HILLIARD LYONS

COMPANY UPDATE / ESTIMATE CHANGE/
PRICE TARGET CHANGE

Health Care Services
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Key Metrics

LDR - NYSE (as of 05/09/17)		$51.55
Price Target		$37.00
52-Week Range		$55.80 - $34.49
Shares Outstanding (mm)		9.6
Market Cap. ($mm)		$496.0
Enterprise Value ($mm)		$588.1
1-Mo. Average Daily Volume		27,555
Institutional Ownership		94.8%
Debt / Total Capital		85.0%
ROE (TTM)		97.6%
Price / Book Value		20.8x
Indicated Dividend / Yield	$1.10	2.1%
TTM Operating Margin		18.8%

Operating EPS FY 9/30

	2016A	Prior 2017E	Curr. 2017E	Prior 2018E	Curr. 2018E
1Q	$0.40		$0.45A	$0.44	$0.41
2Q	$0.44		$0.55A	$0.56	$0.55
3Q	$0.50	$0.45	$0.46	$0.51	$0.52
4Q	$0.37	$0.27	$0.26	$0.34	$0.34
Year	$1.71	$1.73	$1.72	$1.85	$1.83
P/E	30.2x		29.9x		28.2x

Figures may not add up due to rounding

Revenue ($mm)

	2016A	Prior 2017E	Curr. 2017E	Prior 2018E	Curr. 2018E
1Q	$36.5		$37.6A	$37.9	$37.6
2Q	$38.1		$39.1A	$38.8	$38.5
3Q	$37.9	$38.0	$38.2	$39.2	$39.3
4Q	$36.8	$36.5	$36.5	$38.1	$38.0
Year	$149.2	$151.1	$151.4	$154.0	$153.4

Company Description *– Based in Glenwood, IL, Landauer, Inc. is the world's largest provider of personnel radiation monitoring services. The dosimetry badges are sold to health care providers, energy producers, and military customers. The company also provides medical physics services for customers with diagnostic imaging equipment and radiation oncology operations.*

Landauer, Inc.

LDR – NYSE – Underperform – 4

Solid Radiation Measurement Results; Shares Remain Priced for Rosy Assumptions, Reiterate Underperform

- **2Q17 Results:** Landauer reported revenue of $39.1 million, even with our estimate and below the Street consensus estimate of $39.5 million. Operating EPS were $0.55, also even with our estimate but above the Street consensus of $0.50; GAAP EPS were $0.54. Non-GAAP EBITDA were $10.7 million versus our estimate of $10.8 million.
- **Positive Highlights:** Radiation Measurement revenue was higher than expected, despite military sales that were $0.2 million lower than we estimated. Additionally, Corporate Expenses of $4.3 million were slightly lower than our estimate.
- **Negative Highlights:** The Medical Physics segment posted solid growth led by imaging physics, but the segment fell just shy of our estimate. The bigger issue from Medical Physics was an operating margin of 6.4% versus our expectations of 9.5%. The company's gross margin was roughly flat at 51.9% compared to our estimate of 52.6%.
- **FY17 Guidance:** Management maintained previous guidance. Revenue is expected to be between $149 million and $154 million. Management expects GAAP EPS to be between $1.65 and $1.71, and suggested they will come in at the top end of that range.
- **Outlook, Estimates, & Rating:** Our outlook for Landauer has improved modestly. For FY17, our total company estimates are now $151.4 million in revenue and $1.72 in operating EPS. Our adjusted EBITDA estimate remains unchanged at $36.9 million.
  For FY18, our total company estimates are now $153.4 million in revenue, $37.6 million in adjusted EBITDA, and $1.83 in EPS. Our FY18 adjusted EBITDA estimate was $37.7 million previously. We are maintaining our Underperform rating but raising our price target to $37 from $36. See pages 4 and 5 for valuation discussion and price target derivation.

