

July 7, 2009

**This Morning's Highlights**

**PMTI:** Laser Aesthetics Not Likely to Recover Soon; Post-Approval Development of Home-Use Product Will Likely Take Longer than Expected; Initiating Coverage with Sell Rating, \$11 Target Price

**HNSN:** Hansen Pre-announces a Miss as the Capital Equipment Debacle Continues to Unfold; Downgrading to Hold

**China Internet, Media, and Software:** China Online Games Bi-Weekly

**WTR:** Adjusting Estimates; Reiterating Buy Rating

**Palomar Medical Technologies, Inc.****PMTI \$13.82****Initiating Coverage at Sell/Target Price: \$11**

**Laser Aesthetics Not Likely to Recover Soon; Post-Approval Development of Home-Use Product Will Likely Take Longer than Expected; Initiating Coverage with Sell Rating, \$11 Target Price**

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EPS	Mar	Jun	Sep	Dec	FY	P/E	FY Rev. (mm)
FY08	\$(0.05)	\$0.04	\$0.03	\$(0.12)	\$0.00	NM	\$87.6
FY09	\$(0.08)A	\$(0.04)	\$(0.04)	\$(0.03)	\$(0.19)	NM	\$59.1
FY10	\$(0.02)	\$0.03	\$0.04	\$0.06	\$0.16	88.2x	\$68.2

Price	\$13.82
52-Week High/Low	\$18.94 - 5.83
Shares Outstanding (mm)	18.04
Market Cap. (mm)	\$249.33
Average Daily Volume (mm)	0.61

**Investment Summary**

Shares of Palomar Medical have experienced a recent run due to the FDA approval of a home-use product developed in partnership with J&J. While this is a positive in the long run, we believe the lack of newsflow and the inherently weak fundamentals in the aesthetic hardware sector will be a disappointment to investors in the near term. We are initiating coverage with a Sell rating and an \$11 target price, which is based on a 1x EV/S multiple – a multiple that is still a 100% premium to its peer group.

**Discussion**

- **Palomar Medical is one of many companies that sell medical aesthetic equipment to dermatologists, plastic surgeons, other physicians or med-spas.** In recent quarters the company, along with its peers, has suffered dramatically from the economic downturn as the credit crunch made it impossible for customers to get leases, and decreased consumer spending made the ROI on aesthetic equipment simply untenable for all but the most financially stable physicians.
- **Laser-aesthetic companies not likely to benefit from recent increases in foot traffic.** We believe that the biological and injectable dermal fillers have benefited from a recent spike in foot traffic commensurate with “pre-summer” seasonality typical of the aesthetic market. However, given the uncertainty of the longer-term economic recovery, we do not believe that physicians have become less conservative in their hardware purchasing decisions. *We expect second quarter results to disappoint, but given the mitigated expectations, this may not be a negative catalyst for the stock.*
- **Home-use devices not likely to launch in 2009, in our view, and newsflow could be lacking.** Recently, the stock experienced a substantial surge due to the approval of a wrinkle-reduction product developed alongside J&J. Although we view this as a positive in the long run, we do not believe the approval will result in meaningful revenues and earnings in 2009 or 2010. We believe the lack of newsflow around the product will weigh on the stock and bring its valuation more in line with its peers. Other companies like Cynosure (CYNO \$7.12, Not Rated) and Syneron (ELOS \$6.74, Not Rated) also have partnerships in this space, so the company is likely to face increasing competition.

- **Valuation and rating.** The company has \$6.78/share in cash. Shares of Palomar are trading at 2.3x EV/S based on our FY10 sales estimate of \$68 million, while its peers are trading at 0.4x EV/S. Shares of Palomar have always traded at a slight premium, but even if we value the stock at 1x EV/S, the shares are only worth \$11 at best. Hence, while we do have an overall favorable outlook on the aesthetic space and on Palomar on a longer-term basis, we are initiating coverage with a Sell rating and an \$11 target price. We consider some of the other more devalued laser stocks with a more positive bias.

