

CER Report

CONM: NYSE AMEX

Update

February 1, 2010

Rating: **Accumulate**
(Unchanged)

Recent Price: **\$3.16**
(1/29/10)

Price Target: **\$5.75**
(Changed from \$5.25)

Conmed Healthcare Management, Inc.

Healthcare Services; Corrections

MARKET DATA

52-Week High/Low	\$4.40 - \$1.65
Ave. Daily Volume (6-mos.)	7 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-three county sites in seven states, caring for over 18,000 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	\$39.8 M
- Cash & Equivalents	\$10.1 M
+ Long-term Debt	\$ -0- M
Enterprise Value	\$29.7 M
Book Value	\$11.9 M
Working Capital	\$ 6.3 M
Dividend Yield	Nil

Balance sheet figures as of 9/30/09

HIGHLIGHTS

- New Contracts.** The Company was the successful bidder in Clark County, Washington and expanded its relationship with Pima County, Arizona, demonstrating the merits of the Company's hub-and-spoke approach to establishing a market foothold and building on Conmed's reputation for quality and economy.
- Revenue Run Rate.** We estimate the two new contracts increased Conmed's annual revenue run rate to \$59 million per year.
- Revised Estimates.** We have revised our earnings model to reflect the incremental revenue in 2010 from the two new contracts. The net effect of this incremental revenue is an extra penny in earnings per share, bringing our estimated 2010 EPS to \$0.22 (from \$0.21) on \$67.4 million in sales (from \$64.0 million). Our revised estimate for 2010 cash flow from operations is \$5.1 million (from \$4.8 million).
- Rating Change, New Price Target.** Following the revision in estimates we are increasing our target price to \$5.50 (from \$5.25) and reiterate our Accumulate rating on Conmed shares.
- Outlook.** Assuming no further additions, the full amortization of intangibles is likely within the year 2010 and could dramatically increase reported EPS. We expect this to be one of the most significant catalysts for the stock in the next few months.

	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	\$67.4	\$3.0	\$5.1	\$0.22

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	9.8 X
Price/Trailing 12-mo. Earnings	Neg
Price/Book Value	3.3 X
Consensus EPS Estimate 2009	NA
Consensus EPS Estimate 2010	NA

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SUMMARY

We update our coverage of Conmed Healthcare Management with revised estimates following the award of new contracts for health care services in two detention centers. The Company was the successful bidder in Clark County, Washington and expanded its relationship with Pima County, Arizona, demonstrating the merits of the Company's hub-and-spoke approach to establishing a market foothold. We believe the Pima win also confirms Conmed's reputation for quality and economy. We estimate the two new contracts increased Conmed's annual revenue run rate to \$58.6 million per year (from \$55.0 million).

Following the revision in estimates we are increasing our target price to \$5.50 (from \$5.25) and reiterate our Accumulate rating on Conmed shares. In our view, the two new contracts demonstrate Conmed's value proposition in what has become a more competitive space as local jurisdictions face a steep drop in tax revenue in the wake of the economic downturn.

RECENT NEW CONTRACTS

Clark County, Washington

Conmed expanded its presence in the northeastern region with a new contract to provide a menu of health care and mental health services for Clark County, Washington. Clark County is a county located in the southwestern part of the state, across the Columbia River from Portland, Oregon and is the first county of Washington, named after William Clark of the Lewis and Clark Expedition. The U.S. Census estimated in 2009 the population of Clark County was approximately 425,000 with a crime rate of approximately 124.5 crimes per 1000 residents. Approximately 700 inmates are housed in the county's facilities.

The two-year contract includes four annual renewal options, bringing the total possible contract length to six years and total contract value to \$16.0 million. The Company will commence providing health care services in Clark County's adult and juvenile detention centers at the beginning of February 2010. We expect the contract to contribute \$2.3 million to 2010 revenue and \$2.5 million each year through the contract term. We expect profit margins to be similar to existing contracts.