Note Important Disclosures on pages 7 and 8
Note Analyst Certification on page 7

ADDITIONAL COMMENTARY

Performance Review

- The **Radiation Measurement** segment recorded revenue of $28.7 million, exceeding our estimate of $28.6 million. Management stated military sales were $2.9 million in the quarter, coming in slightly below the $3.1 million we had modeled. Management noted international service growth was offset by a decline in product sales, while domestic service revenues in the segment were up 2%. Operating income in the segment was $11.4 million, representing an operating margin of 39.8% versus the segment's 2Q16 operating margin of 39.1% and our estimate of 39.7%. The increased military sales, which carry a higher operating margin, likely offset increased spending in preparation of the Verifii launch. Management still expects the National Guard contract (~$3.3 million remaining) to wrap up in 3Q17, and Japanese product sales from last year are expected to provide a tough comparison, and may have already started to do so. Based on our estimates, when excluding military deliveries and the divested Medical Products segment, product sales declined ~16% year-over-year.
- The **Medical Physics** segment generated year-over-year growth of 4.0% to achieve revenue of $10.4 million. This fell short of our estimate of $10.6 million. The imaging physics piece of the business expanded 18.8% year-over-year, showing continued execution on regulatory tailwinds. However, this is a slowdown from the FY16 imaging growth rate of ~28%. We do note this business can be lumpy but believe investors should keep an eye on it as the most impactful regulations have now anniversaried. The other piece of the business (therapy and commissioning) was down ~3% year-over-year due to approximately $700,000 less in commissioning business, which is very episodic by nature. The operating margin in the segment declined to 6.4% from 9.1% in 2Q16; we estimated a 9.5% margin. The lower commissioning business was likely a significant drag on the margin. While we still expect operating margins in this segment to expand over time, we continue to taper our expectations for the speed at which this occurs, especially as it becomes clearer how important commissioning revenues are to margins.
- Corporate operating expenses were $4.3 million for the quarter, coming in below our estimate of $4.5 million. Excluding $250,000 in proxy expenses, corporate expenses actually contracted year-over-year.
- The company-wide gross margin of 51.9% was flat from 2Q16 and fell short of our estimate of 52.6%. Total Selling, General, & Administrative expenses were $12.5 million, resulting in an operating margin of 20.0% versus the 2Q16 operating margin of 19.0% and our estimate of 20.0%. Although management did not break out proxy expenses, we excluded them to obtain a normalized operating margin of 20.6%.
- Our non-GAAP EBITDA calculation, which excludes Equity in Income of JVs, Other Income, and proxy expenses, resulted in $10.7 million for the quarter, falling just shy of our estimate of $10.8 million. We remind investors we believe this is the key metric to watch, as EPS can swing significantly due to a volatile tax situation and small number of shares outstanding.
- Equity in Income of JVs was $1.2 million, a jump of 365% from a year ago. That compares to our estimate of $0.5 million.
- Net interest expense was $0.6 million versus $1.1 million last year, as the company has paid down approximately $20.9 million in debt from this time last year using the proceeds from the sale of a business and operating cash flows. The company paid down $2.5 million in debt this quarter.
- The effective tax rate was 36.6% versus our estimate of 31.0%. We remind investors this will likely be volatile over the next couple of years, as the company noted the Medical Products divestiture will enable them to monetize approximately $20 million in tax assets over the next four years or so. Management noted the cash tax rate was less than 10% for the quarter. Management also guided the full year tax rate to be in the low 30s.
- Net income was $5.2 million. Our calculation of operating net income was $5.3 million, an increase of 25.7% year-over-year. GAAP EPS were $0.54 versus $0.45 a year ago. Operating EPS were $0.55 versus $0.44 a year ago. Our estimate was $0.55 and the Street consensus was $0.50.

