

CONM: NYSE AMEX

Update

August 13, 2009

Rating: **Accumulate**
(Changed from Speculative Buy)

Recent Price: **\$3.73**
(8/12/09)

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.)	13 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	\$47.0 M
- Cash & Equivalents	\$ 8.9 M
+ Long-term Debt	\$ -0- M
Enterprise Value	\$38.1 M
Book Value	\$10.6 M
Working Capital	\$ 6.2 M
Dividend Yield	Nil

Balance sheet figures as of 6/30/09

HIGHLIGHTS

- **Record Revenue.** Conmed Healthcare Management reported \$12.7 million in sales in the June quarter. Sales increased 41% year-over-year, the preponderance of which can be attributable to the addition of new contracts in Maryland, Virginia, Oregon, and Arizona in within the last year.
- **Strong Profits.** Gross profit was 20.5% in the June quarter compared to 21.5% in the March quarter. Although the profit margin fell slightly sequentially, profitability improved over the year-ago quarter.
- **Updated Earnings Model.** Our revised 2009 sales estimate is \$54.7 million, resulting in a net loss of \$1.6 million or \$0.13 per share. We estimate that net income would be \$570,000 or \$0.04 per share, excluding the one-time charges in 2Q09.
- **Rating Upgrade.** We have upgraded our rating of CONM shares to Accumulate (from Speculative Buy) since we now view the Company's business model as fully proven. Our target price remains \$5.25.
- **Valuation and Outlook.** The implied multiples against our 2010 base case and 2010 growth scenario EPS estimates are 25 times and 17.5 times, respectively. In our view, the Company's sales and earnings growth rates justify a 25 times multiple.

	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)
3Q09E	\$14.5	\$0.3		\$0.02
4Q09E	\$15.1	\$0.4		\$0.03
FY09E	\$54.7	(\$1.6)	\$3.5	(\$0.13)
FY10E	\$64.0	\$2.8	\$3.8	\$0.21

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

VALUATION

Price/Sales	1.0 X
Price/CFO	NM
Price/Trailing 12-mo. Earnings	Neg
Price/Book Value	4.4 X
Consensus EPS Estimate 2009	NA
Consensus EPS Estimate 2010	NA

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SUMMARY

Conmed Healthcare Management reported another stellar quarter, prompting our upgrade in rating to Accumulate from Speculative Buy. In our view, management has fully proven its ability to execute on the business strategy of both organic and acquired growth. The Company's track record for winning competitive contracts continues to impress and the recently acquired mental health services operations, CMHS, has contributed to the top-line as well as to Conmed's competitive position. A string of contract awards across the country demonstrate management's success in elevating the Conmed brand beyond its home turf in the Mid-Atlantic region. We also note that the Company continues to "take care of business" with a successful season of contract renewals and upgrades that recently added an estimated \$1.3 million to the Company's base business. The revenue run rate at the beginning of August 2009 rose to a record \$55.0 million.

SECOND QUARTER 2009 HIGHLIGHTS

Operating Performance

Conmed Healthcare Management reported \$12.7 million in sales in the June quarter compared to our estimate for \$13.0 million in sales. Sales increased 41% year-over-year, the preponderance of which can be attributable to the addition of new contracts in Maryland, Virginia, Oregon, and Arizona in within the last year. Expansion of services in existing contracts accounted for 7% of the increase or \$266,000.

Direct costs totaled \$10.1 million. Gross profit was 20.5% in the June quarter compared to 21.5% in the March quarter. Although the profit margin fell slightly sequentially, there was substantial improvement in profitability over the year-ago quarter when an exceptional hospitalization rate trimmed the profit margin to 16.6%. Thus despite a slight increase in salaries and wages to 57% of sales, a decline in medical expenses to 18.7% of revenue helped maintain profits. Operating expenses totaled \$2.6 million. SG&A increased to 15.2% of sales compared to 14.6% in the March quarter and 16.6% in the year-ago period.

The quarter was essentially breakeven from an operating standpoint with operating income of \$51,000. However, the Company reported a net loss of \$2.4 million or \$0.19 per share following a \$2.4 million non-cash charge related to the recently adopted accounting treatment for derivative securities. These securities are in the form of warrants issued when the Conmed operation was acquired by the parent company. We estimate operations generated \$800,000 in cash during the quarter, bringing cash flow from operations to \$1.8 million in the first six months of the year.

Balance Sheet Notes

Conmed Healthcare ended the June quarter with \$8.9 million in cash on the balance sheet. Working capital totaled \$6.2 million. The Company has no long-term debt. The long-term liability for derivative securities was reduced by \$2.4 million commensurate with the charge taken in the quarter to reflect the fair value of the warrants with the recent stock price increase. The Company has 12.6 million common stock shares, 1.9 million warrants with an average exercise price of \$1.32, and 2.0 million options with various exercise prices.

