

NovaBay Pharmaceuticals (NBY - \$4.60)

Turnaround Story Keeps Trucking Along, FY17 Guidance Reiterated

NBY reported 2Q17 results last night after the close with a slight beat on bottom line with EPS of (\$0.11) vs. our estimated (\$0.14) due to lower than anticipated operating expenses. Top line growth is key, in our opinion, to the turnaround story and we are encouraged to see NBY hit our top line estimate of \$4.1M. With record unit volume through their pharmacy channel in 2Q17 and an 80% increase vs. 2Q16 through this new sales model (sales growth 48% yoy), we view as a real positive management's reiteration of their YE17 topline guidance of \$19M. NBY noted that their new ophthalmology high margin sales channel vs. their prior buy and bill model has already led to an 89% gross margin. As NBY's primary focus remains on their US Avenova sales, with their other products shelved for the time being (constantly entertaining discussions for potential capital inflow); we have lowered our anticipated R&D expenses. Additionally NBY announced their collaboration with MedVantx, which enables patients to get home deliveries of Avenova in all 50 states or pick-up at one of thousands of in-store pharmacies. With a sales force still at only 1/3 of its capacity and already >10,600 medical professionals prescribing Avenova (21% increase vs. 2Q16), we believe NBY is executing on their strategy and continue to view NBY as undervalued at these levels. We reiterate our Buy rating and \$10 price target.

- **Topline hit and bottom line beat, lower operating expenses.** Following a strong 1Q17 amidst expected seasonality, we were encouraged by continued momentum. With a similar sales team the company reported a topline hit of \$4.1M and bottom line beat of (\$0.11) vs. our anticipated (\$0.14) due to lower operating expenses of \$5.2M vs. estimated 5.6M.
- **FY17 US Avenova sales guidance reiterated, another solid quarter.** We view as a real positive NBY's reiteration of their topline FY17 guidance of \$19M. As only 1/3 of sales reps hired to date, their 48% sales growth yoy sets them well on their way to achieving their goals, in our opinion.
- **We reiterate our Buy rating, \$10 PT.** Our price target is based on Avenova at \$9/share and cash (end'18) & tech value at \$1/share.

Earnings Estimates: (per share)

| Dec FY | 1Q | 2Q | 3Q | 4Q | FY | P/E |
|--------------|---------|---------|--------|--------|--------|-----|
| FY18E | (0.03) | 0.03 | (0.03) | 0.03 | 0.01 | NA |
| FY17E | (0.15)A | (0.11)A | (0.10) | (0.05) | (0.39) | NA |
| FY16 | (1.15) | (0.31) | (0.19) | (0.13) | (1.17) | NA |
| FY15 | (2.15) | (1.83) | (1.82) | (1.84) | (7.59) | NA |

Source: Laidlaw & Company estimates

Healthcare / Biotechnology

| | |
|---------------|-------------|
| Ticker: | NBY |
| Rating: | Buy |
| Price Target: | \$10 |

Trading Data:

| | |
|---------------------------|--------|
| Last Price (08/10/2017) | \$4.60 |
| 52-Week High (08/15/2016) | \$5.29 |
| 52-Week Low (06/02/2017) | \$2.25 |
| Market Cap. (MM) | \$70.4 |
| Shares Out. (MM) | 15.3 |

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Figure 1: Variance Analysis

| Novabay Pharmaceuticals | | | | | |
|------------------------------------|-----------------|-----------------|-----------------|--------------|-------------|
| Quarterly variance analysis | | | | | |
| <i>(\$000 except per share)</i> | 2Q16A | 2Q17A | 2Q17E | Variance | % Y/Y |
| Total revenues | \$2,663 | \$4,122 | \$4,127 | (\$5) | 55% |
| Gross margin | 2,184 | 3,424 | 3,525 | (\$101) | 57% |
| Sales & Marketing | 2,853 | 3,376 | 3,625 | (\$249) | 18% |
| G&A | 1,258 | 1,735 | 1,750 | (\$15) | 38% |
| R&D | 278 | 70 | 225 | (\$155) | -75% |
| Operating income/(loss) | (2,205) | (1,757) | (2,273) | \$516 | -20% |
| Other income (exp) | (59) | 4 | (50) | \$54 | -107% |
| Adj-Net income/(loss) | (2,266) | (1,753) | (2,125) | \$372 | -23% |
| Avg Shares (000) | 11,199 | 17,808 | 18,034 | (\$226) | 59% |
| Adj. EPS | (\$0.31) | (\$0.11) | (\$0.14) | \$0 | -63% |

