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Apricus Biosciences, Inc. (Nasdaq/APRI)

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BUY Apricus reports Q3/2011; broadens pipeline

Apricus provides drug delivery technology services

Investment Highlights

1) Apricus Biosciences released their 10Q and held a conference call for their third quarter earlier this week. Financial results for Q3/2011 for Apricus included revenues of \$800,000 compared with \$1.1 million in the prior year period, and a net loss of \$2.2 million or (\$0.11) per share versus a net loss of \$2.6 million or (\$0.20) per share in Q3/2010. Results in the prior year period included operations from the Company's recently sold contract service division, Bio-Quant; total revenues sans contract services increased approximately \$500,000 during the third quarter, due primarily to the receipt of US government Qualifying Therapeutic Discovery Project (QTDP) funds. On the expense side of the ledger, R&D costs increased from \$514,000 in Q3/2010 to \$621,000 in Q3/2011, primarily due to increased spending on NexACT technology-related projects and international regulatory filings for Vitaros. Other overhead costs increased as well, to \$2.3 million from \$2.1 million, due to increased personnel and investor relations activities. Overall, net loss decreased in Q3/2011 from Q3/2010 due principally to the high margin grant revenues collected during the quarter. Operating cash burn was approximately \$2.8 million in Q3/2011; this was offset to a large degree by net cash proceeds received under a stock sales agreement. Apricus held about \$8.9 million in cash and equivalents at the end of the quarter, just a little less than was on hand at the start of the year.

2) Apricus has been busy on the R&D front over the past several months, most notably with their Femprox clinical program for Female Sexual Arousal Disorder (FSAD), including the acceptance and presentation of scientific papers at medical specialty conferences in both the US and Europe this fall. This week, APRI and other stocks such as Antares Pharma (ASE/AIS/Buy) have received a boost from positive trial results released by BioSante (Nasdaq/BPAX/Not Rated) for LibiGel, their topical gel testosterone treatment for the related female sexual dysfunction

Current Price \$4.53

Price Target \$8.25

| Estimates | F2009A | F2010A | F2011E |
|------------------------|----------|----------|----------|
| Revenue(\$000s) | \$2,974 | \$4,973 | \$6,000 |
| 1Q March | 2,467 | 1,446 | 1,587 A |
| 2Q June | 103 | 1,471 | 1,595 A |
| 3Q September | 110 | 1,194 | 799 A |
| 4Q December | 295 | 863 | 2,018 E |
| EPS | (\$5.43) | (\$2.49) | (\$0.70) |
| 1Q March | 0.12 | (1.25) | (0.18) A |
| 2Q June | (0.25) | (0.47) | (0.39) A |
| 3Q September | (0.20) | (0.20) | (0.11) A |
| 4Q December | (5.10) | (0.74) | (0.02) E |
| P/E (x) | N/A | N/A | N/A |
| EBITDA/Share | (\$0.50) | (\$1.30) | (\$0.38) |
| EV/EBITDA (x) | N/A | N/A | N/A |

| Stock Data | |
|----------------------------------|---------------|
| 52-Week Range | \$2.05-\$6.10 |
| Shares Outstanding (mil.) | 20.5 |
| Market Capitalization (mil.) | \$92.9 |
| Enterprise Value (mil.) | \$88.0 |
| Debt to Capital (9/11) | 38.9% |
| Book Value/Share (9/11) | \$0.31 |
| Price/Book | 14.8 X |
| Average Trading Volume (3-month) | 160,000 |
| Insider Ownership | 11.7% |
| Institutional Ownership | 3.5% |
| Short interest (Million shares) | 1.46 |
| Dividend / Yield | \$0.00/0.0% |



Price target and ratings changes over the past 3 years:
Initiated - Buy - December 13, 2010 – Target \$5.50
Price target changed to \$8.25 - Buy - January 15, 2011

(FSD) disorder. Earlier this week, the Company announced that a new partner, Exodos Life Sciences, completed a positive pre-IND meeting with the FDA regarding a new drug formulation employing NSAID pain reliever Ketoprofen and Apricus' NexACT drug delivery technology. Privately-held Exodos is a North Carolina-based drug development company with several other new formulations in their pipeline, and could develop into a more extensive partner for NexACT technology in the future.

