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Oculus Innovative Sciences (Nasdaq/OCLS)
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BUY Fiscal 2016 still going strong
Oculus markets the Microcyn line of anti-infective and wound care products
Investment Highlights

1) Oculus Innovative Sciences (“Oculus”) reported financial results for their Q2/2016 (ending September) quarter, including revenues of \$4.1 million, up 24% year-over-year, with a net loss of \$1.8 million or (\$0.11) per share, as compared with a net loss of \$0.7 million or (\$0.08) per share for the same period one year ago. Revenues in the second quarter were led by growth in US product revenues to \$1.2 million, from \$356,000 in the prior year period, specifically from higher sales of dermatology product through the new IntraDerm group, fueled by new product launches and an expansion of the IntraDerm sales team. Revenues for Europe and rest of world also increased during the quarter, up 72% to \$952,000, as launches in new non-EU countries helped overcome the negative currency effects of a decline in the Euro. Sales in Latin America also increased slightly in the second quarter (8%), due primarily to the larger resources of the new partner for that area, Lab Sanfer, while revenues from product licensing fees and royalties fell in Q2/2016 due to transition in the Animal Health sector. Product-related gross margins held steady this year, at 54% versus 55% last year, although increased operating expenses from the new IntraDerm group led to higher net losses in Q2/2016. Operating cash burn for the first six months of the fiscal year was approximately \$3 million, offset this year by proceeds from the sale of stock in a former subsidiary as well as proceeds from an equity line of credit, and at the end of September Oculus had \$8.0 million in cash on hand as compared with \$6.1 million at the start of the year.

2) Oculus management has provided financial guidance for the upcoming fiscal third quarter (December), including continued strong growth in US product revenues (up 90%-110% year-over-year) and International product revenues (up 12%-18%). Results to date this year have been very close to our expectations, and thus we are adjusting our forecasts for fiscal 2016E for Oculus only to a small degree, including revenues of \$15.6 million for the year (up from \$15.2 million), representing a 13% increase year-over-year, and net losses of \$7.5 million, or (\$0.45) per share, from \$8.0 million or (\$0.50) per share previously. Our estimates assume

Current Price \$1.19
Price Target \$4.00

Estimates	F2014A	F2015A	F2016E
Revenue(\$000s)	\$13,668	\$13,854	\$15,200 E
1Q June	3,372	3,392	3,680 A
2Q September	4,089	3,264	4,054 A
3Q December	3,293	3,218	
4Q March	2,914	3,980	
Prev. Rev. Estimate (\$000s)			\$15,200

EPS	(\$0.44)	(\$0.85)	(\$0.45) E
1Q June	(0.26)	(0.01)	(0.15) A
2Q September	(0.21)	(0.08)	(0.11) A
3Q December	(0.09)	(0.69)	
4Q March	0.99	(0.11)	
Previous EPS Estimate			(\$0.50)
P/E (x)	N/A	N/A	N/A

EBITDA/Share	(\$1.18)	(\$0.65)	(\$0.48)
EV/EBITDA (x)	N/A	N/A	N/A

Stock Data		
52-Week Range		\$0.65-\$1.97
Shares Outstanding (mil.)		16.5
Market Capitalization (mil.)		\$19.6
Enterprise Value (mil.)		\$11.7
Debt to Capital (9/15)		0.0%
Book Value/Share (9/15)		\$0.65
Price/Book		1.8 X
Average Trading Volume (3-Month)		154,600
Insider Ownership		3.1%
Institutional Ownership		6.3%
Short interest (Million)		0.9
Dividend / Yield		\$0.00/0.0%



Price target and ratings changes over the past 3 years:
 Initiated - August 17, 2009 – Buy - Target \$4.50
 Price target lowered to \$2.25 - March 1, 2012
 Price target adjusted to \$12.00 - April 10, 2013
 Rating lowered to Neutral - June 18, 2013
 Rating raised to Buy - April 30, 2014 - Price Target \$7.50
 Price target lowered to \$4.00 - February 18, 2015

product gross margins just slightly better than those of 2015, at 55.6% versus 54.5%, as well as slightly higher R&D costs of \$1.65 million (up from \$1.53 million in 2015) and S, G & A expenses of \$14.2 million (up from \$12.4 million in 2015), as well as higher weighted average shares outstanding of 16.5 million. Our forecasts of cash burn per share of \$5-\$6 million for 2016E for Oculus should provide plenty of cushion for the Company's current cash on hand of \$8 million.

