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Sonoma Pharmaceuticals (Nasdaq/SNOA)

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BUY Results for Q2/19 continue positive trend

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 positive financial results for its fiscal Q2/19 quarter ending September, including overall revenue growth of 14% year-over-year, the second straight quarter of bounce-back financial results for the Company following a disappointing year-end 2018 (ending March) report. Revenue growth in the quarter was led by a 12% increase in product revenues, including an 18% increase in international sales and a 7% increase in US revenues. In the US, revenues were led by higher sales of animal health products, partially offset by lower revenues of dermatology and acute care products, although prescriptions filled by dermatology product lines increased in Q2/19 as the Company reduced its inventory overhang, pointing to revenue growth in this area in the future. Overseas, Sonoma posted growth in Latin America, led by a new distributor and its product approvals in Brazil, and to a lesser extent growth in Europe and India, offset by declines in the Middle East, Asia and New Zealand. Higher sales in the US and Brazil, particularly for higher-margin dermatology products, helped boost overall gross margins to 49% in the quarter for the Company, up from 43% one year ago. Operating expenses (minus non-cash items) came in at \$4.5 million for Sonoma in the quarter, about 5% above last year's level, due to higher marketing and legal costs, and net loss improved to \$2.7 million, down from \$2.9 million in the same period last year. Results for the third quarter were also aided by Sonoma's new patient-friendly home delivery mail order program in the US, first initiated in Q1/19. The mail-order program now makes up about 42% of the company's dermatology prescription shipments during the third quarter, and has helped reduce the Company's excess inventory units from 7,900 at the start of the year to 3,700 at the end of the recent quarter. Operating cash burn for Sonoma was approximately \$6 million for the first six months of fiscal 2019, including certain receivables and international inventory items which have since been collected after the quarter end, and at the end of the September quarter the Company had \$4 million in cash on hand, an

Current Price \$0.78
Price Target \$7.00

Estimates	F2017A	F2018A	F2019E
Revenue(\$000s)	\$12,825	\$16,658	\$19,938 E
1Q June	2,638	3,835	4,369 A
2Q September	4,108	4,325	4,939 A
3Q December	3,361	4,843	5,210 E
4Q March	4,029	3,655	5,420 E

EPS	\$2.20	(\$3.16)	(\$1.21) E
1Q June	(0.61)	(0.82)	(0.55) A
2Q September	(0.46)	(0.67)	(0.44) A
3Q December	3.84	(0.73)	(0.21) E
4Q March	(0.58)	(0.93)	(0.20) E

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

EBITDA/Share	(\$2.38)	(\$2.47)	(\$0.90)
EV/EBITDA (x)	N/A	N/A	N/A

Stock Data	
52-Week Range	\$0.76-\$5.92
Shares Outstanding (mil.)	12.0
Market Capitalization (mil.)	\$9.4
Enterprise Value (mil.)	\$5.6
Debt to Capital (9/18)	2.9%
Book Value/Share (9/18)	\$0.90
Price/Book	0.9 X
Average Trading Volume (3-Month)	238,300
Insider Ownership	2.1%
Institutional Ownership	10.1%
Short interest	289,000
Dividend / Yield	\$0.00/0.0%


Price target and ratings changes over the past 3 years:

 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

Please find Important Disclosures beginning on Page 5.

amount bolstered from proceeds from an approximate \$5.5 million equity placement completed just recently.



2) **Going forward, we anticipate that operating results for the remainder of fiscal 2019 ending in March 2019 (including Q3/19 and Q4/19) will follow in the positive vein of the first two quarters of this fiscal year.** Two key product launches are expected to boost results for the remainder of Sonoma’s fiscal year, including **Gramacyn** (shown to the left), sold in both hydrogel and solution packages for the treatment of acne and launched in November in Brazil by the Company’s marketing partner NC Group/U.SK. In addition, **Epicyn** antimicrobial facial cleanser is expected to be launched in January 2019 in the US (see product packaging photo to the right). In November, Sonoma also launched its Ceramax Skin Barrier Lotion in the US market, a companion to the Company’s current Ceramax Skin Barrier Cream product.



Ceramax is indicated for seborrhea, burning, itching and atopic dermatitis and employs the company’s proprietary Lipogrid Skin Enriching Technology. Related to research and development, the Company presented results of a double blinded, placebo-controlled, randomized clinical trial using its HOCl-based solution on Acne Lesions as part of an acne management regimen in August at the 5th Annual Practical Symposium Dermatology Conference in Colorado. The data from these studies showed statistically significant reductions in both inflammatory and non-inflammatory acne lesions, with no reports of irritation. For this fiscal year, then, we are forecasting that Sonoma will post revenues of \$19.9 million, representing a nearly 20% increase year-over-year, with a net loss of \$11.2 million or (\$1.21) per share, an improvement over the \$14.3 million or (\$3.16) per share loss reported in fiscal 2018. We estimate that Sonoma will show revenue growth in 2019E from its each of major geographic territories, the US, Latin America and Europe/Rest of World, and also that product gross margins will improve to 49% for 2019E from 45% in the year prior.

Conclusion/Stock Valuation

We are reiterating our BUY rating on Sonoma Pharmaceuticals and maintaining our 12-18 month price target of \$7. With a solid and recently bolstered 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 under 0.5X estimated fiscal 2019E revenues and approximately equal to current levels of cash on hand (pro forma following a recent equity offering), the Company’s valuation metrics continue to be well below valuations given to a number of recent dermatology-oriented specialty pharma buyouts, and thus value-oriented investors may also soon 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.

