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Sonoma Pharmaceuticals (Nasdaq/SNOA)
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BUY Revenues lower in Q4/18, but 2019 holds promise

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 positive financial results for its fiscal 2018 ending March**, including overall revenue growth of 30% year-over-year, led by 40% growth in US dermatology sales, but also including key contributions from international business (up 36% over 2017) and total US sales, which increased 27% year-over-year. Key regulatory and development milestones for the year for Sonoma included US FDA approval and launch for Loyon (for treating scaling and erythema in dermatoses), dermatology product approvals in Brazil, Singapore and the United Arab Emirates, and FDA nods for adding antimicrobial language on labels for four products. Product gross margins slipped a bit to 44.7% for the year as a whole, compared to 46.3% in fiscal 2017, due primarily to higher product rebates recorded in Q4/18. Combined with higher operating expenses for the year (\$21.5 million as compared with \$18.6 million last year), Sonoma saw its operating loss increase in 2018 to \$14.3 million, as compared with \$12.9 million in 2017. Operating cash burn for Sonoma was approximately \$11.3 million in 2018, though, similar to the \$11.8 million cash burn in 2017, and at the end of the March quarter the Company held \$10.1 million in cash on hand, an amount bolstered from proceeds from a \$5 million equity placement completed in March.

2) **While overall results for the fiscal year were promising for Sonoma, most recent Q4/2018 financials were somewhat less positive.** Revenues decreased 14% in Q4, to \$3.7 million, after showing increases in each of the previous quarters of the fiscal year, and net losses increased to \$4.8 million, or (\$0.93) per share, from \$2.4 million, or (\$0.58) in Q4/2017. The primary negative factors in the most recent quarterly results were health insurance deductible resets at the beginning of the calendar year and the impact of increased product rebates for Sonoma's US dermatology business, which resulted in a significant drop in factory units shipped to wholesalers even while prescriptions for these products were increasing in Q4/18.

Current Price \$2.63
Price Target \$7.00

| Estimates | F2016A | F2017A | F2018A |
|------------------------|----------------|-----------------|-------------------|
| Revenue(\$000s) | \$9,369 | \$12,825 | \$16,658 A |
| 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 | 3,655 A |

| EPS | (\$3.09) | \$2.20 | (\$3.16) A |
|--------------|----------|--------|------------|
| 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) | (0.93) A |

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

| | | | |
|---------------|----------|----------|----------|
| EBITDA/Share | (\$3.56) | (\$2.38) | (\$2.47) |
| EV/EBITDA (x) | N/A | N/A | N/A |

| Stock Data | |
|----------------------------------|---------------|
| 52-Week Range | \$2.46-\$7.20 |
| Shares Outstanding (mil.) | 6.20 |
| Market Capitalization (mil.) | \$16.3 |
| Enterprise Value (mil.) | \$6.8 |
| Debt to Capital (3/18) | 3.5% |
| Book Value/Share (3/18) | \$2.47 |
| Price/Book | 1.1 X |
| Average Trading Volume (3-Month) | 28,800 |
| Insider Ownership | 3.7% |
| Institutional Ownership | 22.1% |
| Short interest | 20,900 |
| 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
- Price target lowered to \$7 - June 26, 2018

There were some bright spots for the quarter, however, including higher product revenues in Latin America, Europe, Singapore, Hong Kong and India, and for acute care products in the US. The Company is also taking steps to reduce the negative sales effects for US dermatology products, including working with managed care consultants to increase reimbursement and shifting product delivery from traditional wholesalers to mail order pharmacies.

3) Going forward, we are estimating that Sonoma will post revenues of \$19.0 million in 2019E (ending March), an increase of 14.9% over 2018, led by growth in US dermatology prescriptions and especially international sales in markets such as Brazil, where new product approvals and a new distribution agreement are in hand. We also expect the Company's track record of one new product approval (or license) approximately every six months to continue in 2019, as well as additional international market product approvals, as was the case in fiscal 2018. For the year, we are assuming that gross margins will bounce back to 47%, similar to metrics in 2017 and the first part of fiscal 2018, and that other operating expense levels will remain on par with those of 2018, in the \$21.5 million range, helping reduce net losses to \$12.4 million for 2019E, or (\$2.00) per share. Our forecasted cash burn for 2019E will be within current levels of cash on hand for Sonoma, assuring no new financings are needed until perhaps mid-year calendar 2019. Also potentially of benefit to the Company would be new international distribution agreements which could fuel new growth and/or bring in new cash. We are not implementing quarterly estimates for fiscal 2019E for Sonoma at this time, but may do so later in the fiscal year.

