

**Oculus Innovative Sciences (Nasdaq/OCLS)**

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**BUY**

**Q3 Results in-line/  
Gearing up for big Q4/2010**

*Oculus markets the Microcyn line of anti-infective and wound care products*

**Investment Highlights**

1) Oculus report financial results for their Q3/2010 (ending December) earlier this month, including revenues of \$1.61 million, up 32% year-over-year, and a net loss of \$1.3 million, or (\$0.05) per share, reduced from a net loss of \$3.3 million, or (\$0.21) per share in the prior year period. Our estimates had been revenues of \$1.7 million and a loss of (\$0.07) per share. Revenue growth was led by large increases in US sales for human and veterinary wound care products, and also by smaller but solid sales increases in Mexico and Europe, offset by the delay in a large shipment to a distributor in China. Gross margins fell during the quarter, to 46% of product revenues from 69% in the prior year period due to an inventory write-off in Q3/2010 and higher shipping costs to Europe as manufacturing was transferred to a domestic location this year. Gross margins in Mexico, with more established manufacturing and sales operations, increased during the quarter to 80% from 77%. Other cost components including R&D and S, G & A expenses declined significantly year-over-year thanks to Company cost-cutting measures implemented over the past 12 months, helping reduce losses year-over-year. Cash burn in the quarter was approximately \$1.3 million.

2) During the quarterly conference call, Oculus management also reiterated certain financial metrics forecasted for the final Q4 of the calendar year, ending March. These included revenues of over \$2 million during the quarter, break-even results for the final month of the year, March, (aided by a large annual minimum payment from a long-term partner) and a net cash burn of approximately \$1.0 million for the quarter as a whole. Thus, we are adjusting our estimate for Q4/2010 for Oculus slightly, to revenues of \$2.3 million (down from \$2.5 million) representing a 60% increase year-over-year, and maintaining our net loss forecast of (\$0.04) per share, or a little under \$1.0 million. Fueling expected growth this quarter for Oculus is new product launch of Microcyn in the US surgical market, shipments to China after a lull

**Current Price \$1.95**

**Price Target \$4.50**

Estimates	F2008A	F2009A	F2010E
<b>Revenue(\$000s)</b>	\$3,835	\$5,388	\$7,492
<b>1Q June</b>	866	1,211	1,847 A
<b>2Q September</b>	977	1,481	1,672 A
<b>3Q December</b>	1,066	1,221	1,613 A
<b>4Q March</b>	926	1,475	2,360 E
Prev. Rev. Estimate (\$000s)			\$7,769

EPS	(F2008A)	(F2009A)	(F2010E)
<b>1Q June</b>	(0.42)	(0.33)	(0.18) A
<b>2Q September</b>	(0.44)	(0.43)	(0.08) A
<b>3Q December</b>	(0.40)	(0.21)	(0.05) A
<b>4Q March</b>	(0.34)	(0.13)	(0.04) E
Previous EPS Estimate			(\$0.37)
P/E (x)	N/A	N/A	N/A

EBITDA/Share	(\$1.15)	(\$0.88)	(\$0.13)
EV/EBITDA (x)	N/A	N/A	N/A

Stock Data	
52-Week Range	\$0.72-\$5.75
Shares Outstanding (mil.)	24.7
Market Capitalization (mil.)	\$48.1
Enterprise Value (mil.)	\$43.1
Debt to Capital (12/09)	3.2%
Book Value/Share (12/09)	\$0.23
Price/Book	8.6 x
Average Trading Volume (3-Month)	190,000
Insider Ownership	19.1%
Institutional Ownership	9.3%
Short interest (millions)	0.7
Dividend / Yield	\$0.00/0.0%



**Price target and ratings changes over the past 3 years:**  
Initiated - August 17, 2009 - Target \$4.50

in Q3, growth in Europe from new distributors, and potential launch late in the quarter of Microcyn Hydrogel in the US dermatology market. We expect Oculus to release financial results for their year-end in May around the time of their annual meeting, at which time more will be known regarding prospects for the upcoming fiscal year, at least for Q1/2011, which ends in June.

For fiscal 2011, which begins April 1<sup>st</sup> of this year, we are estimating that revenues for Oculus will be \$13.8 million, including \$12.5 million in product revenues, with a net loss of \$4.5 million, or (\$0.18) per share. Key drivers of growth next fiscal year for Oculus are expected to be new products in the US prescription market, including in the surgical, dental, dermatology and possibly allergy areas, growth in sales to new countries in the European Union, growth in sales to Mexico, especially if the Mexican peso strengthens, and growth in Asian markets such as China and India. We are also forecasting gross margins to improve next year for Oculus as the Company completes its transition to US-based manufacturing.

