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ProPhase Labs (NASDAQ: PRPH)

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BUY: Reports an Underwhelming Quarter; Lowering Price Target to \$9.00 from \$25.00

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ProPhase reported revenues of just \$9.1M versus our estimate of \$14.6M sequentially, down from the reported \$15.2M in the prior period. This translated into a net loss of \$1.4M versus our model, which had the company at \$3.4M in positive cash flow. All of this suggests that the COVID testing ramp we assumed is too aggressive. Complicating the analysis is recent news that the company spent \$15M for a "whole genome" sequencing company. We disagree with management that this acquisition is a pathway towards personalized medicine. In fact, the CEO suggested to us that he sees the acquisition as a competitor to services provided by ancestry.com. We are revising our model, which lowers our price target to \$9.00.

Highlights:

The Quarter's Results: The company's press release is, in our opinion, misleading. Management states that the 2Q21 results were up 153% from the same period a year ago (true), but that's a false comparison, as last year, there were no COVID testing revenues. The key question is: how is the COVID testing business doing? We see a sequential drop from Q1 to Q2, suggesting our COVID ramp is well below our assumptions. We have reduced our assumed market penetration rate, which drops the target valuation from \$25.00 to \$9.00.

A Whole Genome Sequencing Acquisition? We are, at best, "confused." The company announced an acquisition of Nebula Genomics, which provides a whole genomic sequencing service, for \$14.6M. We can certainly appreciate that whole genomic sequencing represents the future, but we are skeptical of how the data can be monetized today. In fact, when we challenged the CEO, he related that part of the business plan is to provide a more comprehensive product versus that of ancestry.com. That's fine, but it's hard to understand what the real synergy is with building a COVID/Flu testing machine. In terms of competing in the personalized medicine space, such as cancer (which the CEO suggested is also the plan), we see a naivety in the company's thinking, dramatically underestimating how that market works and how it's dominated by some very big players today.

The company has a conference call at 11:00 today. We hope management will provide guidance for COVID and Flu testing revenues and better explain the rationale behind the recent Nebula acquisition.

Valuation: We project detailed revenue assumptions in our model out to 2030. We apply a 70% success probability (30% risk cut) to our revenue estimates. On top of this, we apply a 30% risk rate in our Free Cash Flow to the Firm (FCFF), discounted EPS (dEPS), and Sum-of-the-Parts (SOP) models, which are then equal-weighted and averaged and rounded to the nearest whole number to derive our 12-month projected price target of \$9.00.

Risks to our thesis include: (1) commercial; (2) financial; (3) intellectual property; (4) regulatory, and (5) OEM and/or manufacturing. See the Risk Analysis section of this report.

Current Price	\$5.31		
Price Target	\$9.00		
Estimates	F2020A	F2021E	F2022E
Revenues (\$000s)	\$ 14,514	\$ 58,721	\$ 52,276
1Q March	\$ 1,888	\$ 15,271	\$ 13,054
2Q June	\$ 3,623	\$ 9,142	\$ 12,222
3Q September	\$ 3,840	\$ 16,576	\$ 13,238
4Q December	\$ 5,163	\$ 17,732	\$ 13,761
	F2020A	F2021E	F2022E
EPS (diluted)	\$ (0.18)	\$ 0.74	\$ 0.80
1Q March	\$ (0.07)	\$ 0.06	\$ 0.21
2Q June	\$ 0.01	\$ (0.09)	\$ 0.18
3Q September	\$ (0.04)	\$ 0.36	\$ 0.20
4Q December	\$ (0.08)	\$ 0.42	\$ 0.21
EBITDA/Share	(\$0.18)	\$0.76	\$1.12
EV/EBITDA (x)	-391.3	94.4	64.0
Stock Data			
52-Week Range	\$2.34 - \$16.04		
Shares Outstanding (mil.)	15.2		
Market Capitalization (mil.)	\$80		
Enterprise Value (mil.)	\$72		
Debt to Capital	0%		
Book Value/Share	\$2.86		
Price/Book	-		
Average Three Months Trading Volume (K)	45		
Insider Ownership	15.8%		
Institutional Ownership	6.7%		
Short interest (mil.)	2.6%		
Dividend / Yield	\$0.00/0.0%		



Model Changes: In our population model, we lower the input for the percent of the population tested from 20% to 10%. We maintain the net revenue each test generates for the company at \$50.00. We assume 10% of the U.S. population is tested just once annually. Some of us will be tested regularly. For example, many college students have been mandated to weekly testing.

