CER Report

CONM: NYSE AMEX

Update **March 26, 2010**

Rating:	**Accumulate** (Unchanged)
Recent Price:	**$3.36** (3/25/10)
Price Target:	**$5.75** (Unchanged)

Conmed Healthcare Management, Inc.

Healthcare Services; Corrections

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.

MARKET DATA

52-Week High/Low	$4.40 - $1.70
Ave. Daily Volume (6-mos.)	6 K
Shares Outstanding	12.6 M
Inside Ownership	25%
Institutional Ownership	50%
Float	9.4 mln
Short Interest (% of float)	<1%

FINANCIAL DATA

Market Capitalization	$42.3 M
- Cash & Equivalents	$11.1 M
+ Long-term Debt	$ -0- M
Enterprise Value	$31.2 M
Book Value	$15.5 M
Working Capital	$ 7.1 M
Dividend Yield	Nil

Balance sheet figures as of 12/31/09

	SALES	NET EARN	CFO	EPS
2008A	$40.6	($0.9)	$2.8	($0.08)
2009A	$52.8	($0.3)	$4.3	($0.00)
1Q10E	*$15.0*	*$0.3*		*$0.03*
2Q10E	*$16.4*	*$0.5*		*$0.04*
3Q10E	*$17.5*	*$0.7*		*$0.05*
4Q10E	*$18.5*	*$0.9*		*$0.07*
2010E	*$67.4*	*$2.4*	*$4.0*	*$0.19*
2011E	*$74.0*	*$3.3*	*$4.7*	*$0.25*

Dollars in millions, except EPS; Fiscal year ends Dec.

VALUATION

Price/Sales	0.8 X
Price/CFO	9.8 X
Price/Trailing 12-mo. Earnings	Neg
Price/Book Value	2.7 X
Consensus EPS Estimate 2010	NA
Consensus EPS Estimate 2011	NA

HIGHLIGHTS

- **Record Revenue.** Fourth quarter performance brought total revenue for the year 2009 to $52.8 million, representing year-over-year top-line growth of 30.0%. The Company met its target with a gross profit margin of 20.2%. Reduction in medical expenses to 19.5% of total sales was the principal contributor to the increase in profitability.

- **Expanded Addressable Market.** During the fourth quarter 2009 earnings conference call management described the bidding opportunities as greater in both number of contract opportunities and dollar value compared to a year ago. Expanded addressable market and accelerated business development efforts are at play.

- **Contract Backlog.** We remain confident in our 2010 sales estimate of $67.4 million. Management reports a $162.0 million contract backlog with average contract duration of 3.8 years.

- **Price Target and Rating.** We reiterate our Accumulate rating and $5.75 price target on CONM. Our price target implies a multiple of 30.0 times and 18.0 times our 2010 earnings and cash flow estimates.

- **Outlook.** In our view, CONM is undervalued by as much as 40%. We expect strong quarterly comparisons as 2010 unfolds, providing compelling catalysts for valuation.

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SUMMARY

We reiterate our Accumulate rating and $5.75 price target on Conmed Healthcare Management. The Company has had a string of contract awards and renewals that have boosted management's confidence to pursue larger, higher value opportunities among local detention centers. The acquisition of Correctional Mental Health Services (CMHS) in late 2008 has helped differentiate Conmed from competition and may serve as an entre to behavioral healthcare services in state and federal prisons. We are also optimistic about earnings growth as Conmed was successful in boosting the profit margin by 190 basis points over the prior year. The margin appears sustainable as the Company has gained competence managing patient care regimens.

FOURTH QUARTER AND YEAR-END 2009 RESULTS

Conmed reported $14.0 million in sales in the fourth quarter 2009, compared to our estimate for $13.8 million in sales. Gross margin dipped slightly sequentially to 19.2% compared to 20.0% in the September quarter and 19.7% in the prior-year quarter. Operating expenses totaled $2.3 million or 16.4% of revenue, leading to operating income of $400,000. Net income $1.4 million or $0.07 per share after the accounting treatment for the Company's outstanding derivatives added $498,000 and a reversal in tax assets added $515,000 to the bottom line. We estimate that without these two non-cash items, net earnings would have been $0.02 per share.

