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Sonoma Pharmaceuticals (Nasdaq/SNOA)

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BUY
Q2/18 Results positive

Sonoma is a specialty pharmaceutical company that develops and markets unique and effective solutions for the treatment of dermatological conditions and advanced tissue care

Investment Highlights

1) Sonoma reported positive financial results for its most recent Q2/2018 (ending September) quarter, including 61% growth in product revenues year-over-year and a reduction in EBITDA loss to \$2.3 million from \$2.5 million in the prior quarterly period. Overall, revenues came in at \$4.3 million for Sonoma in Q2/18, up from \$2.8 million the prior year, with a net loss of \$2.9 million or (\$0.67) per share compared to \$3.0 million or (\$0.63) per share before one-time benefits in the prior year period. Revenue growth in Q2/18 was led by an increase of 42% in prescriptions filled to 19,660, due to strong demand for dermatological and acute care products in the US, Europe, Latin America and other international markets. Particularly strong growth in the quarter (in terms of demand dollars) was exhibited by Mondoxylene, Sonoma's severe acne product launched about two years ago, which has averaged quarterly growth of 48% over the past year. Gross profit this year increased to \$1.8 million, or 43% of revenue, from \$1.0 million or 37%, which allowed the Company to offset a 15% increase in non-cash operating expenses this year and help bring down EBITDA net loss to \$2.3 million from \$2.5 million one year ago. Operating cash burn was \$2.3 million in the second quarter for Sonoma, and at the end of September the Company retained \$10 million in cash.

2) Looking ahead, third quarter results are expected to be favorably impacted by the September launch of skin descaling product Loyon. For the upcoming third quarter (December 2017) we are estimating that Sonoma will post revenues of \$4.5 million, including product revenues of \$4.3 million, up 35% year-over-year, and a net loss of \$2.8 million or (\$0.63) per share. For the fiscal 2018 year as a whole (ending 2018E) we are estimating that the Company will post revenues of \$17.4 million, which includes product sales of \$16.5 million, an increase of 38% from fiscal 2017, and a net loss of \$11.8 million, or (\$2.71) per share. In addition to Loyon, recent


Current Price \$4.23
Price Target \$11.00

Estimates	F2016A	F2017A	F2018E
Revenue(\$000s)	\$9,369	\$12,825	\$17,370 E
1Q June	3,372	2,638	3,835 A
2Q September	4,089	4,108	4,325 A
3Q December	3,293	3,361	4,500 E
4Q March	2,914	4,029	4,710 E

EPS	(\$3.09)	\$2.20	(\$2.71) E
1Q June	(0.77)	(0.61)	(0.82) A
2Q September	(0.54)	(0.46)	(0.67) A
3Q December	(0.96)	3.84	(0.63) E
4Q March	(0.82)	(0.58)	(0.60) E

P/E (x)	N/A	N/A	N/A
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EBITDA/Share	(\$3.56)	(\$2.38)	(\$2.10)
EV/EBITDA (x)	N/A	N/A	N/A

Stock Data		
52-Week Range		\$4.16-\$8.25
Shares Outstanding (mil.)		4.3
Market Capitalization (mil.)		\$18.2
Enterprise Value (mil.)		\$8.7
Debt to Capital (9/17)		2.7%
Book Value/Share (9/17)		\$3.75
Price/Book		1.1 X
Average Trading Volume (10-Day)		48,700
Insider Ownership		2.3%
Institutional Ownership		11.0%
Short interest		45,000
Dividend / Yield		\$0.00/0.0%



Please find Important Disclosures beginning on Page 5.

product approvals from Brazil may contribute to sales, potentially this fiscal year but more likely in fiscal 2019. For fiscal 2019, we are projecting that the Company will post revenues of \$19 million, with \$18 million in product sales, representing an increase of close to 9% year-over-year, with a net loss of \$10.4 million or (\$2.30) per share. Current levels of cash on hand are expected to last well into next fiscal year for Sonoma, or perhaps further if the Company can continue its recent pace of reducing EBITDA losses and operating cash burn.

Conclusion/Stock Valuation

We are reiterating our BUY rating on Sonoma Pharmaceuticals and 12-18 month price target of \$11. With a solid balance sheet, a new dermatology-focused internal sales force, and a versatile business development effort in both R&D and M&A, growth-oriented investors may find these shares attractive. In addition, with a current valuation of less than 1.2X expected revenues of \$16.0 million for this calendar year, well below valuations given to a number of recent dermatology-oriented specialty pharma buyouts, value-oriented investors may also look with interest at SNOA shares.