This results in 2030E revenues of \$128M. This is when washed through the same operating and valuation models (Free Cash Flow to the Firm or FCFF, discounted EPS or dEPS, and Sum of the Parts [SOP]), all at a 30% discount rate, and recall that the revenue models also have a probability of success factor of 70%, so this is like a double discount rate.

10% & \$50.00: The net result of these assumptions is a net present value of \$9.00 per share.

Inputs	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
	330,000,000	330,000,000	333,300,000	336,633,000	339,999,330	343,399,323	346,833,317	350,301,650	353,804,666	357,342,713	360,916,140
10%	33,000,000	33,000,000	33,330,000	33,663,300	33,999,933	34,339,932	34,683,332	35,030,165	35,380,467	35,734,271	36,091,614
	0%	2%	3%	5%	6%	7%	8%	9%	10%	10%	10%
	0	660,000	999,900	1,683,165	2,039,996	2,403,795	2,774,667	3,152,715	3,538,047	3,573,427	3,609,161
\$50	\$50	\$51	\$51	\$51	\$51	\$51	\$51	\$51	\$51	\$51	\$51
	0	33	50	85	103	121	140	159	179	180	182
	70%	70%	70%	70%	70%	70%	70%	70%	70%	70%	70%
	\$0	\$23	\$35	\$59	\$72	\$85	\$98	\$111	\$125	\$126	\$128

Bottom row: projected revenue in \$ millions

Source: Dawson James estimates

Risk Analysis

Commercial risk. The focus of the company is on successfully developing its products and bringing them to the market. Competition may be intense from external players as well as customers who choose to “build it themselves.”

Financial risk. The company may need to raise capital in the marketplace relatively soon. There can be no assurance that the company will be able to raise capital and do so on favorable terms successfully.

Intellectual property risk. The company may have to defend its patents and technical know-how, and there can be no assurances that the patents will not be infringed or will be held as valid if challenged, and the company may infringe on third parties' patents.

Regulatory risk. Diagnostic testing is regulated by the government. There can be no assurances that ProPhase’s process will not be interrupted as a result of regulatory requirements.

OEM and/or manufacturing risk. Original Equipment Manufacturers (OEMs) may decide to make products themselves, and, as such, terminate production contracts before completion, creating revenue shortfalls. Manufacturing risks include the ability to produce and do so in a competitive, timely, and efficient way.

