



MGC
DIAGNOSTICS®

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MGC Diagnostics Corporate Mid-year Shareholder Letter

July 2016

To our shareholders,

Upon completion of the first half of the fiscal year 2016 we are pleased to report that we continue on pace to meet our primary objectives for the full year of achieving consistent performance and driving operational excellence throughout the Company. The fiscal 2016 second quarter performance was solid, continuing to build on the strong operational results generated in the first quarter of the fiscal year.

Total revenue for the six months increased 6% to \$18.7 million. Domestic sales were solid, increasing 16% to \$14.1 million and accounting for 76% of total sales in the six month period. Operating cash flow increased 437% to \$1.8 million compared to \$337,000 in the six month period of 2015. Current and long-term deferred revenue increased 10% to \$7.1 million and the sales backlog at the completion of the second quarter of fiscal 2016 totaled \$1.9 million.

We reported net income for the six months of \$41,000 versus a net loss of \$(459,000) in last year's first half and earnings per share of \$0.01 per diluted share versus a loss of \$(0.11) per diluted share in the first six months of fiscal 2015. Excluding one-time legal settlement expenses of \$670,000, net income was \$424,000 or \$0.10 per diluted share for the six-month period ended April 30, 2016. We are pleased with the progress achieved during the first half of the fiscal year.

Total revenue at our Medical Graphics business grew during the first half of fiscal 2016 as sales of domestic equipment, supplies and accessories increased 20% compared to the first half of 2015.

The domestic Medical Graphics sales team was very successful in converting 52 accounts from our competitors, generating \$2.5 million of sales in the first half, versus 23 competitive conversions and \$895,000 in revenue in the first half of 2015.

Our continued ability to attract customers from other providers while maintaining our existing customers with upgrades to their legacy equipment, demonstrates the value proposition that our products and services provide. Our products increasingly offer the appropriate features, reliability, quality, and price point that today's market demands. We continue to adapt our products to the needs of the market and are being rewarded by attracting new customers while enhancing our existing customers with product upgrades unmatched by our competitors. This is a powerful validation that our R&D developments are evolving our products and addressing the needs of our markets.

As we did in the first quarter, we continue to leverage the sales momentum generated from our Ultima Series redesign. During the second quarter, our Medical Graphics business sold a total of



24 pulmonary function and gas exchange units, bringing the total to 54 units sold during the first half of this fiscal year. The redesigned Ultima is now the product of choice for customers looking to upgrade equipment. Coupled with our proven data management workflow solutions, the Ultima Series is proving to be a very strong message in the marketplace. The redesign of the Ultima Series has proven to be a viable upgrade pathway, allowing us to retain and expand our installed base. It is a compelling replacement option to attract and convert competitive accounts as well. We are proud of the efforts of our sales team as they continue to win new business, resulting in double-digit growth in equipment sales.

We plan to release a series of enhancements and options to this platform throughout the second half of the fiscal year, and remain confident that the market will continue to recognize the value of these product offerings.

In addition to our strong focus on competitive conversions, we are working to develop a recurring revenue platform as demonstrated by our internal sales team growing our UltraCare service offerings and our domestic supplies revenues. The UltraCare service attachment rate for domestic sales during the fiscal 2016 second quarter was 34%, compared to the overall fiscal 2015 average of 32%. Additionally, the just completed second quarter of 2016 is the first quarter since we launched our supplies growth strategies that we are seeing a significant impact and we are looking for that to continue in future quarters.

On the International side of our business, Medisoft's second quarter revenue was \$1.6 million compared to \$1.44 million in last year's second quarter. During the second quarter, Medisoft processed and delivered orders that could not be shipped during the first quarter of 2016 due to logistical issues with three of our business partners. Consequently, Medisoft's gross margin for the quarter increased to 42.2%, up from 32.2% in the second quarter last year. As we enter the seasonally slow European summer holidays, we are focusing our efforts on improving Medisoft's operating efficiencies and placing greater emphasis on further developing their direct core markets in France and Belgium.

We are fully committed to establishing Medisoft as a leading cardiorespiratory diagnostic provider in our international markets. We continue to make progress in configuring Medisoft to achieve consistent operational and financial performance. In that regard, we are also looking to more effectively to redeploy the assets of Medisoft in order to significantly improve operating efficiencies through streamlining our purchasing, manufacturing, R&D, sales and marketing functions. We have made a significant investment in Medisoft and we are beginning to see progress. As we have said since the acquisition, we expect our efforts to yield substantially improved operational and financial results in the coming years. The first half of fiscal 2016 was very solid and we have every expectation to deliver comparable results in the second half of the fiscal year.

