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## Sonoma Pharmaceuticals (Nasdaq/SNOA)

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**BUY**
**Revenues post record in Q3/18**

*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 record financial results for its most recent Q3/2018 (ending December) quarter**, including revenues of \$4.8 million, an increase of 44% year-over-year. Revenue growth in the December quarter was led by \$2.2 million in dermatology sales in the US, or roughly 45% of overall sales, and represented a 78% increase over the prior year period and 36% increase over the prior quarter. Revenues also increased for non-dermatology products in the US (acute care and animal health) during the quarter, as well as in Europe and Asia, to be offset to some degree by lower revenues from the Middle East. Gross margins dipped slightly during the third quarter to 49% from 51% due to lower margins in Latin America caused by a contractual mark-up of only 6% required to a new partner in those countries, but this factor was partially offset by higher margins in the US due to a richer product mix toward dermatology products. After overhead expenses of \$5.7 million in Q3/2018, up somewhat from \$5.3 million in Q3/2017, net loss for Sonoma decreased to \$3.2 million for the quarter, or (\$0.73) per share, as compared to a net loss of \$3.3 million or (\$0.78) per share in the prior year period, before one-time gains. EBITDA loss also showed a 4% improvement in the most recent quarter, to \$2.4 million. At the end of the period Sonoma held slightly more than \$8.6 million in cash on hand.

**2) Looking ahead, fourth quarter results, although seasonally weaker, are expected to benefit** from three FDA approvals in the US for expanded indications to add anti-microbial language to Alevicyn products (November and December 2017) and three new products approved in the United Arab Emirates (January 2018). Also a favorable factor could be the signing in the near future of a marketing partner in Brazil and launch of the seven dermatology products approved in that country last October, which could possibly contribute some upfront cash as well. For the current Q4/2018 quarter ending March, we are estimating that Sonoma will post revenues of \$4.5 million, up from \$4.0 million in the prior year's quarter, aided by an

**Current Price \$4.34**
**Price Target \$9.00**

Estimates	F2016A	F2017A	F2018E
Revenue(\$000s)	\$9,369	\$12,825	\$17,513 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	4,843 A
4Q March	2,914	4,029	4,510 E

EPS	(\$3.09)	\$2.20	(\$2.86) 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	(0.73) A
4Q March	(0.82)	(0.58)	(0.65) E

P/E (x) N/A N/A N/A

EBITDA/Share (\$3.56) (\$2.38) (\$2.22)

EV/EBITDA (x) N/A N/A N/A

#### Stock Data

52-Week Range	\$4.16-\$8.25
Shares Outstanding (mil.)	4.75
Market Capitalization (mil.)	\$20.6
Enterprise Value (mil.)	\$12.4
Debt to Capital (12/17)	2.5%
Book Value/Share (12/17)	\$3.00
Price/Book	1.4 X
Average Trading Volume (3-Month)	28,800
Insider Ownership	4.6%
Institutional Ownership	14.2%
Short interest	30,200
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  
 Price target lowered to \$9 - February 22, 2018

**Please find Important Disclosures beginning on Page 5.**

estimated 13% increase in product revenues year-over-year, primarily from growth in dermatology sales, particularly in the US. Combined with slightly improving overall gross margins of 51% in the quarter as compared to 50% in the prior year, offset by somewhat higher overhead expenses, we estimate operating losses for Sonoma will increase slightly to \$3.1 million from \$2.9 million last year, or a (\$0.65) net loss per share as compared to (\$0.58) net loss per share in Q4/2017. For fiscal 2019E, we are projecting that the Company will post revenues of \$19 million, with \$18.2 million in product sales, representing an increase of 9% year-over-year, with a net loss of \$10.7 million or (\$2.20) per share, compared with an estimated loss of \$12.7 million or (\$2.86) in fiscal 2018E. Current levels of cash on hand are expected to last well into next fiscal year for Sonoma, or perhaps further if the Company is able to reduce EBITDA losses and operating cash burn or bolster cash reserves through the signing of new product marketing partnerships.

## Conclusion/Stock Valuation

We are reiterating our BUY rating on Sonoma Pharmaceuticals but lowering our 12-18 month price target to \$9 due to recent share dilution as well as other valuation factors related to comparable companies. Still, 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 actual revenues of \$17 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.

