

## NovaBay Pharmaceuticals (NBV - \$4.60)

Healthcare / Biotechnology

### Avenova to Fulfill a Large and Growing Unmet Medical Need

We recently held a KOL call with a leading ophthalmologist on NBV's prescription cleanser Avenova for removal of microorganisms and debris on and around the eyelids and eyelashes due to blepharitis, meibomian gland dysfunction (MGD), and/or dry eye. As the mechanism of action (MOA) of ocular surface diseases such as dry eye is progressively becoming more understood, our KOL views Avenova as a rational treatment approach. With new evidence linking dry eye to blepharitis, we see Avenova as potentially filling an even bigger unmet medical need than originally believed. In fact, in addition to a lack of tear production, dry eye also results from tear evaporation, which seems to be prevented by Avenova's oil production. While Allergan's Restasis and Shire's Xiidra help produce tears, they don't address the newly understood evaporation issue of dry eye. We were encouraged by our KOL's belief in Avenova's synergistic response to not only current dry eye treatment but also pre and post-surgical procedures as an infection prophylaxis as well as contact lens intolerance. As the dry eye market expands and awareness grows through significant marketing spend from large pharma, we see Avenova as well positioned for important growth as a complementary product. Additionally, our KOL was especially impressed with NBV's in vivo data presented at ARVO last year, which showed significant reduction of bacterial load in only 20 minutes. While our KOL noted that commercial reimbursement for Avenova has improved significantly over the past few years, he believes NBV's main challenge lies in their lack of complete coverage in their Part D or Medicare advantage plans. As Avenova could potentially be used as a complementary treatment to any chronic ocular surface diseases, we view NBV as undervalued at these levels and reiterate our Buy rating and \$10 price target.

Ticker: **NBV**  
Rating: **Buy**  
Price Target: **\$10**

#### Trading Data:

Last Price (09/29/2017)	\$4.60
52-Week High (08/15/2016)	\$5.09
52-Week Low (06/02/2017)	\$2.25
Market Cap. (MM)	\$70.4
Shares Out. (MM)	15.3

- **Avenova just scratching the surface, no real competition in a growing market.** As the treatment paradigm for blepharitis, dry eye and other ocular surface diseases evolve, these >40M patients in the US alone could benefit from Avenova's efficacy and tolerability profile in comparison to baby shampoo and other OTC products with impurities.
- **As commercial reimbursement improves, greater Part D coverage and Medicare advantage plans could unlock significant prescription growth.** As many ocular surface diseases increase with age, we believe important sales growth could result from additional Medicare Advantage coverage.
- **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
<b>FY18E</b>	(0.10)	(0.05)	0.00	0.09	(0.04)	NA
<b>FY17E</b>	(0.15)A	(0.11)A	(0.12)	(0.03)	(0.40)	NA
<b>FY16</b>	(1.15)	(0.31)	(0.19)	(0.13)	(1.17)	NA
<b>FY15</b>	(2.15)	(1.83)	(1.82)	(1.84)	(7.59)	NA

#### Analyst

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Source: Laidlaw & Company estimates

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**Figure 1. Sum-of-the-Parts Analysis**

Sum-of-the-parts valuation		
Segment	Valuation (000's)	Per share value
Avenova	\$205,854	\$9.00
Cash (end '18) & tech value	\$20,340	\$1.00
	\$226,194	<b>\$10.00</b>
2018 fully diluted shares out (000)		22,433

