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Sonoma Pharmaceuticals (Nasdaq/SNOA)
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BUY
US Derm business ramping up
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 very solid growth in its US dermatology pharmaceutical business for its most recent quarter**, including 66% growth in prescriptions year-over-year and a 24% increase over the previous quarter. For Q1/18 (ending June) as a whole, Sonoma posted total revenues of \$3.8 million, as compared to \$2.6 million for Q1/17. Net loss for the Company came in at \$3.5 million or (\$0.82) per share for Q1/18, as compared to a net loss of \$2.6 million or (\$0.61) in the prior year, which also included approximately \$0.9 million in non-cash benefits. Growth this year was led by a more complete US dermatology product pipeline, including eight products in dermatitis, scar management, surgical care, severe acne and skin repair, which were marketed by a larger internal sales force, up to 30 sales reps (and six sales managers) this year from 17 (and five managers) last year. In addition to growth of 35% in US revenues this quarter, Sonoma also saw increases in sales in Europe and other international territories of 13% year-over-year, which were offset to some degree by lower revenues in China and India. During the first quarter, Sonoma also posted a little under \$570,000 in revenues from Latin America through its recent agreement with Invektra. Operating cash burn was \$2.8 million in Q1/18 for Sonoma, and at the end of period the Company retained \$12.6 million in cash.

2) **Going forward, Sonoma is counting on its US derm business to drive growth and bring the Company to the break-even point.** Coming up later this year is the expected launch in the US of product line extensions for Loyon,

a skin descaling product licensed in 2016, and Ceramax skin barrier cream for atopic dermatitis and eczema, also in-licensed, in this case in 2015.

Internationally, as many as seven new products are geared-up for launch (once approved) in Brazil and are expected to add to revenues in the near term. New product introductions, combined with a slight

Current Price \$5.17
Price Target \$11.00

Estimates	F2016A	F2017A	F2018E
Revenue(\$000s)	\$9,369	\$12,825	\$16,285 E
1Q June	3,372	2,638	3,835 A
2Q September	4,089	4,108	3,940 E
3Q December	3,293	3,361	4,150 E
4Q March	2,914	4,029	4,360 E
Prev. Rev. Estimate (\$000s)			

EPS	(\$3.09)	\$2.20	(\$3.00) E
1Q June	(0.77)	(0.61)	(0.82) A
2Q September	(0.54)	(0.46)	(0.75) E
3Q December	(0.96)	3.84	(0.73) E
4Q March	(0.82)	(0.58)	(0.70) E
Previous EPS Estimate			

P/E (x)	N/A	N/A	N/A
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EBITDA/Share	(\$3.56)	(\$2.38)	(\$2.32)
EV/EBITDA (x)	N/A	N/A	N/A

Stock Data	
52-Week Range	\$3.65-\$8.25
Shares Outstanding (mil.)	4.3
Market Capitalization (mil.)	\$22.2
Enterprise Value (mil.)	\$10.1
Debt to Capital (6/17)	2.7%
Book Value/Share (6/17)	\$4.33
Price/Book	1.2 X
Average Trading Volume (3-Month)	21,000
Insider Ownership	13.3%
Institutional Ownership	11.8%
Short interest	90,000
Dividend / Yield	\$0.00/0.0%


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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Please find Important Disclosures beginning on Page 5.

increase in internal derm sales force and a larger effect from maturity of its existing sales reps, are expected to help boost the Company's operations to break-even in coming quarters, most likely sometime next calendar year. While the most recent and coming quarters have experienced a bit of a hiccup from returns and rebates, the growing dermatology market world-wide (with several multi-\$billion market indications) and the Company's ability to both develop internally and in-license derm products are expected to bring plenty of positive news flow to Sonoma Pharma investors in the longer-term.

Conclusion/Stock Valuation

We are re-initiating our BUY rating on Sonoma Pharmaceuticals due to the availability of additional research staff, and initiating an \$11 Price Target on these shares as well. 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. On the same hand, with a current valuation of less than 1.5X expected revenues of \$16.0 million for this calendar year, and a slew of recent dermatology-oriented specialty pharma buyouts in the valuation range of 3X-6X revenues, value-oriented investors may also look with interest at SNOA shares. The aforementioned group of dermatology buyouts comprise well-known firms as well as smaller companies including Stiefel Labs, Medicis, Fougera, PreCision Dermatology, Graceway Pharm, Aqua Pharmaceuticals, SkinMedica and Dow Pharma Sciences, with an average buy-out multiple over 3X revenues. Using the 3X multiple of forecasted revenues for Sonoma for this calendar year, we estimate a stock valuation of \$11 for SNOA shares, and therefore we are re-initiating our BUY rating on SNOA shares and initiating a 12-18 month price target of \$11 per share.

