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INITIATION REPORT

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Oculus Innovative Sciences (Nasdaq/OCLS)

BUY **Macro potential from Microcyn**

Oculus markets the Microcyn line of anti-infective and wound care products

August 17, 2009

Robert M. Wasserman
Director of Research
561-208-2905
rwasserman@dawsonjames.com

Investment Highlights

1) Oculus received its **most advanced US FDA approvals** just a few months ago: In May for Microcyn Hydrogel OTC and Rx and in June for Microcyn Skin and Wound Cleanser with preservatives. Both of these products are set to be launched in the US market this month, with a further hard launch for Hydrogel Rx set for January 2010. Revenues and gross profit contribution from these new product lines are expected to help bring the Company closer to operating cash flow break-even this fiscal year (ending March 2010) as well as lessen the Company's reliance on international sales and foreign currency fluctuations.

2) The Company has more going on than just these two new US FDA approvals: **Swine flu concerns in Mexico** have driven sales this summer of the new Microcyn OTC product in that country, while the new **Vetericyn joint venture** launched a line of veterinary products in June. Combined with cost saving measures begun last year, Oculus significantly reduced its operating loss and cash burn in most recent quarterly results (Q1/2010 ending June) and is setting the stage to reach operating cash flow break-even by the end of this fiscal year (March 2010).

3) Oculus is not content to rest on its past regulatory laurels, however, and the Company has a **number of additional new product initiatives** under way to help grow revenues beyond this fiscal year. These include a feasibility study using Microcyn Hydrogel in the **treatment of acne**; additional partnerships for Microcyn Wound Care in **European markets;** a new partnership with **OroScience** for the use of Microcyn in oral-care products in the US, Canada and Europe, and a new drug development program for the use of Microcyn in **diabetic foot ulcers** ready for Phase III clinical trials in the US should a partner be found. These new initiatives combined with revenue growth in existing markets and product lines are forecast to help Oculus reach its goals of $45-$60 million in revenues by fiscal 2013.

Current Price **$2.20**

Price Target **$4.50**

Estimates	F2008A	F2009A	F2010E
Revenue($000s)	$3,835	$5,388	$8,707
1Q June	866	1,211	1,847 A
2Q September	977	1,481	1,900 E
3Q December	1,066	1,221	2,120 E
4Q March	926	1,475	2,840 E
Prev. Rev. Estimate ($000s)			
EPS	($1.60)	($1.09)	($0.42)
1Q June	(0.42)	(0.33)	(0.18) A
2Q September	(0.44)	(0.43)	(0.10) E
3Q December	(0.40)	(0.21)	(0.09) E
4Q March	(0.34)	(0.13)	(0.06) E
Previous EPS Estimate			
P/E (x)	N/A	N/A	N/A
EBITDA/Share	($1.15)	($0.88)	($0.23)
EV/EBITDA (x)	N/A	N/A	N/A

Stock Data	
52-Week Range	$0.20-$5.75
Shares Outstanding (mil.)	22.8
Market Capitalization (mil.)	$50.2
Enterprise Value (mil.)	$48.4
Debt to Capital (6/09)	3.7%
Book Value/Share (6/09)	$0.28
Price/Book	7.9 x
Average Trading Volume (10-Day)	350,000
Insider Ownership	19.1%
Institutional Ownership	9.3%
Short interest (millions)	1.1
Dividend / Yield	$0.00/0.0%

Price target and ratings changes over the past 3 years:
Initiated - August 17, 2009 – Target $4.50

Conclusion

Oculus' Microcyn-based product sales have grown dramatically since initial marketing approvals several years ago, and very recent FDA approvals are projected to keep this sales momentum going for the near future. Longer-term, more new product initiatives are being advanced, and if successful, will keep revenue momentum going for the next several years if not more. Combined with recent equity raises and partnership agreements, Oculus has eased its funding concerns, and is projected to reach break-even operating cash flow by the end of this fiscal year. After spiking earlier this spring on FDA news, continuing a rebound from last year, Oculus shares have eased off this summer due to a general market pull-back and certain company-specific items, including the most recent equity raise and share registration from an earlier round of funding. However, many of the necessary filings and issues related to the common shares have been completed, and projected rapid revenue growth and product news in the coming quarters could help Oculus shares regain their upward momentum from earlier this year. Therefore, we are initiating coverage on OCLS with a BUY rating and a 12-18 month price target of $4.50, still below highs of earlier this year.

History/Capitalization

Oculus Innovative Sciences ("Oculus") was incorporated in April 1999 as Micromed Laboratories, changing their name to Oculus in August 2001. In July 2005, the Company began selling its anti-infective therapeutic product Microcyn in Mexico after receiving approval in that country for the use of Microcyn as an antiseptic, disinfectant and sterilant. Microcyn received the CE Mark, European Union certification in November 2004, with additional approvals following in China, Canada, the US, India and Mexico in subsequent years. In May 2009, the Company received approvals from the US FDA to market the Microcyn Skin and Wound Gel as both a prescription and over-the-counter product and in June 2009, the Company received an expanded 510 (k) clearance to market Microcyn Skin and Wound Cleanser with Preservatives also as both a prescription and OTC product. Oculus has also completed a Phase II trial evaluating the effectiveness of Microcyn in mildly infected diabetic foot ulcers and in 2008 the FDA agreed to allow the Company to move forward into the pivotal phase of clinical trials. The Company maintains its principal executive offices in Petaluma, California and also maintains office and manufacturing space in Zapopan, Mexico and a sales office in Sittard, the Netherlands. Oculus' common stock began trading on the Nasdaq Capital Market on January 25, 2007 following the Company's initial public offering.

