Palomar Medical Technologies

PMTI : NASDAQ : US$12.87

BUY

Target: US$16.25 ↓

Anup Mehta 1.847.864.1139
anup.mehta@canaccordadams.com
William J. Plovanic, CFA 1.847.864.1137
william.plovanic@canaccordadams.com

COMPANY STATISTICS:

52-week Range:	US$5.83 - 18.94
Avg. Daily Vol. (000s):	152.5
Market Cap (M):	US$232.3

EARNINGS SUMMARY:

FYE Dec		2008A	2009E	2010E
EV/Revenue:		1.2x	1.7x	1.5x
EV/EBITDA:		NM	NM	12.6x
P/E:		NM	NM	88.3x
Revenue (M):	Q1	23.0	14.6A	15.9
	Q2	23.1	15.0A	17.4
	Q3	24.2	15.1	17.7
	Q4	17.2	16.2	19.4
Total		87.6	60.9	70.4
EPS:	Q1	(0.09)	(0.08)A	(0.02)
	Q2	0.07	(0.01)A	0.04
	Q3	0.04	(0.01)	0.04
	Q4	(0.03)	0.02	0.08
Total		(0.02)	(0.08)	0.15

SHARE PRICE PERFORMANCE:

COMPANY SUMMARY:

Palomar is focused on the research, development, manfacturing and marketing of light-based systems. The company offers a comprehensive range of products based on its proprietary technologies that include (but are not limited to) hair removal, body sculpting, wrinkle reduction, acne treatment, skin resurfacing, tattoo removal, and removal of leg veins.

All amounts in US$ unless otherwise noted.

Life Sciences -- Biomedical Devices and Services

JOHNSON & JOHNSON TERMINATES HOME LASER DEVELOPMENT AGREEMENT; MAINTAIN BUY, LOWER PT TO $16.25 FROM $21

Event

Palomar Medical announced that Johnson & Johnson has terminated its agreement to develop and commercialize light-based home devices for fat reduction, anti-aging, and anti-acne applications.

Impact

Negative. The reason for Johnson & Johnson's contract termination is the negative economic climate and the desire to not make future commercialization payments. We believe that investors will read through this decision by J&J and make similar arguments for P&G backing out of their agreement for the home hair removal product; however, we do not anticipate a similar decision from P&G.

Action

Maintain BUY rating.

Valuation

We are lowering our price target to $16.25 from $21.00. Our price target is derived from applying a PE of 49.7x to our 2011E GAAP EPS of $0.33. Our lower price target is a function of applying a lower premium to the group multiple (10% vs. 20%) coupled with multiple contraction for the group.

Canaccord Adams is the global capital markets group of Canaccord Capital Inc. (CCI : TSX|AIM)

The recommendations and opinions expressed in this Investment Research accurately reflect the Investment Analyst's personal, independent and objective views about any and all the Designated Investments and Relevant Issuers discussed herein. For important information, please see the Important Disclosures section in the appendix of this document or visit http://www.canaccordadams.com/research/Disclosure.htm.

JOHSON & JOHNSON BACKS AWAY FROM HOME LASER MARKET – PALOMAR WILL CONTINUE ALONE

Palomar Medical announced that Johnson & Johnson has terminated its agreement to develop and commercialize light-based home devices for fat reduction, anti-aging, and anti-acne applications. Per the termination of the agreement, Palomar will retain all IP related to the development completed. This includes the device for periorbital wrinkles that earned FDA OTC clearance in Q2/09.

The company remains very confident regarding the opportunity to enter the home market with a light based device to treat periorbital wrinkles given the results from pre-clinical and clinical testing that was conducted to gain the FDA clearance. We believe that Palomar is not interested in finding a new partner for this product in the near term. Because Palomar and J&J were operating in an exclusive relationship, Palomar was deeply involved in the commercialization efforts for the product. We believe that the company will be able to take over these manufacturing and marketing efforts with minimal disruption as it looks to launch the periorbital wrinkle product into specialty channels in H2/10.

We anticipate the product will priced in the $400-600 price range and will include a disposable component. The company believes it already has relationships to promote an OTC product via certain key physician relationships, and will look to specialty channels such as department stores and online retailers to drive adoption.

IMPACT TO THE MODEL:

The Johnson & Johnson agreement was expected to provide quarterly development revenues of $400K for the foreseeable future. We believe the termination will impact funded development revenues beginning in Q1/10. This represents approximately $0.01 in earnings per quarter.

Additionally, with the company looking to commercialize the periorbital wrinkle product on its own, it will incur certain manufacturing set-up costs along with S&M expenses as they prepare to enter a completely new market segment. We expect these expenses to begin in early 2010 and we anticipate minimal market penetration of the product starting in Q3/10. We are conservatively estimating approximately $200K in expenses through H1/10 increasing through H2/10 with higher marketing costs once the product is launched coupled with associated COGS.

We do not estimate substantial revenues from the consumer product in H2/10. Specifically, we assume a product ASP of $500 and 450 units placed in H2/10. We believe these assumptions are conservative but will be adjusted as we enter 2010.