Risk Factors

In addition to normal economic and market risk factors that impact most equities and the common risks shared by Sonoma with other companies in the industry, we believe an investment in SNOA involves the following risks:

- **Reliance on key management** – At present, SNOA relies on several key members of its management team who either founded the Company or have been in key executive positions for an extended period of time. Should one or more of these key executives leave the Company, SNOA could find it difficult to replace their long-standing knowledge of operations and industry expertise.
- **Reliance on partnerships** – To date, SNOA has signed certain partnerships and agreements for its pharmaceutical technologies and products. Thus, in the future certain factors related to product commercialization and new product development may be determined by third parties and out of the control of Company management.
- **Limited stock liquidity** – Trading volume in SNOA stock is comparatively light and these shares have a relatively limited history of trading on major US stock exchanges compared with other healthcare stocks. As such, news regarding SNOA, its target market, partners and/or competitors could lead to significant volatility in the stock price.
- **Competitive Markets** – The Company competes in its target dermatological product market with a number of companies, many of which are considerably larger than the Company. There can be no assurance that the Company will be able to successfully compete and launch new products into these competitive markets in the future.
- **FDA and regulatory risks** – SNOA is subject to regulatory review for its ongoing research and development activities, principally the US Food and Drug Administration's application processes. In addition, the quality assurance and manufacture of the Company's pharmaceutical products are subject to ongoing oversight and regulation, and any negative correspondence from the FDA or other regulatory agencies could have an adverse effect on the ongoing operations of the Company.
- **Lack of historic profitability** - SNOA has not achieved operating profitability on an annual basis for several years, and according to our forecasts may not be expected to do so in the near future. Although the Company maintains adequate cash reserves at the present time, there can be no assurance the Company will not need to raise additional working capital in the future should operating losses continue.

- **Need to defend patents and other intellectual property** – SNOA currently holds a number of US and International patents on its products and related technologies, some of which expire in the near future. The Company may be required to defend its patents in the US and overseas in the future, and there can be no assurance these defenses will be successful.

Sonoma Pharmaceuticals, Inc.
Consolidated Statements of Income
 (In 000s, except per share data)

FYE March	2012	2013	2014	2015	2016	1Q17	2Q17	3Q17	4Q17	2017	1Q18	2Q18	3Q18	4Q18	2018	2019
		March	March	March	March	June	September	December	March	March	June	September	December	March	March	March
Revenues																
Product and product licensing fees	\$11,853	\$14,583	\$12,723	\$12,995	\$8,308	\$2,411	\$3,884	\$3,174	\$3,799	\$11,957	\$3,603	\$4,144	\$4,300	\$4,500	\$16,547	\$18,000
Service	891	869	945	859	1,061	227	224	187	230	868	232	181	200	210	823	1,000
Total revenues	\$12,744	\$15,452	\$13,668	\$13,854	\$9,369	\$2,638	\$4,108	\$3,361	\$4,029	\$12,825	\$3,835	\$4,325	\$4,500	\$4,710	\$17,370	\$19,000
Cost of revenues																
Product	3,254	3,976	4,510	5,908	5,840	1,472	1,822	1,476	1,912	6,419	1,913	2,308	2,280	2,340	8,841	9,000
Service	776	733	761	658	881	185	204	179	170	738	160	169	170	175	674	680
Total cost of revenues	4,030	4,709	5,271	6,566	6,721	1,657	2,026	1,655	2,082	7,157	2,073	2,477	2,450	2,515	9,515	9,680
Gross Profit	8,714	10,743	8,397	7,288	2,648	981	2,082	1,706	1,947	5,668	1,762	1,848	2,050	2,195	7,855	9,320
Operating Expenses:																
Research and development	1,981	2,223	2,887	1,533	1,806	360	379	487	350	1,576	382	368	380	390	1,520	1,600
Selling, General and administrative	13,200	11,894	11,561	12,414	15,556	4,130	3,643	4,784	4,509	17,066	4,763	4,337	4,400	4,450	17,950	18,000
Operating income (loss)	(6,467)	(3,374)	(6,051)	(6,659)	(14,714)	(3,509)	(1,940)	(3,565)	(2,912)	(12,974)	(3,383)	(2,857)	(2,730)	(2,645)	(11,615)	(10,280)
Interest expense	(931)	(1,107)	(1,058)	(2)	(3)	(1)	(1)	0	(1)	(3)	(10)	(10)	(10)	(10)	(40)	(40)
Other (income) expense, net	69	(950)	10,843	(1,542)	4,555	623	(8)	15,753	249	17,983	(115)	(3)	(10)	(10)	(138)	(40)
Income (loss) before tax	(7,329)	(5,431)	3,734	(8,203)	(10,162)	(2,887)	(1,949)	12,188	(2,664)	5,006	(3,508)	(2,870)	(2,750)	(2,665)	(11,793)	(10,360)
Tax benefit (Expense)	0	(1,062)	0	0	0	319	0	4,040	228	4,268	0	0	0	0	0	0
Net income (loss)	(7,329)	(6,493)	3,734	(8,203)	(10,162)	(2,568)	(1,949)	16,228	(2,436)	9,274	(3,508)	(2,870)	(2,750)	(2,665)	(11,793)	(10,360)
Basic income per share	(\$9.37)	(\$6.52)	\$2.71	(\$4.25)	(\$3.09)	(\$0.61)	(\$0.46)	\$3.84	(\$0.58)	\$2.20	(\$0.82)	(\$0.67)	(\$0.63)	(\$0.60)	(\$2.71)	(\$2.30)
Diluted income per share	(\$9.37)	(\$6.52)	\$2.71	(\$4.25)	(\$3.09)	(\$0.61)	(\$0.46)	\$3.84	(\$0.58)	\$2.20	(\$0.82)	(\$0.67)	(\$0.63)	(\$0.60)	(\$2.71)	(\$2.30)
Basic shares outstanding	782	995	1,376	1,931	3,289	4,198	4,202	4,228	4,224	4,224	4,294	4,313	4,360	4,410	4,344	4,500
Diluted shares outstanding	782	995	1,376	1,931	3,289	4,198	4,202	4,228	4,224	4,224	4,294	4,313	4,360	4,410	4,344	4,500
Key ratios:																
Product/Royalties revenue growth	34.3%	23.0%	-12.8%	2.1%	-36.1%	-23.4%	-73.4%	-75.1%	-70.8%	43.9%	49.4%	6.7%	35.5%	18.5%	38.4%	8.8%
Gross margin-products	72.5%	72.7%	64.6%	54.5%	29.7%	38.9%	53.1%	53.5%	49.7%	46.3%	46.9%	44.3%	47.0%	48.0%	46.6%	50.0%
R&D/revenue	15.5%	14.4%	21.1%	11.1%	19.3%	13.6%	9.2%	14.5%	8.7%	12.3%	10.0%	8.5%	8.4%	8.3%	8.8%	8.4%
S, G & A/revenues	103.6%	77.0%	84.6%	89.6%	166.0%	156.6%	88.7%	142.3%	111.9%	133.1%	124.2%	100.3%	97.8%	94.5%	103.3%	94.7%
Non-cash items	\$2,730	\$2,772	\$2,600	\$2,024	\$3,000	\$470	\$470	\$470	\$470	\$2,500	\$550	\$600	\$650	\$700	\$2,500	\$2,600
Tax Rate	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A						
Cash Flow/share	(\$1.18)	(\$0.73)	(\$3.33)	(\$2.40)	(\$3.56)	(\$0.65)	(\$0.35)	\$0.22	(\$0.52)	(\$1.30)	(\$0.69)	(\$0.53)	(\$0.48)	(\$0.45)	(\$2.11)	(\$1.72)
EBITDA/share	(\$1.16)	(\$1.18)	(\$3.28)	(\$2.40)	(\$3.56)	(\$0.72)	(\$0.35)	(\$0.73)	(\$0.58)	(\$2.38)	(\$0.66)	(\$0.53)	(\$0.48)	(\$0.45)	(\$2.10)	(\$1.73)

