

October 7, 2009

**NovaBay Pharmaceuticals, Inc. (ASE/NBY)**

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**Neutral Partnerships progressing**

*NovaBay is developing treatments for infections in hospitals and other healthcare environments*

**Investment Highlights**

**1) NovaBay is moving ahead with its R&D partnerships, particularly the newer one with Galderma, signed in March.** In September, the Company launched a Phase IIa proof-of-concept study of its lead Aganocide compound NVC-422 in impetigo. The double-blind 120 patient study will be conducted at two sites in the Dominican Republic using a dermal formulation on children between 2-12. Patients have already been enrolled in the study and final results are expected to be released in the first half of 2010. Impetigo is a common skin infection, caused by *s. aureus* and *s. pyogenes* viruses, and affects over one million people in the US alone. Also as part of the Galderma relationship, NovaBay is planning to initiate a Phase I proof-of-concept study for NVC-422 in acne, an even larger indication, with 17 million sufferers in the US.

**2) Despite corporate upheaval, Alcon (now part of Novartis) has also advanced the companies' partnerships this year, initiating a Phase II clinical trial in July for NVC-422 in conjunctivitis (pink eye) patients.** The study calls for treatment of approximately 250 patients at more than 30 sites, primarily in the US, and follows a successful 120-patient Phase I study recently completed. Conjunctivitis is a large indication in the US, with as much as 15 million scripts written per year, with the largest market share held by Alcon's anti-infective Vigamox drops with no anti-virals currently approved for the roughly 50% of the indications caused by viruses.

**3) Going it alone as well.** NovaBay has been busy with its proprietary R&D programs as well, and will be presenting (at IDSA later this month) a pre-clinical study using Aganocide NVC-422 to treat onychomycosis (nail fungus) as well as continuing the Company's exploratory Phase II study with NVC-422 in catheter-associated urinary tract infections (CAUTI), in which patients were first enrolled in November 2008. NovaBay is also pursuing the use of AgaNase (NVC-422 in a nasal spray) in nasal infections, completing a

**Current Price \$1.79**

**Price Target N/A**

Estimates	F2008A	F2009E	F2010E
Revenues(\$000s)	\$6,722	\$10,168	\$13,000
EPS	(\$0.38)	(\$0.03)	\$0.03

Stock Data	
52-Week Range	\$2.15-\$4.79
Shares Outstanding (mil.)	22.5
Market Capitalization (mil.)	\$40.3
Enterprise Value (mil.)	\$30.2
Debt to Capital (6/09)	7.4%
Book Value/Share (6/09)	\$0.33
Price/Book	5.4 x
Average Trading Volume (3-Month)	35,000
Insider Ownership	18.5%
Institutional Ownership	10.5%
Short interest	9,400
Dividend / Yield	\$0.00/0.0%



**Price target and ratings changes over the past 3 yrs:**  
Initiated - January 3, 2008 - Speculative Buy -Price Target \$8.00  
Downgraded - Neutral - October 7, 2009

Phase IIa study last year using AgaNase for nasal decolonization of *staph aureus* infections including MRSA and signing an exclusive agreement in April 2009 with two Austrian researchers who pioneered the use of NCT (Aganocide is a synthetic analog of NCT) and have performed studies using NCT to treat ear infections as well as other medical areas.

### **Conclusion/Stock Valuation**

NovaBay shares have held steady this year after an initial bounce back, while other biotech stocks have performed more favorably, even as the Company has announced a number of new clinical initiatives and advances. The level share price could be a function of a stepped-up proprietary R&D spending this year by NovaBay, perhaps leading to the need for an additional equity financing in the near future (a \$2.45 million offering was completed in August). Alternatively, stock prices could be a function of worries over the recent transition of Alcon into a Novartis subsidiary and uncertainty regarding future possible collaborations between Alcon and the Company, such as for the use of Aganocides in contact lens solution, which would represent a very large potential indication. In addition, we have had difficulty maintaining contact with NovaBay management this fall, despite an active public relations program by the Company, perhaps reflecting an emphasis by the Company on making new investor contacts rather than keeping older ones. Thus, we are lowering our rating on NovaBay to Neutral, recommending that investors stay on the sideline with this stock until certain issues such as future funding and Alcon's long-term involvement can be resolved.

### **Risk Factors**

NovaBay is subject to regulatory review for its ongoing research and development activities, currently with the US Food and Drug Administration but also potentially with other regulatory agencies should the Company pursue regulatory approvals in Europe, Latin America and/or Asia. The Company is also reliant on several development partners for key medical indications, and should one or more of these partners experience regulatory or internal planning issues the Company's near- and medium-term potential returns could be delayed. Finally, the Company may need to defend its product patent portfolio in the event of future challenges by competitors.