Excluding the J&J development revenues and including future expenses and revenues we estimate will be incurred by Palomar for the commercialization of the periorbital product, our new estimates are as follows:

- **2010E:** our revenue estimates decline to $70.4M from $71.7M and GAAP EPS decline to $0.15 from $0.24
- **2011E:** our revenue estimates decline to $79.2M from $80.0M and GAAP EPS decline to $0.33 from $0.40

KEY POINTS FOR WHY WE REMAIN POSITIVE ON PALOMAR MEDICAL:

Despite the exit of Johnson & Johnson from the story, we continue to remain positive on Palomar given the following key points:

- Palomar controls IP in hair removal and fractional laser technology. The company is already getting royalty revenues from 10 of its competitors for hair removal. Furthermore, given the rulings from the PTO, we have a very high confidence level that Palomar will win its patent infringement suits with both Candela and Syneron. As a result, we view Palomar as extremely well positioned to benefit from a general improvement in the aesthetic laser industry.
- The agreement with Gillette (P&G) remains in play, and we have no reason to believe that – after all the time and money Gillette has put into the product ($10M through the last two years despite the economic weakness) – the company would walk away from the product at this point.
- Because Palomar controls the IP related to products developed with J&J and is free to develop products for hair removal as well (non-exclusive agreement with Gillette), the company maintains the opportunity to be one of the first to enter the home-based laser market in the next 12-18 months.
- Palomar expects to remain cash flow positive through 2009 and ended Q2/09 with $128M in cash and no debt position.

COMPARATIVE VALUATION

The broad small-cap (market capitalization less than $1 billion) aesthetic laser medicine industry is currently trading at a PE multiple of 45.2x 2010 expected earnings.

We believe that given Palomar's recent results and its long-term strategy and opportunity for earnings growth, the company should be valued at a premium to the group. Given the exit of J&J, we have lowered our premium to 10% from 20%. We believe the near-term growth opportunities provided by the consumer products, coupled with a strong IP revenue stream, position the company to reap substantial benefits from an improving economic environment and an increase in aesthetic procedure volumes. Furthermore, with a primarily fixed cost COGS the opportunity for earnings leverage is substantial with the return of sales volumes.

In sum, we are lowering our price target on Palomar Medical to $16.25 from $21.00. Our price target is derived from applying a PE of 49.7x to our 2011E GAAP EPS of $0.33. We use 2011E EPS because we believe that will be the first full year of uninhibited earnings growth for Palomar and we view current multiples as depressed.

Figure 1: Matrix of discount rates and implied share price target

		Comp Group		
		-10%	0%	10%
Target PE multiple for PMTI common		40.7x	45.2x	49.7x
Implied Price Target on PMTI common		$13.33	$14.81	$16.29
Financial Metrics Used in P/E Valuation Analysis				
Broad small-cap aesthetic laser 2010E PE multiple	45.2x			
PMTI 2011E EPS	$0.33			
Diluted Shared Outstanding (M)	18.0			

Source: Company reports and Canaccord Adams estimates

WHO IS PALOMAR MEDICAL TECHNOLOGIES?

Since 1995, Palomar Medical Technologies has been focused on the development of laser technologies for various medical and aesthetic applications. The company was formed in 1991 and spent a number of years with a scattered business plan that included lasers, circuit boards, personal computers, and a CD-ROM publishing company. In 1995, a corporate reorganization focused the firm's business strategy with the separation and subsequent spin-off the electronics business, making Palomar a pure-play laser company. For the last 15 years, the company has worked almost exclusively on lasers for cosmetic procedures, addressing everything from hair removal to skin resurfacing.

Palomar offers a number of laser and pulsed light systems to address a variety of cosmetic applications. The company's most popular product is the StarLux 500 system. StarLux 500 is a single platform with interchangeable hand pieces capable of providing a number of treatment options ranging from hair removal to reduction of vascular lesions and acne to fraction skin resurfacing. Along with the StarLux platform, Palomar also offers products for tattoo removal and the SlimLipo product for laser-assisted lipolysis.

JUSTIFICATION FOR OUR BUY RATING

Palomar is the IP keeper for hair removal – resurgence in the industry will drive higher royalties

Over its nearly 20 years of laser development, Palomar has established a strong IP position through organic development and technology licenses. Palomar is the exclusive licensee for two patents for hair removal and one patent for fractional laser technology from Massachusetts General Hospital (MGH). In addition to these exclusive licenses, Palomar has four non-exclusive patents from MGH and is the joint owner of seven additional patents with MGH. Beyond its relationship with MGH, Palomar is the sole owner of 26 patents.

Hair removal patents:

The company has protected its patent position surrounding hair removal in recent years, having won patent infringement suits with 10 competing laser companies. Along with collecting sizeable settlement fees ($13.6M from Cutera and $10.6M from Cynosure being the largest), each of the companies is required to pay Palomar on average a 7.5% royalty on all future sales. Palomar is also currently involved in patent infringement suits with Syneron and Candela (acquired by Syneron in Q3/09) that have been ongoing since 2008 and 2006, respectively. The suit with Candela seems to be leaning in Palomar's favor given the 10 companies already paying a royalty and the US Patent and Trademark Office's rulings that the claims in the suit are valid. Management has noted that should the company win this suit, the settlement would more than cover the associated legal expenses of what we estimate to be $14-16M. Furthermore, considering Candela has been one of the larger players in the energy-based aesthetic market and three of their nine products perform hair removal, the overall settlement including back-owed royalties could be more than $25M. We note that laser hair removal is the most common aesthetic laser procedure performed annually, with 1.2M treatments in 2008.

Fractional technology patents:

In Q4/08, Palomar formed the Fractional Technology Open Patent Program (FTOPP) in conjunction with Reliant (now Solta Medical) and MGH. Combined, these three entities maintain six fundamental patents on fractional laser technology. Palomar is already involved in litigation with Alma regarding its fractional patents and has sent letters or is in negotiations with other companies believed to be infringing. It is expected that Palomar will request back-owed royalties and a similar 7.5% forward royalty rate as was seen with the hair removal products. We would note that the royalties recognized each quarter are based on the results of the royalty-paying firm's prior quarter (i.e., Palomar reports royalty revenues in Q2 based on licensee sales in Q1).