The Clark County relationship could be an important stepping stone in building brand identity in the northwest region including Washington State and Oregon. We expect Conmed to target a number of counties in the region, including Multnomah County, Oregon to the south that home for Portland, Oregon. Each new relationship has the potential to make operations in the region more profitable as the Company realizes efficiencies from better utilization of fixed costs such as management and supervisory personnel.

We also expect Clark County to present another opportunity to demonstrate Conmed's quality-for-economy service offering. In 2008, the most recent year for which statistics are available, the Clark County Jail processed 16,323 intakes and 16,392 releases from the jail. The average length of stay was approximately 17 days. Jail officials estimate about 8% of the jail population suffers from some form of mental illness and as much as 98% of all jail inmates in Clark County are impacted by drug and alcohol additions or abuse issues. Wexford Health Sources was the previous vendor contracted to provide health care and mental health services. Data provided by the Clark County in its annual report indicates that despite indications of mental health and drug abuse issues, the number of detainees seen by medical and mental health professionals declined dramatically in the years Wexford was providing services.

Pima County, Arizona - Juvenile Detention Center

Following the renewal of its contract to provide health care and mental health services to the adult detainees in the Pima County Jail in Tuscan, Arizona, Conmed was tapped to provide care to juveniles in Pima's facility for minors. The contract is for a term of twenty-nine months beginning February 1, 2010, and valued at \$2.8 million. We expect the contract to contribute \$1.1 million to revenue in 2010.

The Pima County Juvenile Court Detention Center can house up to 70 juveniles. The agency operates with a budget of approximately \$33 million annually. A recent report by a Tuscan area television station suggested that the detention center has more beds that it is using right now, and that it may be able to use those extra beds to supplement tax revenue.

We believe Pima County's decision to tap Conmed for its juvenile center immediately following the county's decision to renew Conmed's contract to provide care for the 1,900-inmate adult detention center speaks well to Conmed's service quality. We expect Conmed to rise to the attention of other counties in Arizona and the greater southwestern region. For example, Pima County is a member of the County Supervisors Association of Arizona and the Arizona Sheriffs Association and could serve as a strong reference should Conmed pursue contracts in other Arizona counties.

UPDATED EARNINGS MODEL

We have revised our earnings model to reflect the incremental revenue in 2010 from the Pima County Juvenile Court Center and the Clark County Correctional Facility. We estimate the two contracts will generate \$3.4 million in revenue in the eleven months beginning February 1, 2010. We have made no changes in our cost and expense assumptions as we believe profit margins will be within range of the Company's existing contracts. The net effect of this incremental revenue is an extra penny in earnings per share, bringing our estimated 2010 EPS to \$0.22 (from \$0.21) on \$67.4 million in sales (from \$64.0 million). Our revised estimate for 2010 cash flow from operations is \$5.1 million (from \$4.8 million).

We expect to breakout 2010 estimates by quarter and publish a new estimate for the year 2011 following report of the Company's fourth quarter 2009.

VALUATION AND OUTLOOK

The drag on earnings by non-cash expenses has led us to rely heavily on cash flow from operations to value CONM. In addition to amortization of intangibles, accounting for changes in the value of the Company's outstanding warrants injects considerable noise into reported earnings per share. Conmed shares are currently trading at 9.5 times trailing CFO. This compares to 14.6 times for Corrections Corporation of America (CXW: NYSE), a frequent competitor for county jail healthcare services and 13.3 times for Providence Service Corp. (PRSC: Nasdaq) a provider of outsourced mental health services to local government agencies.

Accordingly, we valued CONM using a multiple of 14 times and moved forward to our 2010 estimated cash flow from operations of \$5.1 million. Our revised price target was set at \$5.75 (from \$5.25).

We suggest investor make particular notice of the Company's intangible assets, which have been amortized down to approximately \$1.3 million at the end of September 2009. Conmed's intangible balances derive from accounting treatments of the original acquisition of Conmed Healthcare Services by the Special Acquisition Corporation in January 2007, the acquisition of Emergency Medicine Documentation Consultants in February 2008, the acquisition of Community Mental Health Services in November 2008. Amortization in the first nine months of 2010 was \$1.5 million or \$0.12 per share before allowances for taxes.