### **Catalysts/Investor Timeline**

- 1) Begin Phase Ia trial with Galderma for Acne – end of year 2009
- 2) Additional Galderma milestone payment – end of year 2009
- 3) Onychomycosis (nail fungus) in-vitro study (non-partnered) results release – end of year 2009
- 4) Begin Phase 1 trial with Alcon for otic applications (ear infections) – end of year 2009
- 5) Release of Phase II trial results for CAUTI (non-partnered) – end of year 2009
- 6) Release of final Phase IIA results for Impetigo – H2/2010

**NovaBay Pharmaceuticals, Inc.**  
**Consolidated Statements of Income**  
 (in \$000s, except EPS)

Robert M. Wasserman

FYE December	2005	2006	2007	1Q08 March	2Q08 June	3Q08 Sept	4Q08 Dec	2008	1Q09 March	2Q09 June	3Q09E Sept	4Q09E Dec	2009E	2010E	2011E
<b>Revenues</b>															
License and collaboration revenue	\$0	\$1,533	\$5,913	\$1,492	\$1,442	\$1,592	\$2,196	\$6,722	\$2,611	\$2,357	\$2,500	\$2,700	\$10,168	\$12,500	\$15,000
Royalties and other	0	0	0	0	0	0	0	0	0	0	0	0	0	500	1,000
<b>Total revenues</b>	0	1,533	5,913	1,492	1,442	1,592	2,196	6,722	2,611	2,357	2,500	2,700	10,168	13,000	16,000
<b>Expenses</b>															
Research and development	1,952	4,087	7,421	2,647	2,371	1,443	2,541	9,002	1,361	1,444	1,450	1,500	5,755	6,500	7,500
General and administrative	1,617	2,972	4,368	1,684	1,575	1,715	1,255	6,229	1,579	1,191	1,200	1,250	5,220	6,000	7,000
One-time and other	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
<b>Total operating expenses</b>	3,569	7,059	11,789	4,331	3,946	3,158	3,796	15,231	2,940	2,635	2,650	2,750	10,975	12,500	14,500
Loss from operations	(3,569)	(5,526)	(5,876)	(2,839)	(2,504)	(1,566)	(1,600)	(8,509)	(329)	(278)	(150)	(50)	(807)	500	1,500
Interest expense					(24)			(24)		(20)	(20)	(20)	(60)	(50)	(50)
Other expense, net	106	240	488	163	118	77	64	422	11	2	50	100	170	200	300
Net loss before income taxes	(3,463)	(5,286)	(5,388)	(2,676)	(2,410)	(1,489)	(1,536)	(8,111)	(318)	(289)	(120)	30	(697)	650	1,750
Provision for income taxes	0	0	(12)	(2)	0	0	0	(2)	0	0	0	0	0	0	0
Net income (loss)	(3,463)	(5,286)	(5,400)	(2,678)	(2,410)	(1,489)	(1,536)	(8,113)	(318)	(289)	(120)	30	(697)	650	1,750
Basic and diluted income (loss) per share	(\$0.71)	(\$0.92)	(\$0.60)	(\$0.13)	(\$0.11)	(\$0.07)	(\$0.07)	(\$0.38)	(\$0.01)	(\$0.01)	(\$0.01)	\$0.00	(\$0.03)	\$0.03	\$0.07
Basic and diluted shares outstanding	4,852	5,715	8,974	21,288	21,334	21,443	21,469	21,312	21,620	21,931	22,500	23,300	21,312	23,500	24,000
<b>Key ratios:</b>															
Cash Flow/share	(\$0.65)	(\$0.86)	(\$0.54)	(\$0.11)	(\$0.10)	(\$0.06)	(\$0.06)	(\$0.32)	\$0.00	\$0.01	\$0.02	\$0.02	\$0.05	\$0.12	\$0.17
EBITDA/share	(\$0.65)	(\$0.86)	(\$0.53)	(\$0.11)	(\$0.09)	(\$0.06)	(\$0.06)	(\$0.32)	\$0.00	\$0.01	\$0.02	\$0.02	\$0.05	\$0.12	\$0.18

**Balance Sheets**

(\$000s)

Assets:	12/31/08	6/30/09
Cash and equivalents	\$12,099	\$8,000
Short-term investments	414	2,685
Prepaid expenses & other	0	769
<b>Total current</b>	12,513	11,454
Property & equip., net	1,456	1,575
Other	0	0
<b>TOTAL ASSETS</b>	\$13,969	\$13,029
<b>Liabilities:</b>		
Accounts payable	\$406	\$533
Accrued liabilities & other	1,574	1,052
Deferred revenue	2,500	3,100
<b>Total current</b>	4,480	4,685
Deferred revenue & other non-current liabilities	2,144	888
Stockholders' equity	7,345	7,456
<b>TOTAL LIAB &amp; EQ</b>	\$13,969	\$13,029

**Investor Catalyst Timeline**

	2Q09 June	3Q09E Sept	4Q09E Dec	2010E
<b>Alcon</b>				
Conjunctivitis (Pink-eye)				
Begin Phase II		X		
Otic applications (ear infections)				
Begin Phase I			X	
<b>Galderma</b>				
Impetigo				
Phase IIA - Launched		X		
Phase IIA - Final results				H/2
<b>Acne</b>				
Phase Ia - Launch			X	
Additional Milestone Payment			X	
<b>Proprietary</b>				
CAUTI				
Phase II trial results			X	
Onychomycosis				
Release of In-vitro results			X	

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

## Important Disclosures:

### Price Chart:



#### Price target and ratings changes over the past 3 years:

Initiated – January 3, 2008 – Speculative Buy – Price Target \$8.00

Downgrade to Neutral – October 7, 2009

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Ratings Distribution	Company Coverage		Investment Banking	
	# of Companies	% of Total	# of Companies	% of Totals
Speculative Buy	5	33%	5	100%
Strong Buy	0	0%	0	0%
Buy	7	47%	1	14%
Neutral	3	20%	2	67%
Sell	0	0%	0	0%
Sell Short	0	0%	0	0%
Under Review	0	0%	0	0%
Restricted	0	0%	0	0%
Total	15	100%	8	53%

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**Information about valuation methods and risks can be found in the “STOCK VALUATION” and “RISKS” sections of this report.**

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