3) We are adjusting our estimates for Apricus Biosciences for 2011 reflecting the recent quarterly results and the sale earlier this year of the Bio-Quant division, to revenues of \$6.0 million (from \$8.5 million) and a net loss of \$14.5 million, or (\$0.70) per share, from the previous estimate of \$16.1 million or (\$0.81) per share. Our estimates for 2011 as a whole equate to an estimate of approximately \$2 million in revenues and a net loss of \$1.0 million or (\$0.02) per share for Q4/2011. Our estimates for Q4/2011 assume additional licensing fees and/or product sales for Apricus and spending on R&D and other overhead items in-line with those of the most recent Q3/2011. For 2012, we are maintaining our revenue estimates for Apricus Biosciences of \$12 million (all from license fees or product sales) but lowering our loss estimates to \$4.1 million or (\$0.20), from \$8.6 million or (\$0.42) per share, primarily due to lower costs budgeted for the remainder of 2011 and 2012. Our forecasted product and investor catalyst timeline for 2011 and 2012 is shown on page 4. Although we are forecasting a net loss for Apricus for the rest of this year and next, our estimated cumulative cash burn for this 12-15 month period is well below the existing amount of cash on hand, and recently Apricus management re-affirmed their guidance that the Company is expected to be able to meet its cash burn through the end of next year. Any major new partnership or marketing agreement in the near future could alter this equation to the positive, however, especially if significant upfront milestone payments or fees are involved.

Conclusion/Stock Valuation

Apricus shares have rebounded this fall after a market-oriented down-turn this summer, most probably due to recent favorable news flow related to ongoing R&D programs, new product partnerships, and a move into the over-the-counter market. Investor anticipation of potential marketing partnerships signed for Vitaros in Canada and perhaps Europe, Latin America and other geographic areas by the end of the year is also driving recent strength in APRI stock. Apricus is currently in solid shape financially with nearly \$9 million in cash and the Company has a number of R&D irons in its fire, and thus we are maintaining our Buy rating and 18-24 month price target for APRI of \$8.25, representing approximately 14X our revenue estimates for 2012. (For a more complete valuation methodology, see our initiation report dated 12/13/2010 for APRI.)

Risk Factors

In addition to normal economic and market risk factors that impact most equities and the common risks shared by Apricus Biosciences with other companies in the industry, we believe the primary risks to our price target include the following:

- **FDA and regulatory risks** – Apricus is subject to regulatory review for its ongoing research and development activities, principally the US Food and Drug Administration but also potentially with other regulatory agencies as well, including in Europe, the Middle East and Asia. In addition, the manufacture and handling of the Company's recently-approved Vitaros treatment will be subject to additional regulatory oversight and regulation, as will be future products should these be approved for commercial launch.
- **Reliance on joint venture partners and/or additional capital** — Currently, Apricus has enough cash on hand to fund ongoing research and development programs through calendar 2012, approximately. Alternatively, the Company could obtain partnership agreements or government funding to offset planned R&D spending or to accelerate development of an existing or new R&D program in the pipeline. While other companies in the drug delivery market space have obtained such partnerships or grants in the past,

there can be no assurance that the Company will be able to sign additional agreements in the future. Should potential partnerships not be forthcoming for Apricus, however, the Company would need to raise additional capital sometime in 2012 which would lead to shareholder dilution.

- **Need to defend patents and other intellectual property** – Apricus currently holds 10 US patents on its technology and product pipeline, which have expiration dates between 2017 and 2026, including one key composition of matter patent related to the NexACT technology. However, the Company may need to defend its patents in the US and overseas in the future, particularly if more products receive approval and are successfully marketed.
- **Lack of Profitability** – Apricus has experienced a series of losses since its inception, and there can be no assurance that the Company's operations will turn a profit or become cash flow positive in the near future.
- **Competitive Markets** – Apricus competes in the drug delivery market with a number of larger, more experienced companies, many of whom have greater financial resources than the Company.

