

NovaBay Pharmaceuticals (NBY - \$ 0.89)

NovaBay Kicked Off i-Lid Cleanser Commercialization Efforts

This morning, NBY announced it will initiate a major marketing campaign and commercialization effort for i-Lid Cleanser; and would be led by a recently hired ophthalmological pharmaceutical marketing veteran Glenn Moro as NBY's VP of Sales and Marketing (S&M).

- Details.** The company's marketing campaign will target both optometrists and ophthalmologists as these are the specialists treating patients with meibomian gland dysfunction (dry eye) and blepharitis. NovaBay initially plans to deploy a dedicated field sales force to market i-Lid Cleanser in a handful of major metropolitan regions, such as New York City and Los Angeles. Should the initial sales targets be met, the company would expand its sales efforts to cover broader geographic areas. Further, the new VP of S&M has extensive experience in launching and expanding several eye care products at Alcon – a major ophthalmological pharmaceutical player which currently is part of Novartis (NVS – NR).
- Implications.** We view the start of i-Lid Cleanser commercialization effort by NBY is an important positive development for the company. It potentially affords NBY possibly growing revenue and additional risk/reward profile diversification for NBY shareholders. We believe NBY has identified physicians treating high volumes of relevant patients (i.e. older instead of younger) and could make more targeted and potentially more effective S&M efforts. The unique product offering of i-Lid Cleanser, in our opinion, could be very competitive for these indications and could be also used as routine cleansing needed pre cataract and LASIK surgery. We recently have received investor questions for partnering prospects vs. self-S&M, and we believe S&M by NBY initially could be a positive step to take. Our rationale is that given the time needed for consummation of a partnership is unpredictable and there is no commercial track record of i-Lid Cleanser, it would be valuable to establish the commercial potential of the product in the market. If S&M is successful, NBY would have the option for either continue marketing by itself (retaining all economic value) or partner i-Lid Cleanser out with substantially favorable deal terms.
- Action.** We view NBY has multiple shots on goal and its risk is more balanced. As such, we are reiterating our Buy rating and our \$2.50 target price, which is supported by several valuation analyses.

Healthcare/Biotechnology

Ticker: **NBY**
Rating: **Buy**
Price Target: **\$ 2.50**

Trading Data:

Last Price (07/15/2014)	\$ 0.89
52-Week High (9/23/2013)	\$ 2.03
52-Week Low (11/7/2013)	\$ 0.76
Market Cap. (MM)	\$ 45
Shares Out. (MM)	51

Earnings Estimates: (per share)

(Dec)	1Q	2Q	3Q	4Q	FY	P/E
FY-14E	-0.08A	-0.10	-0.10	-0.09	-0.38	NM
FY-13A	-0.11	-0.11	-0.10	-0.10	-0.42	NM
FY-12A	-0.09	-0.08	0.00	-0.07	-0.24	NM
FY-11A	-0.08	0.02	0.00	-0.13	-0.20	NM

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Source: Laidlaw & Company estimates.

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Anticipated milestones in 2014 and beyond

Product	Indication	Partner	Event	Timing
Auriclosene (NVC-422)	Impetigo (0.33%)	Galderma	Potential to commence a Phase IIb pilot clinical trial	4Q- '14
			Potential to report Phase IIb pilot clinical trial results	4Q- '15
	Viral conjunctivitis (0.1% - 1.5%)		Potential data release of the Phase IIb study	July/August- '14
	Prevention of urinary catheter blockage and encrustation (UCBE) (0.2%)		Potential to commence a Phase II study	Mid-'14
Potential to report Phase II study results			2Q15	
NeuroPhase	Chronic non-healing wounds		Potential approval in China	2H14
CelleRx	Aesthetic dermatological use		Expand commercialization	2H14
Consumer lens care product		Not yet announced	Commercial launch	2H14

Source: Laidlaw & Company estimates and company presentation.

Major Risks

Failures of current and upcoming clinical programs. Although auriclosene demonstrated promising efficacy and a satisfactory safety profile from the Phase II studies in several indications, there is no assurance that the future clinical developments' efficacy and safety profiles will be satisfactory enough to advance the program into later stage clinical development. Given the clinical study successes are the most near-term hurdles to be overcome before auriclosene can be advanced into the next stage of development, clinical study failure could significantly impair the value of the company's asset and shareholder value.

Maintaining current and expanding future partnerships are not guaranteed. One of major validations of NovaBay's technologies and significant near-term revenue prospects derive from the company's collaborative partners, such as Galderma. Should a partner decide to terminate collaboration with NovaBay, shareholder value could be substantially impacted, due to the potential loss of future revenue and concerns about the company's technology for generating effective therapeutic products. In addition, there is no assurance that the company can forge additional collaborations for generating revenue.

Product may not reach anticipated sales. Although auriclosene and NeutroPhase have illustrated promising efficacy and safety profiles, and the latter has received FDA approval, the sales potential for either product could miss our forecasts. It is difficult to project more accurately the sales potential of auriclosene in impetigo given the market is relatively mature, although Galderma is very experienced in dermatology sales. Further, it could be even more difficult to forecast potential future auriclosene sales in adenoviral conjunctivitis and catheter blockage and encrustation (UCBE) since no approved product or substantial generic products are already in the market. Although NeutroPhase is approved to be used in wound care in the U.S., it is not guaranteed that the product could receive approval in China and can successfully launch in China and Southeast Asian markets. In addition, NovaBay may not generate projected revenue from its own in-house pipeline.