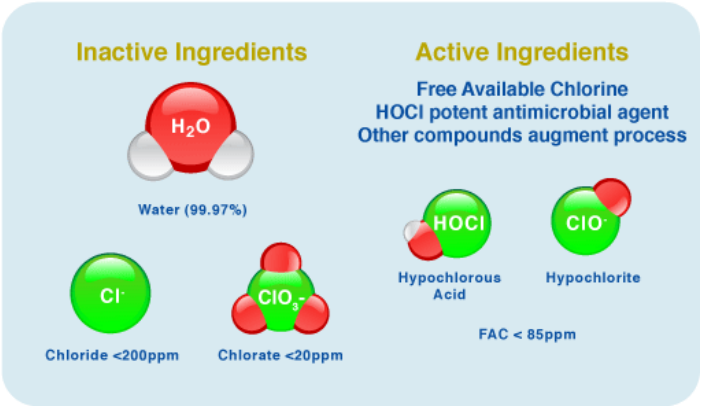
Primary Business/Competition

With its Microcyn Technology Platform, Oculus competes in the $10 billion (based on approximate worldwide sales in 2005) wound care market, which includes products for the treatment of skin ulcers, burns, and surgical and trauma-related chronic and acute wounds. The Company estimates that every year approximately 6 million patients are treated for chronic wounds worldwide, while 40 million receive care for acute wounds. In addition to acute wounds which may occur due to accidents, burns or trauma, the incidence of chronic wounds is increasing worldwide due to several long-term factors, including an increase in the incidence and severity of diabetes, and an increase in the number of antibiotic- resistant bacteria-related infections. Although there is no current standard of care for wound treatment, a variety of solutions, gels, injectables and intravenous formulations are used in hospital, nursing home and outpatient settings, including topical anti-infectives, such as Betadine, silver sulfadiazine, hydrogen peroxide, Dakin's solution and hypochlorous acid, and topical antibiotics, such as Neosporin, Mupirocin and Bacitracin.

The leading systemic anti-microbial agent in current use is Levofloxacin, which is marketed by Johnson & Johnson's Ortho-McNeil-Janssen division in the US under the Levaquin brand name and by Sanofi-Aventis and others in other areas of the world. Although a number of serious side effects have been documented (and a

recent black box warning was required for the drug), Levaquin was the 19th leading pharmaceutical product in the world in 2007, based on sales of $1.4 billion. Levaquin recently went off-patent in Canada but is protected under pediatric exclusivity in the US through the end of 2010. Oculus' Phase II studies in mildly infected diabetic foot ulcers compared Microcyn alone versus Levofloxacin and versus saline solution and Microcyn and Levofloxacin in combination. Oculus' product portfolio is based upon its patented Microcyn technology platform, which is detailed below.

Microcyn Technology Platform



Microcyn is a proprietary solution of oxychlorine compounds that interact with and inactivate surface proteins of cell walls and membranes of microorganisms and viruses. Microcyn's uniquely engineered chemistry, shown to the right, includes free available chlorine particles such as the potent antimicrobial agent Hypochlorous Acid (HOCl) as well as other compounds which augment the beneficial processes of the product. The Company's patented manufacturing process also assists in producing the right amount and availability of active ingredients, yet the resulting solution remains non-irritating to human tissues because human cells have unique protective and interlocking mechanisms. Once Microcyn surrounds single cell organisms, the compound damages these proteins, causing the cell membrane to rupture leading to cell death. Experiments have demonstrated that Microcyn kills bleach-resistant bacteria, thus **Microcyn's mechanism of action appears fundamentally different from the process which occurs as a result of contact with a bleach-based solution**.

Another key attribute of Microcyn is its ability to destroy certain **biofilms**, which are complex clusters of microorganisms or bacteria. In laboratory tests, Microcyn has been shown to destroy certain biofilms. A biofilm is a complex cluster of microorganisms or bacteria marked by the formation of a protective shell, allowing the bacteria to collect and grow. Scientific studies have estimated that over 65% of microbial infections in the body involve bacteria growing as a biofilm, and what's more, bacteria living in a biofilm typically have significantly different properties from free-floating bacteria. One result of this film environment is increased resistance to antibiotics and to the body's immune system. In chronic wounds, biofilms interfere with the normal healing process and halt or slow wound closure. Microcyn was shown to destroy two common biofilms after five minutes of exposure in laboratory studies conducted by the Company. Further attributes of Microcyn include an ability to significantly **increase the dilation of capillaries in wounds (as indicated by higher levels of oxygen)** and also **reduce inflammation** by inhibiting certain inflammatory responses from allergy-producing mast cells.

Microcyn has demonstrated antimicrobial activity against numerous bacterial, viral and fungal pathogens, as evidenced by positive results in a number of standard microbiology tests conducted at certified testing laboratories. The most recent list and complete list of pathogens were compiled following approval by the US FDA in early June of an expanded label (both OTC and Rx) for the Company's Microcyn Skin and Wound Cleansers with preservatives. These pathogens and their categories are listed below:

Category	*Pathogen*
Antibiotic-Resistant Bacteria	Methicillin-resistant Staphylococcus aureus (MRSA) Vancomycin-resistant Enterococcus faecalis (VRE)
Other Bacteria	S. aureus, E. coli, E. coli O157:H7, Acinetobacter baumanii, Bacteroides fragilis, Enterobacter aerogenes, Enterococcus faecium, Klebsiella oxytoca & pneumonia, Micrococcus luteus, Proteus mirabilis, Pseudomonas aeruginosa, Serratia marcescens, S. epidermis, S. haemolyticus, S. homins, S. saprophyticus, Streptococcus pyogenes, Aspergillus niger, C. difficile, Salmonella typhi
Viruses	Human Coronavirus, Human Immunodeficiency Virus Type 1 (HIV), Influenze A, Rhinovirus Type 37, Haemophilus influenzae
Fungi	Candida albicans, Trichophyton mentagrophytes