3) Oculus recently added to its stable of 11 510(k) clearances (US) and 10 CE Marks (Europe and international) with a November 23 FDA premarket notification for its Ceramax skin barrier cream, which is targeted for an early 2016 product launch both as a stand-alone product and as part of a combination product with Alevicyn gel to address the atopic dermatitis/eczema market. Along with previously launched Microcyn-based products including Alevicyn Gel and Dermal Spray, Celacyn Scar treatment as well as an in-licensed oral branded drug, Oculus now offers products in three of the eight key dermatology areas targeted by the Company's long-term plan, including Atopic Dermatitis, Scar Management, and Derm-oriented Surgical Procedures, with four more target markets still to be launched into, including Acne, Seborrheic Dermatitis, Tinea Pedis, and additional areas of post-procedure treatment. Due to Oculus' long history of manufacturing and packaging its Microcyn technology, so far its products have shown good price elasticity as compared with other branded topicals on the market, which has helped the new IntraDerm sales force gain traction. Altogether, the Company's plan is to launch six new dermatology products over the next twelve months and double the size of its IntraDerm direct sales force from 10 to 20 by late 2016. All-in-all, Oculus is on-track to become a fully-integrated dermatology-oriented manufacturer and marketer, with a goal of achieving the type of marketplace valuations ultimately enjoyed by recent buyouts such as Stiefel Labs (\$3.6 billion), Medicis (\$2.6 billion), or Fougera Pharmaceuticals (\$1.5 billion), which fetched multiples of well over 3.5X annual revenues, as compared to Oculus' current 1.3X multiple.

Conclusion/Stock Valuation

Oculus' share price has held steady this fall, reflecting an overall down market softened by investor enthusiasm over the Company's growth this year in the dermatology area. Still, with expected revenue growth in the Company's key business segments going forward, a recently strengthened balance sheet, and a number of new product-related catalysts expected as this fiscal year progresses, we believe OCLS share prices can rebound this year, and thus, we are maintaining our Buy rating on OCLS shares and our 12-18 month price target of \$4.00, based on a three stock comparable company group, including NovaBay Pharmaceuticals (NYSE MKT/NBY/Not Rated), Cubist Pharmaceuticals (Nasdaq/CBST/NR) and Medicis Pharmaceutical (based on its purchase price in 2012 by Valeant Pharmaceuticals (NYSE/VRX/NR)), using average price/revenue multiple metrics. (For full description of our most recent price target for OCLS, please refer to our Company Update dated February 18, 2015.)

Risk Factors

In addition to normal economic and market risk factors that impact most equities and the common risks shared by Oculus Innovative Sciences with other companies in the industry, we believe an investment in OCLS 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. There can be no assurance that the Company will receive regulatory/manufacturing approval for its products.
- **Reliance on joint venture partners and/or additional capital** — Currently, Oculus has enough cash on hand to fund ongoing research and marketing development programs into fiscal 2017 (ending March), approximately. Alternatively, the Company could reach or near operating cash break-even, and meeting this objective would eliminate the need to raise additional equity capital. The Company could also continue to obtain funds through additional partnerships, in particular for prescription products or in 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.
- **Limited stock liquidity** – Trading volume in Oculus stock is comparatively light at an average of 150,000 shares per day. As such, news regarding Oculus, its target market, and/or competitors could lead to significant volatility in the stock price.

