

NEOGENOMICS RAISES FY '07 GUIDANCE. OPENS THIRD LAB, ANNOUNCES SEVERAL NEW GROWTH INITIATIVES. MAINTAIN STRONG BUY RATING.

NEOGENOMICS, INC.

OTCBB: NGNM
COMPANY UPDATE

JANUARY 19, 2007

Q3 '06 Revenue: \$1,601,880

Q3 '06 Net Income: \$31,895

Q3 '06 EPS: \$0.00

Price (01/18/07): \$1.65

52-Wk Range: \$0.12 - \$2.05

Diluted Shares Out.: 31.2 M

Float: 8.8 M

Market Cap: 44.5 M

Insider Ownership: 61%

Average Daily Volume: 167 K

Assets (9/30/06): \$2,971,355

Liabilities (9/30/06): \$2,744,403

Fiscal Year End: Dec. 31

Rating History

Initiated Coverage: Apr. 3, 2006

Rating: *Accumulate*

Price at Rating: \$0.48

Upgrade: July 31, 2006

Rating: *Strong Buy*

Price at Rating: \$0.74

New '07 Target Price:
\$1.80-\$2.10

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Key Points

- Raised FY '07 revenue guidance from to \$10M-\$12M to \$14M-\$16M
- Raised FY '07 net income guidance from \$1-\$1.2M to \$1.3-\$1.7M
- Announced opening of third lab facility in Irvine, CA
- Third consecutive profitable quarter
- Announced record number of new customers in Q3
- Temporary impact to revenues & earnings due to new GPS platform & seasonality
- First to market with new "tech-only" FISH testing
- Announced intent to enter CRO market and develop IP
- Three key additions and a promotion in management
- Doubled sales force after quarter end

Summary

NeoGenomics reported net income of \$31,895 for the third quarter of 2006 and diluted EPS of \$0.00. Revenue was up 186% year over year to \$1.6 million for Q3 though quarterly revenue decreased 9% on a sequential basis due mostly to seasonality and a realignment of its customer mix after introducing the GPS product. Management raised FY '07 revenue guidance to \$14 million to \$16 million and net income guidance to \$1.3 million to \$1.7 million. We believe actual results may trend towards the high end of this range as testing volumes and scale continue to increase due to additional capacity, entry into the CRO testing market, continued rollout of the new GPS product and the introduction of "Tech-Only" FISH testing for pathologists. We maintain our **strong buy rating** and increase our **target price range to \$1.80 to \$2.10 by the end of 2007.** ♦



▲ See Recommendation History on Page 8

Key Statistics

Test and requisition volume were both up approximately 160% on a year-over-year basis but flat to slightly down for the quarter on a sequential basis. Both exceeded our previous projections. An increase in DSOs (days sales outstanding) to 64.5 for the quarter reflected the cessation of all payment processing by Medicare on September 19 for 12 days. While above average for the company, DSOs remain well below industry average. Average number of tests per requisition came in at 1.38 for the quarter, while ARPreq, or average revenue per requisition, was \$668.01. Both declined slightly sequentially due to an increase in single test per requisition work related to FISH – PathVysion and UroVysion – testing.

Take-aways From the Conference Call

What Q3 lacked in blistering sequential growth it made up for with impressive year-over-year comps and personnel, product and strategic headlines. On the November 10 conference call, president Bob Gasparini cited the company's most significant accomplishment for the quarter as securing critical human resources to further scale the company. In addition to tripling its Nashville staff, NeoGenomics also announced that it had hired Frank Yang, M.D. and Ph.D, a noted hematopathologist, and Matthew Moore, Ph.D., an expert in developing diagnostic assays, during the third quarter. In addition, subsequent to quarter end, NeoGenomics also announced that it had doubled its sales force, promoted Jerry Dvonch to principal accounting officer, and hired Robert Feeney, Ph.D., as its Vice President of Sales and Marketing.

Dr. Yang is pivotal in rolling out the company's new Genetic Pathology Solutions (GPS) service, which combines cyto, FISH, flow and morphological test results on a single lab report. Dr. Moore's role is to lead the company's efforts to secure new customers in the Contract Research Organization (CRO) market and, as acting Chief Financial Officer Steve Jones noted, begin to explore how to bring intellectual property (IP) into the company - presumably in the diagnostic testing area. Dr. Feeney is coming in to manage and augment the sales efforts as the company focuses on the new GPS and tech-only FISH services. It is noteworthy that Bob Gasparini used to work with Dr. Feeney when they were both at US Labs.

NeoGenomics also announced the opening of a new lab in Irvine, Calif. Currently going through the licensing process, management expects revenue contribution late in the first quarter of 2007. In addition to tapping an entirely new, potentially high-volume market with the Irvine lab, its proximity to large CROs also holds some strategic importance.