| Table 1. Product/Investor Catalyst Timeline | | | | | | |
|--|---|-----------------------|---------------------------------|-------------|--------------|--------------|
| | <u>Active Pharmaceutical Ingredient</u> | <u>Route</u> | <u>Market Potential</u> | <u>2010</u> | <u>2011E</u> | <u>2012E</u> |
| <u>Vitaros - Erectile Dysfunction</u> | | | | | | |
| Partnership agreement-Canada | Alprostadil | Topical | \$2 billion | | H2 | |
| Launch - Canada | | | | | H2 | |
| Partnership agreement - Europe | | | | | 3 Markets | 3 Markets |
| Launch - Europe | | | | | 2 Markets | 3 Markets |
| Approval/Further studies - US | | | | | H2 | |
| Partnership/Launch - MENA | | | | | H2 (1) | H2 (1) |
| <u>FemProx - Female Sexual Dysfunction</u> | | | | | | |
| Partnership agreement-US | Alprostadil | Topical | \$1-\$2 billion | | | X |
| Begin Phase III - US | | | | | | X |
| Partnership agreement - China | | | | | | X |
| Complete Phase III/File - China | | | | | H2 or | H1 |
| Pre-filing - MENA | | | | | | X |
| <u>PrevOnco - HCC (Liver Cancer)</u> | | | | | | |
| SPA approved/Phase 3 initiated - US | Lansoprazole (PrevAcid) | Oral | \$300 million (Nexavar) | | | H1/H2 |
| Partnership agreement - US | | | | | | X |
| Phase 3 initiated - Europe | | | | | | H1/H2 |
| Partnership agreement - Europe | | | | | | X |
| <u>MycoVa - Onychomycosis (Nail Fungus)</u> | | | | | | |
| Marketing authorization application filed - Europe | Terbinafine | Topical | \$500 million (Anti-fungals) | | H1/H2 | |
| Marketing application filing - Canada | | | | | H1/H2 | |
| <u>RavVa - Raynaud's Syndrome</u> | | | | | | |
| Phase 3 SPA filed - US | Alprostadil | Topical | \$100 million | Q4 | | |
| Phase 3 initiated - US | | | | | | H1/H2 |
| Partnership agreement - US | | | | | | H1/H2 |
| <u>PsoriaVA - Psoriasis</u> | | | | | | |
| Phase 1/2 initiated - US | Calcipotriene/ Betamethasone | Topical | \$1 billion | | | H1/H2 |
| <u>Nupen - Post-chemotherapy recovery</u> | | | | | | |
| Phase 1/2 initiated - US | Filgastim | Topical | \$1 billion | | | H1/H2 |
| <u>Rituxan - Non-Hodgkin's lymphoma</u> | | | | | | |
| Phase 1/2 initiated - US | Rituximab | Subcutaneous | \$500 million | | | H1/H2 |
| <u>Insulin - Diabetes</u> | | | | | | |
| Phase 1/2 initiated - US | Insulin | Subcutaneous | \$Multi-billion | | | H1/H2 |
| <u>Taxol - Squamous carcinoma/oral cancers</u> | | | | | | |
| Phase 1/2 initiated - US | Paclitaxel | Subcutaneous/ Oral | \$1 billion | | | H1/H2 |
| <u>5-fluorouracil (5-fu) - Pre-cancerous conditions</u> | | | | | | |
| Phase 1/2 initiated - US | Adrucil, Etudex, etc. | Topical | \$300 million | | | H1/H2 |
| <u>Zofran - Nausea/vomiting from chemotherapy</u> | | | | | | |
| Phase 1/2 initiated - US | Ondansetron | Transbuccal | \$200 million | | | H1/H2 |
| <u>Lidocaine - pain relief</u> | | | | | | |
| Phase 1/2 initiated - US | Lidocaine | Topical | \$200 million | | | H1/H2 |
| <u>NexACT - new applications</u> | | | | | | |
| Partnership agreements - US | Various | All routes | \$100 million- \$1 billion | | 2 | 2 |
| Phase 1/2 initiated - US | | | | 1 | 3 | 3 |

Apricus Biosciences, Inc.
Consolidated Statements of Operations
(In 000s, except per share data)

