

NovaBay Pharmaceuticals (NBY - \$ 0.63)

Broader Avenova Distribution into Retail Pharmacies with Cardinal Agreement

This morning, NBY reported that the company has signed an agreement with Cardinal Health for the distribution of Avenova into to independent and retail chain pharmacies.

- Details.** NBY announced this morning the deal with Cardinal Health for the distribution of Avenova into to independent and retail chain pharmacies. The agreement is effective immediately and by working with Cardinal Health, NBY is committed to provide sufficient Avenova stocking to meet demand.
- Implication.** With distribution agreements with McKesson and Vision Source signed earlier, NBY believes that Avenova could become available to greater than 90% of retail pharmacies (a total of 67,000) and many optometrists offices in the U.S. Coupled with an aggressive marketing and sales efforts by the company as detailed during the recent conference call (see our 2015-01-22 note), we believe the Avenova commercialization has a strong start. Management indicated that the commercialization is in its early launch stage and estimate the revenue could be modest until 2H15 when a substantial portion of its sales reps have grown to becoming more effective. As a reminder, NBY is scheduled to add new reps to a total of 35 by February and up to 50 by mid-year. Management estimated it takes 8-10 months for a new rep to become break-even based on their sales vs. expenditure. Together, we believe today's announcement is an important incremental positive development for further securing the availability of Avenova in major distributing channels.
- 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 (01/26/2015)	\$ 0.63
52-Week High (3/7/2014)	\$ 1.38
52-Week Low (12/5/2014)	\$ 0.53
Market Cap. (MM)	\$ 33
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

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

DISCLOSURES:

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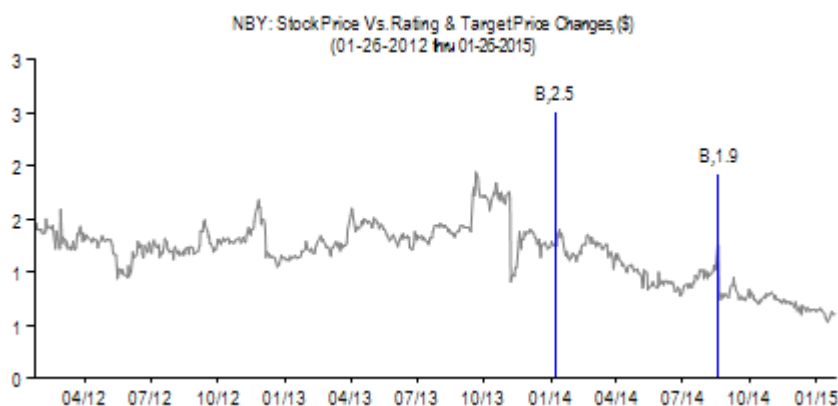
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RATINGS INFORMATION

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.	81.82%	36.36%	9.09%
Hold (H)	Expected returns to be in line with the sector average over 12 months.	4.55%	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

Cardinal Health (CAH – Not Rated)

McKesson (MCK – Not Rated)

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