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Electro-Optical Sciences (Nasdaq: MELA)

2008 Fiscal First Quarter Review

Raising Price Target

Electro-Optical Sciences releases Form 10-Q covering the quarterly period ending March 31, 2008

Current Price: \$7.08

Target Price: \$9.50

BUY

Revenues and Earnings	F2007A	F2008E	F2009E
Sales (\$ mil.) Dec. FYE	\$0.0	\$0.0	\$17.5
1Q	\$0.0	\$0.0 A	
2Q	\$0.0	\$0.0 E	
3Q	\$0.0	\$0.0 E	
4Q	\$0.0	\$0.0 E	
Prev. Sales (\$ mil.)			
EPS	-\$0.84	-\$1.08	-\$0.71
1Q	-\$0.22	-\$0.28 A	
2Q	-\$0.23	-\$0.27 E	
3Q	-\$0.18	-\$0.27 E	
4Q	-\$0.22	-\$0.27 E	
Prev. EPS			
P/E (x)	NA	NA	NA
EBITDA	NA	NA	NA
EV / EBITDA	NA	NA	NA

Stock Data	
52-Week Range	\$3.84 - \$7.80
Shares Outstanding (mil.)	15.4
Market Capitalization (mil.)	\$110.0
Enterprise Value (mil.)	\$87.5
Debt to Capital	0.0
Insider Ownership	19.7%
Institutional Ownership	35.3%
Short Interest (mil. shares)	0.031
Average Daily Volume	90,577
Cash & Securities (3/31/08) (mil.)	\$17.2



Company Description

Electro-Optical Sciences mission is to develop and commercialize a hand-held, point-of-care non-invasive diagnostic tool (MelaFind®) for the early detection of melanoma. If approved by the FDA, MelaFind® will be the only product of its kind on the market.

Highlights

- Electro-Optical Sciences released their first quarter 10-K on May 8th 2008, reporting a loss per share of (\$0.28).
- Overall research and development (R&D) spending during the first quarter of 2008 (Q12008) was \$3.0 million, an increase of 50% year over year and sequentially, from approximately \$2.0 million in both the year ago period and fourth quarter of 2007.
- Selling, general and administrative (SG&A) expense of \$1.4 million was flat sequentially and up slightly from \$1.3 million in the year ago period. **We anticipate an increase in SG&A expense to support the commercialization effort in the second half of 2008 as MelaFind® nears approval**
- The company reported cash, equivalents and marketable securities on hand at quarter end of \$17.2 million, down \$3.7 million from \$20.9 million on December 31, 2007. **This amount is sufficient to fund the ongoing pivotal clinical trial and initial product launch through the middle of 2009.**
- With Q1 results in hand, we are rolling forward our price target calculation. As discussed within, we value the shares of MELA utilizing a forward PE multiple applied to estimated earnings to be generated in 2010. Now, two years from this period, **our price target increases from \$8.00 per share to \$9.50 implying further appreciation in excess of 30%.** We reiterate our **Buy** rating on the shares of MELA.

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Quarterly Detail

Electro-Optical Sciences released their first quarter 10-K on May 8th 2008. *Note: Being a venture stage company without revenues or a currently marketed product, the company does not hold a corresponding conference call.*

Overall research and development (R&D) spending during the first quarter of 2008 (Q12008) was \$3.0 million, an increase of 50% year over year and sequentially, from approximately \$2.0 million in both the year ago period and fourth quarter of 2007. This increase is attributable to costs associated with the ongoing pivotal clinical trial for MelaFind®, the company's point-of-care melanoma detection device. Our R&D estimate of \$2.0 million was short of this result as the company incurred higher costs getting data together, implying the trial is on track and entering the final stages.

Selling, general and administrative (SG&A) expense was reported as \$1.4 million, no change sequentially and up slightly from \$1.3 million in the year ago period. We anticipate an increase in SG&A expense to support the commercialization effort in the second half of 2008 as MelaFind nears approval, possibly by year end.

Electro-Optical reported a loss per share of (\$0.28) versus our expected (\$0.22) and First Call consensus of (\$0.23) on the higher than estimated R&D expense.