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

FYE March	2009	2010	2011	2012	1Q13 June	2Q13 September	3Q13 December	4Q13 March	2013 March	2014 March	2015 March	2016E March
Revenues												
Product and product licensing fees	\$4,415	\$6,298	\$8,826	\$11,853	\$3,816	\$4,264	\$3,357	\$3,146	\$14,583	\$12,723	\$12,995	\$14,400
Service	973	1,066	928	891	235	262	183	189	869	945	859	1,250
Total revenues	\$5,388	\$7,364	\$9,754	\$12,744	\$4,051	\$4,526	\$3,540	\$3,335	\$15,452	\$13,668	\$13,854	\$15,650
Cost of revenues												
Product	1,673	2,633	2,876	3,254	988	1,092	906	990	3,976	4,510	5,908	6,400
Service	913	853	737	776	179	234	163	157	733	761	658	1,000
Total cost of revenues	2,586	3,486	3,613	4,030	1,167	1,326	1,069	1,147	4,709	5,271	6,566	7,400
Gross Profit	2,802	3,878	6,141	8,714	2,884	3,200	2,471	2,188	10,743	8,397	7,288	8,250
Operating Expenses:												
Research and development	6,252	1,996	2,046	1,981	532	513	509	669	2,223	2,887	1,533	1,650
Selling, General and administrative	13,857	9,898	11,600	13,200	2,847	3,504	2,642	2,901	11,894	11,561	12,414	14,200
Operating income (loss)	(17,307)	(8,016)	(7,505)	(6,467)	(495)	(817)	(680)	(1,382)	(3,374)	(6,051)	(6,659)	(7,600)
Interest expense	(437)	(8)	(406)	(931)	(288)	(280)	(275)	(264)	(1,107)	(1,058)	(2)	0
Other (income) expense, net	88	(208)	152	69	1,228	(422)	(957)	(799)	(950)	10,843	(1,542)	100
Income (loss) before tax	(17,656)	(8,232)	(7,759)	(7,329)	445	(1,519)	(1,912)	(2,445)	(5,431)	3,734	(8,203)	(7,500)
Preferred stock dividends	0	0	0	0	(1,062)	0	0	0	(1,062)	0	0	0
Net income (loss)	(17,656)	(8,232)	(7,759)	(7,329)	(617)	(1,519)	(1,912)	(2,445)	(6,493)	3,734	(8,203)	(7,500)
Basic income per share	(\$7.62)	(\$2.51)	(\$2.06)	(\$1.87)	(\$0.14)	(\$0.33)	(\$0.37)	(\$0.44)	(\$1.30)	\$0.54	(\$0.85)	(\$0.45)
Diluted income per share	(\$7.62)	(\$2.51)	(\$2.06)	(\$1.87)	(\$0.14)	(\$0.33)	(\$0.37)	(\$0.44)	(\$1.30)	\$0.54	(\$0.85)	(\$0.45)
Basic shares outstanding	2,317	3,285	3,768	3,912	4,514	4,659	5,126	5,604	4,976	6,882	9,657	16,500
Diluted shares outstanding	2,317	3,285	3,768	3,912	4,514	4,659	5,126	5,604	4,976	6,898	9,657	16,500
Key ratios:												
Product/Royalties revenue growth	53.2%	42.7%	40.1%	34.3%	40.8%	25.8%	29.3%	-0.3%	23.0%	-12.8%	2.1%	10.8%
Gross margin-products	62.1%	58.2%	67.4%	72.5%	74.1%	74.4%	73.0%	68.5%	72.7%	64.6%	54.5%	55.6%
R&D/revenue	116.0%	27.1%	21.0%	15.5%	13.1%	11.3%	14.4%	20.1%	14.4%	21.1%	11.1%	10.5%
S, G & A/revenues	257.2%	134.4%	118.9%	103.6%	70.3%	77.4%	74.6%	87.0%	77.0%	84.6%	89.6%	90.7%
Non-cash items	\$3,335	\$2,245	\$2,793	\$2,730	\$625	\$450	\$525	\$1,172	\$2,772	\$2,600	\$2,024	\$2,200
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
Cash Flow/share	(\$6.18)	(\$1.51)	(\$1.32)	(\$1.18)	\$0.00	(\$0.23)	(\$0.27)	(\$0.23)	(\$0.73)	(\$0.67)	(\$0.48)	(\$0.33)
EBITDA/share	(\$6.14)	(\$1.21)	(\$1.28)	(\$1.16)	(\$0.03)	(\$0.32)	(\$0.46)	(\$0.37)	(\$1.18)	(\$0.65)	(\$0.48)	(\$0.33)