| FYE December | 2007 | 2008 | 1Q09 March | 2Q09 June | 3Q09 Sept | 4Q09 December | 2009 | 1Q10 March | 2Q10 June | 3Q10 Sept | 4Q10 December | 2010 | 2011E | 2012E |
|------------------------------------|----------|----------|---------------|--------------|--------------|------------------|----------|---------------|--------------|--------------|------------------|----------|----------|----------|
| License fee revenue/royalties | \$1,270 | \$5,957 | \$2,467 | \$103 | \$110 | \$2 | \$2,681 | \$3 | \$33 | \$3 | \$3 | \$40 | \$5,000 | \$12,000 |
| Contract service revenue | 0 | 0 | 0 | 0 | 0 | 292 | 292 | 1,443 | 1,438 | 1,191 | 860 | 4,933 | 1,000 | 0 |
| Total revenue | \$1,270 | \$5,957 | 2,467 | 103 | 110 | 295 | \$2,974 | 1,446 | 1,471 | 1,194 | \$863 | \$4,973 | \$6,000 | \$12,000 |
| Cost of services | 0 | 0 | 0 | 0 | 0 | 128 | 128 | 1,037 | 1,022 | 1,035 | 848 | 3,943 | 2,250 | 0 |
| Gross Profit | 1,270 | 5,957 | 2,467 | 103 | 110 | 166 | 2,845 | 409 | 449 | 158 | 14 | 1,030 | 3,750 | 12,000 |
| Costs and expenses | | | | | | | | | | | | | | |
| Research and development | 5,023 | 5,411 | 602 | 716 | 310 | 255 | 1,883 | 426 | 478 | 514 | 693 | 2,110 | 4,500 | 5,000 |
| General and administrative | 5,634 | 5,721 | 1,091 | 695 | 714 | 1,697 | 4,196 | 2,240 | 2,640 | 2,090 | 3,183 | 10,152 | 11,000 | 11,500 |
| Acquisition costs/other one-time | 0 | 0 | 0 | 0 | 0 | 585 | 585 | 0 | 0 | 0 | 10,168 | 10,168 | 2,800 | 0 |
| Total operating expenses | 10,657 | 11,131 | 1,693 | 1,411 | 1,024 | 2,537 | 6,665 | 2,666 | 3,118 | 2,604 | 14,043 | 22,431 | 18,300 | 16,500 |
| Income (loss) from operations | (9,387) | (5,174) | 773 | (1,309) | (914) | (2,370) | (3,820) | (2,257) | (2,669) | (2,446) | (14,029) | (21,401) | (14,550) | (4,500) |
| Interest expense, net & other | (206) | (935) | (88) | (118) | (276) | (28,178) | (28,661) | (6,980) | (1,610) | (161) | 643 | (8,107) | 100 | 400 |
| Income (loss) before tax | (9,593) | (6,109) | 685 | (1,426) | (1,191) | (30,548) | (32,480) | (9,237) | (4,279) | (2,606) | (13,386) | (29,508) | (14,450) | (4,100) |
| Provision for income taxes | (806) | (938) | 0 | 0 | 0 | (438) | (438) | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Net income (loss) | (8,787) | (5,171) | 685 | (1,426) | (1,191) | (30,111) | (32,043) | (9,237) | (4,279) | (2,606) | (13,386) | (29,508) | (14,450) | (4,100) |
| Basic income per share | (\$1.61) | (\$0.93) | \$0.12 | (\$0.25) | (\$0.20) | (\$5.10) | (\$5.43) | (\$1.25) | (\$0.47) | (\$0.20) | (\$0.74) | (\$2.49) | (\$0.70) | (\$0.20) |
| Diluted income per share | (\$1.61) | (\$0.93) | \$0.12 | (\$0.25) | (\$0.20) | (\$5.10) | (\$5.43) | (\$1.25) | (\$0.47) | (\$0.20) | (\$0.74) | (\$2.49) | (\$0.70) | (\$0.20) |
| Basic shares outstanding | 5,468 | 5,579 | 5,626 | 5,626 | 5,915 | 5,906 | 5,906 | 7,379 | 9,140 | 12,757 | 18,110 | 11,847 | 20,500 | 21,000 |
| Diluted shares outstanding | 5,468 | 5,579 | 5,626 | 5,626 | 5,915 | 5,906 | 5,906 | 7,379 | 9,140 | 12,757 | 18,110 | 11,847 | 20,500 | 21,000 |
| Key ratios: | | | | | | | | | | | | | | |
| Revenue growth | | 369.0% | | | | | -50.1% | -41.4% | 1333.5% | 989.1% | 192.5% | 67.2% | 315.0% | 30.0% |
| Gross margin | N/A | N/A | N/A | N/A | N/A | 56.5% | 95.7% | 28.3% | 30.5% | 13.2% | 1.7% | 20.7% | 62.5% | 50.0% |
| R&D/revenue | 395.4% | 90.8% | 24.4% | 698.2% | 282.9% | 86.4% | 63.3% | 29.5% | 32.5% | 43.1% | 80.3% | 42.4% | 75.0% | 11.0% |
| G&S/revenue | 443.5% | 96.0% | 44.2% | 677.1% | 651.6% | 575.4% | 141.1% | 154.9% | 179.5% | 175.1% | 369.0% | 204.2% | 183.3% | 30.0% |
| Depreciation, amort, non-cash comp | \$2,190 | \$2,503 | \$450 | \$375 | \$465 | \$28,354 | \$29,644 | \$7,240 | \$3,150 | \$530 | \$550 | \$11,470 | \$4,000 | \$4,500 |
| Operating margin | N/A | N/A | 31.3% | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A | -37.5% |
| Cash Flow/share | (\$1.21) | (\$0.48) | \$0.20 | (\$0.19) | (\$0.12) | (\$0.30) | (\$0.41) | (\$0.27) | (\$0.12) | (\$0.16) | (\$0.71) | (\$1.27) | (\$0.37) | \$0.02 |
| EBITDA/share | (\$1.32) | (\$0.48) | \$0.22 | (\$0.17) | (\$0.08) | (\$0.47) | (\$0.50) | (\$0.25) | (\$0.15) | (\$0.15) | (\$0.74) | (\$1.30) | (\$0.38) | \$0.00 |