To summarize, Microcyn's key attributes can be described as follows:

- ✓ **Reduces Need for Antibiotics While Curing Infection;**
- ✓ **Accelerates Wound Healing;**
- ✓ **Non-irritating;**
- ✓ **Easy to use, no special handling required; and**
- ✓ **Cost-Effective.**

Regulatory Approvals

Oculus received its initial product approval in 2003 with a product registration in Mexico for the use of Microcyn as an antiseptic disinfection solution for high-level disinfection of medical instruments. This registration was followed by approvals in Europe, Canada, India, China and the United States. The chart below shows regulatory approvals for Microcyn-based products by region and by year of approval, and a summary indication for each:

Region	*Approval/Clearance Type*	*Date*	*Summary Indication*
United States	510 (k)	2005	Moistening and lubricating absorbent wound dressings for traumatic wounds
United States	510 (k)	2005	Moistening and debriding acute and chronic dermal lesions
United States	510 (k)	2006	Moistening absorbent wound dressings and cleaning minor cuts
United States (Microcyn Skin and Wound Hydrogel)	510 (k)	2009	Management of exuding wounds such as leg ulcers, pressure ulcers, diabetic ulcers and for the management of mechanically or surgically debridement of wounds
United States (Expanded label for Microcyn with preservatives)	510 (k)	2009	Debridement of wounds, such as stage I-IV pressure ulcers, diabetic foot ulcers, post surgical wounds, first and second degree burns, grafted and donor sites
Mexico	Product Registration	2003	Antiseptic disinfection solution for high level disinfection of medical instruments, and/or equipment and clean-rooms, areas of medical instruments, equipment, and clean room areas
Mexico	Product Registration	2004	Antiseptic treatment of wounds and infected areas
European Union	CE Mark	2004	Debriding, irrigating and moistening acute and chronic wounds in comprehensive wound treatment by reducing microbial load and creating a moist environment
Canada	Class II Medical Device	2004	Moistening, irrigating, cleansing and debriding acute and chronic dermal lesions, diabetic ulcers and post-surgical wounds
India	Drug License	2006	Cleaning and debriding in wound management
China	Medical Device	2008	Reduces the propagation of microbes in wounds and creates a moist environment for wound healing

Sales and Marketing

Oculus maintains a dedicated contract sales force in Mexico, its largest market at the present, including salespeople, nurses and clinical support staff. Through this internal group the Company markets Microcyn to public and private hospitals and to retail pharmacies, including the recently launched over-the-counter product. The Company also maintains a sales office in the Netherlands. In other markets, including the United States, the Company markets its products through distributors, partnerships, or contract sales organizations. The Company's key partnerships and distribution agreements are as follows:

Advocos – Advocos is a specialty contract sales organization based in Atlanta, Georgia. The Company has hired Advocos to market Microcyn-based prescription wound care products in the US market, and in late 2008, commercialization into the podiatry market was initiated, followed in spring of this year by expanded sales efforts to include wound care centers, hospitals, nursing home, urgent care clinics and home healthcare channels. More recently in 2009, the Company's two new products approved in the US, Microcyn Skin and Wound Hydrogel and Microcyn Skin and Wound Cleanser with preservatives, were approved and are expected to be launched in the US through the Advocos sales force.

Union Springs Pharmaceuticals – Union Springs, a division of the Drug Enhancement Company of America, has marketed McClyns, an over-the-counter "first responder" pen application, with Microcyn in the US since January 2008, under an exclusive licensing agreement signed in June 2007.

Vetericyn, Inc. – In January 2009, Oculus announced a strategic revenue-sharing partnership with VetCure, Inc., a California-based manufacturer and marketer of veterinary products founded in 2008. As part of the agreement, Oculus granted VetCure exclusive rights to market the Microcyn Technology in the North American animal healthcare market, with the two companies to share revenues. In addition, VetCure and its affiliates made a $3 million investment in the Company for stock and warrants. In July, 2009, Vetericyn, Inc, the recently re-named joint venture, launched four Microcyn-based animal healthcare products in the US in conjunction with a national television campaign. Vetericyn has launched a comprehensive web site to explain and market a variety of products, including two sizes of Wound and Infection Treatment trigger bottles (8 oz. and 16 oz.), two 8 oz. pump bottles for cat and general animal wound and infection treatment, two bottle sizes of bovine eye wash, and one bottle specifically designed for hot spot spraying of horses and companion animals. The picture to the right depicts the 8 ounce pump spray bottle for hot spots. The web site also includes a number of videotaped testimonials for the product, focusing on equine use but including more general applications as well.

OroScience, Inc. - In July, 2009, Oculus entered into an agreement granting OroScience, Inc. exclusive rights to Microcyn Technology-based oral care products in the Europe, Canada and European professional dental and oral care markets in a revenue-sharing arrangement. OroScience, Inc. is a Palo Alto, California based subsidiary of OroScience, plc of the Netherlands. Under the agreement, OroScience will support all regulatory, clinical and marketing related to these products with the first product launch anticipated in 2010.

Alkem – Oculus is partnered with Alkem Laboratories, the fifth largest pharma company in India, for the sale of Microcyn-based products in India and Nepal. The first full year of Microcyn product distribution in India was in 2008. Revenues in India were approximately $116,000 in fiscal 2009 and $83,000 in fiscal 2008.

China Bao Tai – In China, Oculus has signed a distribution agreement with China Bao Tai (CBT) which secured marketing approval from the SFDA in March 2008. CBT is working with Sinopharm, the largest pharmaceutical group in China, to distribute Microcyn-based products in hospitals, clinics and doctors' offices in China. Sales to China were $159,000 in fiscal 2009 for Oculus, the first year of sales to that area. CBT and Sinopharm are currently providing samples to healthcare providers in China in anticipation of government reimbursement approval.