The company reported cash, equivalents and marketable securities on hand at quarter end of \$17.2 million, down \$3.7 million from \$20.9 million on December 31, 2007. This amount is sufficient to fund the ongoing pivotal clinical trial and initial product launch through the middle of 2009.

Revisions to our price target

With Q1 results in hand, we are rolling forward our price target calculation. As discussed below (*see Stock Valuation*) we value the shares of MELA utilizing a forward PE multiple applied to estimated earnings to be generated in 2010. As we are now two years from this period, our price target increases from \$8.00 per share to \$9.50, implying further appreciation in excess of 30%. We reiterate our **Buy** rating on the shares of MELA.

Additional Information

- During Q12008, the company received \$26,000 in other income, which includes \$10,000 from L'Oreal as an offset for expenses incurred from the companies joint Feasibility Program (*noted in our March 19th, 2008 initiation report*) and \$10,000 from KaVo reflecting product support for the discontinued dental product sold to KaVo in 2006 (*see initiation report*).
- The company reported 14 active (including training) sites and continues to anticipate submission of their PreMarket Approval (PMA) to the Food and Drug Administration (FDA) early in the second half of 2008.

Stock Valuation

Considering the FDA approval process, we estimate approval of MelaFind® in late 2008 and full product launch in 2009. Factoring in the commercialization process, we do not estimate “significant” sales of MelaFind until the 2010 calendar year. As such, our price target is calculated using a 30x price earnings (PE) multiple off our 2010 estimated earnings per share of \$0.41 and discount back by 15% per year, thereby arriving at our target of \$9.50 per share. This price represents upside to the current market price of more than 30% and, accordingly, we recommend the stock as a **Buy**.

We believe our PE multiple is appropriate for the high growth phase of small-cap medical device companies and that our 15% discount rate accounts for the risks inherent in the FDA approval and product commercialization processes.

Risks

Regulatory

There is significant oversight and regulation of the medical device industry by governmental agencies including the Food and Drug Administration (FDA), Centers for Medicare and Medicaid Services (CMS), Office of the Inspector General (OIG), Department of Health and Human Services (HHS), Department of Justice (DOJ), Office of Civil Rights and others.

Additionally, the PMA approval process is uncertain and, if approved, the indication may be restricted.

Competition

The medical device industry is highly competitive and many competitors are larger and have greater resources than Electro-Optical.

Stock Fundamentals

The market capitalization of the stock is below \$200 million and the trading history is volatile.

Financial

The company currently does not have a sales organization or significant marketing expertise. As such, additional funding will be required to commercialize the product.

Miscellaneous

Electro-Optical is currently unprofitable and the company has a history of losses. Additionally, the stock performance going forward will rely on a single product.