Conclusion/Stock Valuation

We are reiterating our BUY rating on Sonoma Pharmaceuticals but lowering our 12-18 month price target to \$7 due to recent share dilution, lower revenues forecast for fiscal 2019E, 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 just over 1.0X last twelve month revenues, 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 | 2017 | 1Q18 | 2Q18 | 3Q18 | 4Q18 | 2018 | 2019E |
|-------------------------------------|----------|----------|----------|----------|----------|----------|----------|-----------|----------|----------|----------|----------|
| | | March | March | March | March | March | June | September | December | March | March | March |
| Revenues | | | | | | | | | | | | |
| Product and product licensing fees | \$11,853 | \$14,583 | \$12,723 | \$12,995 | \$8,308 | \$11,957 | \$3,603 | \$4,144 | \$4,647 | \$3,269 | \$15,663 | \$18,000 |
| Service | 891 | 869 | 945 | 859 | 1,061 | 868 | 232 | 181 | 196 | 386 | 995 | 1,000 |
| Total revenues | \$12,744 | \$15,452 | \$13,668 | \$13,854 | \$9,369 | \$12,825 | \$3,835 | \$4,325 | \$4,843 | \$3,655 | \$16,658 | \$19,000 |
| Cost of revenues | | | | | | | | | | | | |
| Product | 3,254 | 3,976 | 4,510 | 5,908 | 5,840 | 6,419 | 1,913 | 2,308 | 2,308 | 2,140 | 8,669 | 9,540 |
| Service | 776 | 733 | 761 | 658 | 881 | 738 | 160 | 169 | 167 | 183 | 679 | 680 |
| Total cost of revenues | 4,030 | 4,709 | 5,271 | 6,566 | 6,721 | 7,157 | 2,073 | 2,477 | 2,475 | 2,323 | 9,348 | 10,220 |
| Gross Profit | 8,714 | 10,743 | 8,397 | 7,288 | 2,648 | 5,668 | 1,762 | 1,848 | 2,368 | 1,332 | 7,310 | 8,780 |
| Operating Expenses: | | | | | | | | | | | | |
| Research and development | 1,981 | 2,223 | 2,887 | 1,533 | 1,806 | 1,576 | 382 | 368 | 349 | 476 | 1,575 | 1,650 |
| Selling, General and administrative | 13,200 | 11,894 | 11,561 | 12,414 | 15,556 | 17,066 | 4,763 | 4,337 | 5,219 | 5,605 | 19,924 | 19,600 |
| Operating income (loss) | (6,467) | (3,374) | (6,051) | (6,659) | (14,714) | (12,974) | (3,383) | (2,857) | (3,200) | (4,749) | (14,189) | (12,470) |
| Interest expense | (931) | (1,107) | (1,058) | (2) | (3) | (3) | (10) | (10) | (11) | (9) | (40) | (40) |
| Other (income) expense, net | 69 | (950) | 10,843 | (1,542) | 4,555 | 17,983 | (115) | (3) | 24 | (5) | (99) | 100 |
| Income (loss) before tax | (7,329) | (5,431) | 3,734 | (8,203) | (10,162) | 5,006 | (3,508) | (2,870) | (3,187) | (4,763) | (14,328) | (12,410) |
| Tax benefit (Expense) | 0 | (1,062) | 0 | 0 | 0 | 4,268 | 0 | 0 | 0 | 0 | 0 | 0 |
| Net income (loss) | (7,329) | (6,493) | 3,734 | (8,203) | (10,162) | 9,274 | (3,508) | (2,870) | (3,187) | (4,763) | (14,328) | (12,410) |
| Basic income per share | (\$9.37) | (\$6.52) | \$2.71 | (\$4.25) | (\$3.09) | \$2.20 | (\$0.82) | (\$0.67) | (\$0.73) | (\$0.93) | (\$3.16) | (\$2.00) |
| Diluted income per share | (\$9.37) | (\$6.52) | \$2.71 | (\$4.25) | (\$3.09) | \$2.20 | (\$0.82) | (\$0.67) | (\$0.73) | (\$0.93) | (\$3.16) | (\$2.00) |
| Basic shares outstanding | 782 | 995 | 1,376 | 1,931 | 3,289 | 4,224 | 4,294 | 4,313 | 4,392 | 5,134 | 4,530 | 6,200 |
| Diluted shares outstanding | 782 | 995 | 1,376 | 1,931 | 3,289 | 4,224 | 4,294 | 4,313 | 4,392 | 5,134 | 4,530 | 6,200 |
| Key ratios: | | | | | | | | | | | | |
| Product/Royalties revenue growth | 34.3% | 23.0% | -12.8% | 2.1% | -36.1% | 43.9% | 49.4% | 6.7% | 46.4% | -14.0% | 31.0% | 14.9% |
| Gross margin-products | 72.5% | 72.7% | 64.6% | 54.5% | 29.7% | 46.3% | 46.9% | 44.3% | 50.3% | 34.5% | 44.7% | 47.0% |
| R&D/revenue | 15.5% | 14.4% | 21.1% | 11.1% | 19.3% | 12.3% | 10.0% | 8.5% | 7.2% | 13.0% | 9.5% | 8.7% |
| S, G & A/revenues | 103.6% | 77.0% | 84.6% | 89.6% | 166.0% | 133.1% | 124.2% | 100.3% | 107.8% | 153.4% | 119.6% | 103.2% |
| Non-cash items | \$2,730 | \$2,772 | \$2,600 | \$2,024 | \$3,000 | \$2,500 | \$550 | \$600 | \$750 | \$1,090 | \$2,990 | \$3,200 |
| Tax Rate | N/A | N/A | N/A | N/A | N/A |
| Cash Flow/share | (\$1.18) | (\$0.73) | (\$3.33) | (\$2.40) | (\$3.56) | (\$1.30) | (\$0.69) | (\$0.53) | (\$0.55) | (\$0.72) | (\$2.48) | (\$1.49) |
| EBITDA/share | (\$1.16) | (\$1.18) | (\$3.28) | (\$2.40) | (\$3.56) | (\$2.38) | (\$0.66) | (\$0.53) | (\$0.55) | (\$0.72) | (\$2.47) | (\$1.47) |