Despite top-line success, improved profitability and the benefit of operating leverage, accounting changes in the value of the Company's outstanding derivatives soaked up net profits. Fourth quarter performance brought total revenue for the year 2009 to $52.8 million, representing year-over-year top-line growth of 30.0%. The Company met its target with a gross profit margin of 20.2%. Reduction in medical expenses to 19.5% of total sales compared to 25.6% in the year 2008, was the principal contributor to the increase in profitability. Operating expenses totaled $9.7 million or 18.4% of sales compared to $8.5 million or 20.9% of sales in 2008. Operating profits for the year totaled $997,000.

The Company recorded a net charge of $1.2 million to reflect charges in the value of outstanding warrants leading to a net loss of $27,000. We expect 2009 to be the last year that the Company's results are muddied by derivatives accounting. Management reported having successfully negotiated changes in warrant terms that eliminate the derivative liability on the balance sheet and the accompanying quarterly true-up of warrant values.

Operations generated $4.3 million in cash during the year 2009, representing a cash conversation rate of 8.1%. Cash balances at the end of 2009 totaled $11.1 million, providing Conmed a war chest for future acquisitions. Working capital increased to $7.1 million.

UPDATED EARNINGS MODEL

We remain confident in our 2010 sales estimate of $67.4 million. Management reports a $162.0 million contract backlog with average contract duration of 3.8 years. Backlog includes $60 million in contract value in the initial year and $102 million related to renewal options. New contracts with Pima County Juvenile Detention Center in Arizona ($2.8 million), the Baltimore County Detention Center in Maryland ($1.0 million) and the Sedgewick County Jail in Kansas ($16.0 million) have helped build backlog and the 2010 revenue run rate. According to management, the current annual revenue run rate is $59.0 million.

We are also optimistic about the potential for new contract wins during the year. During the fourth quarter 2009 earnings conference call management described the Company's business pipeline as "robust." Although CEO Richard Turner declined to give specifics, he described the bidding opportunities as greater in both number of contract opportunities and dollar value. Recent successes in winning and managing larger contracts has boosted the confidence and widened the Company's addressable market to larger communities and facilities with higher inmate populations.

We made minor adjustments to our cost and expense assumptions in 2010. Successful management of medical expenses appears to support a 20% gross profit margin. We also expect continued leverage of fixed administrative costs as the top-line grows. Unfortunately, management guided for an increase in the effective tax rate to a level near 40% (from 33%) It is primarily this latter change to our 2010 estimates that trimmed estimated earnings per share to $0.19 (from $0.23) on $67.4 million in revenue. Our estimate for cash flow from operations is $4.0 million, excluding potential contributions from favorable changes in working capital.

For the first time we introduce sales and earnings estimates for the year 2011. We estimate the Company could earn $0.25 per share on $74.0 million in revenue. Our revenue estimate assumes retention of all current contracts and successful exercise of options on those contracts coming up for renewal. We have included only a modest contribution from new contract awards given the difficulty in projecting event-related revenue in the longer term. Given the Company's track record in winning new clients, we view our 2011 estimate as conservative. Our estimate for cash flow from operations in 2011 is $4.7 million.

We believe Conmed has reached an inflection point in its organic growth. The Company's appears to have perfected clinical methodologies and operating strategies that qualify the team to take on larger inmate populations and hence larger contracts. In our view, early renewal of the Company's largest contract in Pima County, Arizona provides a strong reference account for future business development efforts. Also encouraging for long-term growth is management's declared interest in expanding beyond the local detention center market with its behavioral health services.

VALUATION AND OUTLOOK

Our price target of $5.75 implies a multiple of 30.0 times and 18.0 times our 2010 earnings and cash flow estimates. Such multiples may seem to be at a premium. However, we note Conmed delivered 30% top-line growth in 2009, and appears poised to deliver similar growth in 2010. Although tax and derivatives accounting treatments injected considerable noise into Conmed's net earnings in 2009, it is clear earnings growth is equally strong. This implies a PEG ratio of 1:1. In our view, there is a growing list of reasons to look favorably at Conmed: an improving competitive position, expanding addressable market, strong organic growth, potential acquisitions, ample cash reserves and a debt-free balance sheet.

