

## NovaBay Pharmaceuticals (NBY - \$ 0.71)

### 3Q14: Early Stage for i-Lid Cleanser and NeutroPhase Skin and Wound Cleanser Commercialization

NBY reported 3Q14 financial results this morning with net losses of (\$4.2MM) and net losses per share of (\$0.08). The company ended 3Q14 with ~\$9MM cash, sufficient for operation into 2016, in our opinion. Given that the company is still in early stage of commercialization for its NeutroPhase-based products both in the U.S. and China; we do not believe current quarterly financial performance is a key investment focus.

- i-Lid Cleanser U.S. commercialization is underway.** The company started its marketing and sales campaign of i-Lid Cleanser in ten major metropolitan areas in the U.S. targeting both optometrists and ophthalmologists. These are the specialists treating patients with meibomian gland dysfunction (dry eye) and blepharitis. Although management has not provided much detail on current sales, they are generally very up-beat as the unique product offering of i-Lid Cleanser to address the substantial un-met medical needs for these indications. In addition, i-Lid Cleanser could be also used as routine cleansing needed before cataract and LASIK surgery.
- Clearance of NeutroPhase skin and wound cleanser for sale in China by SFDA opens up significant market potential.** NBY has started to ship NeutroPhase skin and wound cleanser to its partner China Pioneer Pharma Holdings in 4Q14. We anticipate increasingly more shipments to and sales by Pioneer in 2015 and beyond. Given the vast market and un-met medical needs in China, long term NeutroPhase sales potentially could reach \$300MM. Pioneer (ranked number 2 in China under the category of medical sales and distribution companies for imported pharma and medical devices) has substantial marketing and sales footprints in China with more than 240 in-house, and over 1,000 third-party promotion partners; as well as more than 500 distributors to sell healthcare products nationwide. As such, we view the potential product launch in early 2015 should benefit NBY significantly.
- Action.** As the company has taken major steps to becoming a commercially centered organization with R&D support, instead of a mainly R&D-driven entity; 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 our peer comparable and risk-adjusted cash flow sum-of-the-parts analyses.

#### Earnings Estimates: (per share)

(Dec)	1Q	2Q	3Q	4Q	FY	P/E
<b>FY-14E</b>	-0.08A	-0.06A	-0.08A	-0.07	-0.30	NM
<b>FY-13A</b>	-0.11	-0.11	-0.10	-0.10	-0.42	NM
<b>FY-12A</b>	-0.09	-0.08	0.00	-0.07	-0.24	NM
<b>FY-11A</b>	-0.08	0.02	0.00	-0.13	-0.20	NM

Source: Laidlaw & Company estimates.

#### Healthcare/Biotechnology

Ticker:	<b>NBY</b>
Rating:	<b>Buy</b>
Price Target:	<b>\$ 1.90</b>

#### Trading Data:

Last Price (11/12/2014)	\$ 0.71
52-Week High (11/19/2013)	\$ 1.60
52-Week Low (8/20/2014)	\$ 0.69
Market Cap. (MM)	\$ 37
Shares Out. (MM)	52

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## Anticipated milestones in 2014 and beyond

Product	Indication	Partner	Event	Timing
NeuroPhase	Chronic non-healing wounds		Potential launch in China	1Q15
Consumer lens care product		Not yet announced	Commercial launch	2015
Auriclosene (NVC-422)	Impetigo (0.33%)	Galderma	Potential to commence a Phase IIb pilot clinical trial	2015
	Prevention of urinary catheter blockage and encrustation (UCBE) (0.2%)		Potential to commence a Phase II study	2015

Source: Laidlaw & Company estimates and company presentation.

## Major Risks

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**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.

