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EQUITY RESEARCH
Company Report

September 3, 2014

NovaBay Pharmaceuticals (NBY - $ 0.78)

Healthcare/Biotechnology

NeutroPhase Skin and Wound Cleanser Approved in China

This morning, NBY and its commercial partner in China, China Pioneer Pharma Holdings, Ltd. announced that China's FDA (SFDA) has cleared NeutroPhase skin and wound cleanser for sale throughout mainland China. NBY is expected to ship NeutroPhase to China in 4Q14 to support Pioneer's launch in early 2015.

- **Details.** In China, managing chronic non-healing wounds, such as venous stasis ulcers, diabetic ulcers, and pressure ulcers are serious unmet medical needs. With a large diabetic population (an estimate of 100 million according to a JAMA publication) and significant annual incidences of necrotizing fasciitis (>2,800), the market potential for NeutroPhase in China could be substantial.
- **Implications.** The company has taken major steps to becoming a commercially centered organization with R&D support instead of a mainly R&D-driven entity. The approval of NeutroPhase in China and the rapid development of the i-Lid cleanser sales organization (such as adding KOLs on the ophthalmic advisory board and deployment of direct sales reps) support this view. We are bullish on the commercial partnership of China Pioneer Pharma Holdings in selling NeutroPhase because the company is one of the major medical sales and distribution companies for imported pharma and medical devices in China (ranked number 2 in this category with market shares of 9.4% and 2013 annual sales of >$200MM or a 32.7% Y/Y growth). China Pioneer Pharma also has a strong commitment in NBY as its largest shareholder owning 13.8% or ~7 million shares. Given the vast market in China and material un-met medical needs, various estimates suggest that the long term NeutroPhase sales could potentially reach 2 billion RMB (~ $300MM). From Pioneer's prospective, NeutroPhase has been a very important element for their continued future growth and we anticipate the company will be very active in sales and marketing (with >240 in-house, > 1,000 third-party promotion partners, >500 distributors and nation-wide market reach) of this product – a scenario which should benefit NBY significantly. We are also encouraged that the approval in China came ahead of our projected 4Q14 timeline.
- **Action.** With greater commercial and certain R&D operation, we view NBY has multiple shots on goal and its risk is more balanced. As such, we are reiterating our Buy rating and our $1.90 target price, which is supported by several valuation analyses.

Ticker:	**NBY**
Rating:	**Buy**
Price Target:	**$ 1.90**

Trading Data:

Last Price (09/03/2014)	$ 0.78
52–Week High (9/23/2013)	$ 2.03
52–Week Low (8/20/2014)	$ 0.69
Market Cap. (MM)	$ 39
Shares Out. (MM)	51

Earnings Estimates: (per share)

(Dec)	1Q	2Q	3Q	4Q	FY	P/E
FY-14E	-0.08A	-0.06A	-0.08	-0.07	-0.29	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

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 clincial trial	**4Q- '14**
			Potential to report Phase IIb pilot clincial trial results	**4Q- '15**
	Prevention of urinary catheter blockage and encrustation (UCBE) (0.2%)		Potential to commence a Phase II study	**3Q14**
			Potential to report Phase II study results	**2Q15**
NeutroPhase	Chronic non-healing wounds		Potential launch in China	**1Q15**
CelleRx	Aesthetic dermatological use		Expand commercialization	**2H14**
Consumer lens care product		Not yet announced	Commercial launch	**2H14**

Source: Laidlaw & Company estimates and company presentation.

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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, NBY subsequently announced that the auriclosene in viral conjunctivitis Phase IIb study did not meet the primary and secondary endpoints; and the company does not intend to initiate any new studies of auriclosene for this indication

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 NeutroPhase has illustrated promising efficacy and safety profiles, and has received FDA approval, the sales potential for the product could miss our forecasts. 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.