Additional financing could dilute shareholder value. Regardless of whether or not the company forges additional collaborations with partners to generate non-dilutive revenue to support operation, it is likely that NovaBay may need to provide offerings to raise cash from investors to fund its operations. As such, the share value for existing investors could be diluted. Further, if the company cannot raise equity capital at more favorable terms, the share value of current shareholder could be further impaired.

Limited trading liquidity limits shareholder options. Given daily trading volume and name recognition of NBY shares are relatively modest, some investors could be hesitant to own the shares as relatively illiquid trading volume could impose constraints if they want to increase or reduce their positions in a volatile stock market.

Figure 1: Income Statement

NovaBay – Income Statement									
(\$'000)	2011	2012	2013	1Q14	2Q14E	3Q14E	4Q14E	2014E	2015E
Revenue									
Product royalty revenue			223	188	194	252	403	1,036	2,093
Cost of goods sold			162	130	97	126	201	554	1,067
Gross profit			61	58	97	126	201	482	1,026
Revenue (upfront, milestone, etc.)	10,993	6,855	3,045	38	46	230	251	565	672
Others	26	92	209	62	45	40	35	182	207
Total non-product revenue	11,019	6,947	3,254	100	91	270	286	747	880
Research and development	9,911	9,275	12,461	2,528	2,629	2,655	2,682	10,494	11,544
General and administrative	5,429	5,981	6,340	1,708	1,879	2,048	2,212	7,846	8,553
Total Operating Expenses	15,340	15,256	18,801	4,236	4,508	4,703	4,894	18,341	20,097
Operating Incomes (losses)	(4,321)	(8,309)	(15,486)	(4,078)	(4,321)	(4,307)	(4,406)	(17,594)	(18,191)
Non-cash gain on decrease in fair value of warrants	(732)	1,439	(555)	520	(400)	(300)	370	190	120
Total Other Income, net	(30)	(155)	1	(7)	1	1	1	(4)	10
Income before tax	(5,083)	(7,025)	(16,040)	(3,565)	(4,720)	(4,606)	(4,035)	(17,408)	(18,061)
Tax Rate	0	0	(16,039)						
Tax	(2)	(2)	(2)					0	(5)
Net Income (Loss)	(5,085)	(7,027)	(16,042)	(3,565)	(4,720)	(4,606)	(4,035)	(17,408)	(18,066)
Net Income (Loss) Applicable to Common Shareholders	(\$5,085)	(\$7,027)	(\$16,044)	(3,564)	(4,718)	(4,602)	(4,031)	(\$17,408)	(\$18,062)
Net Earnings (Losses) Per Share—Basic and Diluted	(\$0.20)	(\$0.24)	(\$0.42)	(\$0.08)	(\$0.10)	(\$0.10)	(\$0.09)	(\$0.38)	(\$0.32)
Shares outstanding—basic and diluted	25,773	29,448	38,183	45,338	45,588	45,838	46,088	45,713	56,088
	25,773	29,448	38,183	45,338	45,588	45,838	46,088	45,713	56,088
Margin Analysis (% of Sales/Revenue)									
R&D	90%	134%	376%	1600%	1403%	670%	550%	854%	606%
MG&A	49%	86%	191%	1081%	1002%	517%	454%	638%	449%
Operating Income (loss)	-39%	-120%	-467%	-2581%	-2305%	-1087%	-904%	-1432%	-955%
Net Income	-46%	-101%	-484%	-2256%	-2517%	-1162%	-827%	-1416%	-948%
Financial Indicator Growth Analysis (YoY%)									
Revenue (upfront, milestone, etc.)	13%	-38%	-56%	-96%	-94%	-78%	-18%	-81%	19%
Other revenue	NA	254%	127%	44%	10%	-38%	-42%	-13%	14%
Total Revenue	13%	-37%	-53%	-90%	-89%	-75%	-22%	-77%	18%
R&D	15%	-6%	34%	-14%	-10%	6%	-34%	-16%	10%
SG&A	-4%	10%	6%	9%	-8%	34%	83%	24%	9%
Operating Loss	-4%	92%	86%	17%	4%	44%	-9%	14%	3%
Total Other Income, net	-112%	417%	-101%	NA	-80%	-67%	-114%	-500%	-350%
Net Income	18%	38%	128%	-11%	16%	20%	-3%	9%	4%
EPS - Diluted	7%	21%	76%	-28%	-5%	-2%	-13%	-9%	-15%

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Source: Bloomberg LP; Company reports; Laidlaw & Company estimates.

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Date	Rating	Closing Price (\$)
01/07/2014	Buy (B)	1.28

Date	Target Price (\$)	Closing Price, (\$)
01/07/2014	2.50	1.28

Source: Laidlaw & Company

Created by: Blue-Compass.net

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			Investment Banking	Brokerage
Strong Buy (SB)	Expected to significantly outperform the sector over 12 months.	0.00%	0.00%	0.00%
Buy (B)	Expected to outperform the sector average over 12 months.	94.12%	35.29%	11.76%
Hold (H)	Expected returns to be in line with the sector average over 12 months.	5.88%	0.00%	0.00%
Sell (S)	Returns expected to significantly underperform the sector average over 12 months.	0.00%	0.00%	0.00%

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