Source: Company Reports; Laidlaw & Company Estimates

Figure 2. Sum-of-the-Parts Analysis

| Sum-of-the-parts valuation | | |
|-------------------------------------|----------------------|--------------------|
| Segment | Valuation (000's) | Per share value |
| Avenova | \$206,091 | \$9.00 |
| Cash (end '18) & tech value | \$16,483 | \$1.00 |
| | \$222,574 | \$10.00 |
| 2018 fully diluted shares out (000) | | 22,433 |

Source: Company reports; Laidlaw and Company estimates

Figure 3: Quarterly Income Statement

| Novabay Pharmaceuticals | | | | | | | | | | |
|------------------------------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| Quarterly income statement | | | | | | | | | | |
| (\$000's except per share) | 2016A | | | | 2016A Year | 2017E | | | | 2017E Year |
| | 1QA | 2QA | 3QA | 4QA | | 1QA | 2QA | 3QE | 4QE | |
| Revenues | | | | | | | | | | |
| Avenova | \$1,655 | \$2,654 | \$3,262 | \$4,046 | \$11,617 | \$3,694 | \$4,094 | \$4,986 | \$5,936 | \$18,709 |
| Other revenue | 64 | 9 | 176 | 31 | \$280 | 7 | 28 | 100 | 100 | \$235 |
| Total revenues | \$1,719 | \$2,663 | \$3,438 | \$4,077 | \$11,897 | \$3,701 | \$4,122 | \$5,086 | \$6,036 | \$18,944 |
| Expenses | | | | | | | | | | |
| COGS | 611 | 479 | 566 | 808 | 2,464 | 588 | 698 | 743 | 881 | 2,910 |
| Gross margin | 1,108 | 2,184 | 2,872 | 3,269 | 9,433 | 3,113 | 3,424 | 4,343 | 5,154 | 16,035 |
| R&D | 933 | 278 | 4 | 156 | 1,371 | 62 | 70 | 100 | 100 | 332 |
| Sales & marketing | 3,144 | 2,853 | 2,663 | 3,149 | 11,809 | 3,740 | 3,376 | 3,875 | 3,875 | 14,866 |
| G&A | 1,655 | 1,258 | 2,218 | 1,994 | 7,235 | 1,588 | 1,735 | 2,000 | 2,000 | 7,323 |
| Tot. Operating expenses | 5,732 | 4,389 | 4,885 | 5,299 | 20,415 | 5,390 | 5,181 | 5,975 | 5,975 | 22,521 |
| Operating income/(loss) | (4,624) | (2,205) | (2,013) | (2,030) | (10,982) | (2,277) | (1,757) | (1,632) | (821) | (6,486) |
| Other income/(exp) | (68) | (59) | (52) | 1 | (68) | 2 | 4 | (50) | (50) | (94) |
| Loss before income tax exp. | (4,692) | (2,264) | (2,065) | (2,029) | (11,050) | (2,275) | (1,753) | (1,682) | (871) | (6,580) |
| Tax expense | 0 | (2) | 0 | 0 | (2) | (1) | 0 | 0 | 0 | (1) |
| Adj-Net income/(loss) | (4,692) | (2,266) | (2,065) | (2,029) | (11,052) | (2,276) | (1,753) | (1,682) | (871) | (6,581) |
| Non-cash gain/(loss), warrant lia | (385) | (424) | (1,671) | 381 | (2,099) | (1,735) | 15 | | | |
| NI/(loss) as reported | (5,077) | (2,690) | (3,736) | (1,648) | (13,151) | (4,011) | (1,738) | | | |
| Adj-EPS ex-non-cash | (\$1.15) | (\$0.31) | (\$0.19) | (\$0.13) | (\$1.17) | (\$0.15) | (\$0.11) | (\$0.10) | (\$0.05) | (\$0.39) |
| EPS as reported | (\$1.24) | (\$0.36) | (\$0.34) | (\$0.11) | (\$1.40) | (\$0.26) | (\$0.11) | | | |
| Shares out (000) | 4,086 | 7,407 | 10,913 | 15,459 | 9,408 | 15,284 | 15,308 | 17,308 | 19,308 | 16,802 |
| Fully diluted shares (000) | 5,844 | 11,199 | 13,344 | 17,959 | 12,086 | 17,784 | 17,808 | 19,808 | 21,808 | 19,302 |