Conference Call Discussion

- Naturally, Verifii was a topic of conversation. CEO Mike Kaminski made a special point to remind investors that it will be a controlled commercial launch. Management had previously discussed this with us, but it sounded like perhaps management had the feeling some investors may have been expecting too much. The launch is still on schedule for the second half of calendar 2017. When discussing the expense ramp for launch, management pointed to increases in 4Q17 or 1Q18. Management noted the commercial build-out of the infrastructure necessary for the digital platform continues, and customer feedback remains positive.
- The imaging physics services business continues to show strong demand, growing just under 19% year-over-year. Year-to-date, growth has averaged around 20%. While impressive, this is lower than the past couple of fiscal years, where growth was around 27-28%. When we inquired about the slowdown, management suggested their focus on maintaining profitability could lead to a slightly lower growth rate for imaging than seen in the past, but they remain bullish long-term. Management also talked about the different offerings in imaging physics. Core physics services, which entails quality control, grew 16%. They are expanding their geographic reach and offering tiered skilled services to meet customer needs. The other primary offering in imaging physics is their clinical dose optimization service (CDOS), which focuses on minimizing radiation exposure for the patient while still maintaining enough for high image quality. The CDOS offering grew 58%, albeit from a small base.
- Management remains bullish on pulling in military business for FY18. They stated the government is in review for FY18 budgeting, and they expect more information to emerge in the second half of 2017.

Balance Sheet and Cash Flow Review

- Total debt-to-equity decreased to 6.6X from 8.2X last quarter. Long-term debt to EBITDA decreased to 3.1X from 3.3X last quarter.
- Free cash flow interest coverage increased to 7.8X from 5.8X last quarter due to tax asset monetization and lower net interest expense. EBITDA interest coverage increased to 17.2X from 12.7X in 1Q17. Free cash flow dividend coverage increased to 1.8X from 1.7X last quarter.
- Cash flow from operations has increased 8.8% year-to-date compared with the same time frame a year ago, while free cash flow growth was 10.0%. The gains were driven largely by the increase in deferred taxes.

ESTIMATES UPDATE

Our estimate changes largely reflect the results of this quarter, with the exception of noticeable changes to Medical Physics assumptions. Within Radiation Measurement, we increased our FY17 revenue estimate to $109.8 million from $109.0 million previously, as a result of the ex-military beat and less concern about competitive pressure. We also tweaked our segment operating margin estimate higher to 36.2% from 36.0%. The positive moves in Radiation Measurement are offset by lowered revenue growth and margin assumptions for Medical Physics. We have decreased our Medical Physics revenue estimate to $41.6 million (versus $42.1 million previously) and decreased our operating margin estimate to 6.9% versus our prior estimate of 9.0%. We still expect Medical Physics margins to expand but continue to increase our time horizon for the company to realize efficiencies; we are also growing a little wary on how dependent the segment is on commissioning revenue for margin. Offsetting the Medical Physics decrease is our lowered Corporate Expense assumptions. For FY17, our total company estimates are now $151.4 million in revenue, $36.9 million in adjusted EBITDA, and $1.72 in operating EPS. This compares to previous estimates of $151.1 million, $36.9 million, and $1.73, respectively. We note both our operating and GAAP EPS estimates exceed management’s GAAP EPS guidance by a penny.

For FY18, we have left Radiation Measurement assumptions largely unchanged, but lowered expectations for Medical Physics. Within Radiation Measurement, we still expect Verifii growth to offset declining military revenue. We have not modeled any new military contracts despite management confidence. Our Radiation Measurement revenue estimate is unchanged at $109.6 million, and we increased our operating margin estimate to 35.7% from 35.5%. Our Medical Physics estimates are now $43.7 million with a 9.5% operating margin versus $44.4 million in revenue with a 10.9% operating margin previously. For FY18, our total company estimates are now $153.4 million in revenue, $37.6 million in adjusted EBITDA, and $1.83 in EPS. This compares to previous estimates of $154.0 million, $37.7 million, and $1.85, respectively. Our FY18 estimates are well below the Street's consensus (based on numbers prior to yesterday's earnings release). The Street has FY18 revenues at $160.0 million and EPS at $2.05. We note the $2.05 is lower than the $2.11 prior to the release of 1Q17 earnings, yet the stock price is largely unchanged.

OUTLOOK & VALUATION

Outlook

Our outlook for Landauer has improved modestly. Although likely an overlooked number by most investors, we believe the 2% growth in domestic Radiation Measurement services shows the company has likely stemmed any competitive pressure from the launch of Instadose+ from Mirion Technologies. While definitely not showing noticeable pricing power or market share gains, growth in this quarter is reassuring considering many hospital systems likely renewed contracts at the end of the calendar year. This does not mean Landauer is out of the woods yet – delays in the launch of their competing product, Verifii, could cause customers to doubt the company's promises. We remind investors the company, and competitor Mirion, have been discussing wireless dosimeters for about five years. Landauer's initial guess, under a different management team, was for a launch around 2015. We believe it is absolutely critical that the Verifii launch is timely and smooth, with few hiccups and rapid response when issues do arise. Otherwise, frustrated customers, forever waiting for wireless dosimetry, could turn to a verified product (pardon the pun), and that yearlong head start Instadose+ has on Verifii could still result in market share loss.

