unchanged)

Conmed Healthcare Management, Inc.

Healthcare Services; Corrections

MARKET DATA

52-Week High/Low	\$4.40 - \$1.65
Ave. Daily Volume (6-mos.)	10 K
Shares Outstanding	12.6 M
Inside Ownership	25%
Institutional Ownership	50%
Float	9.4 mln
Short Interest (% of float)	<1%

Conmed Healthcare Management is a provider of healthcare services at county and municipal correctional facilities in the continental U.S. The Company has contracts for fifty-one county sites in seven states, caring for over 17,000 detainees. Services include medical and behavioral healthcare for all inmates as well as record keeping and compliance functions. Conmed is headquartered in Hanover, Maryland and maintains an Internet presence at www.conmed-inc.com.

FINANCIAL DATA

Market Capitalization	\$38.9 M
- Cash & Equivalents	\$10.1 M
+ Long-term Debt	\$ -0- M
Enterprise Value	\$28.8 M
Book Value	\$11.9 M
Working Capital	\$ 6.3 M
Dividend Yield	Nil

Balance sheet figures as of 9/30/09

HIGHLIGHTS

- **Record Revenue.** Revenue continued to ramp in 3Q09, reaching a record \$13.6 million and representing 18.3% growth over the prior-year quarter.
- **Revenue Run Rate.** Conmed's annual revenue run rate has increased to \$55.0 million. One of the largest contracts in Conmed's portfolio with Baltimore County Detention Center was recently renewed with the customary cost of living adjustments.
- **Estimates.** We updated our earnings model to reflect 3Q09 results. We also made adjustments to our sales, cost and expense assumptions in the final quarter of the year. Our updated 2009 EPS estimate is now a loss of \$0.16 per share on \$52.6 million in sales (from a loss of \$0.12 per share and \$54.7 million). However, we increased our estimate of cash flow from operations in 2009 to \$4.0 million (from \$3.8 million).
- **Rating and Price Target.** We remain bullish on Conmed Healthcare Management, despite what appears to be a lull in the Company's contracting and acquisition activity.
- **Valuation.** Conmed's enterprise value is \$2.29 per share, suggesting the stock is egregiously oversold.

	SALES	NET EARN	CFO	EPS**
2007P*	\$26.1	(\$1.7)	\$1.7	(\$0.16)
2008A	\$40.6	(\$0.9)	\$2.8	(\$0.08)
1Q09A	\$12.4	\$0.1	\$1.0	\$0.01
2Q09A	\$12.7	(\$2.4)	\$0.8	(\$0.19)
3Q09A	\$13.6	\$0.9	\$1.3	\$0.01
4Q09E	\$13.8	\$0.1		\$0.03
FY09E	\$53.6	(\$1.3)	\$4.0	(\$0.16)
FY10E	\$64.0	\$2.8	\$4.8	\$0.21

Dollars in millions, except EPS; Fiscal year ends Dec.
*2007 results shown pro forma for calendar year 2007

VALUATION

Price/Sales	0.8 X
Price/CFO	9.5 X
Price/Trailing 12-mo. Earnings	Neg
Price/Book Value	3.3 X
Consensus EPS Estimate 2009	NA
Consensus EPS Estimate 2010	NA