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Income Statement

	2007					2008					2009	2010
<i>Fiscal Year Ends December 31</i>	Q1	Q2	Q3	Q4	FY	Q1	Q2	Q3	Q4	FY	Estimate	Estimate
\$ in millions						<i>Actual</i>	<i>Estimate</i>	<i>Estimate</i>	<i>Estimate</i>	<i>Estimate</i>		
Revenue	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$17.500	\$41.850
Cost of Goods and Services Sold	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$4.550	\$10.881
Gross Profit	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$12.950	\$30.969
<i>Gross Profit Percentage</i>											74.0%	74.0%
<i>Revenue Growth, year over year</i>												139.1%
Operating Expenses												
Selling General and Administrative Expenses	\$1.311	\$1.439	\$1.218	\$1.432	\$5.400	\$1.440	\$1.450	\$1.600	\$2.500	\$6.990	\$15.000	\$14.000
<i>SG&A Percentage</i>												
Total Research and Development Expense	\$1.953	\$1.886	\$1.811	\$2.028	\$7.678	\$3.045	\$2.900	\$2.700	\$1.900	\$10.545	\$10.000	\$7.200
<i>R&D Percentage</i>												
Total Operating Expenses excluding costs	\$3.265	\$3.325	\$3.029	\$3.460	\$13.08	\$4.485	\$4.350	\$4.300	\$4.400	\$17.53	\$25.00	\$21.20
Operating Income / Loss (incl. Extraordinary Items)	(\$3.265)	(\$3.325)	(\$3.029)	(\$3.460)	(\$13.078)	(\$4.485)	(\$4.350)	(\$4.300)	(\$4.400)	(\$17.535)	(\$12.050)	\$9.769
Nonoperating Gains/(Losses)	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000
Nonoperating Income/(Expense) - Other	\$0.000	\$0.000	\$0.040	\$0.018	\$0.059	\$0.026	\$0.000	\$0.000	\$0.000	\$0.026	\$0.000	\$0.000
Earnings Before Interest & Taxes (EBIT)	(\$3.265)	(\$3.325)	(\$2.989)	(\$3.441)	(\$13.019)	(\$4.459)	(\$4.350)	(\$4.300)	(\$4.400)	(\$17.509)	(\$12.050)	\$9.769
Interest Income (Expense), Net	\$0.271	\$0.228	\$0.280	\$0.275	\$1.054	\$0.182	\$0.180	\$0.180	\$0.170	\$0.712	\$0.400	\$0.300
Income Before Taxes	(\$2.994)	(\$3.097)	(\$2.709)	(\$3.166)	(\$11.965)	(\$4.277)	(\$4.170)	(\$4.120)	(\$4.230)	(\$16.797)	(\$11.650)	\$10.069
<i>Income Before Taxes Margin</i>												
Provision for Income Taxes	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$3.021
<i>Tax Rate</i>												
Income (Loss) from Continuing Operations	(\$2.994)	(\$3.097)	(\$2.709)	(\$3.166)	(\$11.965)	(\$4.277)	(\$4.170)	(\$4.120)	(\$4.230)	(\$16.797)	(\$11.650)	\$7.048
Income (Loss) from Discontinued Operations, Net of Tax	\$0.000	\$0.000	\$0.000	\$0.028	\$0.028	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000
Net Income	(\$2.994)	(\$3.097)	(\$2.709)	(\$3.138)	(\$11.937)	(\$4.277)	(\$4.170)	(\$4.120)	(\$4.230)	(\$16.797)	(\$11.650)	\$7.048
Preferred Stock Dividends	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000
Preferred Stock Accretion	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000	\$0.000
Net Income/Loss Applicable to Common Stockholders	(\$2.994)	(\$3.097)	(\$2.709)	(\$3.138)	(\$11.937)	(\$4.277)	(\$4.170)	(\$4.120)	(\$4.230)	(\$16.797)	(\$11.650)	\$7.048
Weighted Average Number of Shares Outstanding	13.4	13.4	14.7	14.2	14.2	15.4	15.5	15.5	15.6	15.6	16.5	17.0
Weighted Average Number of Diluted Shares Outstanding	13.4	13.4	14.7	14.2	14.2	15.4	15.5	15.5	15.6	15.6	16.5	17.0
Basic Earnings Per Share	(\$0.22)	(\$0.23)	(\$0.18)	(\$0.22)	(\$0.86)	(\$0.28)	(\$0.27)	(\$0.27)	(\$0.27)	(\$1.08)	(\$0.71)	\$0.41
Diluted Earnings Per Share	(\$0.22)	(\$0.23)	(\$0.18)	(\$0.22)	(\$0.86)	(\$0.28)	(\$0.27)	(\$0.27)	(\$0.27)	(\$1.08)	(\$0.71)	\$0.41
Continuing Operations	(\$0.22)	(\$0.23)	(\$0.18)	(\$0.22)	(\$0.84)	(\$0.28)	(\$0.27)	(\$0.27)	(\$0.27)	(\$1.08)	(\$0.71)	\$0.41
Discontinued Operations	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00

Source: Electro-Optical Sciences, Inc. company reports, J&L estimates



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Price Target and Ratings Changes over the Past 3 Years:

Date	Stock Price	Rating	Target Price	Initiation
3/19/2008	\$4.49	Buy	\$8.00	X
5/13/2008	\$7.08	Buy	\$9.50	

Companies Mentioned in Report (in order of mention):

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- 2) **Neutral** means the stock is expected to perform generally in line with the S&P 500 over the next 12-18 months; and
- 3) **Sell** means the stock is expected to under perform the S&P 500 over the next 12-18 months and should be sold.

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