Source: Company reports; Laidlaw and Company estimates

Figure 2: 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	
<b>Revenues</b>										
Avenova	\$1,655	\$2,654	\$3,262	\$4,046	\$11,617	\$3,694	\$4,094	\$4,594	\$6,215	\$18,598
Other revenue	64	9	176	31	\$280	7	28	100	100	\$235
<b>Total revenues</b>	<b>\$1,719</b>	<b>\$2,663</b>	<b>\$3,438</b>	<b>\$4,077</b>	<b>\$11,897</b>	<b>\$3,701</b>	<b>\$4,122</b>	<b>\$4,694</b>	<b>\$6,315</b>	<b>\$18,833</b>
<b>Expenses</b>										
COGS	611	479	566	808	2,464	588	698	704	947	2,937
<b>Gross margin</b>	<b>1,108</b>	<b>2,184</b>	<b>2,872</b>	<b>3,269</b>	<b>9,433</b>	<b>3,113</b>	<b>3,424</b>	<b>3,990</b>	<b>5,368</b>	<b>15,895</b>
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
<b>Tot. Operating expenses</b>	<b>5,732</b>	<b>4,389</b>	<b>4,885</b>	<b>5,299</b>	<b>20,415</b>	<b>5,390</b>	<b>5,181</b>	<b>5,975</b>	<b>5,975</b>	<b>22,521</b>
<b>Operating income/(loss)</b>	<b>(4,624)</b>	<b>(2,205)</b>	<b>(2,013)</b>	<b>(2,030)</b>	<b>(10,982)</b>	<b>(2,277)</b>	<b>(1,757)</b>	<b>(1,985)</b>	<b>(607)</b>	<b>(6,626)</b>
Other income/(exp)	(68)	(59)	(52)	1	(68)	2	4	(50)	(50)	(94)
<b>Loss before income tax exp.</b>	<b>(4,692)</b>	<b>(2,264)</b>	<b>(2,065)</b>	<b>(2,029)</b>	<b>(11,050)</b>	<b>(2,275)</b>	<b>(1,753)</b>	<b>(2,035)</b>	<b>(657)</b>	<b>(6,720)</b>
Tax expense	0	(2)	0	0	(2)	(1)	0	0	0	(1)
<b>Adj-Net income/(loss)</b>	<b>(4,692)</b>	<b>(2,266)</b>	<b>(2,065)</b>	<b>(2,029)</b>	<b>(11,052)</b>	<b>(2,276)</b>	<b>(1,753)</b>	<b>(2,035)</b>	<b>(657)</b>	<b>(6,721)</b>
Non-cash gain/(loss), warrant lia	(385)	(424)	(1,671)	381	(2,099)	(1,735)	15			
<b>NI/(loss) as reported</b>	<b>(5,077)</b>	<b>(2,690)</b>	<b>(3,736)</b>	<b>(1,648)</b>	<b>(13,151)</b>	<b>(4,011)</b>	<b>(1,738)</b>			
<b>Adj-EPS ex-non-cash</b>	<b>(\$1.15)</b>	<b>(\$0.31)</b>	<b>(\$0.19)</b>	<b>(\$0.13)</b>	<b>(\$1.17)</b>	<b>(\$0.15)</b>	<b>(\$0.11)</b>	<b>(\$0.12)</b>	<b>(\$0.03)</b>	<b>(\$0.40)</b>
<b>EPS as reported</b>	<b>(\$1.24)</b>	<b>(\$0.36)</b>	<b>(\$0.34)</b>	<b>(\$0.11)</b>	<b>(\$1.40)</b>	<b>(\$0.26)</b>	<b>(\$0.11)</b>			
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 &amp; Company estimates

Figure 3: Annual Income Statement

Novabay Pharmaceuticals								Comments
Annual income statement								
(\$000's except per share)	2015A	2016A	2017E	2018E	2019E	2020E	2021E	
<b>Revenues</b>								
Avenova	\$4,146	\$11,617	\$18,598	\$37,962	\$75,480	\$107,672	\$122,237	
Other revenue	235	280	235	400	400	400	400	
<b>Total sales</b>	<b>\$4,381</b>	<b>\$11,897</b>	<b>\$18,833</b>	<b>\$38,362</b>	<b>\$75,880</b>	<b>\$108,072</b>	<b>\$122,637</b>	2017 guide: \$19M
COGS	1,261	2,464	2,937	5,754	10,623	15,130	17,169	
<b>Gross margin</b>	<b>3,120</b>	<b>9,433</b>	<b>15,895</b>	<b>32,608</b>	<b>65,257</b>	<b>92,942</b>	<b>105,468</b>	2017 guide: high 80% range
R&D	6,045	1,371	332	550	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	
<b>Tot. Operating expenses</b>	<b>24,134</b>	<b>20,415</b>	<b>22,521</b>	<b>33,175</b>	<b>45,875</b>	<b>49,850</b>	<b>51,500</b>	
<b>Operating income/(loss)</b>	<b>(21,014)</b>	<b>(10,982)</b>	<b>(6,626)</b>	<b>(567)</b>	<b>19,382</b>	<b>43,092</b>	<b>53,968</b>	
Other income/(exp)	(96)	(68)	(94)	(200)	(200)	(200)	(200)	
<b>Loss before inc tax</b>	<b>(21,110)</b>	<b>(11,050)</b>	<b>(6,720)</b>	<b>(767)</b>	<b>19,182</b>	<b>42,892</b>	<b>53,768</b>	
Tax expense	(12)	(2)	(1)	0	(1,219)	(4,289)	(9,506)	Sig. tax loss carryforwards
<b>Adj-Net income/(loss)</b>	<b>(21,122)</b>	<b>(11,052)</b>	<b>(6,721)</b>	<b>(767)</b>	<b>17,963</b>	<b>38,603</b>	<b>44,262</b>	2017 guide: (\$6,200) loss
Non-cash gain/(loss), warrant	2,149	(2,099)	0	0	0	0	0	
<b>NI/(loss) as reported</b>	<b>(18,973)</b>	<b>(13,151)</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	
<b>Adj-EPS ex-non-cash</b>	<b>(\$7.59)</b>	<b>(\$1.17)</b>	<b>(\$0.40)</b>	<b>(\$0.04)</b>	<b>\$0.77</b>	<b>\$1.57</b>	<b>\$1.72</b>	
<b>EPS as reported</b>	<b>(\$6.82)</b>	<b>(\$1.40)</b>						
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 &amp; Company estimates

## Major Risks

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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 (\$)
11/19/2...	Drop (D )	4.18
03/27/2...	Buy (B )	3.75

#### 3 Year Price Change History

Date	Target Price (\$)	Closing Price, (\$)
11/19/2...		4.18
03/27/2...	10.00	3.75
03/27/2...	10.00	3.75

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
<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.	64.58%	31.25%	2.08%
<b>Hold (H)</b>	Expected returns to be in line with the sector average over 12 months.	4.17%	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

Allergan (AGN – Not Rated)  
Shire (SHPG – Not Rated)

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