Lead Analyst: Debra Fiakas, CFA
212-400-7519
dfiakas@crystalequityresearch.com

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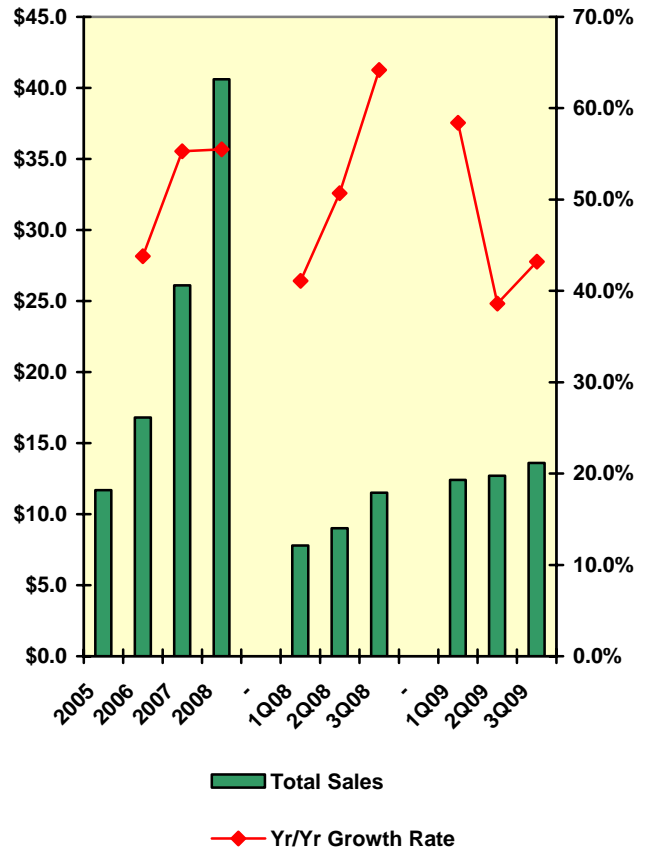
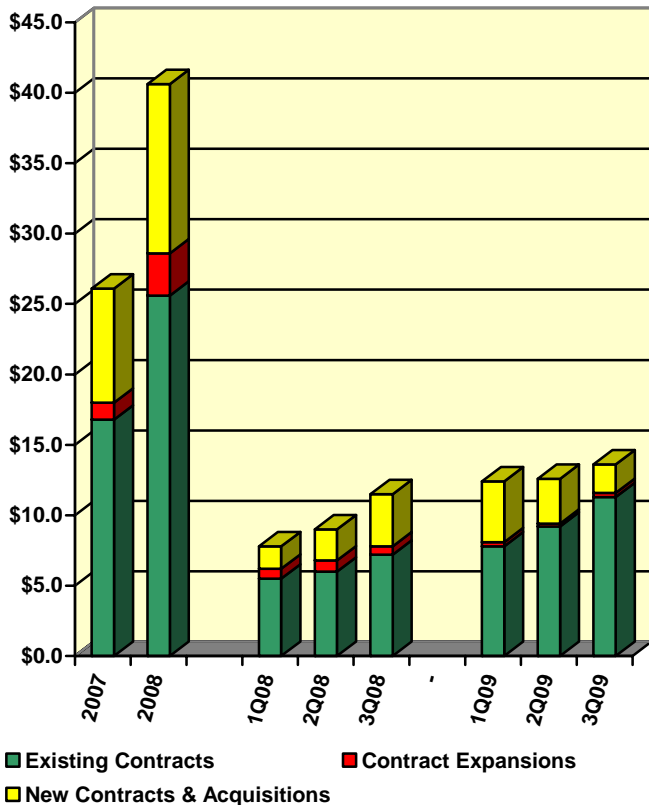
VALUATION AND OUTLOOK

We remain bullish on Conmed Healthcare Management, despite what appears to be a lull in the Company’s contracting and acquisition activity. Conmed has not announced a new contract win in several months and has remained on the sidelines in the hunt for deals since the November 2008 acquisition of Correctional Mental Health Services. We believe the appearance of slowing growth may be weighing on investors sentiment and consequently on valuation metrics for the stock.

Our investment thesis on the Company and the stock is longer term. In our view, it is not reasonable to expect a consistent flow of deals and new contracts in a sector characterized by a relatively small number of potential customers who purchase services infrequently through large, material contracts. We prefer to look at the Company in twelve-month increments rather than focusing on the immediate quarter.

Accounting for derivatives has introduced an element of volatility into Conmed’s reported earnings per share. Accordingly, we emphasize our preference of using cash flow from operations to value CONM. Our price target of \$5.25 represents a 16.5 multiple times our 2009 estimate for cash flow from operations of \$4.0 million and 13.8 times our 2009 estimate. We note that Conmed has \$0.80 per share in cash. Since operations are now solidly generating positive cash flow and the Company has ample working capital of \$6.3 million, we believe the stock should be considered ex-cash. Conmed’s enterprise value is \$2.29 per share, suggesting the stock is egregiously undervalued.