UPDATED EARNINGS MODEL

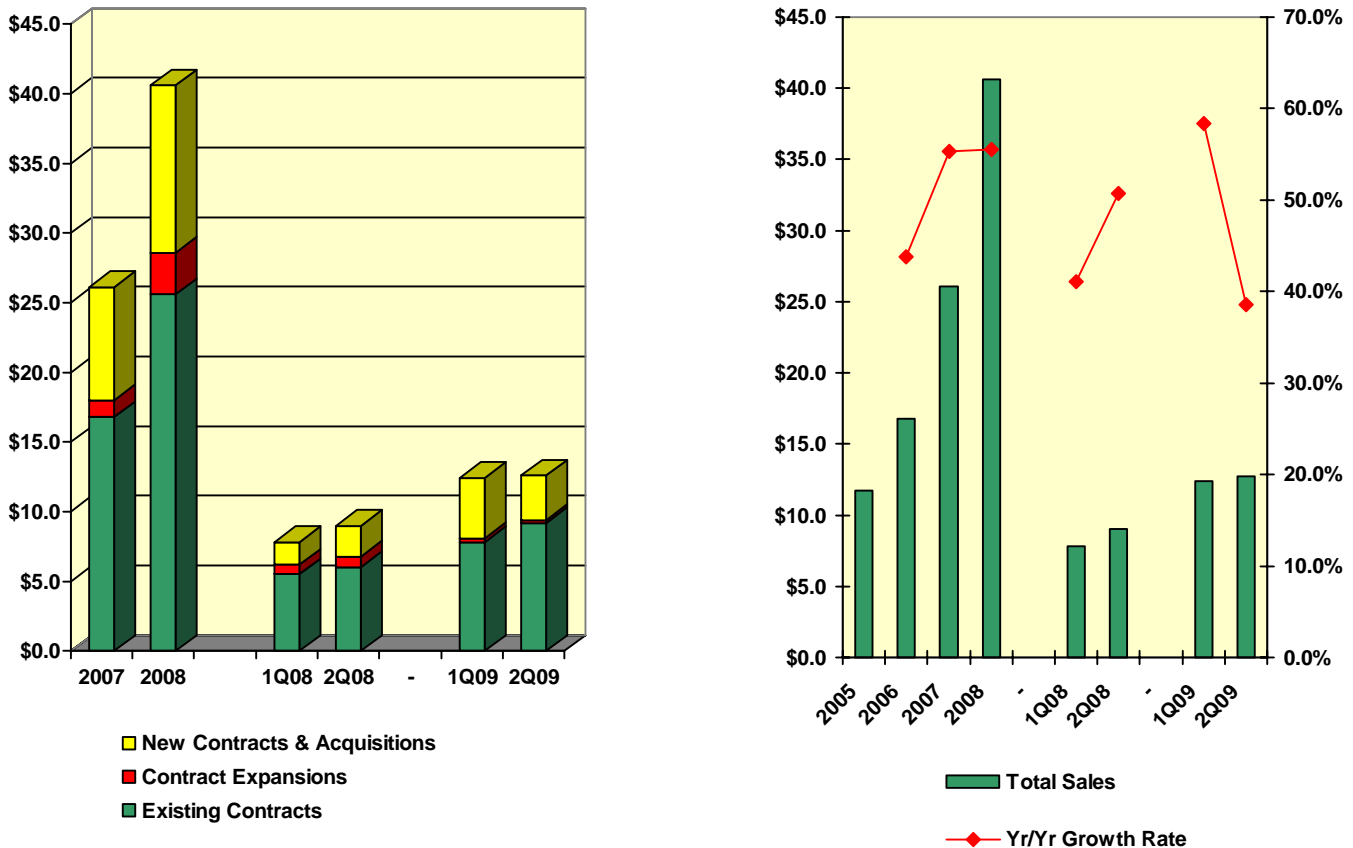
Our earnings model has been updated to reflect 2Q09 results. We made no changes to our revenue or expense assumptions for the balance of 2009 or the base case 2010 estimates. Our 3Q09 revenue estimate may be slightly aggressive based on the Company's revenue run rate of \$55.0 million. This run rate implies quarterly revenue of \$13.8 million while our estimate for 3Q09 is \$14.5 million. We note that the Company has additional contract renewals coming due in the second half of the year that could result in increases in compensation rates and upgrades in service that would bring about incremental revenue. We believe our model reflects those opportunities.

Our revised 2009 sales estimate is \$54.7 million, resulting in a net loss of \$1.6 million or \$0.13 per share. We estimate that net income would be \$570,000 or \$0.04 per share, excluding the one-time charge relating to the accounting treatment of the Company's derivative securities.