Balance Sheets

	(\$000s)	
	3/31/15	9/30/15
Assets:		
Cash and equivalents	\$6,136	\$7,974
Accounts receivable, net	1,517	2,572
Inventories, net	1,402	1,670
Prepaid expenses & other	592	461
Total current	9,647	12,677
Property & equip., net	795	835
Other assets	4,606	72
TOTAL ASSETS	\$15,048	\$13,584
Liabilities:		
Accounts payable	\$932	\$1,161
Accrued expenses	1,562	1,412
Long-term debt - current portion	87	0
Total current	2,581	2,573
Long-term debt		
Other long-term	413	263
Total long-term liabilities	413	263
Stockholders' equity	12,054	10,748
TOTAL LIAB & EQ	\$15,048	\$13,584

Quarterly Earnings Comparisons

	June	Sept	December	March	Total
Revenues (in \$000)					
2008	866	977	1,066	926	3,835
2009	1,211	1,481	1,221	1,475	5,388
2010	1,847	1,672	1,613	2,232	7,364
2011	2,264	2,466	2,313	2,711	9,754
2012	2,940	3,663	2,790	3,351	12,744
2013	4,051	4,526	3,540	3,335	15,452
2014	3,372	4,089	3,293	2,914	13,668
2015	3,392	3,264	3,218	3,980	13,854
2016E	3,680	4,054			15,650
Earnings per Share					
2008	(2.97)	(3.09)	(2.80)	(2.36)	(11.18)
2009	(2.29)	(3.04)	(1.46)	(0.91)	(7.62)
2010	(1.28)	(0.58)	(0.38)	(0.40)	(2.51)
2011	(0.63)	(0.41)	(0.60)	(0.42)	(2.06)
2012	(0.57)	(0.22)	(0.66)	(0.43)	(1.87)
2013	(0.14)	(0.33)	(0.37)	(0.44)	(1.30)
2014	(0.26)	(0.21)	(0.09)	0.99	0.54
2015	(0.01)	(0.08)	(0.69)	(0.11)	(0.85)
2016E	(0.15)	(0.11)			(0.45)

Revenues by Segment

Revenues by Geographic area (FYE March)	2014	2015	2016E
Product-related revenues			
United States	1,406	1,988	3,500
Mexico	3,758	5,053	5,900
Europe and rest-of-world	2,046	2,908	3,400
Total product	7,210	9,949	12,800
Product license fees and royalties			
Sanfer Labs/More Pharma	1,501	1,499	1,200
Innovacyn/Veterinary	3,100	1,120	50
Exeltis/Quinnova	807	427	350
Other	105	0	0
Total license fees and royalties	5,513	3,046	1,600
Service revenues	945	859	1,250
Total	\$13,668	\$13,854	\$15,650

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

Important Disclosures:
Price Chart:

Price target and ratings changes over the past 3 years:

Initiated – August 17, 2009 – Buy - Target \$4.50
 Lowered price target to \$2.25 – Buy - March 1, 2012
 Adjusted price target to \$12 - Buy – April 10, 2013
 Rating lowered to Neutral - June 19, 2013
 Rating raised to Buy – April 30, 2014 –Price Target \$7.50
 Lowered price target to \$4.00 – Buy – February 18, 2015

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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)	17	71%	11	65%
Market Perform (Neutral)	7	29%	5	71%
Market Underperform (Sell)	0	0%	0	0%
Total	24	100%	16	67%

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