## Hansen Medical, Inc.

HNSN \$4.73

### Hansen Pre-announces a Miss as the Capital Equipment Debacle Continues to Unfold; Downgrading to Hold

Hold (from Buy)/Target Price: NA (from \$8)

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EPS	Mar	Jun	Sep	Dec	FY	P/E	FY Rev. (mm)
FY08	\$(0.53)	\$(0.61)	\$(0.48)	\$(0.59)	\$(2.14)	NM	\$30.13
FY09	\$(0.45)A	\$(0.47)	\$(0.41)	\$(0.40)	\$(1.69)	NM	\$20.56
<i>Prior</i>	<i>\$(0.57)</i>	<i>\$(0.41)</i>	<i>\$(0.37)</i>	<i>\$(0.35)</i>	<i>\$(1.57)</i>	-	-
FY10	-	-	-	-	\$(1.67)	NM	\$30.91
<i>Prior</i>	-	-	-	-	\$(1.40)	-	-

Price	\$4.73
52-Week High/Low	\$20.20 - 2.65
Shares Outstanding (mm)	37.27
Market Cap. (mm)	\$176.28
Average Daily Volume (mm)	0.26

#### Investment Summary

- **Hansen Medical announced a substantial miss relative to guidance.** After the close yesterday the company announced that it had only shipped six systems during the second quarter, recognizing revenue on only three of these systems. The six systems shipped were half of what we were expecting. Interestingly, only *one* of the six systems was shipped to a U.S. facility while two of the systems for which the company recognized revenues were shipped to St. Jude demonstration sites.
- **Artisan utilization down, again.** The company sold approximately 629 Artisan catheters during the quarter, also less than our roughly 700-unit estimate. Utilization declined to 9.3 catheters per quarter from 11, which poses a longer-term problem in our view. Actual utilization is likely lower than 9.3, given that 100 of the catheters were bought by a single European institution.
- **Tight credit markets and general market conditions still at fault.** Management blamed customers' need for more approvals and alternative financing as the primary culprits for the shortfall. Both these items extended the sales cycle for the company.
- **Hansen withdrawing guidance, for now.** Management noted its intention to reinstate guidance during the second quarter call; however, we doubt whether any such guidance can be meaningful given the rapid changes that the company cannot foresee.
- **Intuitive's numbers at risk.** While Intuitive's da Vinci is arguably a substantially more mature product, the overall equipment market remains quite at risk, and we remain cautious on our outlook for Intuitive (ISRG \$156.09, Hold) as we get closer to the quarter. Intuitive reports results on July 22.
- **Reducing estimates and downgrading to Hold.** We are reducing our FY09 and FY10 revenue estimates to \$20.5 million and \$30.9 million, respectively, down from \$34.6 million and \$55 million, respectively. Net losses for the same periods are \$(1.69) and \$(1.67), but we are likely to revise these again once the company announces its cost-cutting strategies. The company has approximately \$2/share in cash and no debt, but at this point we would suspect another round of fundraising will be necessary early next year.

## China Internet, Media, and Software

CYOU, GA, GIGM, NCTY, NTES, PWRD, SNDA

## China Online Games Bi-Weekly

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Company	Ticker	Rating	Price	Target	09E EPS / (P/E)	10E EPS / (P/E)
Changyou.com Limited	CYOU	Buy	\$39.84	\$47.00	\$2.92 (13.6x)	\$3.59 (11.1x)
Giant Interactive Group, Inc.	GA	Hold	\$7.89	NA	\$0.57 (13.8x)	\$0.65 (12.1x)
GigaMedia, Ltd.	GIGM	Hold	\$5.48	NA	\$0.37 (14.8x)	\$0.56 (9.8x)
The9 Ltd.	NCTY	Hold	\$9.32	NA	\$-0.07 (NA)	\$-1.29 (NA)
NetEase.com, Inc.	NTES	Buy	\$33.91	\$43.00	\$2.05 (16.5x)	\$3.08 (11.0x)
Perfect World Co., Ltd	PWRD	Buy	\$28.76	\$37.00	\$2.25 (12.8x)	\$2.42 (11.9x)
Shanda Interactive Entertainment Ltd.	SNDA	Hold	\$54.00	NA	\$3.40 (15.9x)	\$4.25 (12.7x)