Balance Sheets

	3/31/17	9/30/17
Assets:		
Cash and equivalents	\$17,461	\$9,983
Accounts receivable, net	2,108	3,035
Inventories, net	2,221	2,603
Prepaid expenses & other	853	1,578
Total current	22,643	17,199
Property & equip., net	1,239	1,358
Other assets	1,577	1,596
TOTAL ASSETS	\$25,459	\$20,153
Liabilities:		
Accounts payable	\$1,255	\$1,275
Accrued expenses	1,836	1,741
Long-term debt - current portion	197	191
Total current	3,288	3,207
Long-term debt	213	255
Other long-term	527	531
Total long-term liabilities	740	786
Stockholders' equity	21,431	16,160
TOTAL LIAB & EQ	\$25,459	\$20,153

Quarterly Earnings Comparisons

	June	Sept	December	March	Total
Revenues (in \$000)					
2014	3,372	4,089	3,293	2,914	13,668
2015	3,392	3,264	3,218	3,980	13,854
2016	3,680	4,034	2,483	2,575	9,369
2017	2,638	4,108	3,361	4,029	12,825
2018E	3,835	4,325	4,500	4,710	17,370
Earnings per Share					
2014					2.71
2015					(4.25)
2016	(0.77)	(0.54)	(0.96)	(0.82)	(3.09)
2017	(0.61)	(0.46)	3.84	(0.58)	2.20
2018E	(0.82)	(0.67)	(0.63)	(0.60)	(2.71)

Revenues by Segment

Revenues by Geographic area (FYE March)	2016	2017	2018E
	March	March	March
Product-related revenues			
United States	4,371	6,580	10,000
Latin America	0	1,299	2,500
Europe and rest-of-world	3,706	4,078	4,047
Total product	8,077	11,957	16,547
Product license fees and royalties	231	0	0
Service revenues	1,061	868	823
Total	\$9,369	\$12,825	\$17,370

Source: Dawson James Securities, Inc. estimates; Company documents

Important Disclosures:

Price Chart:



Price target and ratings changes over the past 3 years:

- Price target lowered to \$20 - February 18, 2015
- Price target re-initiated at \$11 - August 14, 2017

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- 2) **Neutral:** the analyst believes the price of the stock is fairly valued for the next 12-18 months;
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Ratings Distribution	Company Coverage		Investment Banking	
	# of Companies	% of Total	# of Companies	% of Totals
Market Outperform (Buy)	13	87%	2	15%
Market Perform (Neutral)	2	0%	0	0%
Market Underperform (Sell)	0	0%	0	0%
Total	15	100%	2	13%

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