As we move through the second half of fiscal 2016, we intend to absorb Medisoft operations into the Medical Graphics business, and report to you on a "Domestic" and "International" basis moving



forward. The existing synergies will magnify to an even greater extent and this perspective will demonstrate a more accurate and balanced view of how MGC Diagnostics is operating as an enterprise.

Integrating Medisoft into the Medical Graphic business is part of our newly implemented long-range strategic plan that focuses on process improvement throughout the company to generate consistent growth and profitability in the coming years. We have a strong vision of how we want MGC Diagnostics to develop and operate in the coming years.

Subsequent to the quarter a number of important developments have taken place that we believe will have significant impacts in the coming years.

We are extremely pleased to have received FDA clearance on the Resmon PRO FULL Forced Oscillation Device, or "FOT" in June 2016. This regulatory clearance now allows us to offer technology specifically designed for simple, patient independent, measurement of the mechanical properties of the respiratory system. The Resmon PRO FULL is designed to provide medical professionals the ability to measure mechanical properties of the respiratory system during normal tidal breathing, providing a simple, effort-independent assessment for both clinicians and patients. FOT is a highly complementary technology that will present incremental revenue generating opportunities for our sales team, both domestically and internationally. We are pleased to add this product to our existing product platform.

Also in June 2016, the Board of Directors approved the early pay-off of the term loan, which was initiated in August 2014 to acquire Medisoft. The decision for the early pay-off of the loan is consistent with our commitment to enhance shareholder value and demonstrates our confidence in our long-range plan. Internally generated cash flow from operations allowed the Company to pay off this bank debt early. The Company also terminated its revolving credit facility with BMO Harris Bank, which the Company had not drawn upon.

These actions are consistent with our goal to improve our balance sheet, strengthen our financial position and enhance shareholder value by eliminating the bank liens on the Company's assets and its restrictions on the use of our cash. And in the current interest rate environment, the Board determined that paying off this above market interest rate debt was an appropriate and prudent use of our working capital resources

Additionally, the Company reached a settlement in June 2016 with NeuroVirtual under which the Company agreed to make a one-time cash payment of \$650,000 to NeuroVirtual. As part of the settlement, the Company will retain the NeuroVirtual sleep diagnostics inventory it has purchased and NeuroVirtual will continue to support this inventory pursuant to the distribution agreement. The Company has made a loss accrual, including legal fees, of \$670,000 as a general and administrative expense in the three- and six-month periods ended April 30, 2016.



In July 2016 we formed a scientific advisory committee comprised of physicians and scientists to assist in providing advice and guidance on medical and scientific matters domestically and internationally related to the Company's business and to our products. We have created a committee with distinguished healthcare professionals that are recognized global leaders within their respective fields of pulmonary medicine. Consistent with our global strategy we have assembled these leaders to leverage their vast expertise to evaluate current and future opportunities to grow the business globally.

The creation of this committee is firmly in line with our commitment to provide our customers a portfolio of state-of-the-art respiratory diagnostic products. With the creation of our scientific advisory committee, the Company, as well as its customers, will benefit greatly from the expertise and guidance of this outstanding team of cardiorespiratory professionals. We look forward to their contributions.

We hope you share our enthusiasm for the operational and financial performance achieved during the first half of fiscal 2016. We continue generating more consistent results, initiating process improvements that are making us more efficient and responding to the demands of the markets for appropriately appointed products at the right price points. We also made substantial progress during the first half of the year in taking proactive steps that we believe will enhance our ability to perform even more effectively in the quarters and years to come. We remain dedicated to enhancing shareholder value by continuing to focus MGC Diagnostics on being recognized in the market as the leading-edge provider of cardio-respiratory products. We have the technology and the people to achieve these important goals.

As always, we thank you for your continued support and we look forward to updating you during the upcoming quarters.

Best regards,

A handwritten signature in black ink that appears to read "Mark M. Sheffert".

Mark Sheffert
Chairman of the Board of Directors

A handwritten signature in blue ink that appears to read "Todd".

Todd Austin
Chief Executive Officer