

NovaBay Pharmaceuticals (NBY - \$ 0.59)

We View Avenova Commercialization Progress and Development Updates Encouraging

Yesterday, NBY management along with two optometry and ophthalmology KOLs hosted a conference call to update investors on the Avenova commercialization progress and their opinion on the potential of Avenova use in various indications.

- Details.** NBY yesterday hosted a conference call updating investors of Avenova commercialization and developments of other assets. The highlights include: 1) management indicated that sales force expansion is underway with goal of reaching a total of 50 by mid-2015. They estimate it takes 8-10 months for a new rep to become break-even based on their sales vs. expenditure; 2) Dr. Terrence O'Brien indicated that Avenova could potentially be used in general eye lid hygiene, which would be broader than just blepharitis, and might encompass earlier stage dry eye and as part of pre-preparation of various of ophthalmological surgeries, such as glaucoma or cataract, given the drug potentially could reduce infection risks; 3) management indicated that they are developing two ophthalmological/optometry products and potentially to be marketed in 2016; 4) NBY priced Avenova at \$30 -\$40 per month of use and such a price is within the typical co-pay level for most insurance. As such, it could match well with patients' acceptance for a self-paid medication. After gaining broader buy-in by optometrists and ophthalmologists, NBY will contemplate conducting a DTC marketing strategy to increase awareness in prospective patients; and 5) Pioneer could start to launch NeutroPhase in China after Chinese New Year (in February). Pioneer also has the rights of Avenova in China and the company is a major distributor of products of Alcon – a leading ophthalmological product developer.
- Implication.** We view the conference call is positive and very informative by providing greater insights for the commercial outlook of Avenova and potentially paving a smooth path for NBY's transition to a product revenue driven company. The company might need an additional capital infusion to advance its commercialization effort, but the risks could be offset by potential revenue growth from Avenova, in our opinion.
- Action.** Based on the encouraging advancements of its commercialization effort, we view NBY has a more balanced overall risk/reward portfolio. We are reiterating our Buy rating and \$1.90 target price, which is supported by our peer comparable and risk-adjusted cash flow sum-of-the-parts analyses.

Healthcare/Biotechnology

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

Trading Data:

Last Price (01/22/2015)	\$ 0.59
52-Week High (3/7/2014)	\$ 1.38
52-Week Low (12/5/2014)	\$ 0.53
Market Cap. (MM)	\$ 30
Shares Out. (MM)	52

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

Yale Jen, Ph.D.

Managing Director /
Senior Biotechnology Analyst
(212) 953-4978
yjen@laidlawltd.com

Source: Laidlaw & Company estimates.

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Anticipated milestones in 2015 and beyond

Product	Indication	Partner	Event	Timing
Avenova	Blepharitis		Expand sales force	1H15
NeuroPhase	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%
Yale Jen, Ph.D. 212-953-4978									

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

DISCLOSURES:

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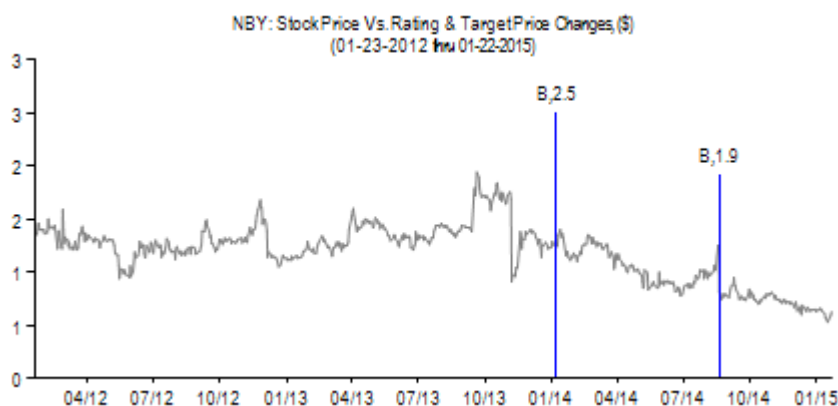
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Rating and Price Target Change History



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

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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.	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)

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