Bottom line:

Net, net, with the hair removal patents expiring in 2015 and the fractional technology patents expiring in 2020, the royalty revenues represent a sustainable revenue stream considering hair removal remains the most highly utilized laser treatment, and fractional skin resurfacing is able to offer high quality results with reduced recovery times. Thus, as the aesthetics and laser market regain momentum with the improving economy, Palomar benefits from the operations of its competitors.

Palomar expected to make significant entry into the consumer market through its work with Gillette

Palomar has been internally working on products for the consumer market since the late 1990s and signed a development agreements with Gillette and Johnson & Johnson in 2003 and 2004, respectively.

Gillette home hair removal represents estimated annual $4M profit or $0.20 in EPS

Palomar developed a home-based hair removal product for women that gained FDA over-the-counter (OTC) clearance in December 2006, potentially providing access to a global market we estimate to be in excess of $10B. The product is now being tweaked and market tested within the Gillette organization. While it is unclear when the product will be released into the market, we know the price of the product will be in the range of $100-999 and will include a disposable component. Based on P&G filings, we estimate the Gillette total grooming business annual run-rate is approximately $6B and that female products represent 20% of sales, or $1.2B. If we assume women spend $60 per year on hair removal products, we estimate approximately 20M women are using Gillette products. We also assume that the home laser system will cost approximately $650 per year for the first year of use ($350 for the device + $300 for disposables). Conservatively assuming a 3% net royalty to Palomar and a 1% penetration of Gillette global female user base, this translates into a $3.9M opportunity for Palomar, or $0.20 in annual earnings.

In 2003, Palomar entered into an agreement with Gillette to develop a light-based home hair removal product for women. Gillette provided Palomar with $9.1M in development funding along with a $2.5M milestone payment upon receiving FDA OTC clearance, which was garnered in December 2006. The initial agreement required Gillette to pay Palomar $10M each year going forward of the exclusive relationship as a minimum payment. Upon initiation of product sales, Palomar would receive a 4% technology royalty and 2% hair removal royalty that would be split with MGH. In 2007, Gillette (now a part of P&G) and Palomar amended the agreement for additional development, but switched to a non-exclusive relationship. As a result, Gillette now pays Palomar $1.25M per quarter and will pay an undisclosed royalty on future sales. We believe it is important that Palomar can seek additional partners for the female hair removal product given the right distribution opportunity.

Palomar to introduce the next generation of anti-aging therapy for the home

In 2004, Palomar and Johnson & Johnson entered into a joint development and license agreement to develop light-based home products to address acne, cellulite, and skin aging. Johnson & Johnson has funded all of the development to date. In June 2009, the FDA granted OTC clearance for a product to address periorbital wrinkles. In October 2009, Johnson & Johnson terminated its agreement with Palomar due to the economic climate and unwillingness to make the necessary commercialization milestone payments or devote the necessary marketing dollars to launch such a product. That said, Palomar retains the IP and technology that has been developed and we anticipate a product to be launched in the H2/10.

In 2008, according to various dermatology and aesthetic medicine estimates, there were approximately 1.2M in-office laser or microdermabrasion procedures to address wrinkles. Assuming 25% of these procedures were to address periorbital wrinkles, which represent at least 300,000 women annually seeking treatment.

Stabilizing revenues suggest opportunity for sequential growth

In Q2/09, Palomar reported sequential revenue growth from both laser and service product sales. Net product revenues were $12.1M, rising 2.7% sequentially following a two-quarter revenue decline that began in Q4/08. As we know, the recessionary economy and sharp increase in unemployment impacted consumer confidence and spending, and froze credit markets through H2/08 and the early part of 2009. These three factors had a direct impact on the broader cosmetic market and a significant impact on the laser industry considering credit is nearly a necessity for large capital goods purchases. With laser revenues for Palomar stabilizing in Q2/09 (along with the broader economy) we believe we are beginning to see a trough run-rate.

We believe that there is pent-up demand for laser products and procedures in the marketplace and that an easing of credit will likely drive a backlog of potential revenues through the pipe. We remain conservative in our estimates for the remainder of 2009 but believe that the company will report nominal QoQ improvements for the near term with strong YoY growth rates being reported through 2010. While the company doesn't publicly comment on new product launches, we expect Palomar will release a new platform system in Q4/09 or early 2010 to refresh the product bag and take advantage of the return of customers.

Substantial gross margin leverage available with higher volumes

We believe as we move through H2/09 that sales volumes will begin to return that will immediately benefit Palomar's product gross margin. The company's product gross margin has historically been as high as 70% during 2006 and at times in 2007, when revenues were driven by volume while sales were primarily derived from the US market. During H1/09, sales volumes dropped, providing less absorption of fixed COGS. Approximately 80% of Palomar's product COGS are fixed (labor, etc.), while material represents the key variable component.

A larger percentage of international sales relative to overall revenues also represents headwind to the gross margin. Palomar sells its products to distributors that market and sell the devices in various international geographies. Sales to distributors are made at transfer prices that can occur at a 35-40% discount to domestic ASPs. As a result, the gross margin in 2009 has been impacted as 53% of revenues in the first six months of 2009 were derived from distributors.