Balance Sheets

| | (\$000s) | |
|----------------------------------|-----------------|-----------------|
| Assets: | 3/31/17 | 3/31/18 |
| Cash and equivalents | \$17,461 | \$10,066 |
| Accounts receivable, net | 2,108 | 1,537 |
| Inventories, net | 2,221 | 2,865 |
| Prepaid expenses & other | 853 | 1,786 |
| Total current | 22,643 | 16,254 |
| Property & equip., net | 1,239 | 1,136 |
| Other assets | 1,577 | 1,816 |
| TOTAL ASSETS | \$25,459 | \$19,206 |
| Liabilities: | | |
| Accounts payable | \$1,255 | \$1,272 |
| Accrued expenses | 1,836 | 1,612 |
| Long-term debt - current portion | 197 | 377 |
| Total current | 3,288 | 3,261 |
| Long-term debt | 213 | 176 |
| Other long-term | 527 | 443 |
| Total long-term liabilities | 740 | 619 |
| Stockholders' equity | 21,431 | 15,326 |
| TOTAL LIAB & EQ | \$25,459 | \$19,206 |

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 |
| 2018 | 3,835 | 4,325 | 4,843 | 3,655 | 16,658 |
| 2019E | | | | | 19,000 |

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 |
| 2018 | (0.82) | (0.67) | (0.73) | (0.93) | (3.16) |
| 2019E | | | | | (2.00) |

Revenues by Segment

| Revenues by Geography (FYE Mar) | 2016 | 2017 | 2018 | 2019E |
|------------------------------------|----------------|-----------------|-----------------|-----------------|
| | March | March | March | March |
| Product-related revenues | | | | |
| United States | 4,371 | 6,580 | 8,372 | 9,500 |
| Latin America | 0 | 1,299 | 3,007 | 4,000 |
| Europe and rest-of-world | 3,706 | 4,078 | 4,284 | 4,500 |
| Total product | 8,077 | 11,957 | 15,663 | 18,000 |
| Product license fees and royalties | 231 | 0 | 0 | 0 |
| Service revenues | 1,061 | 868 | 995 | 1,000 |
| Total | \$9,369 | \$12,825 | \$16,658 | \$19,000 |

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
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- Price target lowered to \$9 – February 22, 2018
- Price target lowered to \$7 – June 26, 2018

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- 1) **Buy:** the analyst believes the price of the stock will appreciate and produce a total return of at least 20% over the next 12-18 months;
- 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) | 21 | 88% | 7 | 33% |
| Market Perform (Neutral) | 3 | 13% | 0 | 0% |
| Market Underperform (Sell) | 0 | 0% | 0 | 0% |
| Total | 24 | 100% | 7 | 29% |

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