## Conclusion/Stock Valuation

Oculus' shares have clawed their way back upward this year due to revenue growth and new product approvals, which further increases our confidence in upcoming earnings releases and forecasts. In addition, the Company has a number of pending FDA applications for new markets for Microcyn-related products, and should approvals be received at a steady pace more good news is expected to be announced as this calendar year progresses. Thus, we are maintaining our BUY rating on OCLS and 12-18 month price target of \$4.50, still below highs of just last summer.

## Risk Factors

We believe an investment in Oculus Innovative Sciences involves the following risks:

- **FDA and regulatory risks** – Oculus is subject to regulatory review for its ongoing research and development activities, principally the US Food and Drug Administration but also with other regulatory agencies as well, including in Europe, Latin America and Asia. In addition, the manufacture and handling of commercial quantities of its Microcyn products are subject to additional oversight and regulation. While the Company has a good track record of regulatory review since its inception, there can be no assurance that future endeavors will go as smoothly.
- **Reliance on joint venture partners and/or additional capital** — Currently, Oculus has enough cash on hand to fund ongoing research and marketing development programs until calendar 2010, approximately. Alternatively, the Company has a stated goal of reaching operating cash break-even by the end of this fiscal year, and meeting this objective would eliminate the need to raise additional equity capital. The Company could also raise funds through additional partnerships, in particular for prescription products or into new therapeutic or geographic markets. Currently, the Company relies on several marketing partners and distributors to drive sales of its products; should any of these partners develop financial difficulties this could diminish or even eliminate revenues from certain geographic areas or product lines.
- **Need to defend patents and other intellectual property** – At present, the Company's existing patent portfolio on its current product line is extensive and has been defended in US courts on at least one occasion. However, as sales of its Microcyn-based products increase, this success may attract competitors and require additional expenses related to patent defense and enhancement.
- **Currency fluctuations** – Currently, Oculus derives a large portion of its revenues from foreign sources, including Mexico, and is susceptible to currency fluctuations which can adversely affect revenues and gross margins. However, with new approvals and partnerships in the US, the Company expects to derive a smaller portion of its revenues and cash flows from international sources in the future.