Robert M. Wasserman

**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	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	\$4,144	\$4,647	\$4,300	\$16,694	\$18,200
Service	891	869	945	859	1,061	227	224	187	230	868	232	181	196	210	819	800
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	\$4,843	\$4,510	\$17,513	\$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	2,308	2,090	8,619	9,100
Service	776	733	761	658	881	185	204	179	170	738	160	169	167	172	668	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	2,475	2,262	9,287	9,780
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	2,368	2,248	8,226	9,220
Operating Expenses:																
Research and development	1,981	2,223	2,887	1,533	1,806	360	379	487	350	1,576	382	368	349	370	1,469	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	5,219	5,000	19,319	18,350
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)	(3,200)	(3,122)	(12,562)	(10,730)
Interest expense	(931)	(1,107)	(1,058)	(2)	(3)	(1)	(1)	0	(1)	(3)	(10)	(10)	(11)	(10)	(41)	(40)
Other (income) expense, net	69	(950)	10,843	(1,542)	4,555	623	(8)	15,753	249	17,983	(115)	(3)	24	22	(72)	100
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)	(3,187)	(3,110)	(12,675)	(10,670)
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)	(3,187)	(3,110)	(12,675)	(10,670)
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)	(\$0.73)	(\$0.65)	(\$2.86)	(\$2.20)
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)	(\$0.73)	(\$0.65)	(\$2.86)	(\$2.20)
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	4,392	4,750	4,437	4,850
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	4,392	4,750	4,437	4,850
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%	46.4%	13.2%	39.6%	9.0%
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%	50.3%	51.3%	48.4%	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%	7.2%	8.2%	8.4%	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%	107.8%	110.9%	110.3%	96.6%
Non-cash items	\$2,730	\$2,772	\$2,600	\$2,024	\$3,000	\$470	\$470	\$470	\$470	\$2,500	\$550	\$600	\$750	\$800	\$2,700	\$2,600
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	(\$1.18)	(\$0.73)	(\$3.33)	(\$2.40)	(\$3.56)	(\$0.65)	(\$0.35)	\$0.22	(\$0.52)	(\$1.30)	(\$0.69)	(\$0.53)	(\$0.55)	(\$0.49)	(\$2.23)	(\$1.66)
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)	(\$0.55)	(\$0.48)	(\$2.22)	(\$1.64)

**Balance Sheets**

(\$000s)

Assets:	3/31/17	12/31/17
Cash and equivalents	\$17,461	\$8,625
Accounts receivable, net	2,108	2,609
Inventories, net	2,221	2,701
Prepaid expenses & other	853	1,737
Total current	22,643	15,672
Property & equip., net	1,239	1,200
Other assets	1,577	1,483
<b>TOTAL ASSETS</b>	<b>\$25,459</b>	<b>\$18,355</b>
<b>Liabilities:</b>		
Accounts payable	\$1,255	\$1,400
Accrued expenses	1,836	1,835
Long-term debt - current portion	197	158
Total current	3,288	3,393
Long-term debt	213	214
Other long-term	527	492
Total long-term liabilities	740	706
Stockholders' equity	21,431	14,256
<b>TOTAL LIAB &amp; EQ</b>	<b>\$25,459</b>	<b>\$18,355</b>

**Quarterly Earnings Comparisons**

	June	Sept	December	March	Total
<b>Revenues (in \$000)</b>					
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	3,835	4,325	4,843	4,510	17,513

**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)	(0.73)	(0.65)	(2.86)

**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	4,194
Total product	8,077	11,957	16,694
Product license fees and royalties	231	0	0
Service revenues	1,061	868	819
<b>Total</b>	<b>\$9,369</b>	<b>\$12,825</b>	<b>\$17,513</b>

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  
Price target lowered to \$9 – February 22, 2018

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	<b>Company Coverage</b>		<b>Investment Banking</b>	
<b>Ratings Distribution</b>	<b># of Companies</b>	<b>% of Total</b>	<b># of Companies</b>	<b>% of Totals</b>
Market Outperform (Buy)	15	88%	5	33%
Market Perform (Neutral)	2	12%	0	0%
Market Underperform (Sell)	0	0%	0	0%
Total	17	100%	5	29%

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