Management also elaborated on the strategic significance of the new GPS service. Gasparini identified heme/onc (hematology/oncology) customers as the company's holy grail, as these customers typically order two to four tests per requisition and those tests usually possess the highest margins and reimbursement rates. Delivering GPS into that market will enable NGNM to maximize the leverage in average revenue per requisition and revenue per test. Jones indicated that among early users the company has seen average revenue per requisition increase by as much as 50% in some cases.

The company did experience a throttling back in volume from reference labs during the quarter due to the roll-out of its new GPS service. Some reference lab customers apparently believed the GPS service competed directly with their own core offerings. Management provided more details on these developments in a press release issued several weeks after the call, which we address more in the next section of this update.

NeoGenomics also experienced some seasonality during the quarter, particularly in its South Florida operations where a significant number of residents return to northern homes during the hot summer months that comprise Q3. Looking ahead, management indicated the ramp-up of customers for their new labs in Nashville and Irvine should mitigate some of the seasonality-based decreases that the company experiences from its Florida customer base.

Also of note on the call was that the company recorded a record number of new customers in Q3. Gasparini stated that as a result of the company's expansion activities in Q3, he believed the company could maintain its leading three- to five-day turnaround times even if its current volume of tests doubled. The company now processes tests from 16 to 17 states with approximately 50% of revenue coming from Florida. The company also attributed a large part of the DSO creep to a moratorium Medicare put on all claim processing in the last 12 days of the federal government's fiscal year as mandated by section 5203 of the Deficit Reduction Act of 2006.

On the call Jones also reiterated his belief that 9-12% net profit margins are realistic in the long term, and that the company could maintain gross margins of approximately 55% and DSOs at 55 to 60 days over the long term. Jones anticipates \$1 million to \$1.5 million in capex in '07, of which \$300,000 to \$400,000 will be related to the new CRO initiative.

Events After The Call

Subsequent to the Q3 conference call, NeoGenomics announced several notable developments in a December 18 press release. The company launched a new "technical only" FISH service, the first of its kind in the nation, which will enable pathologists to earn revenues for performing the "professional component" of FISH testing as classified by insurers. Under this service, NeoGenomics will perform the "technical component" of FISH tests and allow trained and certified pathologists to professionally interpret such results, thereby sharing a significant revenue stream. As pointed out in the release, this will enable pathologists to participate in the fast growing FISH testing market without having to set up and operate a genetics testing lab. By sharing that revenue stream, NeoGenomics anticipates a significant increase in the number of FISH tests it receives from pathologists.

This revenue sharing arrangement along technical and professional lines is not unique to the lab testing industry, but it has not been applied to FISH testing specifically until now. A couple of less obvious points about tech-only FISH testing should also be noted. First and foremost is that pathologists represent a significant new customer base for NGNM – a base that has few alternatives when seeking a non-threatening partner to provide genetic tests. As a novel means to attract high volumes of testing from a new segment of the industry, tech-only FISH testing also provides NeoGenomics a foothold in winning future testing business from those pathologists as well. In order to participate in tech-only FISH, the pathologists must agree to send NeoGenomics all their cytogenetic tests. There also appears to be little stopping NeoGenomics from offering tech-only flow tests to pathologists desiring to use tech-only FISH, further accelerating the growth in total tests performed by the company.

With regards to the volume reductions from reference lab customers due to the introduction of GPS during Q3, management updated its estimates to reflect \$1 million less in revenue contribution in the second half of 2006 from reference lab customers. Though unexpected, it is clear the growth in the company's non-reference lab business has fully offset that decline as management indicated 2006 revenues should come in at approximately \$6.5 million, or the midpoint of guidance released in July. When you consider that management issued this guidance before the reductions from reference lab customers became obvious, we believe it is all the more impressive that

the company was still able to achieve the midpoint of its revised guidance. In our view, that also speaks volumes about the strength of the rest of NeoGenomics' business. We believe the company's shift in customer base from reference labs to higher margin oncology, urology and pathology customers is a definite positive for shareholders, particularly in light of the GPS and tech-only FISH platforms, which should further spur revenue growth among that segment.

Given our long-term view, we are not placing too much weight on the company's revised projections of flat-to-slightly-negative Q4 '06 EPS, either. Given the recent hiring of numerous core executives, an above-average increase in SG&A for the quarter seemed almost certain. In light of favorable seasonality trends expected in Q1 '07, the recent introduction of two new economically attractive testing services, better scalability in operations and a reiteration of recently increased FY '07 guidance, we consider a light Q4 unexpected but not inconsistent with the actions of a management team focused on building long-term value. As with any microcap, volatility in quarterly earnings should be expected.