Europe – Oculus has exclusive agreements with country-specific distributors for the sale of Microcyn-based products in Italy, the Netherlands and Slovakia in Europe. The Company is seeking additional partners across the European Union.

Bayer Animal Health – Oculus has additional partnership agreements with Bayer Animal Health in Australia, China and Taiwan.

Recent Results

In early August, Oculus reported positive financial results for their fiscal Q1/2010 (ending June), including revenues of $1.84 million, an increase of 52% over the prior year period, and a net loss of ($3.5 million) or ($0.18) per share, versus a loss of ($5.2 million) or ($0.33) per share in Q1/09. Product revenue increased 55% during the quarter, due to increases in sales of Microcyn-based products in Mexico, China, India and the United States. Mexico-based sales were particularly strong, up 100% in terms of volume, (57,000 units versus 35,000 in the previous quarter and 28,000 in the prior year period) although a weaker peso limited dollar growth to 59%. Purchases related to swine flu concerns were the primary cause for growth of Microcyn-based products in Mexico during the quarter. Microcyn-based product sales also increased in the Netherlands, Singapore, India and especially China, reflecting the first year of marketing and promotion in that market. Service revenues, primarily tests performed at the Company's microbiology contract testing laboratory in the US, also increased during the quarter, by $74,000 or 37%.

Product gross margins improved to 66% during Q1/2010, up from 57% in the same period one year ago, due to increased sales volumes world-wide and particularly in Mexico. The higher margins were achieved despite lower margins on European sales due to one-time expenses related to the closure of manufacturing operations in the Netherlands, as the Company is consolidating this function into US operations this fiscal year. Operating expenses declined to $3.4 million during the quarter from $5.6 million in the year earlier period, due to lower R&D costs from the completion last year of the Phase II clinical trial in diabetic foot ulcers, as well as other costs reduction programs implemented over the past twelve months. Other expenses for the first fiscal quarter increased $1.1 million year-over-year, due to a one-time non-cash charge of $1.2 million for the adoption of a new accounting treatment for outstanding warrants. Without the one-time accounting and other non-cash charges (including stock-option expense), net loss for the quarter would have been ($1.8 million), or ($0.09) per share. Oculus' net loss and loss per share for fiscal years ended June 2009 (Q1/10) and June 2008 (Q1/09) are outlined below:

Quarter ended ($000s)	June 30th, 2009 (Q1/2010)	June 30th, 2008 (Q1/2009)
Revenues	$1,847	$1,211
Gross Profit	$1,105	$575
Operating expenses	($3,406)	($5,649)
Other income (expense)	($1,240)	($125)
Net loss	($3,541)	($5,199)
Loss per share	($0.18)	($0.33)
Net loss (before non-cash charges)	($0.09)	($0.30)
Shares outstanding	19,388	15,924

Balance Sheet and Operating Cash Flow

Oculus maintained approximately $2.1 million in cash balances at the end of the most recent quarter, June 30th, 2009, offset by approximately $0.2 million in current portion and long-term debt and capital obligations, primarily relating to automobile and insurance premium financing. However, including a recently completed equity offering in July 2009 netting $5.4 million, Oculus' pro forma cash balances were $7.5 million. Stockholders' equity at June 30th was $940,000, or $6.4 million on a pro forma basis.

During the first quarter, Oculus' net cash burn was ($1.7 million), down significantly from ($6.8 million) in the prior year period, due to higher revenues and gross profit in Q1/2010 and a significant cost reduction program completed over the past twelve months. The Company also received $2 million in net proceeds in June 2009 from the completion of a February 2009 direct investment. Although at the most recent rate of cash burn and current pro forma cash balances the Company would appear to need to raise additional capital sometime next fiscal year, projected growth in worldwide revenues and gross profit (leading to estimated cash flow break-even by the end of this fiscal year) is anticipated to reduce the need and urgency for additional growth capital in the near future to a great extent. The chart below shows cash and equivalents, long-term obligations, and stockholders' equity for Oculus for June 30th, 2009, March 31st, 2009, and pro forma for June 30th including adjustments for the recent equity offering completed after the end of the June fiscal quarter:

($000s)	June 30th, 2009	June 30th Pro Forma	March 31, 2009
Cash and equivalents	$2,053	$7,464	$1,921
Long-term obligations	$244	$244	$335
Stockholders' equity	$941	$6,352	$2,269

Outlook/Growth Drivers

Oculus' management has provided both short-term and long-term financial targets in recent months, including reaching cash flow break-even by the end of this fiscal year (March 2010) and annual revenues of $45-$60 million in fiscal 2013, not including new indications. For the remainder of this fiscal year, we are forecasting that revenue will increase steadily on a quarterly basis, to $1.9 million in Q2/2010 (ending September), $2.1 million in Q3/2010 (December), and $2.8 million in Q4/2010. Revenues are forecast to grow primarily due to higher Microcyn-related product sales, specifically growth in OTC markets in Mexico, prescription and OTC sales in the US, veterinary market shipments in the US, and shipments to China under new distribution agreements. With improved gross margins stemming from new manufacturing sources and more favorable royalty arrangements from new accounts (73% forecast for 2010 compared versus 62% actual in 2009), combined with tighter overhead cost controls (S, G & A between $2.7-$2.9 million per quarter, R&D expenses approximately $700,000 per quarter) and slight increases in net interest income from larger cash balances, we are forecasting that Oculus' net loss per share will gradually decrease as this year's quarterly results progress,

culminating in a loss of ($0.06) per share in Q4/2010, or very near to EBITDA and Cash flow break-even, after factoring out non-cash charges such as stock-option compensation expense and depreciation and amortization. The chart below provides more detailed analysis of projected revenue streams for Oculus for fiscal years 2010 through 2013:

