

Zeltiq Aesthetics, Inc. (ZLTQ) Memo

Name: Robert Barbu

College/School: Arts & Sciences

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Important Company Financial Data

Price: \$14.06 Avg. Vol.: 46,999 52wk Range: 13.32-17.41 Market Cap: 476.63M EPS: -0.34 Enterprise Value: 493.49M
Qtrly. Rev. Growth(yoy): 175.20% Total Debt: 641k Debt/Equity: 8.77 Rev: 61.74M

Thesis / Key Points

- **CoolSculpting produces fewer complications than competing fat reduction procedures:** The procedure is non-invasive, making for a much less dangerous cosmetic procedure than liposuction or laser-lipolysis (laser-lipo). Unlike these other two methods, the procedure leaves no scars, only damaging fat cells under the skin (fat cells are more sensitive to cold than skin and other surrounding tissue). 20-30% of fat cells in the region are killed, leaving the body to dispose of them on its own, rather than sucking out fat and potentially muscle tissue as in liposuction. Recovery from all three cosmetic procedures causes roughly the same amount of bruising and pain.
- **CoolSculpting is more convenient for the patient and doctor alike:** While the procedure takes the same amount of time as liposuction or laser-lipo, it can be administered by a technician rather than a team of the doctor and several nurses, freeing up the doctor's time. The technician does not have to be present during the entire procedure—the freezing pads are simply placed on specific fat bulges for about an hour. The patient is awake during the entire procedure. The freezing of the selected area serves as anesthesia on its own, temporarily disabling the nerve cells in the region. The procedure is so benign that at Medical Cosmetic Enhancements (see VAR) patients are allowed to watch tv during the procedure. Most patients (>90%) are able to go back to work the next day, as compared to the 3 day-2 week recovery time exhibited in liposuction and laser-lipo patients. Furthermore, CoolSculpting patients do not have to wear the compression vest that traditional liposuction patients must wear for a month after their procedure.
- **CoolSculpting is significantly cheaper than competing procedures for the patient:** CoolSculpting's average cost is \$850 per region (right thigh and left thigh are separate) and \$1700 for normal procedures (procedures average two regions). Similar procedures in traditional liposuction cost \$3000-\$4000, and the non-invasive laser lipo usually starts at excess of \$5000. CoolSculpting is not meant for obese people, but rather people with persistent concentrated fat bulges. For such people minor bodywork does not justify such a price tag. As the industry of cosmetic surgery is a demand-based one, physicians will provide the procedure that patients are willing to pay for rather than lose their business.
- **The effects of CoolSculpting are permanent:** So long as dietary consumption does not rise (beyond temporary holiday increases) the effects of the region in which CoolSculpting has been applied are permanent. A portion of the total fat cells in that region (20-30%) have been killed, lowering one's rate of metabolic storage. In contrast, patients of liposuction can expect weight gain even with a level of consumption equivalent to that existing prior to the procedure, because the rate of metabolic storage has not declined. Laser lipo can achieve similar permanence to that of CoolSculpting, given the same requirement of not increasing consumption, albeit at a price tag of \$5000 or more.
- **CoolSculpting does not compete with liposuction and laser-lipo for procedure candidates:** CoolSculpting is ideally a procedure for relatively fit people who have 20 pounds or less of excess weight. It is applied to concentrated fat regions, such as the abdomen ("love handles", thighs, back and chest). The procedure begins a process of apoptosis (cell death) that lasts for 2-4 months. An ideal candidate for CoolSculpting is healthy enough to only need 1-2 procedures. Each procedure will realistically eliminate about 10 pounds of fat. While liposuction and laser-lipo can eliminate as much as 20 pounds in a single procedure, they are primarily for people with more weight to lose. It would be unhealthy for a patient to lose 20 pounds of fat if that constituted the total of their excess weight.