This begs to question, will management deliver on Verifii? We remind investors Mr. Kaminski took the helm in August 2015, and CFO Dan Fujii stepped into that role in April 2015. We liked the new management team's vision for the company when we initially starting researching the company. At that point, the company was a bit of a turnaround story, and this management team has executed the turnaround in full force. We are impressed with the management team's execution on their vision and their ability to retain market share in the face of an inherent product disadvantage. Thus, we have confidence they can deliver on their Verifii promises. Nevertheless, the risk remains.

At this point, our concern for the stock has less to do with company fundamentals than what is baked into the share price. As we stated earlier, we are well below Street in FY18 estimates. We believe both the Street consensus and market have fully assumed military revenue, tax reform, and Verifii uptake with margin expansion. We point to management emphasis on a controlled launch as potential concern they may have about FY18 assumptions, particularly the statement about adoption curves.

Valuation

The stock closed yesterday at 15.1X trailing EV/EBITDA and 16.4X our forward 12 month EBITDA estimate, both of which are well above historical norms. The likely reason behind the extended valuation is the promise of tax reform, which would deliver a significant boost to domestically concentrated Landauer. Also potentially aiding share price could be military spending expectations and the presence of an activist shareholder (and now Board member).

Given the company's fairly high debt and the drastic swings in EPS resulting from a small number of shares outstanding and a volatile tax situation, we prefer an EV/EBITDA valuation approach. We project the military dosimetry business, which is a non-recurring source of revenues, to account for just over 5% of next twelve months EBITDA. We believe investors should apply a lower valuation to this business, as Landauer's historical premium to the market is derived from its annuity-like revenue sources, in our opinion. The military business, which we believe is still a great source of cash flow for debt reduction and other activities, is not worth almost twice as much as the S&P 500 on an EV/EBITDA basis, which is where Landauer has historically traded, in our view. As such, we are applying a 12.7X EV/EBITDA valuation, below its historical median of ~13X, to our next twelve months estimates to derive our $37 price target.

Assuming tax reform takes the corporate rate in the U.S. to 20%, we believe that could deliver a 15% boost to FY18 EPS (we currently assume a 30.0% effective tax rate). Applying this 15% to our EV/ EBITDA multiple, we get a "tax reform price target" of $44, up from $43 in our previous report. We are not changing our price target until legislation becomes reality but feel investors should be aware of the difference. Even assuming a military contract worth ~$10-$15 million carrying a 40% EBITDA margin plus tax reform, we still see essentially no upside for the stock from these levels, and risk remains elevated in the near term. Thus, we believe shares are overvalued and remain comfortable with our Underperform rating.

SUITABILITY

Landauer reports approximately 90% recurring revenue and a 94% annual customer retention rate in Radiation Measurement. Further, competition has historically been weak in the Radiation Measurement and Medical Physics industries. However, the company's recent history has raised the risk profile of the stock. Ill-fated acquisitions and accounting issues are the primary sources. Further, the small-cap stock's low trading volumes, relatively weak liquidity, and leverage are also factors in our suitability rating. Finally, a new management team with limited experience at the company pushed our risk rating to 4.

RISKS & CONSIDERATIONS

- **Competition and technological innovation** – The dosimetry business requires complex operations with many technological aspects. A competitor or new company could produce innovations that could displace Landauer as the industry leader.
- **Verifii failures** – Landauer is taking a major stride in deploying the Verifii platform, shifting the company to be as much a software company as a dosimeter manufacturer. The software business carries additional risks such as hacking or cloud disruptions. These issues could lead to customer dissatisfaction and financial disappointment.
- **Changing healthcare trends –** Diagnostic imaging utilization has experienced a massive increase over the past few decades. This has increased the value of the medical physics market. Significantly decreased utilization or innovation that enables ultrasounds to provide clarity on par with radiation-emitting imaging machines could reduce the need for medical physicists and harm the Medical Physics business.
- **Regulatory** – Landauer's growth opportunity in the Medical Physics business primarily revolves around new regulations. Should these regulations be reversed or altered, uncertainty may arise.
- **Legal –** Product lawsuits are common in the health care sector. An unfavorable court decision could hamper the ability to market a product.