Revenue - FYE March ($Mill)	*2010E*	*2011E*	*2012E*	*2013E*
Mexico – Prescription	$3.50	$4.00	$5.00	$7.00
Mexico – OTC	1.30	3.50	7.00	10.40
United States – Prescription	0.50	1.00	3.00	5.00
United States – OTC	0.25	0.50	1.00	1.50
United States – Veterinary	1.25	3.00	5.00	7.00
United States – Oral/Dental		0.50	1.00	1.50
Europe and other	1.00	1.75	2.50	5.00
India	0.40	1.50	2.50	4.00
China	0.50	1.75	3.00	10.00
Total	$8.70	$17.50	$30.00	$51.40

For future years, we are projecting that Oculus' annual product revenues will continue to grow in the 75% range, with slightly improving gross margins driven by manufacturing economies of scale, R&D and other overhead costs rising at rates concordant with historical inflation (7%-10%), and level interest expense, interest income and shares outstanding once the Company has reached forecasted operating cash flow break-even. The chart below depicts forecasted revenues, net income (loss), earnings (loss) per share and shares outstanding for Oculus for the current fiscal year through fiscal 2013:

FYE March ($Mill, except EPS)	*2010E*	*2011E*	*2012E*	*2013E*
Revenues	$8.7	$17.5	$30.0	$51.4
Net Income (loss)	($9.2)	($1.6)	$7.1	$22.1
Earnings (loss) per share	($0.42)	($0.07)	$0.30	$0.90
Shares outstanding	21.7	23.8	24.0	24.5

Management

Hoji Alimi is one of the founders of Oculus and has served as Chief Executive Officer, President and a director of the Company since 1999. He was appointed Chairman of the Board in June 2006. Prior to co-founding the Company, Mr. Alimi was a Corporate Microbiologist for Arterial Vascular Engineering, now part of Medtronic. Mr. Alimi holds a B.A. in biology from Sonoma State University.

Robert Miller has served as Chief Financial Officer of Oculus since June 2004 and had served as a consultant to the Company for a little over a year prior to joining as CFO full time. Prior to joining Oculus, Mr. Miller held financial management positions at Scanis, Evit Labs, Endoscopic Technologies, GAF Corporation, Penwest Ltd, Mead Corporation and other firms. Mr. Miller holds a B.A. degree in economics from Stanford and MBA in finance from Columbia.

James Schutz has served as Vice President of Corporate Development and General Counsel since August 2003 and as a director since May 2004. Prior to joining Oculus, Mr. Schutz served as General Counsel at Jomed (formerly EndoSonic) and as in-house counsel at Urban Medica Communications Corporation. Mr. Schutz holds a B.A. degree in economics from the University of California, San Diego and a J.D. from the University of San Francisco School of Law.

Bruce Thornton has served as Executive Vice President of International Operations since June 2005. He also served as general manager for US operations from March 2004 to July 2005. Prior to joining Oculus, Mr. Thornton held operations and manufacturing management positions at Jomed and Volcano Therapeutics, a medical device company. Mr. Thornton holds a B.S. degree in aeronautical science from Embry-Riddle and an MBA from National University.

Robert Northey, Ph.D. has served as Director of research and development at Oculus since July 2005. Prior to joining the Company, Dr. Northey served as a consultant from 2001 to 2005 and as an assistant professor in the paper science and engineering department at the University of Washington. Dr. Northey holds B.S. in wood and fiber science and a Ph.D. in wood chemistry degrees from the University of Washington.

In addition to management team members Mr. Alimi and Mr. Schutz, Oculus' board includes **Gregg Alton**, currently Senior Vice President and General Counsel of Gilead Sciences; **Jay Birnbaum**, a former executive with Novartis/Sandoz; **Richard Conley**, currently Chief Operating Officer at Kautz Family Vineyards; **Gregory French**, formerly an engineer and senior manager at several medical device companies; and **Robert Burlingame**, CEO and Chairman of Burlingame Industries. Mr. Burlingame is also the founder and president of VetCure, a joint venture partner of Oculus.

Research and Development

Oculus' largest R&D program is for the use of Microcyn in the treatment of mildly infected diabetic foot ulcers. The Company has completed a Phase II randomized clinical trial in this program, enrolling 48 patients at 15 clinical sites in three arms: Microcyn alone, Microcyn plus an oral antibiotic (Levofloxacin) and saline solution plus the same antibiotic. The primary endpoint of the Phase II trial was clinical cure or improvement in signs and symptoms of infection according to IDSA (Infectious Disease Society of America) guidelines; top-line data showed that Microcyn monotherapy recorded greater success than both combination arms of the trial, with 78% of the patients showing cure or improvements after 10 days (the primary endpoint of the trial) versus 61% and 70% for the other two arms, and 93% of the patients showing cure or improvement after the 24-day follow-up visit, as compared with 56% and 83% for the other two arms.

Oculus announced these results in March 2008; in August of last year the Company held a review meeting with the FDA to discuss the results of this Phase II and the future of this clinical program. Following a review of these data the FDA agreed that the Company may move forward into the pivotal phase of the program, there were no safety issues and thus no carcinogenicity studies will be required, and that the clinical trial designs agreed upon were appropriate for a new drug application. In order to complete an NDA submission to the FDA for this indication, two pivotal clinical trials must be completed, and Oculus is currently seeking strategic partners for the diabetic foot ulcer indication as well as other indications in medical areas such as ophthalmology, respiratory and dermatology.

In addition to the Phase II clinical trial mentioned above for the use of Microcyn in the treatment of diabetic foot ulcers, in June 2009 Oculus announced positive preliminary results of a 40-patient feasibility study using an enhanced Microcyn Hydrogel formulation for the treatment of acne. The preliminary results suggested that this Hydrogel formulation may reduce the need for laser treatment and chemical peels to address acne-caused

skin damage. In the near term, Oculus intends to use the results of this study to evaluate potential marketing strategies, and in the longer-term to seek potential partnerships in the dermatology market.