Chart I: Organic and Acquired Growth



Source: Company Reports and Crystal Equity Research Estimates

REVIEW OF THIRD QUARTER 2009

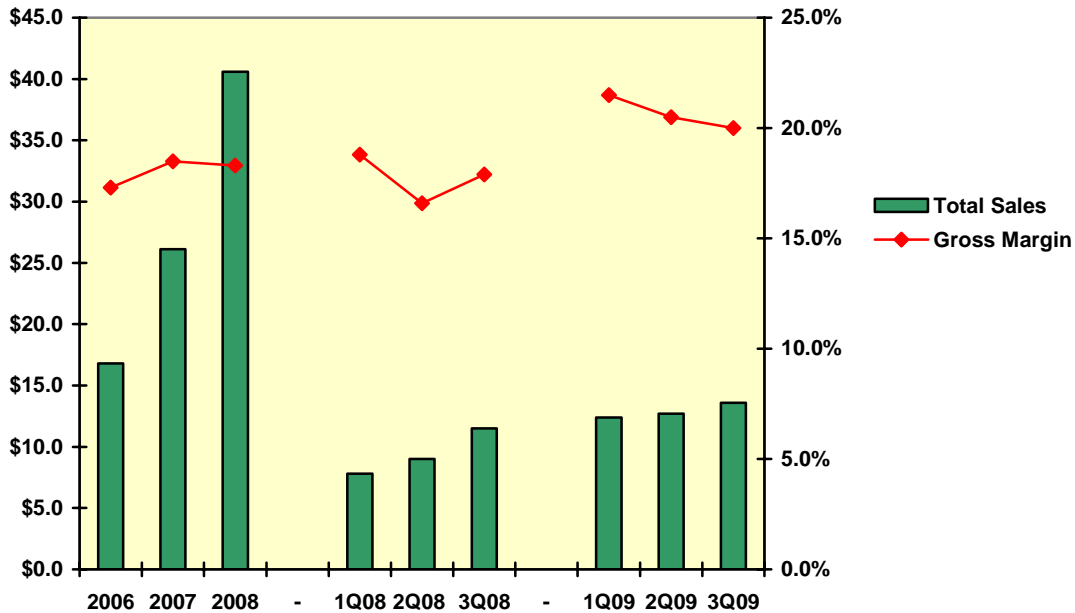
Revenue continued to ramp in the third quarter 2009, reaching a record \$13.6 million and representing 18.3% growth over the prior-year quarter. As illustrated in Chart I on the preceding page, the recurring element in the Company’s business model is building. Existing contracts contributed 83% of total revenue in the quarter or \$11.3 million. We believe the Company’s exceptional retention rate is the fuel behind the recurring revenue component. One of the largest contracts in Conmed’s portfolio with Baltimore County Detention Center was recently renewed with the customary cost of living adjustments. The contract includes a full complement of Conmed’s services, each of which were renewed through the exercise of the first of two renewal options.

The gross margin slipped slightly in the third quarter 2009 to 20.0%, but remains well above the profit margin in the year-ago quarter of 17.9%. It appears the Company continues to manage costs and expenses against revenue. Salaries, wages and benefits for medical personnel totaled \$7.9 million or 57.9% of total sales. This compares to 51.8% in the year-ago quarter. Medical costs declined to 18.2% of total sales compared to 26.4% in the year-ago quarter. Out-of-facility treatment had been a factor in escalating costs in the year-ago period. Other direct operating costs were 3.8% of sales.

Operating expenses total \$2.4 million or 14.8% of total sales. This is a slightly higher spending rate than in the year-ago quarter when general and administrative expenses were 12.9% of total sales. We believe the increase in the spending rate at the operating level is due primarily to the addition of new personnel as the Company has geared up for growth in the number of contracts under management. We expect to observe a resurgence in operating leverage in the coming quarters as Conmed “grows into” its administrative capacity through the addition of new contracts and execution on its acquisition strategy.

Operating income was \$331,000 or 2.4% of sales. This compares to an operating margin of 0.6% in the year-ago quarter. Net income was \$854,000, including recognition of \$756,000 in other income to account for the fair value of warrants issued in the Conmed reverse merger in 2007. We estimate the net income would have been \$269,000 or \$0.02 per share excluding the one-time derivative accounting treatment.