Macro Developments

Followers of the largest lab testing companies also noted a significant event during the third quarter, which we believe reinforces the value in NeoGenomics' strategic focus on genetic testing. On October 3, UnitedHealthcare chose to award a 10-year, \$3 billion exclusive contract to LabCorp over Quest Diagnostics, until then the company's sole provider. Quest had been negotiating terms of the agreement over the previous year, but CEO Surya Mohapatra balked at accepting last-minute terms demanded by UnitedHealthcare which in his words "would have given them the ability to unilaterally dictate certain key terms over a period of up to eight years." As a result, Quest lost 7% of its total revenues, which were approximately \$5.5 billion in 2005.

We believe this intense price competition among legacy testing providers bodes well for NeoGenomics. As discussed in our initial report, NGNM customers are sensitive to turnaround times, not price. We suspect recent consolidation trends in the industry will continue as both Quest and LabCorp look to acquire less competitive revenue streams - if for no other reason than to replace revenues like those just lost by Quest. We maintain that if NeoGenomics can execute and continue to scale its revenues, the company should become a likely candidate for takeover in the second half of 2008.

Also important to note in the investment case for NeoGenomics is that the Centers for Medicare and Medicaid Services (CMS) has increased the reimbursement rate for the technical component of flow cytometry testing for FY 2007 by approximately 22%. Reimbursement rates for FISH and cytogenetics will be held roughly flat. This reimbursement rate increase combined with NeoGenomics' ability to bring the professional component of flow testing in-house as a result of hiring Dr. Yang should translate into markedly increased flow cytometry revenue for NeoGenomics in 2007. ❖

Outlook

Given the number of new initiatives announced by the company in Q3 and mid-December, we will wait for more data before formally updating our financial model. However, this does not deter our enthusiasm for the shares in the least. As indicated in our initial report, NeoGenomics is a compelling long-term investment opportunity, and the last three quarters have only reinforced that belief. While we continue to feel confident the company will reach at least \$0.05 EPS in FY '07, we cannot yet quantify the probability of it reaching significantly higher than that.

That said, we do believe \$0.06 in EPS in 2007 is now within range. We will re-visit that projection as the year progresses, but as a result of the recent doubling of their physical infrastructure and their sales staff, we think '07 could be stronger than even the company's increased guidance suggests. The fiscal first quarter is usually the strongest overall revenue period for the company as a result of favorable South Florida seasonality trends and when combined with new testing services, we believe NeoGenomics will have a strong Q1 '07. With the Irvine lab coming online at the end of that first quarter and assuming traction has been developed in the two new services, it seems highly likely that strong Q1 momentum will continue through the following quarters.

To reach EPS of \$0.06 in '07, the company would need \$1.98 million in earnings on a diluted share base of 33 million shares at the end of next year. (There were 31,172,953 diluted shares outstanding on a weighted average basis at the end of Q3). That is approximately \$280,000 more than the high end of its new income guidance for the year and would represent 12% profit margins on sales of \$16 million for the year, also at the high end of new guidance.

There are a handful of ways to realize that incremental \$280,000 and reach \$0.06 EPS. NeoGenomics could simply do 560 more single \$500 FISH tests during the year, an increase of only 2% on the 24,000 tests we project the company to process in 2007. Alternatively, by simply maintaining its recent year-to-date average revenue per test and increasing its average number of tests per requisition from 1.38 to 2.0, the company could book sales of over \$16 million. Early results from GPS testing seem to indicate that degree of increase in tests per requisition is well within the realm of possibility. Although the introduction of the tech-only FISH service will probably result in a higher number of single test per case Urovysion and Pathvysion tests, expansion in tests per req seems highly probable.

The ultimate top-line results for the year will depend largely on the percentage of overall customer mix made up of heme/onc customers. We believe that the hiring of a full-time hematopathologist will allow the company to increase this percentage considerably since the company can now provide both technical and professional components of all tests offered. As a result of that hire, the company's potential revenue capture on heme/onc cases has increased from \$1,300 - \$2,200 to \$1,700 - \$3,000 per requisition.

As a result of all of the above, we believe that it is entirely possible that NeoGenomics realizes considerably more than \$16 million of revenue in 2007. Despite plenty of variables in the above, our point is that regardless of the lever used and even without being shot through the prism of our formal model, we feel confident in increasing our estimate of 2007 EPS for the company to \$0.06. As usual, we will reserve the right to re-calibrate as more data comes in over the next few months. On the same 30 to 35x P/E multiple, our new target price range for the shares in 2007 becomes \$1.80 to \$2.10 a share. ❖

Conclusion

By far the most significant events of the last few months to us were the introductions of the GPS platform and tech-only FISH testing. We believe adoption of those offerings more than anything else will accelerate the momentum of the company into the foreseeable future. The increase in testing volumes (and ARPreq, potentially) as a result of these new tests represents, in our view, a huge potential catalyst for the shares. In addition, we think that management is on target to lessen its dependence on reference labs and directly target heme/onc customers. We believe that new heme/onc base will be a much better longer-term revenue source both due to the higher margins it represents as well as the higher switching costs those customers would incur if sending tests elsewhere.