We believe as we move through H2/09 that both volumes and domestic sales will begin to rebound, providing an improvement to Palomar's product gross margin. As the domestic economy continues to improve, we would expect the company to begin to expand its direct sales force, which has decreased by 25% since Q2/08 to 30 representatives from 40. With an increased presence in the US coupled with new product offerings, we would expect domestic revenues to return to approximately 53% of revenues as we approach YE:10

Figure 2: Palomar Medical income statement

PALOMAR MEDICAL income statement

Anup Mehta - Canaccord Adams - 847-864-1139

($ in 000's, except per share data)	2005	2006	2007	2008	Q1/09	Q2/09	Q3/09E	Q4/09E	2009E	Q1/10E	Q2/10E	Q3/10E	Q4/10E	2010E	2011E
Product revenues	65,824.3	92,222.7	103,220.9	69,378.9	11,473.6	12,120.9	12,005.0	13,143.3	48,742.7	12,953.7	14,524.7	14,455.2	16,333.9	58,267.4	66,025.5
Royalty revenues	4,921.1	30,481.5	13,005.5	10,520.1	1,493.4	1,274.6	1,416.6	1,380.1	5,564.7	1,717.4	1,644.2	1,983.2	1,794.1	7,139.0	8,209.8
Funded development revenues	5,408.4	3,840.3	6,698.1	2,434.4	431.1	398.5	400.0	400.0	1,629.6	0.0	0.0	0.0	0.0	0.0	0.0
Other revenues	0.0	0.0	894.2	5,247.6	1,250.0	1,250.0	1,250.0	1,250.0	5,000.0	1,250.0	1,250.0	1,250.0	1,250.0	5,000.0	5,000.0
Net Sales	**76,153.8**	**126,544.4**	**123,818.6**	**87,581.1**	**14,648.1**	**15,043.9**	**15,071.6**	**16,173.4**	**60,937.0**	**15,921.1**	**17,418.9**	**17,688.4**	**19,378.0**	**70,406.4**	**79,235.4**
Cost of product revenues	20,952.2	26,896.8	33,390.9	25,217.6	5,224.7	5,266.7	5,255.2	5,317.5	21,064.1	5,540.4	5,678.7	5,538.8	5,918.7	22,676.5	23,299.4
Cost of royalty revenues	1,968.4	12,192.6	5,202.2	4,208.1	597.4	509.8	566.6	552.0	2,225.9	687.0	657.7	793.3	717.6	2,855.6	3,283.9
Gross profit	53,233.2	87,455.0	85,225.5	58,155.4	8,826.1	9,267.3	9,249.7	10,303.8	37,646.9	9,693.8	11,082.6	11,356.3	12,741.6	44,874.2	52,652.1
Gross Margin	*69.9%*	*69.1%*	*68.8%*	*66.4%*	*60.3%*	*61.6%*	*61.4%*	*63.7%*	*61.8%*	*60.9%*	*63.6%*	*64.2%*	*65.8%*	*63.7%*	*66%*
Operating costs and expenses:															
Research and development	11,338.9	14,055.6	16,673.2	17,692.9	3,743.5	3,076.5	3,089.7	3,072.9	12,982.6	2,865.8	2,961.2	3,095.5	3,100.5	12,023.0	12,281.5
Sales and marketing	17,234.1	22,467.2	24,885.7	23,339.8	4,668.9	4,732.9	4,615.5	4,848.1	18,865.4	4,992.0	5,192.4	5,277.5	5,466.5	20,928.3	22,964.6
General and administrative	7,906.5	7,645.1	17,495.4	20,516.5	2,873.2	2,241.3	2,250.0	2,250.0	9,614.6	2,250.0	2,250.0	2,250.0	2,250.0	9,000.0	9,500.0
Operating income (loss)	16,753.7	43,287.1	26,171.2	(3,393.8)	(2,459.5)	(783.4)	(705.5)	132.8	(3,815.6)	(414.0)	679.0	733.3	1,924.6	2,922.9	7,906.0
EBITDA	**18,843.7**	**44,222.9**	**27,246.3**	**3,229.2**	**(1,474.0)**	**175.0**	**415.6**	**1,182.8**	**1,199.4**	**851.0**	**1,694.0**	**1,803.3**	**3,024.6**	**8,272.9**	**13,256.0**
Interest income	1,172.7	4,718.7	6,423.6	3,649.3	193.2	140.4	150.0	150.0	633.6	250.0	250.0	250.0	250.0	1,000.0	1,000.0
Other (loss) income	0.0	0.0	488.4	(313.8)	(26.9)	376.8	350.0	300.0	999.8	250.0	250.0	250.0	250.0	1,000.0	1,000.0
Pre-tax income	17,926.5	48,005.8	33,083.2	(58.2)	(2,293.3)	(266.2)	(205.5)	582.8	(2,182.2)	86.0	1,179.0	1,233.3	2,424.6	4,922.9	9,906.0
Provision for income taxes	473.3	(4,970.8)	12,575.5	9.9	(878.8)	(22.3)	(78.1)	221.5	(757.7)	398.0	448.0	468.7	921.4	2,236.0	3,764
Net earnings (loss)	17,453.2	52,976.6	20,507.7	(68.2)	(1,414.5)	(243.9)	(127.4)	361.3	(1,424.5)	(312.0)	731.0	764.7	1,503.3	2,686.9	6,141.7
EPS	**0.91**	**2.62**	**1.07**	**(0.00)**	**(0.08)**	**(0.01)**	**(0.01)**	**0.02**	**(0.08)**	**(0.02)**	**0.04**	**0.04**	**0.08**	**0.15**	**0.33**
Adjusted EPS (excluding one-time charges)	**0.91**	**1.33**	**1.35**	**(0.02)**	**(0.08)**	**(0.01)**	**(0.01)**	**0.02**	**(0.08)**	**(0.02)**	**0.04**	**0.04**	**0.08**	**0.15**	**0.33**
Diluted shares outstanding	19,158	20,209	19,254	18,161	18,060	18,049	18,150	18,200	18,115	18,200	18,250	18,400	18,500	18,338	18,750