In our view, CONM is undervalued by as much as 40%. We expect strong quarterly comparisons as 2010 unfolds, providing compelling catalysts for trading volume and valuation. We believe contract awards during the year are likely given the apparent size of the business pipeline. Such announcements should also create interest in the stock, boosting valuation and trading action.

STOCK CHART

Source: Stockcharts.com

ADDITIONAL INFORMATION AVAILABLE UPON REQUEST

Table I: Historical and Projected Sales and Expenses

Dollars in Thousands	2007	2008	1Q09	2Q09	3Q09	4Q09	2009	*1Q10E*	*2Q10E*	*3Q10E*	*4Q10E*	*2010E*	*2011E*
Total revenue	26,073	40,550	12,419	12,713	13,643	14,009	52,784	*15,000*	*16,400*	*17,500*	*18,500*	*67,400*	*74,000*
Direct costs													
Salaries, wages & benefits	13,653	21,413	6,988	7,250	7,900	7,733	29,871	*8,400*	*9,102*	*9,625*	*10,083*	*37,210*	*38,110*
Medical expenses	6,693	10,378	2,382	2,382	2,485	3,036	10,285	*3,000*	*3,280*	*3,500*	*3,700*	*13,480*	*18,870*
Other operating expenses	906	1,334	384	480	525	551	1,940	*600*	*656*	*700*	*740*	*2,696*	*2,220*
Direct costs	21,252	33,125	9,754	10,112	10,910	11,320	42,096	*12,000*	*13,120*	*14,000*	*14,800*	*53,920*	*59,200*
Gross profit	4,821	7,425	2,665	2,601	2,733	2,689	10,688	*3,000*	*3,280*	*3,500*	*3,700*	*13,480*	*14,800*
Operating expenses:													
Selling, general & administrative	4,543	6,359	1,816	1,944	2,015	1,946	7,721	*2,025*	*2,050*	*2,100*	*2,128*	*8,303*	*8,880*
Depreciation & amortization	2,093	2,132	634	606	387	343	1,970	*425*	*425*	*325*	*125*	*1,300*	*321*
Total operating expenses	6,636	8,491	2,450	2,550	2,402	2,289	9,691	*2,450*	*2,475*	*2,425*	*2,253*	*9,603*	*9,201*
Operating income (loss)	(1,815)	(1,066)	215	51	331	400	997	*550*	*805*	*1,075*	*1,448*	*3,878*	*5,599*
Other income (expense)													
Interest income	313	154	28	16	17	19	80	*25*	*25*	*25*	*25*	*100*	*50*
Interest expense	(7)	(7)	(5)	(2)	(1)	-	(8)	*-*	*-*	*-*	*-*	*-*	*(78)*
Other, net	-	-	1	(2,445)	756	479	(1,209)	*-*	*-*	*-*	*-*	*-*	*-*
Total other income (expense)	306	148	24	(2,431)	772	498	(1,137)	*25*	*25*	*25*	*25*	*100*	*(28)*
Income (loss) before income taxes	(1,509)	(919)	239	(2,380)	1,103	898	(140)	*575*	*830*	*1,100*	*1,473*	*3,978*	*5,571*
Provision for income taxes (benefit)	162	-	121	32	249	(515)	(113)	*230*	*332*	*440*	*589*	*1,591*	*2,228*
Net income (loss)	(1,671)	(919)	118	(2,412)	854	1,413	(27)	*345*	*498*	*660*	*884*	*2,387*	*3,343*
Net earnings (loss) per share	$ (0.16)	$ (0.08)	$ 0.01	$ (0.19)	$ 0.06	$ 0.11	$ (0.00)	*$ 0.03*	*$ 0.04*	*$ 0.05*	*$ 0.07*	*$ 0.19*	*$ 0.25*
Weighted shares outstanding, diluted	10,300	12,090	13,529	12,560	14,183	14,105	12,566	*13,250*	*13,250*	*13,250*	*13,250*	*13,250*	*13,500*

