

NovaBay Pharmaceuticals (NBY - \$ 0.64)

Updates on Avenova Commercialization Progress and Pipeline Development Strategy Changes

NBY updated investors recently of their continued Avenova commercialization activities and the company's future direction in pipeline development. The company is scheduled to host a conference call on January 21st 2015 at 12:00 pm (EST) to provide more details. The dial-in number is 866-880-4999 (U.S.) or 702-495-1913 (ex-U.S.) with conference ID# of 62204781.

- Details.** NBY updated their Avenova marketing and sales campaign indicating the company plans to expand their medical direct sales force to 35 reps from 10 (started September 2014) by February this year and further increase it to 50 by July 2015. Targeted optometrists and ophthalmologists are those who have treated patients with meibomian gland dysfunction (dry eye) and blepharitis. On the R&D front, the company plans to reduce their in-house effort and plans to seek partners to further develop Auriclosene (NVC-422) as a potential treatment for the reduction of encrustation and blockage of in-dwelling urinary catheters (UCBE). NBY is also contemplating to in-license mature ophthalmological products that potentially could increase the product varieties of to be sold by the reps.
- Implication.** Although the company did not provide details on the current sales of Avenova, we view the significant commitment to increase sales reps from 10 to 50 by mid-year 2015 likely signifies NBY's strong confidence in the substantial market potential for Avenova. We believe the company could potentially provide more insights on the accomplished and projected sales potential during the conference call later this month. The company recently consummated a deal with McKesson as distributor and we believe the company could potentially form more similar deals with other major players near term to increase the coverage to an even broader patient population. Together with potential launch of NeutroPhase in China by Pioneer in 1Q15, NBY could likely be successful via its transition to revenue—driven commercial entity from a prior R&D focused company.
- Action.** Based on the encouraging advancements of its commercialization effort and adjusted R&D approach, we view NBY's overall risk/reward portfolio now 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
FY-14E	-0.08A	-0.06A	-0.08A	-0.07	-0.30	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.

Healthcare/Biotechnology

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

Trading Data:

Last Price (01/08/2015)	\$ 0.64
52-Week High (1/13/2014)	\$ 1.47
52-Week Low (12/5/2014)	\$ 0.53
Market Cap. (MM)	\$ 33
Shares Out. (MM)	52

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Anticipated milestones in 2015 and beyond

Product	Indication	Partner	Event	Timing
Avenova	Blepharitis		Expand sales force	1H15
NeutroPhase	Chronic non-healing wounds		Potential launch in China	1Q15
Consumer lens care product		Not yet announced	Commercial launch	2015
Auriclosene (NVC-422)	Prevention of urinary catheter blockage and encrustation (UCBE) (0.2%)		Potentially to outlicense for further development	2015

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, 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

NovaBay – Income Statement									
(\$'000)	2011	2012	2013	1Q14	2Q14	3Q14	4Q14E	2014E	2015E
Revenue									
Product royalty revenue			223	188	21	90	225	524	6,000
Cost of goods sold			162	130	18	42	113	303	1,000
Gross profit			61	58	3	48	113	222	5,000
Revenue (upfront, milestone, etc.)	10,993	6,855	3,045	38	38	23	25	124	40
Others	26	92	209	62	64	39	35	200	20
Total non-product revenue	11,019	6,947	3,254	100	102	62	60	324	60
Research and development	9,911	9,275	12,461	2,528	2,238	2,312	1,965	9,043	2,618
General and administrative	5,429	5,981	6,340	1,708	1,653	1,911	2,064	7,336	6,044
Sales and marketing									7,166
Total Operating Expenses	15,340	15,256	18,801	4,236	3,891	4,223	4,029	16,379	15,828
Operating Incomes (losses)	(4,321)	(8,309)	(15,486)	(4,078)	(3,786)	(4,113)	(3,857)	(16,055)	(10,768)
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	12
Income before tax	(5,083)	(7,025)	(16,040)	(3,565)	(2,932)	(4,219)	(3,666)	(14,603)	(10,636)
Tax	(2)	(2)	(2)	(2)	(10)			(10)	(5)
Net Income (Loss)	(5,085)	(7,027)	(16,042)	(3,565)	(2,942)	(4,219)	(3,666)	(14,613)	(10,641)
Net Income (Loss) Applicable to Common Shareholders	(\$5,085)	(\$7,027)	(\$16,044)	(3,564)	(2,940)	(4,216)	(3,662)	(\$14,613)	(\$10,637)
Net Earnings (Losses) Per Share—Basic and Diluted	(\$0.20)	(\$0.24)	(\$0.42)	(\$0.08)	(\$0.06)	(\$0.08)	(\$0.07)	(\$0.30)	(\$0.17)
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
Margin Analysis (% of Sales/Revenue)									
R&D	90%	134%	376%	1600%	2131%	2102%	1139%	1658%	52%
MG&A	49%	86%	191%	1081%	1574%	1737%	1196%	1345%	119%
Operating Income (loss)	-39%	-120%	-467%	-2581%	-3606%	-3739%	-2235%	-2943%	-213%
Net Income	-46%	-101%	-484%	-2256%	-2800%	-3833%	-2122%	-2678%	-210%
Financial Indicator Growth Analysis (YoY%)									
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%	-81%
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%	-33%
Total Other Income, net	-112%	417%	-101%	NA	1040%	-167%	-114%	4800%	-76%
Net Income	18%	38%	128%	-11%	-28%	10%	-12%	-9%	-27%
EPS - Diluted	7%	21%	76%	-28%	-47%	-19%	-29%	-30%	-41%

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

DISCLOSURES:

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RATINGS INFORMATION

Rating and Price Target Change History



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

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.	80.95%	33.33%	9.52%
Hold (H)	Expected returns to be in line with the sector average over 12 months.	4.76%	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 – Not Rated)
McKesson (MCK – Not Rated)

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