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Figure 1: Income Statement

NovaBay – Income Statement

($'000)	2011	2012	2013	1Q14	2Q14	3Q14E	4Q14E	2014E	2015E
Revenue									
Product royalty revenue			223	188	21	27	44	280	566
Cost of goods sold			162	130	18	14	22	183	288
Gross profit			61	58	3	14	22	96	277
Revenue (upfront, milestone, etc.)	10,993	6,855	3,045	38	38	192	209	477	568
Others	26	92	209	62	64	40	35	201	229
Total non-product revenue	11,019	6,947	3,254	100	102	232	244	678	797
Research and development	9,911	9,275	12,461	2,528	2,238	2,260	2,283	9,309	10,240
General and administrative	5,429	5,981	6,340	1,708	1,653	1,802	1,946	7,109	7,748
Total Operating Expenses	15,340	15,256	18,801	4,236	3,891	4,062	4,229	16,418	17,989
Operating Incomes (losses)	(4,321)	(8,309)	(15,486)	(4,078)	(3,786)	(3,817)	(3,963)	(15,740)	(16,915)
Non-cash gain on decrease in fair value of warrants	(732)	1,439	(555)	520	797	(300)	370	1,387	120
Total Other Income, net	(30)	(155)	1	(7)	57	1	1	52	10
Income before tax	(5,083)	(7,025)	(16,040)	(3,565)	(2,932)	(4,116)	(3,592)	(14,301)	(16,785)
Tax	(2)	(2)	(2)		(10)			(10)	(5)
Net Income (Loss)	(5,085)	(7,027)	(16,042)	(3,565)	(2,942)	(4,116)	(3,592)	(14,311)	(16,790)
Net Income (Loss) Applicable to Common Shareholders	($5,085)	($7,027)	($16,044)	(3,564)	(2,940)	(4,112)	(3,588)	($14,311)	($16,786)
Net Earnings (Losses) Per Share—Basic and Diluted	($0.20)	($0.24)	($0.42)	($0.08)	($0.06)	($0.08)	($0.07)	($0.29)	($0.27)
Shares outstanding—basic and diluted	25,773	29,448	38,183	45,338	50,767	51,017	51,267	49,597	61,267
	25,773	29,448	38,183	45,338	50,767	51,017	51,267	49,597	61,267
Margin Analysis (% of Sales/Revenue)									
R&D	90%	134%	376%	1600%	2131%	921%	858%	1202%	953%
MG&A	49%	86%	191%	1081%	1574%	734%	732%	918%	721%
Operating Income (loss)	-39%	-120%	-467%	-2581%	-3606%	-1554%	-1490%	-2032%	-1575%
Net Income	-46%	-101%	-484%	-2256%	-2800%	-1674%	-1349%	-1848%	-1563%
Financial Indicator Growth Analysis (YoY%)									
Revenue (upfront, milestone, etc.)	13%	-38%	-56%	-96%	-95%	-81%	-32%	-84%	19%
Other revenue	NA	254%	127%	44%	56%	-38%	-42%	-4%	14%
Total Revenue	13%	-37%	-53%	-90%	-88%	-79%	-33%	-79%	18%
R&D	15%	-6%	34%	-14%	-24%	-10%	-44%	-25%	10%
SG&A	-4%	10%	6%	9%	-19%	18%	61%	12%	9%
Operating Loss	-4%	92%	86%	17%	-9%	28%	-19%	2%	7%
Total Other Income, net	-112%	417%	-101%	NA	1040%	-67%	-114%	5100%	-81%
Net Income	18%	38%	128%	-11%	-28%	7%	-13%	-11%	17%
EPS - Diluted	7%	21%	76%	-28%	-47%	-21%	-30%	-31%	-5%

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

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Additional information available upon request.

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RATINGS INFORMATION

Rating and Price Target Change History

3 Year Rating Change History

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

3 Year Price Change History

Date	Target Price ($)	Closing Price, ($)
01/07/2014	2.50	1.28
08/20/2014	1.90	0.81

Source: Laidlaw & Company **Created by: Blue-Compass.net**

Laidlaw & Company Rating System*		% of Companies Under Coverage With This Rating	% of Companies for which Laidlaw & Company has performed services for in the last 12 months	
			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.	94.74%	31.58%	10.53%
Hold (H)	Expected returns to be in line with the sector average over 12 months.	5.26%	0.00%	0.00%
Sell (S)	Returns expected to significantly underperform the sector average over 12 months.	0.00%	0.00%	0.00%

ADDITIONAL COMPANIES MENTIONED

China Pioneer Pharma Holdings, Ltd: HK 01345 – NR

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