Assuming no further additions, the full amortization of intangibles is likely within the year 2010 and could dramatically increase reported earnings per share. We expect this to be one of the most significant catalysts for the stock in the next few months for those investors for whom earnings per share remains the most important gauge of value. New contracts should also boost investor confidence and enthusiasm. Management indicates the business pipeline remains robust, suggesting that opportunities exist for new contracts. The Company has reported three recent contract renewals and two new contract awards during a time that has historically been the slowest period of the year. We expect the pace of contracting to accelerate in the coming months.

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	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	67,400
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	37,744
Medical expenses	6,693	2,017	2,643	3,043	2,675	10,378	2,382	2,382	2,485	2,553	9,802	15,502
Other operating expenses	906	233	255	446	400	1,334	384	480	525	552	1,941	2,022
Direct costs	21,252	6,364	7,504	9,465	9,792	33,125	9,754	10,112	10,910	11,109	41,885	54,594
Gross profit	4,821	1,472	1,491	2,066	2,396	7,425	2,665	2,601	2,733	2,691	10,690	12,806
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	8,088
Depreciation & amortization	2,093	499	530	504	599	2,132	634	606	387	380	2,007	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	8,438
Operating income (loss)	(1,815)	(616)	(534)	72	12	(1,066)	215	51	331	379	976	4,368
Other income (expense)												
Interest income	313	66	41	37	10	154	28	16	17	10	71	100
Interest expense	(7)	(2)	(2)	(1)	(2)	(7)	(5)	(2)	(1)	(10)	(18)	(21)
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
Income (loss) before income taxes	(1,509)	(552)	(495)	108	19	(919)	239	(2,380)	1,103	379	(659)	4,448
Provision for income taxes (benefit)	162	-	-	-	-	-	121	32	249	125	527	1,481
Net income (loss)	(1,671)	(552)	(495)	108	19	(919)	118	(2,412)	854	254	(1,186)	2,966
Net earnings (loss) per share	\$ (0.16)	\$ (0.05)	\$ (0.04)	\$ 0.01	\$ 0.00	\$ (0.08)	\$ 0.01	\$ (0.19)	\$ 0.06	\$ 0.02	\$ (0.09)	\$ 0.22
Wghtd 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

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	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	67,400
Gross profit	4,821	1,472	1,491	2,066	2,396	7,425	2,665	2,601	2,733	2,691	10,690	12,806
Operating income (loss)	(1,815)	(616)	(534)	72	12	(1,066)	215	51	331	379	976	4,368
Net income (loss)	(1,671)	(552)	(495)	108	19	(919)	118	(2,412)	854	254	(1,186)	2,966
Net earnings (loss) per share	\$ (0.16)	\$ (0.05)	\$ (0.04)	\$ 0.01	\$ 0.00	\$ (0.08)	\$ 0.01	\$ (0.19)	\$ 0.06	\$ 0.02	\$ (0.09)	\$ 0.22
SELECTED MEASURES:												
Sales growth, yr/yr	55.4%					55.5%					29.7%	28.2%
Net income from growth, yr/yr	258.5%					45.0%					-29.1%	-350.1%
EPS growth, yr/yr						53.2%					-15.1%	-356.1%
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%
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%
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%
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%
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%
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%
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%
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%
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%
EBITDA, \$\$	279					1,066					2,766	4,718
EBITDA margin	1.1%					2.6%					5.3%	7.0%

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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CER REPORT RESEARCH UNIVERSE*

Speculative Buy	4	80%	Unproved business model; catalysts exist to generate higher returns
Accumulate	1	20%	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	0	0%	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
Update	2/1/10	\$3.16	Accumulate	\$5.75

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<u>Name</u>	<u>Symbol: Exchange</u>	<u>Disclosures</u>
Conmed Healthcare Management, Inc.	CONM: NYSE AMEX	D

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