

PhotoMedex (PHMD): No!no! doesn't cut it

Would've. Could've. Definitely should've. Those words ring in investors' ears just after PhotoMedex's (Nasdaq: [PHMD](#)) bungled earnings report. But there's a lot more to this story as the company faces ongoing challenges.

Here are highlights from issues TheStreetSweeper has exposed about the company whose main product is the no!no! device that removes body hair with a hot wire device:

***Japan's no!no! revenue no more.** Ax falls on potentially \$43 million-plus worth of product.

***Flawed stock buyback program.** Insiders benefit.

***Food and Drug Administration reportable events, plus a quiet recall.** Events include a fire that apparently ignited inside a patient's throat.

***Lawsuits.** With a federal lawsuit loss behind it, additional litigation possibilities loom.

***Reason to sell.** Key company product is fading.

TheStreetSweeper advised investors last month about concerns that we had about PHMD.

Now we're warning about additional complications that deserve investors' close attention.

Japan loss jeopardizes multi-millions

PHMD reported revenue of only \$45.9 million last quarter. That is the lowest revenue since the PhotoMedex-Radiancy reverse merger in December 2011 and about \$10 million below expectations.

The primary excuse? A failure to sell virtually any product in Japan, as the distributor's orders lurch to a complete stop.

How much inventory is sitting around the Japanese distributor's warehouse while everyone tries to figure out what to do? An astounding 160,000 units. These units typically sell for about \$270 apiece.

That means \$43.2 million worth of product is at risk. That's obviously terrible news for a company with revenue of only \$45.9 million.

"From the Japan standpoint it's a complete zero," said an analyst who covers the company.

"I don't care what the company says," he added. "It's a zero."

And that \$46 million-worth is only a fraction of the no!no! units in limbo in Japan, the company's second-biggest market. PHMD executives [admitted](#) under analysts' grilling that they really didn't

know how many units are in the possession of a middleman distributor between the key distributor, Ya-Man, and the retailer. They also don't know how many are gathering dust on Japanese retail store shelves. Those two unknowns together could be a million bucks or upwards of \$50 million – no one knows. Even if the monetary loss to PHMD turns out to be more controllable than we anticipate, the damage to PHMD's reputation could spin out of control.

The Japan distributor, Ya-Man, suddenly changed its business plan, PHMD executives explained, and stopped orders of no!no!, in both the third and fourth quarters, so Ya-Man could conserve cash.

But TheStreetSweeper is skeptical. PHMD said the distributor wants to eliminate its middleman distributor and go directly to retailers.

Yet, Ya-Man is *seeking* distributors.

The company [website](#) FAQs feature this question: “How can I become your international distributor?” Interested parties may then submit a request through the online form. So this part of PHMD's claims makes no sense.

Ya-Man's website also contains many products but surprisingly it does not appear to contain PHMD's no!no! hair removal products.

TheStreetSweeper has requested an interview with Ya-Man for further clarification but we have not yet heard back from the company.

Distributor reports less income than the likely cost of the no!no!

Fred Russell of Fredric E. Russell Investment Management pointed out another important question about the Japanese distributor that recently signed a two-year extension on its exclusive contract with PHMD.

“Why does this company have only one distributor in a big market like Japan?” Russell asked. “That situation makes this company very vulnerable,”

If the company had been paying attention to [Ya-Man](#), executives would have realized that the Japanese distributor's net income as of April 30, 2013 suddenly slipped to less than a third of 2012 net income.

[Ya-Man](#) trades on the [Tokyo](#) Stock Exchange. So it was fairly easy to spot the falling revenue and the net income tumble to about \$3 million US dollars.

And that takes us back to Ya-Man's obligations to PHMD. If PHMD had paid attention to Ya-Man's apparent decline in fortunes, executives would have surely thought twice about shipping about \$46 million worth of product mid-year to Ya-Man (that number is arguably closer to \$10.6 million if, as execs' comments suggested, the distributor was expected to pay PHMD about \$66 per unit) when Ya-Man's net income had fallen to \$3 million.

We have asked PHMD for an interview to clear up those questions and others. But the company has not yet responded.

Also, what role is the company's auditor playing in the Japanese arrangements? And why is a \$260 million company using a little-known Israeli [auditor](#)? Doesn't PHMD – and its investors – deserve an established Big 4 [auditing firm](#)?