LANDAUER, INC.									LDR: UNDERPERFORM
In millions	2014 A	2015 A	2016 A	1Q17 A	2Q17 A	3Q17 E	4Q17 E	2017 E	2018 E
Fiscal Period End	9/30/2014	9/30/2015	9/30/2016	12/31/2016	3/31/2017	6/30/2017	9/30/2017	9/30/2017	9/30/2018
Income Statement									
Radiation Measurement	113.6	106.0	104.2	27.6	28.7	27.6	25.8	109.8	109.6
Operating Margin %	*33.7%*	*33.6%*	*36.3%*	*40.6%*	*39.8%*	*35.2%*	*28.7%*	*36.2%*	*35.7%*
Medical Physics	32.2	35.4	39.2	9.9	10.4	10.5	10.7	41.6	43.7
Operating Margin %	*5.7%*	*8.8%*	*8.2%*	*6.8%*	*6.4%*	*7.0%*	*7.5%*	*6.9%*	*9.5%*
Medical Products	9.3	9.9	5.8						
Operating Margin %	*-673.3%*	*15.5%*	*18.3%*						
Total Revenue	**155.1**	**151.3**	**149.2**	**37.6**	**39.1**	**38.2**	**36.5**	**151.4**	**153.4**
Gross Margin %	*52.2%*	*52.0%*	*50.6%*	*52.3%*	*51.9%*	*49.6%*	*47.5%*	*50.4%*	*51.0%*
Gross Profit	**80.9**	**78.7**	**75.5**	**19.6**	**20.3**	**19.0**	**17.4**	**76.3**	**78.2**
SG&A Expenses	54.9	54.0	48.8	12.2	12.5	12.0	13.2	49.9	51.2
Non-GAAP Operating Income	**26.0**	**24.7**	**26.6**	**7.4**	**7.8**	**6.9**	**4.1**	**26.3**	**27.0**
Operating Margin %	*16.8%*	*16.3%*	*17.9%*	*19.8%*	*20.0%*	*18.1%*	*11.4%*	*17.4%*	*17.6%*
Adjusted EBITDA*	**39.9**	**37.1**	**37.7**	**9.7**	**10.7**	**9.6**	**6.8**	**36.9**	**37.6**
EBITDA Margin %	*25.7%*	*24.5%*	*25.3%*	*25.9%*	*27.4%*	*25.1%*	*18.6%*	*24.3%*	*24.5%*
Non-recurring Items**	(66.0)	(1.0)	0.0	0.4	(0.3)	0.0	0.0	0.0	0.0
Equity in Income of JVs	2.9	2.3	1.5	0.6	1.2	0.5	0.5	2.8	2.4
Interest Expense	(3.4)	(4.4)	(3.4)	(0.8)	(0.6)	(0.8)	(0.8)	(2.9)	(3.1)
Other Income	(0.0)	(0.3)	3.6	(0.3)	0.1	0.0	0.0	0.0	0.0
Pre-tax Income	**(40.5)**	**21.3**	**28.4**	**7.0**	**8.4**	**6.7**	**3.9**	**26.2**	**26.3**
Effective Tax Rate	*39.0%*	*29.4%*	*34.9%*	*34.2%*	*36.6%*	*31.0%*	*31.0%*	*33.3%*	*30.0%*
Net income attributed to noncontrolling interest	0.5	0.5	0.7	0.2	0.2	0.2	0.2	0.7	0.7
Net Income (attributed to LDR)	**(25.2)**	**14.5**	**17.8**	**4.4**	**5.2**	**4.4**	**2.5**	**16.5**	**17.7**
Non-GAAP Operating Net Income***	**17.7**	**14.8**	**16.3**	**4.4**	**5.3**	**4.4**	**2.5**	**16.6**	**17.7**
Diluted Shares Outstanding	9.5	9.6	9.6	9.6	9.6	9.6	9.6	9.6	9.7
GAAP EPS Attributed to LDR Shareholders	**($2.65)**	**$1.52**	**$1.86**	**$0.46**	**$0.54**	**$0.46**	**$0.26**	**$1.72**	**$1.83**
Non-GAAP EPS Attributed to LDR Shareholders***	**$1.86**	**$1.55**	**$1.71**	**$0.45**	**$0.55**	**$0.46**	**$0.26**	**$1.72**	**$1.83**
Balance Sheet									
Cash and Equivalents	6.8	15.3	13.3	12.4	12.9	18.5	21.2	21.2	28.3
Other Current Assets	47.6	46.4	42.7	44.7	48.8	44.3	42.5	42.5	45.0
Total Current Assets	**54.3**	**61.8**	**56.0**	**57.1**	**61.7**	**62.8**	**63.7**	**63.7**	**73.2**
Net PP&E	46.8	46.4	46.4	46.1	46.6	57.9	57.6	57.6	57.6
Equity in Joint Ventures	23.8	24.0	26.2	25.0	25.3	25.3	25.3	25.3	25.3
Intangible Assets	57.3	48.1	43.1	42.3	42.3	33.5	33.5	33.5	33.5
Other Assets	34.4	28.5	19.1	17.3	14.7	11.2	10.4	10.4	7.3
Total Assets	**216.6**	**208.7**	**190.8**	**187.8**	**190.5**	**190.7**	**190.5**	**190.5**	**196.9**
Current Liabilities	44.7	38.5	34.5	33.1	33.4	34.2	34.8	34.8	36.0
Long-term Debt	133.6	133.4	109.1	107.6	105.1	103.1	101.1	101.1	92.6
Other Non-Current Liabilities	24.5	24.5	26.6	26.7	27.0	27.0	27.0	27.0	27.0
Total Liabilities	**202.9**	**196.4**	**170.2**	**167.3**	**165.4**	**164.2**	**162.9**	**162.9**	**155.6**
Non-controlling Equity Interest	1.5	1.1	1.4	1.2	1.3	1.3	1.3	1.3	1.3
Total LDR Shareholders' Equity	**12.3**	**11.2**	**19.2**	**19.2**	**23.8**	**25.2**	**26.3**	**26.3**	**40.0**