We continue to display both a base case and growth scenario for the year 2010. The growth scenario demonstrates an assumption of growth through acquisitions and/or new contract awards based on the Company's two-year track record for executing on deals and landing competitive bids. The top-line expanded by 55.5% in 2008 over the prior year through a combination of expansion of existing contracts, new contract awards and acquisitions. We have projected 35% growth in 2009 and our growth scenario for 2010 reflects a 37% growth rate. The supplier side of the jail and detention center health care market remains highly fragmented and penetration rates for outsourcing is still only 2%. We believe these two metrics suggest the economic conditions remain intact for continued exception growth.

Our growth scenario suggests a revenue level of \$75.0 million is achievable if the Company is successful in maintaining its current pace of acquisitions and contract wins. Without expansion in profit margins this revenue level could produce \$0.30 per share in earnings. Neither our 2010 base case or growth scenario reflect any additional charges relating to derivative securities, although we acknowledge that the strong performance suggested by our growth scenario could lead to increases in the stock price that would trigger such charges. Additional charges could be recorded in subsequent quarters as the stock price increases. Basically, for every \$0.10 increase in the stock price above \$2.50 as determined at the end of each quarter the Company will be required to take an additional charge of \$122,000.

Chart I: Organic and Acquired Growth



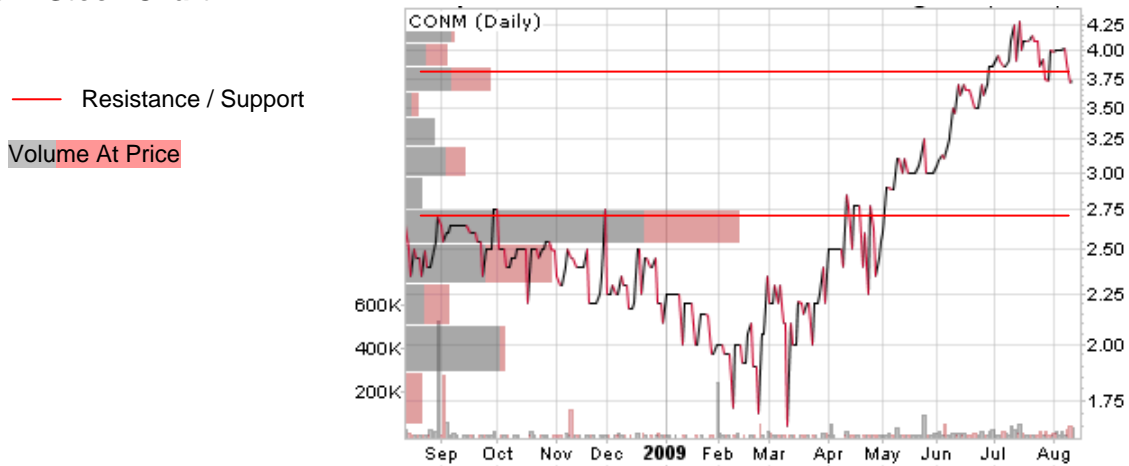
Source: Company Reports and Crystal Equity Research Estimates

VALUATION AND OUTLOOK

We have upgraded our rating of CONM shares to Accumulate (from Speculative Buy) since we now view the Company’s business model as fully proven. Our target price remains \$5.25. The implied multiples against our 2010 base case and 2010 growth scenario EPS estimates are 25 times and 17.5 times, respectively. In our view, the Company’s sales and earnings growth rates justify a 25 times multiple. Applying the 25 times multiple to our 2010 growth scenario EPS estimate of \$0.30 generates a future value of \$7.50.

We believe the one-time charge against earnings related to the accounting treatment for derivative securities could lead to some confusion over fundamental performance in 2009. Rather than reflecting an improvement in performance at the bottom line, 2009 comparisons or reported results may appear to reflect a decline in income attributable to shareholders. That said comparisons of sales and cash flows from operations should be positive in coming quarters and could then create new interest in the stock. We also believe the move to a national market listing on the NYSE AMEX is a positive and could encourage trading activity in CONM shares.