Exhibit 1. Income Statement

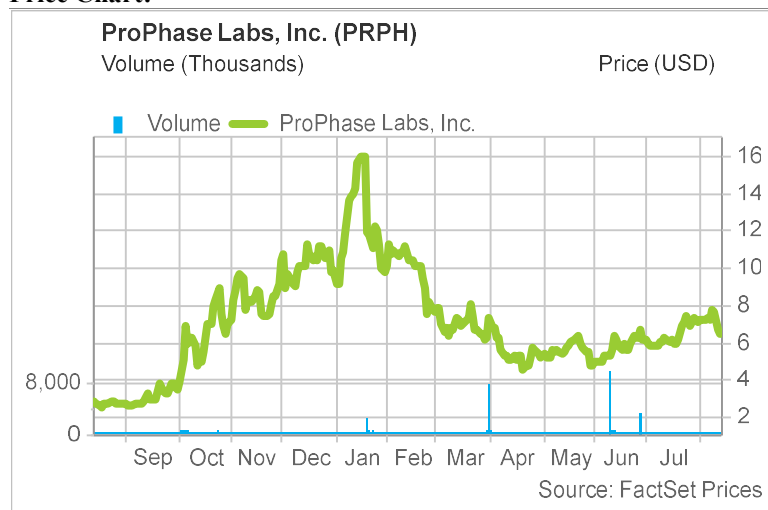
PRPH, Inc. Income Statement (\$000)																			
YE Dec. 31	2020A	1Q21A	2Q21A	3Q21E	4Q21E	2021E	1Q22E	2Q22E	3Q22E	4Q22E	2022E	2023E	2024E	2025E	2026E	2027E	2028E	2029E	2030E
Revenue (\$000)																			
OTC Consumer Healthcare Products	14,514	4,232	3,135	4,076	4,232	15,675	4,571	3,386	4,402	4,571	16,929	18,283	19,746	21,326	23,032	24,874	26,864	29,014	31,335
Other Business																			
COVID & Flu Diagnostics		11,039	6,007	12,500	13,500	43,046	8,483	8,837	8,837	9,190	35,346	59,500	72,114	84,974	98,084	111,448	125,070	126,321	127,584
Total Revenues	14,514	15,271	9,142	16,576	17,732	58,721	13,054	12,222	13,238	13,761	52,276	77,783	91,860	106,300	121,116	136,323	151,934	155,334	158,918
Expenses																			
COGS	9,908	6,344	4,676	6,962	7,448	25,429	5,874	5,500	5,957	6,192	23,524	35,003	41,337	47,835	54,502	61,345	68,370	69,900	71,513
% COGS	68%	42%	51%	42%	42%	43%	45%	45%	45%	45%	45%	45%	45%	45%	45%	45%	45%	45%	45%
Gross Profit	4,606	8,927	4,466	9,614	10,285	33,292	7,180	6,722	7,281	7,569	28,752	42,781	50,523	58,465	66,614	74,978	83,564	85,434	87,405
Real estate Gain	633																		
Sales (Advertising & Marketing) expense	1,287	3,809	830	2,000	2,000	8,639	1,451	1,512	1,512	1,572	6,047	6,168	6,292	6,417	6,546	6,677	6,810	6,946	7,085
General and administrative	6,671	3,782	4,993	2,000	1,800	12,575	1,200	1,250	1,250	1,300	5,000	5,100	5,202	5,306	5,412	5,520	5,631	5,743	5,858
Research & Development	633	115	93	125	167	500	122	128	128	133	510	520	531	541	552	563	574	586	598
Total expenses	8,591	7,706	5,916	4,125	3,967	21,714	2,774	2,889	2,889	3,005	11,557	11,788	12,024	12,265	12,510	12,760	13,015	13,276	13,541
Operating Profit	(2,093)	1,221	(1,450)	5,489	6,318	11,578	4,406	3,833	4,392	4,564	17,194	30,992	38,499	46,200	54,104	62,217	70,548	72,158	73,864
Oper Margin																			
Unrealized gain on debt securities	62	87	214			301					-	-	-	-	-	-	-	-	-
Interest expense	(295)	(251)	(323)			(574)					-	-	-	-	-	-	-	-	-
Income discontinued ops	201		164			164					-	-	-	-	-	-	-	-	-
Other (loss)	(9)					-					-	-	-	-	-	-	-	-	-
Pre-tax income	(2,134)	1,057	(1,395)	5,489	6,318	11,469	4,406	3,833	4,392	4,564	17,194	30,992	38,499	46,200	54,104	62,217	70,548	72,158	73,864
Pretax Margin																			
Income Tax (Benefit)		11	(67)				661	575	659	685	2,579	6,198	9,625	12,936	16,231	19,287	22,576	23,812	24,375
Tax Rate							15%	15%	15%	15%	15%	20%	25%	28%	30%	31%	32%	33%	33%
GAAP Net Income	(2,134)	1,046	(1,462)	5,489	6,318	11,391	3,745	3,258	3,733	3,879	14,615	24,794	28,874	33,264	37,873	42,930	47,973	48,346	49,489
GAAP EPS	(0.18)	0.07	(0.09)	0.36	0.42	0.76	0.21	0.18	0.20	0.21	0.80	1.35	1.57	1.81	2.05	2.32	2.59	2.61	2.66
Non GAAP EPS (dil)	(0.18)	0.06	(0.09)	0.36	0.42	0.74	0.21	0.18	0.20	0.21	0.80	1.35	1.57	1.81	2.05	2.32	2.59	2.61	2.66
Wgtd Avg Shrs (Bas) - '000s	11,595	14,563	15,154	15,184	15,215	15,029	15,245	15,276	15,306	15,337	15,291	15,414	15,537	15,662	15,788	15,914	16,042	16,171	16,300
Wgtd Avg Shrs (Dil) - '000s	11,595	18,200	15,154	15,184	15,215	15,938	18,236	18,273	18,309	18,346	18,291	18,328	18,364	18,401	18,438	18,475	18,512	18,549	18,586

Source: Dawson James estimates, company reports

Companies mentioned in this report:

Important Disclosures:

Price Chart:



Price target and ratings changes over the past three years:

Initiated – Buy – January 20, 2021 – Price Target \$25.00
 Update – Buy – February 1, 2021 – Price Target \$25.00
 Update – Buy – February 22, 2021 – Price Target \$25.00
 Update – Buy – March 4, 2021 – Price Target \$25.00
 Update – Buy – April 9, 2021 – Price Target \$25.00
 Update – Buy – April 23, 2021 – Price Target \$25.00
 Update – Buy – May 14, 2021 – Price Target \$25.00
 Update – Buy – June 10, 2021 – Price Target \$25.00
 Price Target Change – Buy – August 13, 2021 – Price Target lowered from \$25.00 to \$9.00

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As of: 3-Aug-21

	Company Coverage		Investment Banking	
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Market Perform (Neutral)	10	29%	0	0%
Market Underperform (Sell)	0	0%	0	0%
Total	35	100%	4	11%

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