Chart I: Revenue and Gross Margin



Source: Company Reports and Crystal Equity Research Estimates

Balance Sheet and Cash Flows

We estimate operations generated \$1.3 million in cash during the quarter, bringing total cash flow from operations to \$3.1 million for the first nine months of 2009. Cash on the balance sheet rose to \$10.1 million or \$0.80 per share. Working capital was \$6.3 million at the end of September 2009. Conmed remains debt free.

BUSINESS PIPELINE

During the earnings conference call management emphasized the robust pace of quoting and proposal activity, indicating the Company has more bids and proposals in the hopper than the same time last year. During the earnings conference call management appeared invigorated by the most recent contract renewal with Baltimore County Detention Center in Maryland. In our view, this renewal provides validation of the Company's ability to continue to provide its historic high quality service even as it navigates double digit growth and the expansion into new regions of the country. The renewal of all services also provides some assurance that despite the fiscal pressures and budgetary short-falls besetting most county and municipal governments, Conmed can be successful in retaining contract terms.

For competitive reasons Conmed's CEO, Dick Turner, has been somewhat circumspect with regard to specific proposals in the business pipeline. However, Turner did indicate that there are "attractive renewals" in the cue in the near-term. The Company is also apparently pursuing bids against certain requests for proposals as well as certain negotiated contracts, some of which could come to fruition in the next three to six months. Given the

REVISED EARNINGS MODEL

We updated our earnings model to reflect third quarter 2009 results. We also made adjustments to our sales, cost and expense assumptions in the final quarter of the year. Given that Conmed's annual revenue run rate has increased to \$55.0 million but that now new contracts have been won in the past couple of months, we adjusted our revenue assumption for 4Q09 to \$13.8 million (from \$15.1 million). We also reduced certain direct cost and operating expense assumption to reflect recent performance. These changes resulted in a revised EPS estimate of \$0.02 (from \$0.03).

Our updated 2009 EPS estimate is now a loss of \$0.16 per share on \$52.6 million in sales (from a loss of \$0.12 per share and \$54.7 million). We also increased our estimate of cash flow from operations in 2009 to \$4.0 million (from \$3.8 million).

During the third quarter 2009 earnings conference call management also allowed that it at least two contracts were lost to competition on apparently pricing issues. Profit margins apparently continue to be a priority over top-line growth. Our model reflects a 19% to 20% gross margin going forward. Admittedly, this is a conservative figure as the Company has demonstrated the ability to managed profits to a higher level.

Our earnings model still demonstrates a base case and a growth case for 2010. We offer two scenarios for the next year in order to demonstrate the potential impact of new contract awards and acquisitions on the Company's future earnings. Our base case represents growth from existing contracts and the growth case includes a factor for incremental contracts as well as acquisitions, which we calculated as a growth factor near 40%. This compares to the 55.5% and 55.4% year-over-year growth rates in 2008 and 2007, respectively. We continue to view our growth scenario as plausible given the potential for the Company to capture market share in its newest geographies. Conmed has established "beach heads" in Washington, Oregon, Arizona and Oklahoma within the last year and a half. Management reports considerable quoting and proposal activity in these markets.

One factor that could weigh on future prospects is the slow pace at which the U.S. economy appears to be recovering from the economic downturn. Many jurisdictions are facing dramatically reduced taxes collections. Conmed management reports no deterioration in the pace of collections. Nonetheless, the sales cycle has lengthening as local officials take particular care in entering into new contractual commitments.