We also view entry into the CRO market as an additional long-term positive. Of all tangential markets to dip a toe in, the fast growing, \$10 billion CRO market seems an attractive and logical one. Many medical laboratories support CRO lab testing and it appears that NeoGenomics could offer many of its same services into this new and different customer base. In addition, by being able to capture both components of flow cytometry testing in-house as a result of bringing Dr. Yang onboard, the company can further leverage that ability by targeting high-volume flow testing done by CROs. The development of proprietary tests kits also represents an eventual long-term premium on NGNM shares if the valuations of proprietary kit providers remain high.

The opening of the Irvine lab also implies obvious future scale for NeoGenomics. Population density alone will ensure a receptive market, though we believe left unsaid on the call was another significant aspect of the decision to open that lab. NeoGenomics is opening a lab quite literally just across town from two other major laboratory facilities operated by Quest and Lab Corp. Qualified potential employees and managers will be available in the area.

NGNM appears to have already ruffled some feathers at US Labs with these hires, as per the disclosure of a complaint by US Labs against NeoGenomics surrounding the hiring of four new sales people. In the complaint, US Labs asked the courts to bar NeoGenomics from soliciting or hiring any further employees of US Labs, and to bar NeoGenomics from soliciting or establishing commercial relationships with US Labs' customers. NeoGenomics seems to have won on a majority of these points at a preliminary hearing held on November 15, 2006. Management has stated in the 10Q that they believe this is essentially a nuisance lawsuit and do not believe that it will have a material impact on their business. To date, we have seen or heard nothing that would lead us to disagree.

Ironically, the US Labs complaint seems a strong endorsement of NeoGenomics' business model and certainly speaks volumes about the value these sales personnel may bring. We suspect that US Labs is highly concerned about NeoGenomics attracting more of their key personnel, given the company has opened a new facility just across town. After all, Gasparini himself hired many of the US Labs personnel when he was the head of that company's genetics division and surely knows the top employees to pursue. In addition, Gasparini presumably still maintains relationships with potential customers in the area, meaning the revenue ramp from California-based customers might be quicker than anticipated once licensing of that facility is complete.

In general, we view Q3 as a bit of a breather for NeoGenomics – though we trust management might not feel too rested. Q4 may see flat-to-down EPS but as management indicated revenues should still be up 10% to 15% sequentially. Despite several legitimate and infrequent events in the quarter, the company continued to execute

and expand its existing business, added key personnel, introduced two attractive new testing services with even more attractive financial characteristics, and identified several potentially transformative long-term initiatives. While trading off low margin reference lab customers for high margin heme/onc clientele and booking \$1 million less from reference lab customers than expected, the company believes it will still hit the mid-range of its full year '06 revenue guidance. While we cannot say NeoGenomics shares are cheap when looking in the rearview mirror, we believe the year ahead will be a strong one for the company, making the shares a very attractive long-term opportunity. For these reasons we maintain a strong buy. ❖

Investment Risks

- Need for further working capital financing
- Highly competitive market
- Industry shortage of highly trained genetic technologists
- Rapid rate of technological change in industry
- Adverse regulatory developments including reduced reimbursement rates
- Dilution related to unanticipated financings and/or further draw-downs on Cornell SEDA

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Neutral – The current price reflects a fair valuation relative to the company's peers and the broader market. The company's performance should be in-line with the Russell Micro Cap Index over the next 12 months.

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Analyst Bio

The AMI research service is headed by Senior Analyst Cale Smith. Prior to joining Hawk Associates, Smith was a lead equity analyst for an independent research provider in Maryland. Smith is an honors graduate of the U.S. Coast Guard Academy where he majored in management. He holds an M.B.A. from the College of William & Mary, has an executive certificate in financial planning from Georgetown University and is a Level II candidate in the CFA Program.

Analyst Certification

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Distribution of Ratings:

	#	%
Strong Buy	1	50
Accumulate	1	50
Neutral	0	0
Sell	0	0

Recommendation History:

Date	Rating	Price Target	'06/'07 EPS
April 3, 2006	Accumulate	\$0.60-\$0.70	\$0.02/\$0.05
May 12, 2006	Accumulate	\$0.60-\$0.70	\$0.02/\$0.05
July 31, 2006	Strong Buy	\$0.90-\$1.05	\$0.02/\$0.05
Jan. 19, 2007	Strong Buy	\$1.80-\$2.10	\$0.02/\$0.06

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