## Investment Summary

- Entering seasonally stronger time.** As university exams have been winding down over the past one to two weeks, we would expect to see game usage pick up across the board during July and August on strong seasonality around the summer break. We would expect to see an uptick in promotions from the major operators and active releases of new expansion packs.
- Changyou: TLBB keeps up the momentum.** TLBB was able to maintain growth over the last two weeks despite the drag from student exams, and the game is getting a new expansion pack on July 8. Given the company's previous record, we would expect to see a pickup in the user growth rate immediately following the expansion pack release. In addition, Changyou has recently expanded the number of testing servers for *Duke of Mountain Deer* from one to two, which at this early stage suggests the company is receiving positive gamer feedback and is progressing towards the open beta.
- Perfect World: Content seems to be flattening.** We are seeing some flattening in the "base content" of Perfect World and some leveling off in the momentum in *BOI*. At the same time, the company has stepped up the pace of its promotional activities, which historically yields higher ARPU that compensates for some declines in ACU. Further, *Battle of the Immortals* seems to be leveling off at a pretty high level, and we believe the company remains well positioned entering 3Q09. As a reminder, recognizing the need for content, the company is working towards the launch *Fantasy Zhu Xian* and a major expansion pack for the traditional *Zhu Xian* sometime in late 3Q09.
- NetEase: Total portfolio looks stable, all eyes on WoW.** The majority of the company's titles, including *Fantasy Westward Journey*, *Westward Journey 2 & 3*, and *New Fly For Fun* seem to be either stable or showing some signs of growth. More importantly for the stock, while the *WoW* launch date is yet to be determined, *battle.net* has been released for user registration. The company also started compensating *WoW* players that signed for a *battle.net* account with free minutes. Based on our own experience, gamers appear to be getting about 3,600 free minutes as compensation for the interruption of *WoW* in China. We estimate that translates into about 20 days of actual playtime for an average *WoW* player. To be fair, we believe continued uncertainty over the actual launch date for *WoW* may keep a short-term lid on the stock.
- Shanda: AION growth stalled.** We believe the growth of *AION* has stalled as indicated by its flattish server counts and decreasing download numbers. We suspect the primary cause of this stagnation is due to widespread and heavily implemented cheating codes and programs which are typical for Korean games in China. Several gaming companies suggested that by now the game appears to have flopped. Additionally, given the expected 2H09 launches of major game titles, including *JX3* and *WoW*, we believe the competitive landscape will only worsen for *AION*. At the same time, Shanda's casual game, *Maple Story*, has been showing some momentum and, following the release of an expansion pack, the downloads increased noticeably.

**Aqua America, Inc.**

WTR \$17.45

**Adjusting Estimates; Reiterating Buy Rating**

Buy/Target Price: \$26

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EPS	Mar	Jun	Sep	Dec	FY	P/E	FY Rev. (mm)
FY08	\$0.11	\$0.17	\$0.26	\$0.19	\$0.73	24.0x	\$626.97
FY09	\$0.14A	\$0.18	\$0.29	\$0.24	\$0.85	20.7x	\$693.63
<i>Prior</i>	-	<i>\$0.19</i>	-	-	<i>\$0.86</i>	-	-
FY10	\$0.18	\$0.22	\$0.30	\$0.26	\$0.96	18.2x	\$735.25

Price	\$17.45
52-Week High/Low	\$22.00 - 12.20
Shares Outstanding (mm)	135.65
Market Cap. (mm)	\$2,469.93
Average Daily Volume (mm)	0.82

**Investment Summary**

We are lowering our 2Q09 EPS estimate from \$0.19 to \$0.18 for Aqua America. The average rainfall in the quarter in Pennsylvania and New Jersey (which combined accounted for 58% of revenue in 2008) was higher than expected in the quarter, and we have adjusted our estimates accordingly. Our new 2009 EPS estimate has dropped from \$0.86 to \$0.85, and our 2010 EPS remains at \$0.96. We consider the changes insignificant from a valuation perspective.

Weather effects aside, we still believe Aqua America stands to benefit from additional rate cases to be settled on a go-forward basis, and also from tuck-in acquisitions. We remain positive on Aqua's future prospects for earnings growth, and continue to recommend share accumulation at current levels. We are reiterating our Buy rating and \$26 target price, based on a P/E multiple of 28x our 2010 EPS estimate of \$0.96.

### Important Disclosures

#### Ratings and Target Price History

For historical rating and target price information please use the following links:

CYOU: [http://www2.investars.com/cgi-bin/charts/\\_nasdaq.exe?f=1&s=CYOU&analystid=93&re=1&width=500&height=350&wmf=1](http://www2.investars.com/cgi-bin/charts/_nasdaq.exe?f=1&s=CYOU&analystid=93&re=1&width=500&height=350&wmf=1)

GA: [http://www2.investars.com/cgi-bin/charts/\\_nasdaq.exe?f=1&s=GA&analystid=93&re=1&width=500&height=350&wmf=1](http://www2.investars.com/cgi-bin/charts/_nasdaq.exe?f=1&s=GA&analystid=93&re=1&width=500&height=350&wmf=1)