Several physicians and scientists in a number of separate countries have conducted more than 28 clinical studies of Microcyn in wound care and wound irrigation treatment, and in many cases the data from these studies treating over 1,500 patients combined were published and presented at peer-review meetings worldwide.

Intellectual Property

Oculus has been issued 14 patents for the Microcyn Technology to date, with 90 applications pending. The Company's patent claims cover a number of areas, including chemical composition, manufacturing apparatus, method of manufacturing and therapeutic uses. Although the Microcyn Technology has been commercialized globally for over five years, there have been no infringement lawsuits filed against the company. In 2007, Oculus prevailed in a federal court ruling (the U.S. District Court for the Northern District of California) against a company (Nofil Corp.) that had infringed upon Oculus' intellectual property, affirming that the company's intellectual property rights for the Microcyn® Technology are enforceable.

Oculus has also filed for protection for trademarks used with Microcyn products in each of the United States, Europe, Canada, certain countries in Central and South America, including Mexico and Brazil, and certain countries in Asia, including Japan, China, the Republic of Korea, India and Australia.

Stock Valuation/Comparables

We have included a five-stock comparison group table for Oculus in Table 1; stocks in our group include wound care provider Kinetic Concepts (NYSE/KCI/Not Rated); anti-infective pharma companies Cubist Pharmaceuticals (Nasdaq/CBST/Not Rated) and NovaBay (ASE/NBY/Speculative Buy); dermatology firm Medicis (NYSE/MDX/Not Rated); and surgical products company Integra Life Sciences (Nasdaq/IART/Not Rated). The best comparative metric for Oculus vis-à-vis its peers is price/revenues, since the Company is not year profitable, and although Oculus' shares currently trade at a premium to the average of its comparable group based on 2010 estimated revenues (2.9x versus 2.1x), Oculus is forecast to have higher revenue growth than this peer group (with more mature products) and also trades at a discount to its smaller cohort in the anti-infective space, NovaBay, which trades at 5X estimated 2010 revenues, nearly twice the ratio of Oculus. Although Oculus' shares have rebounded from lows of last year to some extent, these shares have not held up as strongly as others in this group (only between 10%-30% off of highs), while OCLS shares are currently trading at less than one-half highs from last year. Thus we are recommending that value-oriented (and growth-seeking) investors Buy shares of Oculus with a 12-18 month price target of $4.50 per share, or 5.7x estimated revenues for calendar 2010 and a little over 20% off of the share price highs from just last year. Our $4.50 price target also represents a price/earnings multiple of 15x estimate earnings for Oculus fiscal 2012E, just two years into the future.

Catalysts/Investor Timeline

1) Launch of additional Vetericyn products – Fall 2009
2) US launch of Microcyn Wound Care with preservatives – August 2009
3) US launch of Microcyn Hydrogel – OTC August 2009; Rx January 2010; International late 2009
4) Third Quarter 2009 (ending September) financial results release – November 2009
5) Agreements with additional European distribution partners – 2009-10
6) Microcyn Hydrogel in treatment of acne – Final study results published, partnerships – Late 2009-2010
7) Microcyn for diabetic foot ulcers – Phase III/Partnerships - 2010

Risk Factors

We believe an investment in Oculus Innovative Sciences involves the following risks:

- **FDA and regulatory risks** – Oculus is subject to regulatory review for its ongoing research and development activities, principally the US Food and Drug Administration but also with other regulatory agencies as well, including in Europe, Latin America and Asia. In addition, the manufacture and handling of commercial quantities of its Microcyn products are subject to additional oversight and regulation. While the Company has a good track record of regulatory review since its inception, there can be assurance that future endeavors will go as smoothly.
- **Reliance on joint venture partners and/or additional capital** — Currently, Oculus has enough cash on hand to fund ongoing research and marketing development programs until calendar 2010, approximately. Alternatively, the Company has a stated goal of reaching operating cash break-even by the end of this fiscal year, and meeting this objective would eliminate the need to raise additional equity capital. The Company could also raise funds through additional partnerships, in particular for prescription products or into new therapeutic or geographic markets. Currently, the Company relies on several marketing partners and distributors to drive sales of its products; should any of these partners develop financial difficulties this could diminish or even eliminate revenues from certain geographic areas or product lines.
- **Need to defend patents and other intellectual property** – At present, the Company's existing patent portfolio on its current product line is extensive and has been defended in US courts on at least one occasion. However, as sales of its Microcyn-based products increase, this success may attract competitors and require additional expenses related to patent defense and enhancement.
- **Currency fluctuations** – Currently, Oculus derives a large portion of its revenues from foreign sources, including Mexico, and is susceptible to currency fluctuations which can adversely affect revenues and gross margins. However, with new approvals and partnerships in the US, the Company expects to derive a smaller portion of its revenues and cash flows from international sources in the future.