Margin Analysis															
Product Gross Margin	68.2%	70.8%	67.7%	63.7%	54.5%	56.5%	56.2%	59.5%	56.8%	57.2%	60.9%	61.7%	63.8%	61.1%	64.7%
Royalty Gross Margin	60.0%	60.0%	60.0%	60.0%	60.0%	60.0%	60.0%	60.0%	60.0%	60.0%	60.0%	60.0%	60.0%	60.0%	60.0%
Overall Gross Margin	69.9%	69.1%	68.8%	66.4%	60.3%	61.6%	61.4%	63.7%	61.8%	60.9%	63.6%	64.2%	65.8%	63.7%	66.5%
R&D as % of total revenues	14.9%	11.1%	13.5%	20.2%	25.6%	20.5%	20.5%	19.0%	21.3%	18.0%	17.0%	17.5%	16.0%	17.1%	15.5%
S&M as % of total revenues	22.6%	17.8%	20.1%	26.6%	31.9%	31.5%	30.6%	30.0%	31.0%	31.4%	29.8%	29.8%	28.2%	29.7%	29.0%
G&A as a % of total revenues	10.4%	6.0%	14.1%	23.4%	19.6%	14.9%	14.9%	13.9%	15.8%	14.1%	12.9%	12.7%	11.6%	12.8%	12.0%
Operating margin	22.0%	34.2%	21.1%	(3.9%)	(16.8%)	(5.2%)	(4.7%)	0.8%	(6.3%)	(2.6%)	3.9%	4.1%	9.9%	4.2%	10.0%
EBITDA	24.7%	34.9%	22.0%	3.7%	(10.1%)	1.2%	2.8%	7.3%	2.0%	5.3%	9.7%	10.2%	15.6%	11.8%	16.7%
Tax Rate	2.6%	(10.4%)	38.0%	(17.0%)	38.3%	8.4%	38.0%	38.0%	34.7%	38.0%	38.0%	38.0%	38.0%	45.4%	38.0%
Net	22.9%	41.9%	16.6%	(0.1%)	(9.7%)	(1.6%)	(0.8%)	2.2%	(2.3%)	(2.0%)	4.2%	4.3%	7.8%	3.8%	7.8%
YoY Growth Rates															
Revenues	-	66.2%	(2.2%)	(29.3%)	(36.4%)	(34.9%)	(37.7%)	(6.1%)	(30.4%)	8.7%	15.8%	17.4%	19.8%	15.5%	12.5%
Net Income	-	203.5%	(61.3%)	(100.3%)	40.8%	(132.1%)	(121.4%)	(186.0%)	1989.7%	(77.9%)	(399.7%)	(700.2%)	316.1%	(288.6%)	128.6%
Adjusted EPS	-	45.7%	1.6%	(101.5%)	(16.8%)	(120.1%)	(117.5%)	(159.1%)	291.2%	(78.1%)	(396.4%)	(692.0%)	309.3%	(284.5%)	124.8%
Seq. Growth Rates															
Revenues	-	-	-	-	(14.9%)	2.7%	0.2%	7.3%	-	(1.6%)	9.4%	1.5%	9.6%	-	-
Net Income	-	-	-	-	236.7%	(82.8%)	(47.8%)	(383.6%)	-	(186.3%)	(334.3%)	4.6%	96.6%	-	-
Adjusted EPS	-	-	-	-	133.0%	(82.7%)	(48.1%)	(382.8%)	-	(186.3%)	(333.6%)	3.8%	95.5%	-	-