STOCK CHART



Source: Stockcharts.com

ADDITIONAL INFORMATION AVAILABLE UPON REQUEST

Table I: Historical and Projected Sales and Expenses

Dollars in Thousands	2007	1Q08	2Q08	3Q08	4Q08	2008	1Q09	2Q09	3Q09	4Q09E	2009E	Base Case 2010E	Growth Scenario 2010E
Total revenue	26,073	7,836	8,995	11,531	12,188	40,550	12,419	12,713	13,643	13,800	52,575	64,000	75,000
Direct costs													
Salaries, wages & benefits	13,653	4,114	4,606	5,976	6,717	21,413	6,988	7,250	7,900	8,004	30,142	35,840	41,000
Medical expenses	6,693	2,017	2,643	3,043	2,675	10,378	2,382	2,382	2,485	2,553	9,802	14,720	17,250
Other operating expenses	906	233	255	446	400	1,334	384	480	525	552	1,941	1,920	2,250
Direct costs	21,252	6,364	7,504	9,465	9,792	33,125	9,754	10,112	10,910	11,109	41,885	51,840	60,500
Gross profit	4,821	1,472	1,491	2,066	2,396	7,425	2,665	2,601	2,733	2,691	10,690	12,160	14,500
Operating expenses:													
Selling, general & administrative	4,543	1,589	1,495	1,490	1,785	6,359	1,816	1,944	2,015	1,932	7,707	7,680	8,250
Depreciation & amortization	2,093	499	530	504	599	2,132	634	606	387	380	2,007	350	350
Total operating expenses	6,636	2,088	2,025	1,994	2,384	8,491	2,450	2,550	2,402	2,312	9,714	8,030	8,600
Operating income (loss)	(1,815)	(616)	(534)	72	12	(1,066)	215	51	331	379	976	4,130	5,900
Other income (expense)													
Interest income	313	66	41	37	10	154	28	16	17	10	71	100	100
Interest expense	(7)	(2)	(2)	(1)	(2)	(7)	(5)	(2)	(1)	(10)	(18)	(21)	(20)
Other, net	-	-	-	-	-	-	1	(2,445)	756	-	(1,688)	-	-
Total other income (expense)	306	64	39	36	9	148	24	(2,431)	772	(0)	(1,635)	80	80
Income (loss) before income taxes	(1,509)	(552)	(495)	108	19	(919)	239	(2,380)	1,103	379	(659)	4,210	5,980
Provision for income taxes (benefit)	162	-	-	-	-	-	121	32	249	125	527	1,402	1,973
Net income (loss)	(1,671)	(552)	(495)	108	19	(919)	118	(2,412)	854	254	(1,186)	2,808	4,007
Net EPS (loss)	\$ (0.16)	\$ (0.05)	\$ (0.04)	\$ 0.01	\$ 0.00	\$ (0.08)	\$ 0.01	\$ (0.19)	\$ 0.01	\$ 0.02	\$ (0.16)	\$ 0.21	\$ 0.30
Weighted shares outstanding, diluted	10,300	11,989	12,024	13,305	13,325	12,090	13,529	12,560	14,183	14,000	13,568	13,250	13,250

2007 results are shown pro forma for the calendar year, reflecting a combination of reported results for the Conmed predecessor for January 1 through January 26, 2007 and the Conmed successor for January 27 through December 31, 2007.