**We do not include Equity in Income of JVs and Other Income*

***Excludes impairment and restructuring charges and non-recurring items*

****Excludes non-recurring items and other income, with a constant tax rate of 35% applied to FY14 and 31% applied to 4Q16*

Source: Company Reports and Hilliard Lyons estimates

Additional information is available upon request.

Analyst Certification

I, Kurt A. Kemper, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company(ies) and its (their) securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

Important Disclosures

Hilliard Lyons' analysts receive bonus compensation based on Hilliard Lyons' profitability. They do not receive direct payments from investment banking activity.

Investment Ratings:
Buy - We believe the stock has significant total return potential in the coming 12 months.
Long-term Buy - We believe the stock is an above average holding in its sector, and expect solid returns to be realized over a longer time frame than our Buy rated issues, typically 2-3 years.
Neutral - We believe the stock is an average holding in its sector, is currently fully valued, and may be used as a source of funds if better opportunities arise.
Underperform - We believe the stock is vulnerable to a price set back in the next 12 months.

Definitions of Suitabilities:
1. A large cap, core holding with a solid history.
2. A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks.
3. An above average risk/reward ratio could be due to small size, lack of product diversity, sporadic earnings or high leverage.
4. Speculative, due to small size, inconsistent profitability, erratic revenue, volatility, low trading volume or a narrow customer or product base

	Hilliard Lyons Recommended Issues		Investment Banking Provided in Past 12 Mo.	
Rating	**# of Stocks Covered**	**% of Stocks Covered**	**Banking**	**No Banking**
Buy	32	26%	13%	88%
Hold/Neutral	79	64%	8%	92%
Sell	12	10%	0%	100%

As of 8 May 2017

Other Disclosures

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