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Misperception

- **Zeltiq currently has a low-profile.** It is a microcap stock with a market cap of 477M. It has only one analyst, an unspecified member of IPOfinancial.com. It IPOed on October 18, has a low trading volume (46,999). Information about its CoolSculpting system is still scarce (I had to call physicians to find out fee structure that Zeltiq charges). The low-profile and microcap nature of this company ensure that MII does not have to compete with the research of large investors and strengthens the value of value-added research in gaining an edge over the market.
- **At first glance, the negative earnings of the company discourage investment.** However, revenue grew 175% for Q3 2011 compared to Q3 2010. The corresponding cost of revenue only grew 138%, primarily due to increasing efficiency of production. Comparing the 9 months ending September 30 2010 and 2011, revenue increased from \$13.1M to \$49.3M and net loss decreased from \$11.5M to \$4.2M. Given that the Fall and Winter are the traditionally the best seasons for cosmetic surgery sales, demand for CoolSculpting should increase even more in the coming months. Zeltiq will likely make its first quarterly profit in either Q4 2011 or Q1 2012.
- **There are too many unknowns with Zeltiq:** CoolSculpting is still relatively new, the first procedure having taken place in 2009. Much is still not know about how CoolSculpting and the resulting apoptosis works at the cellular level. As such, this company is seen as somewhat risky. However, CoolSculpting has worked in real-world use. 134,000 procedures have been conducted to date, and patients generally report positive results. The FDA, which doubles as screener for the safety as well as effectiveness of new drugs, has approved CoolSculpting applied to the abdomen, thighs, back and chest. Furthermore, I have discussed the underlying theory behind why CoolSculpting works with two doctors who had no vested interest in CoolSculpting (they do not conduct cosmetic surgery), and both believed the theory behind the procedure was plausible.

VAR

- **Cosmetic Surgeons:**
 - Christopher L. Hess, M.D. Hess Plastic Surgery
 - Melda Isaac, M.D. MI-SKIN Dermatology Center
 - Drew Varano, M.D. Medical Cosmetic Enhancements
 - Timothy S. Mountcastle, M.D. Mountcastle Plastic Surgery & Vein Institute
- **Other Physicians:**
 - Richard R. Barbu Alexandria Association of Radiologists
 - Carlos Artiles Alexandria Association of Radiologists
- <http://www.realself.com/coolsculpting-by-zeltiq> (compiles patient reviews and aggregates procedure ratings)

How It Plays Out

- **Zeltiq posts its first quarterly profit.** This is likely to occur during Q4 2011 or Q1 2012, as Fall and Winter are traditionally the peak-demand seasons for cosmetic surgery. This should augment already-growing demand. Zeltiq has been narrowing its loss over the last year, and these consecutive strong seasons should put Zeltiq in the black.
- **Zeltiq continues to sell its CoolSculpting systems.** The installation base of its systems rose from 346 on December 21, 2010 to 629 units by June 30, 2011. Once a physician owns a CoolSculpting system, he is of course best off putting his investment to work. Each procedure conducted with a CoolSculpting system creates \$200 in the form of a usage fee that increases Zeltiq's revenues. Zeltiq's estimated install base is
- **Zeltiq uses the \$89M is raised from its IPO to begin a marketing campaign in earnest.** Up to this point it has primarily marketed

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to physicians by offering strong discounts (usually selling the initial systems at a loss) on a base unit that is already cheaper than competing procedures (\$10,000 per CoolSculpting system, \$15,000-18,000 for liposuction machine, >\$35,000 for laser-lipo system). While Zeltiq may continue to sell the system at a loss, it would be best served marketing CoolSculpting to consumers, since the industry of cosmetic surgery is a demand based one. This should increase demand and force physicians to conduct the procedure, even though they make a lower margin than on traditional liposuction and on laser-lipo.

Risks / What Signs Would Indicate We Are Wrong?

- Percent revenue growth does not increase relative to cost of revenue growth in the next quarterly report. This would indicate that the unit cost of producing and marketing CoolSculpting machines is not decreasing.
- Zeltiq fails to make a profit the Q3 2012. This may indicate there is not strong enough demand, or unexpected expenses have accrued.
- The FDA rescinds its approval of CoolSculpting on one of the currently approved areas or fails to approve its use on more parts of the body in which Zeltiq is seeking approval (upper arms, gynecomastia, inner knees). This could indicate that CoolSculpting may have as-of-yet unidentified side effects (at least in the rejected region(s)).

Signposts / Follow-Up

- Revenue growth continues
- Net income continues to trend up
- Growth/decline of counterfeit CoolSculpting
- FDA approval of CoolSculpting to other regions
- First external Audit conducted
- Compare changes in the cost of liposuction and laser-lipo to ensure CoolSculpting is maintaining a price advantage

Company Description

Zeltiq Aesthetics is a medical device maker that went public in October. Its sole product is CoolSculpting, a new, FDA-approved fat reduction device. The system is selectively applied to fat bulges, freezing them in order to cause a reduction of fat over the 2-3 months following the procedure. Of the average 20-30% of fat reduction typically experienced in the regions to which CoolSculpting is applied over the 2-3 months following the procedure. This procedure is meant for moderately overweight individuals rather than the obese, realistically eliminating up to 10 pounds for a single procedure. Zeltiq sells its system to physicians and charges fees for each treatment performed. There have been 134,000 procedures to date. 629 systems have been sold, out of a predicted market of 4000-5000.