Source: Bloomberg LP; Company Reports; Laidlaw & Company estimates

Figure 4: Annual Income Statement

| Novabay Pharmaceuticals | | | | | | | | |
|--------------------------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------------------------|
| Annual income statement | | | | | | | | |
| (\$000's except per share) | 2015A | 2016A | 2017E | 2018E | 2019E | 2020E | 2021E | Comments |
| Revenues | | | | | | | | |
| Avenova | \$4,146 | \$11,617 | \$18,709 | \$39,672 | \$56,675 | \$80,847 | \$91,783 | |
| Other revenue | 235 | 280 | 235 | 400 | 400 | 400 | 400 | |
| Total sales | \$4,381 | \$11,897 | \$18,944 | \$40,072 | \$57,075 | \$81,247 | \$92,183 | 2017 guide: \$19M |
| COGS | 1,261 | 2,464 | 2,910 | 6,011 | 7,990 | 11,375 | 12,906 | |
| Gross margin | 3,120 | 9,433 | 16,035 | 34,061 | 49,084 | 69,872 | 79,278 | 2017 guide: high 80% range |
| R&D | 6,045 | 1,371 | 332 | 1,000 | 1,500 | 1,750 | 2,000 | scaling back R&D spend |
| Sales & marketing | 11,006 | 11,809 | 14,866 | 24,875 | 35,625 | 38,500 | 39,500 | ~50 reps currently |
| G&A | 7,083 | 7,235 | 7,323 | 7,750 | 8,750 | 9,600 | 10,000 | |
| Tot. Operating expenses | 24,134 | 20,415 | 22,521 | 33,625 | 45,875 | 49,850 | 51,500 | |
| Operating income/(loss) | (21,014) | (10,982) | (6,486) | 436 | 3,209 | 20,022 | 27,778 | |
| Other income/(exp) | (96) | (68) | (94) | (200) | (200) | (200) | (200) | |
| Loss before inc tax | (21,110) | (11,050) | (6,580) | 236 | 3,009 | 19,822 | 27,578 | |
| Tax expense | (12) | (2) | (1) | 0 | (161) | (1,982) | (4,896) | Sig. tax loss carryforwards |
| Adj-Net income/(loss) | (21,122) | (11,052) | (6,581) | 236 | 2,848 | 17,840 | 22,682 | 2017 guide: (\$6,200) loss |
| Non-cash gain/(loss), warrant | 2,149 | (2,099) | 0 | 0 | 0 | 0 | 0 | |
| NI/(loss) as reported | (18,973) | (13,151) | 0 | 0 | 0 | 0 | 0 | |
| Adj-EPS ex-non-cash | (\$7.59) | (\$1.17) | (\$0.39) | \$0.01 | \$0.12 | \$0.73 | \$0.88 | |
| EPS as reported | (\$6.82) | (\$1.40) | | | | | | |
| Shares out (000) | 2,784 | 9,408 | 16,802 | 19,933 | 20,933 | 22,058 | 23,258 | |
| Fully diluted shares (000) | 4,630 | 12,086 | 19,302 | 22,433 | 23,433 | 24,558 | 25,758 | |

Source: Bloomberg LP; Company Reports; Laidlaw & Company estimates

Major Risks

Exogenous events could impact our outlook. We believe pharmaceutical companies have the least control over competitive, political, and regulatory risks. Although we have incorporated competitive assumptions into our forecasts, there may be other risks beyond the scope of our analysis. Changes in the drug reimbursement system, as well as any political or regulatory amendments, may significantly influence the earnings power of these companies.

Actual clinical results and the FDA's conclusions may deviate from expectations. Many of our assumptions are based on a review of incomplete clinical trial data available in the public domain. Often, our conclusions are drawn from early stage data, which may not be reflected by pivotal studies. Furthermore, the FDA's conclusions may not coincide with our own, materially changing our revenue and earnings assumptions.

Compliance issues, product recalls, and other mandates by regulatory authorities could materially change our expectations. Regulatory compliance issues, ranging from accounting irregularities to defective manufacturing practices, could materially change our assumptions and earnings outlook. Unanticipated product recalls and labeling changes could also have adverse consequences on our earnings assumptions.

Legal risks could lead to additional liabilities and revenue loss. In addition to the expenses incurred by patent challenges, product liability and other legal suits could occur and lead to additional liabilities and revenue loss, which could substantially change our financial assumption

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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 (\$) |
|------------|----------|--------------------|
| 08/20/2... | Buy (B) | 20.25 |
| 11/19/2... | Drop (U) | 4.18 |
| 03/27/2... | Buy (B) | 3.75 |

3 Year Price Change History

| Date | Target Price (\$) | Closing Price, (\$) |
|------------|-------------------|---------------------|
| 08/20/2... | 47.50** | 20.25 |
| 11/19/2... | | 4.18 |
| 03/27/2... | 10.00 | 3.75 |
| 03/27/2... | 10.00 | 3.75 |

** Split Adjusted

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. | 63.04% | 30.43% | 2.17% |
| Hold (H) | Expected returns to be in line with the sector average over 12 months. | 4.35% | 0.00% | 0.00% |
| Sell (S) | Returns expected to significantly underperform the sector average over 12 months. | 0.00% | 0.00% | 0.00% |

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