October 16, 2009

Source: Canaccord Adams and Company Documents

Source: Company reports and Canaccord Adams estimates

Figure 3: Palomar Medical revenue mix

PALOMAR MEDICAL revenue mix

Anup Mehta - Canaccord Adams - 847-864-1139

($ in 000's)	2005	2006	2007	2008	Q1/09	Q2/09	Q3/09E	Q4/09E	2009E	Q1/10E	Q2/10E	Q3/10E	Q4/10E	2010E	2011E
Laser revenues	60,095	83,686	92,001	55,439	8,032	8,135	8,138	9,354	33,658	9,237	10,738	10,579	12,160	42,713	49,120
Consumer revenues												86	195	281	869
Customer Service	5,730	8,537	11,220	13,940	3,442	3,986	3,867	3,790	15,085	3,717	3,787	3,790	3,979	15,273	16,037
Total product revenues	*65,824*	*92,223*	*103,221*	*69,379*	*11,474*	*12,121*	*12,005*	*13,143*	*48,743*	*12,954*	*14,525*	*14,455*	*16,334*	*58,267*	66,026
Royalty revenue	4,921	30,481	13,005	10,520	1,493	1,275	1,417	1,380	5,565	1,717	1,644	1,983	1,794	7,139	8,210
Funded product development revenue	5,408	3,840	6,698	2,434	431	398	400	400	1,630	400	400	400	400	1,600	1,600
Other revenues	0	0	894	5,248	1,250	1,250	1,250	1,250	5,000	1,250	1,250	1,250	1,250	5,000	5,000
Total revenues	**76,154**	**126,544**	**123,819**	**87,581**	**14,648**	**15,044**	**15,072**	**16,173**	**60,937**	**15,071**	**16,569**	**16,838**	**18,528**	**72,006**	**80,835**
Geographic Distribution															
US	46,735	67,255	64,106	40,800	5,209	5,915	5,882	6,572	23,578	6,606	7,553	7,517	8,657	30,333	35,654
% sales	*71%*	*73%*	*62%*	*59%*	*45%*	*49%*	*49%*	*50%*	*48%*	*51%*	*52%*	*52%*	*53%*	*52%*	*54%*
International	21,722	22,313	39,115	28,667	6,265	6,206	6,123	6,572	25,165	6,347	6,972	6,794	7,350	27,463	30,372
% sales	*33%*	*24%*	*38%*	*41%*	*55%*	*51%*	*51%*	*50%*	*52%*	*49%*	*48%*	*47%*	*45%*	*47%*	*46%*
YoY Growth															
Laser revenues	-	39.3%	9.9%	(39.7%)	(43.3%)	(47.9%)	(48.5%)	(5.0%)	(39.3%)	15.0%	32.0%	30.0%	30.0%	26.9%	15.0%
Consumer revenues												-	-	-	208.9%
Customer Service	-	49.0%	31.4%	24.2%	(2.0%)	11.0%	13.0%	11.0%	8.2%	8.0%	(5.0%)	(2.0%)	5.0%	1.2%	5.0%
Total product revenues	-	40.1%	11.9%	(32.8%)	(35.1%)	(36.9%)	(37.6%)	(0.9%)	(29.7%)	12.9%	19.8%	20.4%	24.3%	19.5%	13.3%
Royalty revenue	-	519.4%	(57.3%)	(19.1%)	(54.0%)	(43.8%)	(49.0%)	(38.0%)	(47.1%)	15.0%	29.0%	40.0%	30.0%	28.3%	15.0%
Funded product development revenue	-	(29.0%)	74.4%	(63.7%)	(27.7%)	0.0%	(58.1%)	(17.4%)	(33.1%)	(7.2%)	0.4%	0.0%	0.0%	(1.8%)	0.0%
Other revenues	-	NA	NA	486.9%	(16.5%)	0.0%	0.0%	0.0%	(4.7%)	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Total revenues	-	66.2%	(2.2%)	(29.3%)	(36.4%)	(34.9%)	(37.7%)	(6.1%)	(30.4%)	2.9%	10.1%	11.7%	14.6%	18.2%	12.3%
Domestic	-	43.9%	(4.7%)	(36.4%)	(47.4%)	(51.1%)	(44.4%)	(20.1%)	(42.2%)	26.8%	27.7%	27.8%	31.7%	28.6%	17.5%
International	-	2.7%	75.3%	(26.7%)	(20.4%)	(12.7%)	(29.2%)	30.4%	(12.2%)	1.3%	12.3%	11.0%	11.8%	9.1%	10.6%
QoQ Growth															
Laser revenues	-	-	-	-	(18.4%)	1.3%	0.0%	14.9%	-	(1.3%)	16.3%	(1.5%)	14.9%	-	-
Consumer revenues												-	126.1%	-	-
Customer Service	-	-	-	-	0.8%	15.8%	(3.0%)	(2.0%)	-	(1.9%)	1.9%	0.1%	5.0%	-	-
Total product revenues	-	-	-	-	(13.5%)	5.6%	(1.0%)	9.5%	-	(1.4%)	12.1%	(0.5%)	13.0%	-	-
Royalty revenue	-	-	-	-	(32.9%)	(14.7%)	11.1%	(2.6%)	-	24.4%	(4.3%)	20.6%	(9.5%)	-	-
Funded product development revenue	-	-	-	-	(11.0%)	(7.6%)	0.4%	0.0%	-	0.0%	0.0%	0.0%	0.0%	-	-
Other revenues	-	-	-	-	0.0%	0.0%	0.0%	0.0%	-	0.0%	0.0%	0.0%	0.0%	-	-
Total revenues	-	-	-	-	(14.9%)	2.7%	0.2%	7.3%	-	(6.8%)	9.9%	1.6%	10.0%	-	-
Domestic	-	-	-	-	(36.6%)	13.6%	(0.6%)	11.7%	-	0.5%	14.3%	(0.5%)	15.2%	-	-
International	-	-	-	-	24.3%	(0.9%)	(1.3%)	7.3%	-	(3.4%)	9.8%	(2.6%)	8.2%	-	-

October 16, 2009

Source: Canaccord Adams and Company Documents

Source: Company reports and Canaccord Adams estimates

INVESTMENT RISKS

Results are susceptible to macroeconomic factors

Palomar Medical's business is highly dependent on macroeconomic factors such as unemployment, consumer confidence, and the availability of credit. As has been witnessed since the H2/08, a depressed economy directly impacts the company's ability to generate sales and negatively impacts earnings and cash flows. Negative pressures for any or all of these growth factors within any of the geographies in which Palomar operates could impact the company's performance.

High level of competition within laser industry

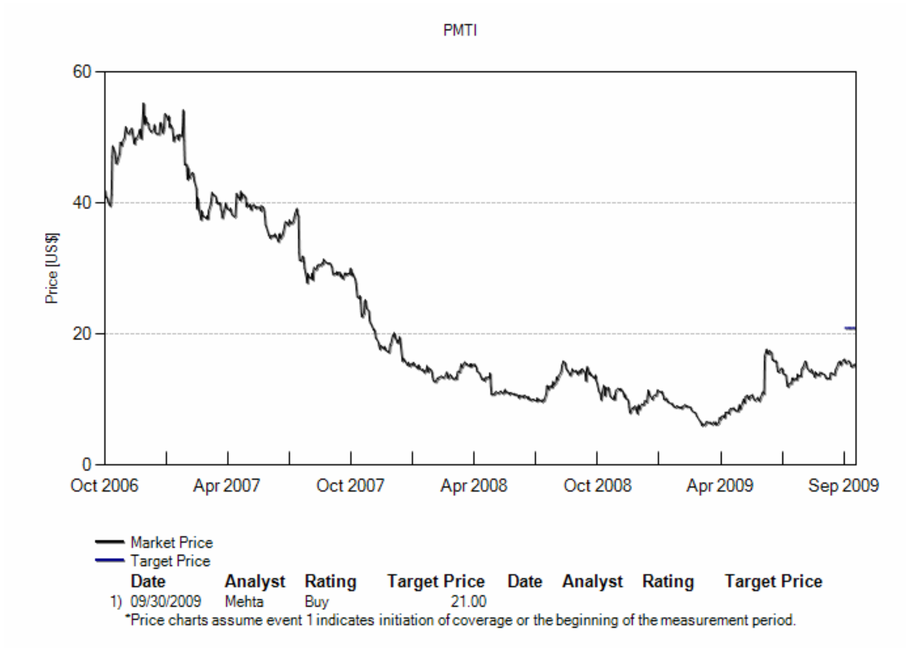
Palomar Medical operates in a fast growing segment of the aesthetic medicine industry where there are a number of players constantly developing new enhancements to laser technology. If Palomar is unable to stay at the forefront of product development, the company may be unable to compete for new business or retain its existing customer base.