Write-down fears

“My biggest fear is there could be a write-down because they're telling The Street they're transitioning from the (older no!no! model) 8800 to the no!no! pro,” said the analyst who requested anonymity.

“When you're transitioning to products and your biggest customers are also selling other products, newer products and you have inventory built up, you usually have some sort of write-down,” he said. [Write-downs](#) can be big trouble and have been at the heart of company failures.

Chief executive Dolev Rafaeli told analysts he would be visiting Japan to attempt to hammer out the issues with Ya-Man.

TheStreetSweeper had already warned in the Oct. 17 PHMD article – click on the link [here](#) – that PHMD may be overstating the prospects for no!no! in Japan. Extrapolating from a Nagoya University School of Medicine study, we found that researchers' clinical assessment determined a lower level of body hair among the Japanese. So the interest in hair removal there would logically be limited.

In any event, it was obvious during the Nov. 6 quarterly [conference call](#) that the distributorship, guidance and related issues shocked analysts.

Hamed Khorsand of BWS Financial clearly was not ready to sing Kumbaya: “Let's start off with, we had an earnings call back in August, right. So we are in the middle of the quarter, you guys were guiding flat, which means around \$58 million revenue and so, but, you guys didn't know Japan wasn't placing any orders?”

CEO Rafaeli: “Japan places an order once a quarter ... though, we might get that order all the way up through the end of the quarter. Was really towards the second half of September, where there were issues that certainly surfaced and we needed to start dealing with that.”

Flawed stock buyback timing

Multiple questions revolve around the timing of Japan and other events.

PHMD boasted that it continued the second half of its stock [buyback](#) program, a roughly \$13 million effort this past quarter that would normally please investors. But two issues sully this program.

First, the company conducted the purchases close to when the Japan distribution problems began to drive down the stock price.

The company's president and financial officer, Dennis McGrath, explained that the stock price seemed inexpensive at the time and that the buying stopped on Sept. 16, just before the end of the month when executives say they discovered the distribution problem.

Russell pointed out that the stock price was very high at that time. It was over \$16 on Sept. 16, very near this year's high of \$17 and change.

Second, just before the stock repurchase program ended, CEO Rafaeli and a director, Katsumi Oneda, were happily [selling](#) thousands upon thousands of shares of stock. Rafaeli said he retains about 1.5 million shares and the sales occurred under an automatic sales plan, a 10b-5.

"I have nothing to do with the execution of the plan and I don't control it. I set up the formula a long time ago and I let it roll and it happens and reports when it does," Rafaeli said.

Regardless, Russell said, "The timing was not wise."

So who would blame investors if they felt the company threw around their hard-earned dollars to repurchase stock at exorbitant prices that unfairly benefited some insiders?

"This company is really good at removing women's wrinkles," Russell said, referring to the company's heat-and-light anti-aging treatment. "But I'm not sure they are good at removing the wrinkles in their business strategy."

Fire, other FDA reportable events

Along with the key no!no! hair product, PHMD also offers the LHE light-heat treatment for wrinkles, plus skin lotion. Another category is the Xtrac laser technology used on a variety of medical issues, primarily psoriasis.

Some analysts consider Xtrac the bright spot for PHMD. But numerous issues tarnish these products, too.

Eight [adverse event](#) reports on PHMD products have been submitted to the U.S. Food and Drug Administration. These include:

June 19, 2013 – Things went terribly wrong when a laser surgical instrument manufactured by PhotoMedex was used on a patient with cancer of the [windpipe](#). A breathing tube was placed inside the patient's trachea and doctors began using the laser instrument to remove the cancerous tumor. But the tube inside the patient's throat caught [on fire](#). The laser fiber tip broke off and apparently fell into the patient. The patient appeared to suffer only minor injury.

This was not an isolated problem. “We have had several failures in the past where the tips burn off and get lost,” noted the person who reported the accident to the FDA.

Broken laser tip incidents were reported three more times. In one 2008 case, a tip was lost in a patient’s [brain](#) but surgeons peering through a microscope were able to remove it without complication.

May 22, 2013 – A patient treated with PHMD’s Xtrac suffered open wounds and second-degree [burns](#) on the bottom of her feet after the Xtrac was used to treat an undisclosed malady, perhaps psoriasis. A company representative checked on the incident and confirmed that the device had been used properly. The report states “It remains unclear why the patient burned severely enough to require medical treatment.”