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	2Q18E	3Q18E	4Q18E	2018E	2019E
		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	\$3,700	\$3,900	\$4,100	\$15,303	\$18,000
Service	891	869	945	859	1,061	227	224	187	230	868	252	240	250	260	982	1,000
Total revenues	\$12,744	\$15,452	\$13,668	\$13,854	\$9,369	\$2,638	\$4,108	\$3,361	\$4,029	\$12,825	\$3,855	\$3,940	\$4,150	\$4,360	\$16,285	\$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	1,920	1,990	2,050	7,873	7,650
Service	726	733	761	658	881	185	204	179	170	738	160	160	165	170	655	660
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	2,080	2,155	2,220	8,528	8,310
Gross Profit	8,714	10,743	8,397	7,288	2,648	981	2,082	1,706	1,947	5,668	1,762	1,860	1,995	2,140	7,757	10,690
Operating Expenses:																
Research and development	1,981	2,223	2,887	1,533	1,806	360	379	487	350	1,576	382	390	400	410	1,582	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	4,600	4,650	4,700	18,713	19,000
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)	(3,130)	(3,055)	(2,970)	(12,538)	(9,910)
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)	(100)	(100)	(100)	(415)	(400)
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)	(3,240)	(3,165)	(3,080)	(12,993)	(10,350)
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)	(3,240)	(3,165)	(3,080)	(12,993)	(10,350)
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)	(\$0.75)	(\$0.73)	(\$0.70)	(\$3.00)	(\$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)	(\$0.75)	(\$0.73)	(\$0.70)	(\$3.00)	(\$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	4,300	4,350	4,400	4,336	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	4,300	4,350	4,400	4,336	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%	-4.7%	22.9%	7.9%	28.0%	17.6%
Gross margin-products	72.5%	72.7%	64.6%	54.5%	29.7%	38.9%	53.1%	53.3%	49.7%	46.3%	46.9%	48.1%	49.0%	50.0%	48.6%	57.5%
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%	9.9%	9.6%	9.4%	9.7%	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%	116.8%	112.0%	107.8%	114.9%	100.0%
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)	(\$0.61)	(\$0.58)	(\$0.54)	(\$2.32)	(\$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)	(\$0.64)	(\$0.60)	(\$0.56)	(\$2.32)	(\$1.81)

Balance Sheets

	(\$000s)	
Assets:	3/31/17	6/30/17
Cash and equivalents	\$17,461	\$12,638
Accounts receivable, net	2,108	2,741
Inventories, net	2,221	2,380
Prepaid expenses & other	853	1,554
Total current	22,643	19,313
Property & equip., net	1,239	1,496
Other assets	1,527	1,612
TOTAL ASSETS	\$25,459	\$22,421
Liabilities:		
Accounts payable	\$1,255	\$774
Accrued expenses	1,836	1,983
Long-term debt - current portion	197	226
Total current	3,288	2,983
Long-term debt	213	294
Other long-term	527	538
Total long-term liabilities	740	832
Stockholders' equity	21,431	18,606
TOTAL LIAB & EQ	\$25,459	\$22,421

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	4,054	2,483	2,575	9,369
2017	2,638	4,108	3,361	4,029	12,825
2018E	3,855	3,940	4,150	4,360	16,285
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)	(0.75)	(0.73)	(0.70)	(3.00)

Revenues by Segment

Revenues by Geographic area (FYE March)	2016	2017	2018E
	March	March	March
Product-related revenues			
United States	4,371	6,380	10,000
Latin America	0	1,299	1,300
Europe and rest-of-world	3,706	4,078	4,003
Total product	8,077	11,957	15,303
Product license fees and royalties	251	0	0
Service revenues	1,061	868	982
Total	\$9,369	\$12,825	\$16,285

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;
- 3) **Sell:** the analyst believes the price of the stock will decline by at least 20% over the next 12-18 months and should be sold.

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	Company Coverage		Investment Banking	
Ratings Distribution	# of Companies	% of Total	# of Companies	% of Totals
Market Outperform (Buy)	10	77%	2	20%
Market Perform (Neutral)	0	0%	0	0%
Market Underperform (Sell)	0	0%	0	0%
Ratings Suspension*	3	23%	3	100%
Total	13	100%	5	38%

*Suspensions are ratings under review for possible change due to unusual market-moving news, and/or analyst departure/change

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