Robert M. Wasserman

Oculus Innovative Sciences, Inc.
Consolidated Statements of Income
(In 000s, except per share data)

FYE March	2006	2007	2008	1Q09 June	2Q09 September	3Q09 December	4Q09 March	2009	1Q10 June	2Q10E September	3Q10E December	4Q10E March	2010E	2011E March	2012E March	2013E March
Revenues																
Product	$1,966	$3,679	$2,881	$1,007	$1,212	$999	$1,197	$4,415	$1,567	$1,600	$1,800	$2,500	$7,467	$16,200	$28,500	$49,600
Service	618	864	954	204	269	222	278	973	280	300	320	340	1,240	1,300	1,500	1,800
Total revenues	$2,584	$4,543	$3,835	$1,211	$1,481	$1,221	$1,475	$5,388	$1,847	$1,900	$2,120	$2,840	$8,707	$17,500	$30,000	$51,400
Cost of revenues																
Product	3,899	2,104	1,774	438	446	313	476	1,673	$527	$460	$450	$580	2,017	3,730	6,130	$10,660
Service	1,003	895	977	198	251	195	269	913	215	230	240	250	935	1,000	1,200	1,400
Total cost of revenues	4,902	2,999	2,751	636	697	508	745	2,586	742	690	690	830	2,952	4,730	7,330	12,060
Gross Profit	(2,318)	1,544	1,084	575	784	713	730	2,802	1,105	1,210	1,430	2,010	5,755	12,770	22,670	39,340
Operating Expenses:																
Research and development	2,600	4,508	9,778	2,321	2,150	933	631	6,252	721	730	740	750	2,941	3,250	3,500	3,750
Selling, General and administrative	15,933	16,520	13,731	3,328	5,262	2,920	2,347	13,857	2,685	2,750	2,800	2,850	11,085	11,500	12,500	14,000
Operating income (loss)	(20,851)	(19,484)	(22,425)	(5,074)	(6,628)	(3,140)	(2,248)	(17,307)	(2,301)	(2,270)	(2,110)	(1,590)	(8,271)	(1,980)	6,670	21,590
Interest expense	(172)	(956)	(1,016)	(162)	(149)	(113)	(13)	(437)	(4)	(10)	(20)	(20)	(54)	(100)	(50)	(100)
Other (income) expense, net	(2,076)	657	3,102	37	(135)	(67)	36	88	(1,236)	100	120	140	(876)	450	500	600
Income (loss) before tax	(23,099)	(19,783)	(20,339)	(5,199)	(6,912)	(3,320)	(2,225)	(17,656)	(3,541)	(2,180)	(2,010)	(1,470)	(9,201)	(1,630)	7,120	22,090
Preferred stock dividends	(121)	(404)	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Net income (loss)	(23,220)	(20,187)	(20,339)	(5,199)	(6,912)	(3,320)	(2,225)	(17,656)	(3,541)	(2,180)	(2,010)	(1,470)	(9,201)	(1,630)	7,120	22,090
Basic income per share	($5.60)	($3.71)	($1.60)	($0.33)	($0.43)	($0.21)	($0.13)	($1.09)	($0.18)	($0.10)	($0.09)	($0.06)	($0.42)	($0.07)	$0.30	$0.90
Diluted income per share	($5.60)	($3.71)	($1.60)	($0.33)	($0.43)	($0.21)	($0.13)	($1.09)	($0.18)	($0.10)	($0.09)	($0.06)	($0.42)	($0.07)	$0.30	$0.90
Basic shares outstanding	4,150	5,448	12,737	15,924	15,924	15,924	17,130	16,221	19,388	21,100	22,800	23,600	21,722	23,800	24,000	24,500
Diluted shares outstanding	4,150	5,448	12,737	15,924	15,914	15,924	17,130	16,221	19,388	21,100	22,800	23,600	21,722	23,800	24,000	24,500
Key ratios:																
Revenue growth	90.6%	75.8%	-15.6%	39.8%	51.6%	14.5%	59.3%	40.5%	55.6%	32.0%	80.2%	108.9%	61.6%	117.0%	75.9%	74.0%
Gross margin-products	-98.3%	42.8%	38.4%	56.5%	63.2%	68.7%	60.2%	62.1%	66.4%	71.0%	75.0%	77.0%	73.0%	77.0%	78.5%	78.5%
R&D/revenue	100.6%	99.2%	255.0%	191.7%	145.2%	76.4%	42.8%	116.0%	39.0%	38.4%	34.9%	26.4%	33.8%	18.6%	11.7%	7.3%
S, G & A/revenues	616.6%	363.6%	358.0%	274.8%	355.3%	239.1%	159.1%	257.2%	145.4%	144.7%	132.1%	100.4%	127.3%	65.7%	41.7%	27.2%
Non-cash items	$1,269	$2,801	$2,601	$830	$835	$835	$835	$3,335	$590	$600	$700	$800	$2,690	$3,200	$3,800	$3,800
Tax Rate	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Cash Flow/share	($5.29)	($3.19)	($1.39)	($0.27)	($0.38)	($0.16)	($0.08)	($0.88)	($0.09)	($0.07)	($0.06)	($0.03)	($0.25)	$0.07	$0.46	$1.06
EBITDA/share	($5.76)	($3.00)	($1.15)	($0.27)	($0.39)	($0.16)	($0.08)	($0.88)	($0.09)	($0.07)	($0.05)	($0.02)	($0.23)	$0.08	$0.48	$1.08

Balance Sheets

($000s)			Pro-Forma
Assets:	3/31/09	6/30/09	6/30/09
Cash and equivalents	$1,921	$2,053	$7,464
Accounts receivable, net	923	1,293	1,293
Inventory, net	340	355	355
Prepaid expenses & other	758	667	667
Total current	3,942	4,368	9,779
Property & equip., net	1,432	1,350	1,350
Deferred offering costs	0	54	54
Other assets	73	104	104
TOTAL ASSETS	$5,447	$5,876	$11,287
Liabilities:			
Accounts payable	$1,565	$1,319	$1,319
Accrued expenses	853	1,440	1,440
Long-term debt - current portion	261	179	179
Total current	2,679	2,938	2,938
Long-term debt	74	65	65
Other long-term	425	1,932	1,932
Total long-term liabilities	499	1,997	1,997
Stockholders' equity	2,269	941	6,352
TOTAL LIAB & EQ	$5,447	$5,876	$11,287