With the exception of malfunctioning tubing and suction pumps reported in 2008, the reports appear to refer primarily to issues with the company’s laser machines. Though PHMD promotes its Xtrac laser treatment as a “highly effective, safe, and painless therapy,” for psoriasis and vitiligo, two reports also said patients claimed the effects on psoriasis were disappointing or actually seemed to cause the problem to spread.

Xtrac is placed free in U.S. doctors’ offices and PHMD receives \$65-\$85 each time a patient is treated with the laser machine. In the third quarter, those revenues rose to about \$4.2 million. The machines are sold, not given away, overseas.

No need to “unnecessarily panic the public”

Investors might want to keep an eye on the Xtrac. Along with the FDA adverse event reports, the company quietly conducted a [recall](#) due to a sealing problem with sterile barriers. In this [letter](#) on PhotoMedex letterhead and marked “confidential,” PHMD describes its international field correction/recall initiated Jan. 4, 2013. Though no injuries apparently resulted, more than 500 potentially affected machines were involved. The letter ends with this interesting comment:

“PhotoMedex still does **not** believe that public notification is necessary, as these are prescription medical devices sold only to distributors who then sell only to physicians. Consumers will not have any means to identify whether the products in question were used in their procedure; therefore the information will not be relevant and would unnecessarily panic the public.”

That comment may help explain why the recall occurred in January but the notice didn’t appear on the FDA website until October. TheStreetSweeper couldn’t find reference to the voluntary recall in PHMD’s federal filings.

TheStreetSweeper’s previous article described issues indicating PHMD’s chief product, the hair removal device, is fading, resulting in the company’s struggle to develop another profitable product. But now, the recall and adverse event issues with Xtrac point to problems for the very product that some experts hope will help preserve the company.

Lawsuits

On top of those issues, throw in the company's possible legal issues. Investors will see the negatives spreading for PHMD.

PHMD apparently lost a big federal lawsuit awhile back, according to this [document](#). PHMD got pretty much knocked down in its lawsuit alleging false advertising and unfair business practices were committed by Ra Medical and its founder, who claimed he invented PHMD's laser system. The settlement details were not released.

The lawsuit may or may not foretell the resolution of a couple of other litigation possibilities, including any that could result from those FDA adverse event reports we've already discussed.

PHMD mentioned a couple of letters in recent filings.

A demand letter in November 2011 by [Milstein Adelman](#) LLP, followed by a similar one from another company, alleges PHMD subsidiary Radiancy violated California law in marketing and advertising its no!no! hair removal device. Furthermore, the Milstein letter requests restitution for a class of consumers due to alleged violations of California's unfair competition, false advertising, health and safety laws. It's unclear whether this will develop into a major legal issue but the risk does exist.

Another litigation issue is this year's [lawsuit](#) revolving around false and misleading advertising, and patent/trademark infringement claims of PHMD subsidiary Radiancy against Viatek Consumer Products Group. Viatek is countersuing in this ongoing lawsuit.

Reason to sell

Russell pointed out that the company's own Securities and Exchange Commission filings notes PHMD has many strong competitors that have "substantially more resources."

"So if you are looking for company with impregnable barriers to entry, this is not the company you are looking for," Russell said.

And beware the one-product company, cautioned several analysts who spoke with TheStreetSweeper. Eventually that once-shiny object of affection – particularly if it is an electronic - just fades.

It is much like that TV commercial that shows people tossing their cell phones into full drink glasses or insisting that robbers take their old phones just so they can get the latest and greatest cell phone.

"It's how much of the consumer population can you hit and how much of the consumer population is really interested before the consumer moves away?" said the anonymous analyst who holds a limited long position. "The consumer gets tired."

He indicated that, regardless of market penetration, he doubts the new no!no! pro hair removal device that PHMD is pushing will cut it.

“My biggest concern is it’s not enough to reinvigorate the consumer to think, ‘I should buy it,’” he said.

He wonders how long PHMD can go on and suggests that the stock price could get a good shaving.

“If the U.S. starts flattening out,” said the analyst, “this could eventually just bottom to 8 or 9 bucks.”

** Important Disclosure: The owners of TheStreetSweeper hold a short position in PHMD and stand to profit on any future declines in the stock price.*

- *Editor's Note: As a matter of policy, TheStreetSweeper prohibits members of its editorial team from taking financial positions in the companies that they cover. To contact Sonya Colberg, the author of this story, please send an email to scolberg@thestreetsweeper.org.*