APPENDIX: IMPORTANT DISCLOSURES

Analyst Certification: Each authoring analyst of Canaccord Adams whose name appears on the front page of this investment research hereby certifies that (i) the recommendations and opinions expressed in this investment research accurately reflect the authoring analyst's personal, independent and objective views about any and all of the designated investments or relevant issuers discussed herein that are within such authoring analyst's coverage universe and (ii) no part of the authoring analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by the authoring analyst in the investment research.

Site Visit: An analyst has visited the issuer's material operations in Burlington, Massachusetts. No payment or reimbursement was received from the issuer for the related travel costs.

Price Chart:*



Distribution of Ratings:
Global Stock Ratings
(as of 1 October 2009)

	Coverage Universe		IB Clients
Rating	#	%	%
Buy	369	56.5%	26.6%
Speculative Buy	70	10.7%	45.7%
Hold	190	29.1%	14.2%
Sell	24	3.7%	4.2%
	653	100.0%	

Canaccord Ratings System:

BUY: The stock is expected to generate risk-adjusted returns of over 10% during the next 12 months.
HOLD: The stock is expected to generate risk-adjusted returns of 0-10% during the next 12 months.
SELL: The stock is expected to generate negative risk-adjusted returns during the next 12 months.
NOT RATED: Canaccord Adams does not provide research coverage of the relevant issuer.

"Risk-adjusted return" refers to the expected return in relation to the amount of risk associated with the designated investment or the relevant issuer.

Risk Qualifier: **SPECULATIVE:** Stocks bear significantly higher risk that typically cannot be valued by normal fundamental criteria. Investments in the stock may result in material loss.

Canaccord Adams Research Disclosures as of 16 October 2009

Company	Disclosure
Palomar Medical Technologies	**5, 7**

1	The relevant issuer currently is, or in the past 12 months was, a client of Canaccord Adams or its affiliated companies. During this period, Canaccord Adams or its affiliated companies provided the following services to the relevant issuer: A. investment banking services. B. non-investment banking securities-related services. C. non-securities related services.
2	In the past 12 months, Canaccord Adams or its affiliated companies have received compensation for Corporate Finance/Investment Banking services from the relevant issuer.
3	In the past 12 months, Canaccord Adams or any of its affiliated companies have been lead manager, co-lead manager or co-manager of a public offering of securities of the relevant issuer or any publicly disclosed offer of securities of the relevant issuer or in any related derivatives.
4	Canaccord Adams acts as corporate broker for the relevant issuer and/or Canaccord Adams or any of its affiliated companies may have an agreement with the relevant issuer relating to the provision of Corporate Finance/Investment Banking services.
5	Canaccord Adams or any of its affiliated companies is a market maker or liquidity provider in the securities of the relevant issuer or in any related derivatives.
6	In the past 12 months, Canaccord Adams, its partners, affiliated companies, officers or directors, or any authoring analyst involved in the preparation of this investment research has provided services to the relevant issuer for remuneration, other than normal course investment advisory or trade execution services.
7	Canaccord Adams intends to seek or expects to receive compensation for Corporate Finance/Investment Banking services from the relevant issuer in the next six months.
8	The authoring analyst, a member of the authoring analyst's household, or any individual directly involved in the preparation of this investment research, has a long position in the shares or derivatives, or has any other financial interest in the relevant issuer, the value of which increases as the value of the underlying equity increases.
9	The authoring analyst, a member of the authoring analyst's household, or any individual directly involved in the preparation of this investment research, has a short position in the shares or derivatives, or has any other financial interest in the relevant issuer, the value of which increases as the value of the underlying equity decreases.
10	Those persons identified as the author(s) of this investment research, or any individual involved in the preparation of this investment research, have purchased/received shares in the relevant issuer prior to a public offering of those shares, and such person's name and details are disclosed above.
11	A partner, director, officer, employee or agent of Canaccord Adams and its affiliated companies, or a member of his/her household, is an officer, or director, or serves as an advisor or board member of the relevant issuer and/or one of its subsidiaries, and such person's name is disclosed above.
12	As of the month end immediately preceding the date of publication of this investment research, or the prior month end if publication is within 10 days following a month end, Canaccord Adams or its affiliate companies, in the aggregate, beneficially owned 1% or more of any class of the total issued share capital or other common equity securities of the relevant issuer or held any other financial interests in the relevant issuer which are significant in relation to the investment research (as disclosed above).
13	As of the month end immediately preceding the date of publication of this investment research, or the prior month end if publication is within 10 days following a month end, the relevant issuer owned 1% or more of any class of the total issued share capital in Canaccord Adams or any of its affiliated companies.
14	Other specific disclosures as described above.

Canaccord Adams is the business name used by certain subsidiaries of Canaccord Capital Inc., including Canaccord Adams Inc., Canaccord Adams Limited, and Canaccord Adams, a division of Canaccord Capital Corporation.