GIGM: [http://www2.investars.com/cgi-bin/charts/\\_nasdaq.exe?f=1&s=GIGM&analystid=93&re=1&width=500&height=350&wmf=1](http://www2.investars.com/cgi-bin/charts/_nasdaq.exe?f=1&s=GIGM&analystid=93&re=1&width=500&height=350&wmf=1)

HNSN: [http://www2.investars.com/cgi-bin/charts/\\_nasdaq.exe?f=1&s=HNSN&analystid=93&re=1&width=500&height=350&wmf=1](http://www2.investars.com/cgi-bin/charts/_nasdaq.exe?f=1&s=HNSN&analystid=93&re=1&width=500&height=350&wmf=1)

ISRG: [http://www2.investars.com/cgi-bin/charts/\\_nasdaq.exe?f=1&s=ISRG&analystid=93&re=1&width=500&height=350&wmf=1](http://www2.investars.com/cgi-bin/charts/_nasdaq.exe?f=1&s=ISRG&analystid=93&re=1&width=500&height=350&wmf=1)

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PMTI: [http://www2.investars.com/cgi-bin/charts/\\_nasdaq.exe?f=1&s=PMTI&analystid=93&re=1&width=500&height=350&wmf=1](http://www2.investars.com/cgi-bin/charts/_nasdaq.exe?f=1&s=PMTI&analystid=93&re=1&width=500&height=350&wmf=1)

PWRD: [http://www2.investars.com/cgi-bin/charts/\\_nasdaq.exe?f=1&s=PWRD&analystid=93&re=1&width=500&height=350&wmf=1](http://www2.investars.com/cgi-bin/charts/_nasdaq.exe?f=1&s=PWRD&analystid=93&re=1&width=500&height=350&wmf=1)

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All prices are as of the market close on 7/6/2009.

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#### Brean Murray, Carret & Co. Stock Rating System

Buy - Expected to appreciate by at least 10% within the next 12 months.

Hold - Fully valued, not expected to appreciate or decline materially within the next 12 months.

Sell - Expected to decline by at least 10% within the next 12 months.

	# of Securities	% of Total Securities	# of IB-Related Securities in Past 12 mos.	% of Total Securities
BUY	97	59.88%	11	11.34%
HOLD	53	32.72%	0	0%
SELL	10	6.17%	0	0%
NOT RATED	2	1.23%	0	0%
<b>TOTAL</b>	<b>162</b>			

Note : Stock price volatility may cause temporary non-alignment of some ratings with some target prices.

### Valuation Methodology and Risks

**Changyou.com Ltd. (CYOU):** Our \$47 target price is based on the shares trading at 13x our FY10 EPS forecast. Risks to the achievement of our target price include rising competition, high dependence on a single game, significant risk associated with game launches, and rising compensation levels in the industry.

**NetEase.com (NTES):** Our \$43 target price is based on 14x our FY10 EPS forecast, using the upper end of the historical trading multiple range. Risks to the achievement of our target price include significant revenue dependency on one game, potential delays in game launches, potential failure to diversify the games pipeline, higher corporate income tax in China, and potential for increased government regulations.

**Perfect World Co. (PWRD):** Our \$37 target price is based on the shares trading at a group average 12x our FY10 pro-forma EPADS forecast. Risks to the achievement of our target price include increased potential for government regulations, dependence on a single geography, meaningful revenue concentration around a single game, potential failure of the upcoming games and operating margin from increased competition in the industry.

**Aqua America, Inc. (WTR):** Our \$26 target price is based on a P/E multiple of 28x our 2010 EPS estimate of \$0.96. Risks to the achievement of our target price include weather, acquisition integration, interest rates, environmental / public health responsibilities and regulatory climate.

**Palomar Medical Technologies (PMTI):** Shares of Palomar are trading at 2.3x EV/S based on our FY10 sales estimate of \$68 million, while its peers are trading at 0.4x EV/S. Shares of Palomar have always traded at a slight premium, but even if we value the stock at 1x EV/S, the shares are only worth \$11 at best. Risks to the achievement of our target price include (1) conservative revenue expectations; (2) the company deciding to provide regular updates about its home-use devices; and (3) an increase in consumer spending or a steady resurgence in the aesthetic markets.

### Analyst Certification

We, Jose Haresco, Ph.D., Andrey Glukhov, CFA, Kyle Zilles, Michael Gaugler and Christopher Noon, hereby certify that the views expressed in this research report accurately reflect our personal views about any and all of the subject securities or issuers referred to in this document. The analyst and associate analyst further certify that they have not received and will not be receiving direct or indirect compensation in exchange for expressing the recommendation contained in this publication.

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