Balance Sheets

(\$000s)

| Assets: | 12/31/10 | 9/30/11 |
|------------------------------|----------|----------|
| Cash and equivalents | \$9,146 | \$8,878 |
| Accounts receivable | 289 | 107 |
| Restricted cash | 604 | 50 |
| Prepaid expenses & other | 439 | 315 |
| Total current | 10,477 | 9,350 |
| Fixed assets, net | 5,421 | 4,388 |
| Goodwill & intangible assets | 2,702 | 0 |
| Other long-term assets | 264 | 240 |
| TOTAL ASSETS | \$18,864 | \$13,977 |
| Liabilities: | | |
| Accounts payable | \$790 | \$1,524 |
| Accrued liabilities-current | 916 | 1,020 |
| Deferred revenue-current | 210 | 343 |
| Due to related parties | 0 | 0 |
| Short-term borrowings | 401 | 0 |
| Total current | 2,317 | 2,888 |
| Convertible notes payable | 4,000 | 4,000 |
| Capital lease payable | 102 | 0 |
| Deferred revenue & other | 878 | 815 |
| Stockholders' equity | 11,567 | 6,275 |
| TOTAL LIAB & EQ | \$18,864 | \$13,977 |

Quarterly Earnings Comparisons

| | March | June | Sept | December | Total |
|-----------------------------|----------|----------|----------|----------|----------|
| Revenues (in \$Mill) | | | | | |
| 2008 | \$952 | \$1,200 | \$306 | \$3,500 | \$5,957 |
| 2009 | 2,467 | 103 | 110 | 295 | 2,974 |
| 2010 | 1,446 | 1,471 | 1,194 | 863 | 4,973 |
| 2011E | 1,587 | 1,595 | 799 | 2,018 | 6,000 |
| Earnings per Share | | | | | |
| 2008 | (\$0.29) | (\$0.29) | (\$0.54) | \$0.20 | (\$0.93) |
| 2009 | 0.12 | (0.25) | (0.20) | (5.10) | (5.43) |
| 2010 | (1.25) | (0.47) | (0.20) | (0.74) | (2.49) |
| 2011E | (0.18) | (0.39) | (0.11) | (0.02) | (0.70) |

Source: Dawson James Securities, Inc. estimates; Company documents

Important Disclosures:

Price Chart:



Price target and ratings changes over the past 3 years:

Initiated – Buy - December 13, 2010 – Target \$5.50
 Price target increased to \$8.25 – Buy - January 15, 2011

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| Ratings Distribution | Company Coverage | | Investment Banking | |
|----------------------|------------------|------------|--------------------|-------------|
| | # of Companies | % of Total | # of Companies | % of Totals |
| Buy | 27 | 84% | 8 | 30% |
| Neutral | 4 | 13% | 3 | 75% |
| Sell | 1 | 3% | 0 | 0% |
| Total | 32 | 100% | 11 | 34% |

Information about valuation methods and risks can be found in the "STOCK VALUATION" and "RISK FACTORS" sections of this report.

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