The authoring analysts who are responsible for the preparation of this investment research are employed by Canaccord Adams, a securities broker-dealer with principal offices located in Vancouver, Calgary, Toronto, Montreal (all Canada), Boston, New York, San Francisco (all US) and London (UK).

In the event that this is compendium investment research (covering six or more relevant issuers), Canaccord Adams and its affiliated companies may choose to provide specific disclosures of the subject companies by reference, as well as its policies and procedures regarding the dissemination of investment research. To access this material or for more information, please send a request to Canaccord Adams Research, Attn: Disclosures, P.O. Box 10337 Pacific Centre, 2200-609 Granville Street, Vancouver, BC, Canada V7Y 1H2 or disclosures@canaccordadams.com.

The authoring analysts who are responsible for the preparation of this investment research have received (or will receive) compensation based upon (among other factors) the Corporate Finance/Investment Banking revenues and general profits of Canaccord Adams. However, such authoring analysts have not received, and will not receive, compensation that is directly based upon or linked to one or more specific Corporate

Finance/Investment Banking activities, or to recommendations contained in the investment research.

Canaccord Adams and its affiliated companies may have a Corporate Finance/Investment Banking or other relationship with the company that is the subject of this investment research and may trade in any of the designated investments mentioned herein either for their own account or the accounts of their customers, in good faith or in the normal course of market making. Accordingly, Canaccord Adams or their affiliated companies, principals or employees (other than the authoring analyst(s) who prepared this investment research) may at any time have a long or short position in any such designated investments, Related designated investments or in options, futures or other derivative instruments based thereon.

Some regulators require that a firm must establish, implement and make available a policy for managing conflicts of interest arising as a result of publication or distribution of investment research. This investment research has been prepared in accordance with Canaccord Adams' policy on managing conflicts of interest, and information barriers or firewalls have been used where appropriate. Canaccord Adams' policy is available upon request.

The information contained in this investment research has been compiled by Canaccord Adams from sources believed to be reliable, but (with the exception of the information about Canaccord Adams) no representation or warranty, express or implied, is made by Canaccord Adams, its affiliated companies or any other person as to its fairness, accuracy, completeness or correctness. Canaccord Adams has not independently verified the facts, assumptions, and estimates contained herein. All estimates, opinions and other information contained in this investment research constitute Canaccord Adams' judgement as of the date of this investment research, are subject to change without notice and are provided in good faith but without legal responsibility or liability.

Canaccord Adams salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to our clients and our proprietary trading desk that reflect opinions that are contrary to the opinions expressed in this investment research. Canaccord Adams' affiliates, proprietary trading desk, and investing businesses may make investment decisions that are inconsistent with the recommendations or views expressed in this investment research.

This investment research is provided for information purposes only and does not constitute an offer or solicitation to buy or sell any designated investments discussed herein in any jurisdiction where such offer or solicitation would be prohibited. As a result, the designated investments discussed in this investment research may not be eligible for sale in some jurisdictions. This investment research is not, and under no circumstances should be construed as, a solicitation to act as a securities broker or dealer in any jurisdiction by any person or company that is not legally permitted to carry on the business of a securities broker or dealer in that jurisdiction. This material is prepared for general circulation to clients and does not have regard to the investment objectives, financial situation or particular needs of any particular person. Investors should obtain advice based on their own individual circumstances before making an investment decision. To the fullest extent permitted by law, none of Canaccord Adams, its affiliated companies or any other person accepts any liability whatsoever for any direct or consequential loss arising from or relating to any use of the information contained in this investment research.

For Canadian Residents: This Investment Research has been approved by Canaccord Adams, a division of Canaccord Capital Corporation, which accepts responsibility for this Investment Research and its dissemination in Canada. Canadian clients wishing to effect transactions in any Designated Investment discussed should do so through a qualified salesperson of Canaccord Adams, a division of Canaccord Capital Corporation in their particular jurisdiction.

For United Kingdom Residents: This investment research complies with the Financial Services Authority's Handbook chapter on Conduct of Business and is approved by Canaccord Adams Limited, which is authorized and regulated by the Financial Services Authority, in connection with its distribution in the United Kingdom. This material is not for distribution in the United Kingdom to retail clients, as defined under the rules of the Financial Services Authority. Canaccord Adams Limited accepts responsibility for this investment research and its dissemination in the United Kingdom. The information contained in this investment research is only intended for distribution in the UK to persons who qualify as professional clients or eligible counterparties, as defined under the rules of the Financial Services Authority.

For United States Residents: Canaccord Adams Inc., a US registered broker-dealer, accepts responsibility for this Investment Research and its dissemination in the United States. This Investment Research is intended for distribution in the United States only to certain US institutional investors. US clients wishing to effect transactions in any Designated Investment discussed should do so through a qualified salesperson of Canaccord Adams Inc.

For European Residents: If this Investment Research is intended for disclosure in any jurisdiction other than the United Kingdom, the US or Canada, then the relevant rules and regulatory requirements of that jurisdiction will apply.

Additional information is available on request.

Copyright © Canaccord Adams, a division of Canaccord Capital Corporation 2009. – Member IIROC/CIPF

Copyright © Canaccord Adams Limited 2009. – Member LSE, authorized and regulated by the Financial Services Authority.
Copyright © Canaccord Adams Inc. 2009. – Member FINRA/SIPC
All rights reserved. All material presented in this document, unless specifically indicated otherwise, is under copyright to Canaccord Adams, a division of Canaccord Capital Corporation, Canaccord Adams Limited, and Canaccord Adams Inc. None of the material, nor its content, nor any copy of it, may be altered in any way, or transmitted to or distributed to any other party, without the prior express written permission of the entities listed above.