Source: Company Reports and Crystal Equity Research Estimates

Table II: Selected Measures of Historical and Projected Sales and Expenses

Dollars in Thousands	2007	1Q08	2Q08	3Q08	4Q08	2008	1Q09	2Q09	3Q09	4Q09E	2009E	Base Case 2010E	Growth Scenario 2010E
Total revenue	26,073	7,836	8,995	11,531	12,188	40,550	12,419	12,713	13,643	13,800	52,575	64,000	75,000
Operating income (loss)	(1,815)	(616)	(534)	72	12	(1,066)	215	51	331	379	976	4,130	5,900
Net income (loss)	(1,671)	(552)	(495)	108	19	(919)	118	(2,412)	854	254	(1,186)	2,808	4,007
Net EPS (loss)	\$ (0.16)	\$ (0.05)	\$ (0.04)	\$ 0.01	\$ 0.00	\$ (0.08)	\$ 0.01	\$ (0.19)	\$ 0.01	\$ 0.02	\$ (0.16)	\$ 0.21	\$ 0.30
Weighted shares outstanding, diluted	10,300	11,989	12,024	13,305	13,325	12,090	13,529	12,560	14,183	14,000	13,568	13,250	13,250
SELECTED MEASURES:													
Sales growth, yr/yr	55.4%					55.5%					29.7%	21.7%	42.7%
Net income from growth, yr/yr	258.5%					45.0%					-29.1%	-336.7%	-437.8%
EPS growth, yr/yr						53.2%					-15.1%	-342.4%	-445.9%
Gross margin	18.5%	18.8%	16.6%	17.9%	19.7%	18.3%	21.5%	20.5%	20.0%	19.5%	20.3%	19.0%	19.3%
Operating margin	-7.0%	-7.9%	-5.9%	0.6%	0.1%	-2.6%	1.7%	0.4%	2.4%	2.7%	1.9%	6.5%	7.9%
Net margin	-6.4%	-7.0%	-5.5%	0.9%	0.2%	-2.3%	1.0%	-19.0%	6.3%	1.8%	-2.3%	4.4%	5.3%
Direct costs, % sales	81.5%	81.2%	83.4%	82.1%	80.3%	81.7%	78.5%	79.5%	80.0%	80.5%	79.7%	81.0%	80.7%
Salaries, wages & benefits	52.4%	52.5%	51.2%	51.8%	55.1%	52.8%	56.3%	57.0%	57.9%	58.0%	57.3%	56.0%	54.7%
Medical expenses	25.7%	25.7%	29.4%	26.4%	21.9%	25.6%	19.2%	18.7%	18.2%	18.5%	18.6%	23.0%	23.0%
Other direct operating expenses	3.5%	3.0%	2.8%	3.9%	3.3%	3.3%	3.1%	3.8%	3.8%	4.0%	3.7%	3.0%	3.0%
G&A expense, % sales	17.4%	20.3%	16.6%	12.9%	14.6%	15.7%	14.6%	15.3%	14.8%	14.0%	14.7%	12.0%	11.0%
Effective tax rate	-10.7%	0.0%	0.0%	0.0%	0.0%	0.0%	50.6%	-1.3%	22.6%	33.0%	-79.9%	33.3%	33.0%
EBITDA, \$\$	279					1,066					2,766	4,480	7,690
EBITDA margin	1.1%					2.6%					5.3%	7.0%	10.3%

2007 results are shown pro forma for the calendar year, reflecting a combination of reported results for the Conmed predecessor for January 1 through January 26, 2007 and the Conmed successor for January 27 through December 31, 2007.

Source: Company Reports and Crystal Equity Research Estimates

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ANALYST

Debra Fiakas, CFA is a seasoned, credentialed investment professional with a diversified and successful track record as a research analyst and as an investment banker. Her decade-plus career includes solid experience in all aspects of the equity capital markets with particular emphasis on emerging growth companies operating in the technology sectors. Ms. Fiakas is also the principal member of Crystal Equity Research, LLC.

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Speculative Buy	2	40%	Unproved business model; catalysts exist to generate higher returns
Accumulate	2	40%	Long-term return potential above 10%; near-term catalysts may not exist
Hold	0	0%	Total return potential below 10%; an acceptable long-term holding
Sell	0	0%	Potential return greater than negative 10%; take profits or stem losses
Not Rated	1	20%	No rating
Total	5	100%	

*Research universe categorized by rating only; Crystal Equity Research provides no investment banking services.

HISTORICAL RECOMMENDATIONS AND TARGET PRICE: Conmed Healthcare Management

<u>Report</u>	<u>Date</u>	<u>Price</u>	<u>Rating</u>	<u>Target Price</u>
Initial	7/7/08	\$1.70	Speculative Buy	\$4.50
Update	7/25/08	\$2.05	Speculative Buy	\$5.00
Update	8/15/08	\$2.50	Speculative Buy	\$5.00
Update	11/14/08	\$2.40	Speculative Buy	\$5.00
Update	2/20/09	\$2.10	Speculative Buy	\$5.00
Update	3/27/09	\$2.20	Speculative Buy	\$5.00
Update	5/15/09	\$3.00	Speculative Buy	\$5.00
Update	6/22/09	\$3.50	Speculative Buy	\$5.25
Update	8/13/09	\$3.73	Accumulate	\$5.25
Update	11/13/09	\$3.09	Accumulate	\$5.25

DISCLOSURES

<u>Name</u>	<u>Symbol: Exchange</u>	<u>Disclosures</u>
Conmed Healthcare Management, Inc.	CMHM: OCT/BB	D

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- G The securities covered in this report can be margined.

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