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	2008	1Q09	2Q09	3Q09	4Q09	2009	1Q10E	2Q10E	3Q10E	4Q10E	2010E	2011E
Total revenue	26,073	40,550	12,419	12,713	13,643	14,009	52,784	15,000	16,400	17,500	18,500	67,400	74,000
Operating income (loss)	(1,815)	(1,066)	215	51	331	400	997	550	805	1,075	1,448	3,878	5,599
Net income (loss)	(1,671)	(919)	118	(2,412)	854	1,413	(27)	345	498	660	884	2,387	3,343
Net earnings (loss) per share	$ (0.16)	$ (0.08)	$ 0.01	$ (0.19)	$ 0.06	$ 0.11	$ (0.00)	$ 0.03	$ 0.04	$ 0.05	$ 0.07	$ 0.19	$ 0.25
Weighted shares outstanding, diluted	10,300	12,090	13,529	12,560	14,183	14,105	12,566	13,250	13,250	13,250	13,250	13,250	13,500
SELECTED MEASURES:													
Sales growth, yr/yr	55.4%	55.5%					30.2%					27.7%	9.8%
Net income growth, yr/yr	258.5%	45.0%					97.1%					8938.9%	40.1%
EPS growth, yr/yr		53.2%					97.2%					8482.6%	37.5%
Gross margin	18.5%	18.3%	21.5%	20.5%	20.0%	19.2%	20.2%	20.0%	20.0%	20.0%	20.0%	20.0%	20.0%
Operating margin	-7.0%	-2.6%	1.7%	0.4%	2.4%	2.9%	1.9%	3.7%	4.9%	6.1%	7.8%	5.8%	7.6%
Net margin	-6.4%	-2.3%	1.0%	-19.0%	6.3%	10.1%	-0.1%	2.3%	3.0%	3.8%	4.8%	3.5%	4.5%
Direct costs, % sales	81.5%	81.7%	78.5%	79.5%	80.0%	80.8%	79.8%	80.0%	80.0%	80.0%	80.0%	80.0%	80.0%
Salaries, wages & benefits	52.4%	52.8%	56.3%	57.0%	57.9%	55.2%	56.6%	56.0%	55.5%	55.0%	54.5%	55.2%	51.5%
Medical expenses	25.7%	25.6%	19.2%	18.7%	18.2%	21.7%	19.5%	20.0%	20.0%	20.0%	20.0%	20.0%	25.5%
Other direct operating expenses	3.5%	3.3%	3.1%	3.8%	3.8%	3.9%	3.7%	4.0%	4.0%	4.0%	4.0%	4.0%	3.0%
G&A expense, % sales	17.4%	15.7%	14.6%	15.3%	14.8%	13.9%	14.6%	13.5%	12.5%	12.0%	11.5%	12.3%	12.0%
Effective tax rate	-10.7%	0.0%	50.6%	-1.3%	22.6%	-57.3%	80.7%	40.0%	40.0%	40.0%	40.0%	40.0%	40.0%
EBITDA, $$	279	1,066					2,968					5,178	5,920
EBITDA margin	1.1%	2.6%					5.6%					7.7%	8.0%

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.

ANALYST CERTIFICATION

The analyst who is primarily responsible for this research and whose name is listed first under Analysts above certifies that: 1) all of the views expressed in this research accurately reflect his or her professional views about any and all of the subject securities or issuers, and 2) no part of any of the analyst's compensation was, is or will be directly or indirectly related to the specific rating expressed by analyst in this research.

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

Report	Date	Price	Rating	Target Price
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
Update	3/26/10	$3.36	Accumulate	$5.75

DISCLOSURES

Name	Symbol: Exchange	Disclosures
Conmed Healthcare Management, Inc.	CONM: NYSE AMEX	D

Disclosure Key

A A member or employee of Crystal Equity Research, LLC serves on the board of directors of the company.

B A controlling member of Crystal Equity Research, LLC has a beneficial interest in the common stock of the company.

C A person or persons preparing this report or an immediate family member of the preparer has a beneficial interest in the common stock of the company.

D Crystal Equity Research, LLC received compensation for research coverage from the company or one of its agents. Subscription fees for CER Research Coverage are paid in advance in cash.

E The company has a convertible issue outstanding.

F The securities covered in this report can be optioned.

G The securities covered in this report can be margined.

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