Exhibit I: 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	3Q09E	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	14,500	15,100	54,732	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	8,120	8,456	30,814	35,840	41,000
Medical expenses	6,693	2,017	2,643	3,043	2,675	10,378	2,382	2,382	3,335	3,473	11,572	14,720	17,250
Other operating expenses	906	233	255	446	400	1,334	384	480	435	453	1,752	1,920	2,250
Direct costs	21,252	6,364	7,504	9,465	9,792	33,125	9,754	10,112	11,890	12,382	44,138	51,840	60,500
Gross profit	4,821	1,472	1,491	2,066	2,396	7,425	2,665	2,601	2,610	2,718	10,594	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	1,740	1,737	7,237	7,680	8,250
Depreciation & amortization	2,093	499	530	504	599	2,132	634	606	425	380	2,045	350	350
Total operating expenses	6,636	2,088	2,025	1,994	2,384	8,491	2,450	2,550	2,165	2,117	9,282	8,030	8,600
Operating income (loss)	(1,815)	(616)	(534)	72	12	(1,066)	215	51	445	602	1,313	4,130	5,900
Other income (expense)													
Interest income	313	66	41	37	10	154	28	16	10	10	64	100	100
Interest expense	(7)	(2)	(2)	(1)	(2)	(7)	(5)	(2)	(10)	(10)	(28)	(21)	(20)
Other, net	-	-	-	-	-	-	1	(2,445)	-	-	(2,444)	-	-
Total other income (expense)	306	64	39	36	9	148	24	(2,431)	(0)	(0)	(2,408)	80	80
Income (loss) before income taxes	(1,509)	(552)	(495)	108	19	(919)	239	(2,380)	445	601	(1,095)	4,210	5,980
Provision for income taxes (benefit from)	162	-	-	-	-	-	121	32	147	198	498	1,402	1,973
Net income (loss)	(1,671)	(552)	(495)	108	19	(919)	118	(2,412)	298	403	(1,593)	2,808	4,007
Net earnings (loss) per share	\$ (0.16)	\$ (0.05)	\$ (0.04)	\$ 0.01	\$ 0.00	\$ (0.08)	\$ 0.01	\$ (0.19)	\$ 0.02	\$ 0.03	\$ (0.12)	\$ 0.21	\$ 0.30
Weighted shares outstanding, diluted	10,300	11,989	12,024	13,305	13,325	12,090	13,529	12,560	13,000	13,000	13,022	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	3Q09E	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	14,500	15,100	54,732	64,000	75,000
Operating income (loss)	(1,815)	(616)	(534)	72	12	(1,066)	215	51	445	602	1,313	4,130	5,900
Net income (loss)	(1,671)	(552)	(495)	108	19	(919)	118	(2,412)	298	403	(1,593)	2,808	4,007
Net earnings (loss) per share	\$ (0.16)	\$ (0.05)	\$ (0.04)	\$ 0.01	\$ 0.00	\$ (0.08)	\$ 0.01	\$ (0.19)	\$ 0.02	\$ 0.03	\$ (0.12)	\$ 0.21	\$ 0.30
Weighted shares outstanding, diluted	10,300	11,989	12,024	13,305	13,325	12,090	13,529	12,560	13,000	13,000	13,022	13,250	13,250
SELECTED MEASURES:													
Sales growth, yr/yr	55.4%					55.5%					35.0%	16.9%	37.0%
Net income growth, yr/yr	258.5%					45.0%					-73.5%	-276.2%	-351.5%
EPS growth, yr/yr						53.2%					-61.0%	-273.2%	-347.2%
Gross margin	18.5%	18.8%	16.6%	17.9%	19.7%	18.3%	21.5%	20.5%	18.0%	18.0%	19.4%	19.0%	19.3%
Operating margin	-7.0%	-7.9%	-5.9%	0.6%	0.1%	-2.6%	1.7%	0.4%	3.1%	4.0%	2.4%	6.5%	7.9%
Net margin	-6.4%	-7.0%	-5.5%	0.9%	0.2%	-2.3%	1.0%	-19.0%	2.1%	2.7%	-2.9%	4.4%	5.3%
Direct costs, % sales	81.5%	81.2%	83.4%	82.1%	80.3%	81.7%	78.5%	79.5%	82.0%	82.0%	80.6%	81.0%	80.7%
Salaries, wages & benefits	52.4%	52.5%	51.2%	51.8%	55.1%	52.8%	56.3%	57.0%	56.0%	56.0%	56.3%	56.0%	54.7%
Medical expenses	25.7%	25.7%	29.4%	26.4%	21.9%	25.6%	19.2%	18.7%	23.0%	23.0%	21.1%	23.0%	23.0%
Other direct operating expenses	3.5%	3.0%	2.8%	3.9%	3.3%	3.3%	3.1%	3.8%	3.0%	3.0%	3.2%	3.0%	3.0%
G&A expense, % sales	17.4%	20.3%	16.6%	12.9%	14.6%	15.7%	14.6%	15.3%	12.0%	11.5%	13.2%	12.0%	11.0%
Effective tax rate	-10.7%	0.0%	0.0%	0.0%	0.0%	0.0%	50.6%	-1.3%	33.0%	33.0%	-45.5%	33.3%	33.0%
EBITDA, \$\$	279					1,066					3,103	4,480	7,690
EBITDA margin	1.1%					2.6%					5.7%	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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CER REPORT RESEARCH UNIVERSE*

Speculative Buy	2	50%	Unproved business model; catalysts exist to generate higher returns
Accumulate	1	25%	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	25%	No rating
Total	4	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

DISCLOSURES

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

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- 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.
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- 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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