Quarterly Earnings Comparisons

	June	September	December	March	Total
Revenues (in $000)					
2004					$902
2005					1,356
2006					2,584
2007					4,543
2008	866	977	1,066	926	3,835
2009	1,211	1,481	1,221	1,475	5,388
2010E	1,847	1,900	2,120	2,840	8,707
Earnings per Share					
2004					($1.87)
2005					(4.22)
2006					(5.60)
2007					(3.71)
2008	(0.42)	(0.44)	(0.40)	(0.34)	(1.60)
2009	(0.33)	(0.43)	(0.21)	(0.13)	(1.09)
2010E	(0.18)	(0.10)	(0.09)	(0.06)	(0.42)

Revenues by Geography

Revenues by Geographic area (FYE March)	2006	2007	2008	2009	2010E	2011E	2012E	2013E
United States	$109	$140	$1,151	$1,271	$2,000	$5,000	$10,000	$15,000
Veterinary					1,250	3,000	5,000	7,000
Oral/Dental					0	500	1,000	1,500
Prescription (Includes acne, wound care)					500	1,000	3,000	5,000
Over-the-counter					250	500	1,000	1,500
Mexico	1,788	2,513	2,118	3,273	4,800	7,500	12,000	17,400
Prescription					3,500	4,000	5,000	7,000
Over-the-counter					1,300	3,500	7,000	10,400
India	0	604	83	116	400	1,500	2,500	4,000
China	0	0	0	159	500	1,750	3,000	10,000
Europe and other	69	422	483	569	1,000	1,750	2,500	5,000
Total	$1,966	$3,679	$3,835	$5,388	$8,700	$17,500	$30,000	$51,400

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

Table 1. Wound Care/Anti-infectives/Dermatologic Products Comparable Company Analysis

			Shares	Market Cap	Calendar Year		Revenues	Calendar Year		Price/Revs	52-Week		Earnings	
Company	Symbol	Price	(millions)	($Millions)	EPS '09E	EPS '10E	2010E	P/E '09E	P/E '10E	2010E	Low	High	Growth	Notes
Cubist	CBST	$19.24	57.8	$ 1,110.0	1.35	1.65	670	14.3	11.7	1.66	$13.81	$28.74	22.2%	Cubicin anti-infective is primary product
Integra Life Sciences	IART	$33.60	28.4	$ 960.0	2.11	2.41	740	15.9	13.9	1.30	$18.97	$49.89	14.2%	Orthopedic and surgical products
Kinetic Concepts	KCI	$33.30	71.1	$ 2,370.0	3.96	4.33	2,080	8.4	7.7	1.14	$17.86	$36.20	9.3%	LifeCell wound care subsidiary
Medicis	MRX	$17.07	57.1	$ 970.0	1.46	1.72	668	11.7	9.9	1.45	$7.85	$21.68	17.8%	Dermatology/cosmetic products
Novabay	NBY	$2.15	21.9	$ 50.0	N/A	N/A	10	N/A	N/A	5.00	$0.40	$3.24	*N/A*	Partnerhsips with Galderma, Alcon
Average								12.6	10.8	2.11			15.9%	
Oculus Innovative Sciences	OCLS	$2.20	22.8	$ 50.0	N/A	N/A	18	N/A	N/A	2.86	$0.20	$5.75	N/A	2 new approvals in US, Vet product launched in July

Source: Dawson James Securities; Capital IQ

Important Disclosures:

Price Chart:

Price target and ratings changes over the past 3 years:
Initiated – August 17, 2009 – Target $4.50

Analyst Certification: The analyst(s) whose name appears on this research report certifies that 1) all of the views expressed in this report accurately reflect his personal views about any and all of the subject securities or issuers discussed; and 2) no part of the research analyst's compensation was, is, or will be directly or indirectly related to the specific recommendations or views expressed by the research analyst in this research report; and 3) All Dawson James employees, including the analyst(s) responsible for preparing this research report, may be eligible to receive non-product or service specific monetary bonus compensation that is based upon various factors, including total revenues of Dawson James and its affiliates as well as a portion of the proceeds from a broad pool of investment vehicles consisting of components of the compensation generated by investment banking activities, including but not limited to shares of stock and/or warrants, which may or may not include the securities referenced in this report.

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Ratings definitions: 1) Speculative Buy: the stock is expected to appreciate and produce a total return of at least 30% over the next 12-18 months but **the volatility and investment risk is substantially higher** than our "Strong Buy" recommendation; **2) Strong Buy:** the stock is expected to appreciate and produce a total return of at least 30% over the next 12-18 months; **3) Buy:** the stock is expected to appreciate and produce a total return of at least 20% over the next 12-18 months; **4) Neutral:** the stock is fairly valued for the next 12-18 months; **5) Sell:** the stock is expected to decline at least 20% over the next 12-18 months and should be sold; **6) Sell Short:** the stock is expected to decline at least 30% over next 12-18 months and should be sold short, however **the volatility and investment risk is substantially higher** than our "Sell" recommendation; **7) Under Review:** the previous rating and/or price target is suspended due to a significant event which now requires additional analysis and the previous rating and/or price target cannot be relied upon; and **8) Restricted:** coverage cannot be initiated or has been temporarily suspended to comply with applicable regulations and/or firm policies in certain circumstances such as investment banking or an advisory capacity involving the company.

	Company Coverage		Investment Banking	
Ratings Distribution	# of Companies	% of Total	# of Companies	% of Totals
Speculative Buy	6	46%	5	83%
Strong Buy	1	8%	0	0%
Buy	4	31%	1	100%
Neutral	2	15%	2	100%
Sell	0	0%	0	0%
Sell Short	0	0%	0	0%
Under Review	0	0%	0	0%
Restricted	0	0%	0	0%
Total	13	100%	8	62%

Information about valuation methods and risks can be found in the "STOCK VALUATION" and "RISKS" sections of this report.