Figure 1: Income Statement

<b>NovaBay – Income Statement</b>									
(\$'000)	2011	2012	2013	1Q14	2Q14	3Q14	4Q14E	2014E	2015E
<b>Revenue</b>									
Product royalty revenue			223	188	21	90	225	524	1,058
Cost of goods sold			162	130	18	42	113	303	540
Gross profit			61	58	3	48	113	222	519
Revenue (upfront, milestone, etc.)	10,993	6,855	3,045	38	38	23	25	124	148
Others	26	92	209	62	64	39	35	200	228
Total non-product revenue	11,019	6,947	3,254	100	102	62	60	324	376
Research and development	9,911	9,275	12,461	2,528	2,238	2,312	1,965	9,043	7,415
General and administrative	5,429	5,981	6,340	1,708	1,653	1,911	2,064	7,336	8,583
<b>Total Operating Expenses</b>	15,340	15,256	18,801	4,236	3,891	4,223	4,029	16,379	15,998
Operating Incomes (losses)	(4,321)	(8,309)	(15,486)	(4,078)	(3,786)	(4,113)	(3,857)	(16,055)	(15,104)
Non-cash gain on decrease in fair value of warrants	(732)	1,439	(555)	520	797	(104)	190	1,403	120
Total Other Income, net	(30)	(155)	1	(7)	57	(2)	1	49	10
<b>Income before tax</b>	(5,083)	(7,025)	(16,040)	(3,565)	(2,932)	(4,219)	(3,666)	(14,603)	(14,974)
Tax	(2)	(2)	(2)		(10)			(10)	(5)
<b>Net Income (Loss)</b>	(5,085)	(7,027)	(16,042)	(3,565)	(2,942)	(4,219)	(3,666)	(14,613)	(14,979)
Net Income (Loss) Applicable to Common Shareholders	(\$5,085)	(\$7,027)	(\$16,044)	(3,564)	(2,940)	(4,216)	(3,662)	(\$14,613)	(\$14,975)
Net Earnings (Losses) Per Share—Basic and Diluted	(\$0.20)	(\$0.24)	(\$0.42)	(\$0.08)	(\$0.06)	(\$0.08)	(\$0.07)	(\$0.30)	(\$0.25)
Shares outstanding—basic and diluted	25,773	29,448	38,183	45,338	50,767	50,821	51,071	49,499	61,071
	25,773	29,448	38,183	45,338	50,767	50,821	51,071	49,499	61,071
<b>Margin Analysis (% of Sales/Revenue)</b>									
R&D	90%	134%	376%	1600%	2131%	2102%	1139%	1658%	829%
MG&A	49%	86%	191%	1081%	1574%	1737%	1196%	1345%	960%
Operating Income (loss)	-39%	-120%	-467%	-2581%	-3606%	-3739%	-2235%	-2943%	-1689%
Net Income	-46%	-101%	-484%	-2256%	-2800%	-3833%	-2122%	-2678%	-1675%
<b>Financial Indicator Growth Analysis (YoY%)</b>									
Revenue (upfront, milestone, etc.)	13%	-38%	-56%	-96%	-95%	-98%	-92%	-96%	19%
Other revenue	NA	254%	127%	44%	56%	-40%	-42%	-4%	14%
Total Revenue	13%	-37%	-53%	-90%	-88%	-94%	-84%	-90%	16%
R&D	15%	-6%	34%	-14%	-24%	-8%	-52%	-27%	-18%
SG&A	-4%	10%	6%	9%	-19%	25%	71%	16%	17%
Operating Loss	-4%	92%	86%	17%	-9%	38%	-21%	4%	-6%
Total Other Income, net	-112%	417%	-101%	NA	1040%	-167%	-114%	4800%	-80%
Net Income	18%	38%	128%	-11%	-28%	10%	-12%	-9%	2%
EPS - Diluted	7%	21%	76%	-28%	-47%	-19%	-29%	-30%	-17%
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Source: Bloomberg LP; Company reports; Laidlaw &amp; Company estimates.

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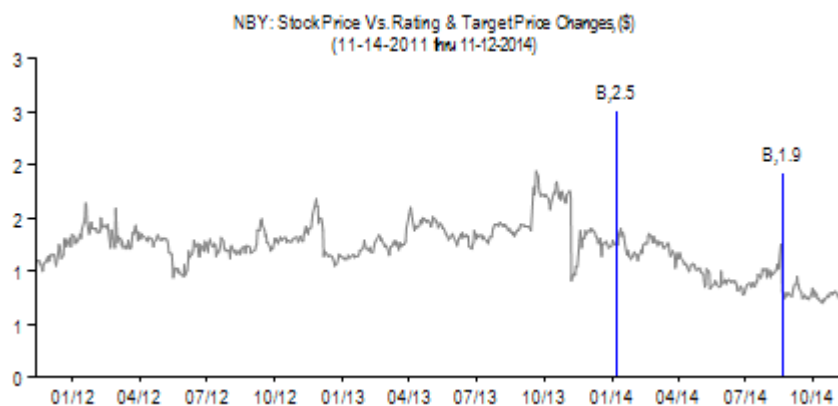
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Source: Laidlaw &amp; Company

Created by: Blue-Compass.net

**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

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
<b>Strong Buy (SB)</b>	Expected to significantly outperform the sector over 12 months.	0.00%	0.00%	0.00%
<b>Buy (B)</b>	Expected to outperform the sector average over 12 months.	95.24%	33.33%	14.29%
<b>Hold (H)</b>	Expected returns to be in line with the sector average over 12 months.	4.76%	0.00%	0.00%
<b>Sell (S)</b>	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 – Not Rated

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