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	1Q19	2Q19	3Q19E	4Q19E	2019E	
		March	March	March	March	March	June	September	December	March	March	June	September	December	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	\$4,095	\$4,635	\$4,900	\$5,100	\$18,730	
Service	891	869	945	859	1,061	868	232	181	196	386	995	274	304	310	320	1,208	
Total revenues	\$12,744	\$15,452	\$13,668	\$13,854	\$9,369	\$12,825	\$3,835	\$4,325	\$4,843	\$3,655	\$16,658	\$4,369	\$4,939	\$5,210	\$5,420	\$19,938	
Cost of revenues														\$1,142			
Product	3,254	3,976	4,510	5,908	5,840	6,419	1,913	2,308	2,308	2,140	8,669	2,424	2,313	2,400	2,450	9,587	
Service	776	733	761	658	881	738	160	169	167	183	679	214	199	200	200	813	
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	2,638	2,512	2,600	2,650	10,400	
Gross Profit	8,714	10,743	8,397	7,288	2,648	5,668	1,762	1,848	2,368	1,332	7,310	1,731	2,427	2,610	2,770	9,538	
Operating Expenses:																	
Research and development	1,981	2,223	2,887	1,533	1,806	1,576	382	368	349	476	1,575	350	390	400	400	1,540	
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	4,933	4,689	4,800	4,850	19,272	
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)	(3,552)	(2,652)	(2,590)	(2,480)	(11,274)	
Interest expense	(931)	(1,107)	(1,058)	(2)	(3)	(3)	(10)	(10)	(11)	(9)	(40)	(12)	(7)	(10)	(10)	(39)	
Other (income) expense, net	69	(950)	10,843	(1,542)	4,555	17,983	(115)	(3)	24	(5)	(99)	106	(161)	100	100	145	
Income (loss) before tax	(7,329)	(5,431)	3,734	(8,203)	(10,162)	(2,288)	(3,508)	(2,870)	(3,187)	(4,763)	(14,328)	(3,458)	(2,820)	(2,500)	(2,390)	(11,168)	
Tax benefit (Expense)	0	(1,062)	0	0	0	4,268	0	0	0	0	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)	(3,458)	(2,820)	(2,500)	(2,390)	(11,168)	
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)	(\$0.55)	(\$0.44)	(\$0.21)	(\$0.20)	(\$1.21)	
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)	(\$0.55)	(\$0.44)	(\$0.21)	(\$0.20)	(\$1.21)	
Basic shares outstanding	782	995	1,376	1,931	3,289	4,224	4,294	4,313	4,392	5,134	4,530	6,241	6,465	12,000	12,100	9,202	
Diluted shares outstanding	782	995	1,376	1,931	3,289	4,224	4,294	4,313	4,392	5,134	4,530	6,241	6,465	12,000	12,100	9,202	
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%	13.7%	11.8%	5.4%	56.0%	19.6%	
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%	40.8%	50.1%	51.0%	52.0%	48.8%	
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%	8.0%	7.9%	7.7%	7.4%	7.7%	
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%	112.9%	94.9%	92.1%	89.5%	96.7%	
Non-cash items	\$2,730	\$2,772	\$2,600	\$2,024	\$3,000	\$2,500	\$550	\$590	\$750	\$1,100	\$2,990	\$470	\$700	\$750	\$800	\$2,990	
Tax Rate	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)	(\$1.30)	(\$0.69)	(\$0.53)	(\$0.55)	(\$0.71)	(\$2.48)	(\$0.48)	(\$0.33)	(\$0.15)	(\$0.13)	(\$0.90)	
EBITDA/share	(\$1.16)	(\$1.18)	(\$3.28)	(\$2.40)	(\$3.56)	(\$2.38)	(\$0.66)	(\$0.53)	(\$0.55)	(\$0.71)	(\$2.47)	(\$0.46)	(\$0.35)	(\$0.14)	(\$0.12)	(\$0.90)	

Balance Sheets

(\$000s)

Assets:	3/31/18	9/30/18
Cash and equivalents	\$10,066	\$4,048
Accounts receivable, net	1,537	2,971
Inventories, net	2,865	2,953
Prepaid expenses & other	1,786	1,696
Total current	16,254	11,668
Property & equip., net	1,136	935
Other assets	1,816	1,745
TOTAL ASSETS	\$19,206	\$14,348
Liabilities:		
Accounts payable	\$1,272	\$1,362
Accrued expenses	1,612	1,484
Long-term debt - current portion	377	231
Total current	3,261	3,077
Long-term debt	176	87
Other long-term	443	399
Total long-term liabilities	619	486
Stockholders' equity	15,326	10,785
TOTAL LIAB & EQ	\$19,206	\$14,348

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	4,369	4,939	5,210	5,420	19,938
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	(0.55)	(0.44)	(0.21)	(0.20)	(1.21)

Revenues by Segment	2016	2017	2018	2019E
Revenues by Geography (FYE Mar)	March	March	March	March
Product-related revenues				
United States	4,371	6,580	8,372	9,400
Latin America	0	1,299	3,007	4,400
Europe and rest-of-world	3,706	4,078	4,284	4,930
Total product	8,077	11,957	15,663	18,730
Product license fees and royalties	231	0	0	0
Service revenues	1,061	868	995	1,208
Total	\$9,369	\$12,825	\$16,658	\$19,938

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

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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)	35	88%	10	29%
Market Perform (Neutral)	5	13%	0	0%
Market Underperform (Sell)	0	0%	0	0%
Total	40	100%	10	25%

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