**Oculus Innovative Sciences, Inc.**  
**Consolidated Statements of Income**  
 (In 000s, except per share data)

FYE March	2006	2007	2008	1Q09 June	2Q09 September	3Q09 December	4Q09 March	2009	1Q10 June	2Q10 September	3Q10 December	4Q10E March	2010E	2011E March	2012E March	2013E March
Revenues																
Product	\$1,966	\$3,679	\$2,881	\$1,007	\$1,212	\$999	\$1,197	\$4,415	\$1,567	\$1,403	\$1,357	\$2,100	\$6,427	\$12,500	\$20,000	\$27,500
Service	618	864	954	204	269	222	278	973	280	269	256	260	1,065	1,300	1,500	1,800
Total revenues	\$2,584	\$4,543	\$3,835	\$1,211	\$1,481	\$1,221	\$1,475	\$5,388	\$1,847	\$1,672	\$1,613	\$2,360	\$7,492	\$13,800	\$21,500	\$29,300
Cost of revenues																
Product	3,899	2,104	1,774	438	446	313	476	1,673	527	601	736	750	2,614	2,880	4,300	5,780
Service	1,003	895	977	198	231	195	269	913	215	258	186	200	859	1,000	1,200	1,500
Total cost of revenues	4,902	2,999	2,751	636	697	508	745	2,586	742	859	922	950	3,473	3,880	5,500	7,280
Gross Profit	(2,318)	1,544	1,084	575	784	713	730	2,802	1,105	813	691	1,410	4,019	9,920	16,000	22,020
Operating Expenses:																
Research and development	2,600	4,508	9,778	2,321	2,150	933	631	6,252	721	583	372	380	2,056	3,250	3,500	3,750
Selling, General and administrative	15,933	16,320	13,731	3,328	5,262	2,920	2,347	13,857	2,685	2,485	2,324	2,350	9,844	11,500	12,500	14,000
Operating income (loss)	(20,851)	(19,484)	(22,425)	(5,074)	(6,628)	(3,140)	(2,248)	(17,307)	(2,301)	(2,255)	(2,005)	(1,320)	(7,881)	(4,830)	0	4,270
Interest expense	(172)	(956)	(1,016)	(162)	(149)	(113)	(13)	(437)	(4)	(3)	(2)	(20)	(29)	(100)	(50)	(200)
Other (income) expense, net	(2,076)	657	3,102	37	(132)	(67)	36	88	(1,236)	362	661	350	140	450	500	600
Income (loss) before tax	(23,099)	(19,783)	(20,339)	(5,199)	(6,912)	(3,320)	(2,225)	(17,656)	(3,541)	(1,893)	(1,346)	(990)	(7,770)	(4,480)	450	4,670
Preferred stock dividends	(121)	(404)	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Net income (loss)	(23,220)	(20,187)	(20,339)	(5,199)	(6,912)	(3,320)	(2,225)	(17,656)	(3,541)	(1,893)	(1,346)	(990)	(7,770)	(4,480)	450	4,670
Basic income per share	(\$5.60)	(\$3.71)	(\$1.60)	(\$0.33)	(\$0.43)	(\$0.21)	(\$0.13)	(\$1.09)	(\$0.18)	(\$0.08)	(\$0.05)	(\$0.04)	(\$0.34)	(\$0.18)	\$0.02	\$0.18
Diluted income per share	(\$5.60)	(\$3.71)	(\$1.60)	(\$0.33)	(\$0.43)	(\$0.21)	(\$0.13)	(\$1.09)	(\$0.18)	(\$0.08)	(\$0.05)	(\$0.04)	(\$0.34)	(\$0.18)	\$0.02	\$0.18
Basic shares outstanding	4,150	5,448	12,737	15,924	15,924	15,924	17,130	16,221	19,388	22,750	24,657	24,700	22,874	25,000	25,200	25,400
Diluted shares outstanding	4,150	5,448	12,737	15,924	15,914	15,924	17,130	16,221	19,388	22,750	24,657	24,700	22,874	25,000	25,200	25,400
Key ratios:																
Revenue growth	90.6%	75.8%	-15.6%	39.8%	51.6%	14.5%	59.3%	40.5%	55.6%	15.8%	35.8%	75.4%	39.0%	94.5%	60.0%	37.5%
Gross margin-products	-98.3%	42.8%	38.4%	56.5%	63.2%	68.7%	60.2%	62.1%	66.4%	57.2%	45.8%	77.0%	59.3%	77.0%	78.5%	79.0%
R&D/revenue	100.6%	99.2%	255.0%	191.7%	145.2%	76.4%	42.8%	116.0%	39.0%	34.9%	23.1%	16.1%	27.4%	23.6%	16.3%	12.8%
S, G & A/revenues	616.6%	363.6%	358.0%	274.8%	353.3%	239.1%	159.1%	257.2%	145.4%	148.6%	144.1%	99.6%	131.4%	83.3%	58.1%	47.8%
Non-cash items	\$1,269	\$2,801	\$2,601	\$830	\$835	\$835	\$835	\$3,335	\$590	\$555	\$650	\$750	\$2,545	\$3,200	\$3,500	\$3,800
Tax Rate	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Cash Flow/share	(\$5.29)	(\$3.19)	(\$1.39)	(\$0.27)	(\$0.38)	(\$0.16)	(\$0.08)	(\$0.88)	(\$0.09)	(\$0.06)	(\$0.03)	(\$0.01)	(\$0.19)	(\$0.03)	\$0.16	\$0.33
EBITDA/share	(\$5.76)	(\$3.00)	(\$1.15)	(\$0.27)	(\$0.39)	(\$0.16)	(\$0.08)	(\$0.88)	(\$0.09)	(\$0.04)	(\$0.00)	\$0.00	(\$0.13)	(\$0.03)	\$0.18	\$0.36

**Balance Sheets**  
(\$000s)

**Quarterly Earnings Comparisons**

	3/31/09	12/31/09
<b>Assets:</b>		
Cash and equivalents	\$1,921	\$5,158
Accounts receivable, net	923	1,132
Inventories, net	340	563
Prepaid expenses & other	758	396
Total current	3,942	7,249
Property & equip., net	1,432	1,218
Deferred offering costs	0	0
Other assets	73	109
<b>TOTAL ASSETS</b>	\$5,447	\$8,576
<b>Liabilities:</b>		
Accounts payable	\$1,565	\$885
Accrued expenses	853	1,135
Long-term debt - current portion	261	64
Total current	2,679	2,084
Long-term debt	74	121
Other long-term	425	807
Total long-term liabilities	499	928
Stockholders' equity	2,269	5,564
<b>TOTAL LIAB &amp; EQ</b>	\$5,447	\$8,576

**Revenues (in \$000)**

	June	September	December	March	Total
2004					\$902
2005					1,356
2006					2,584
2007					4,543
2008	866	977	1,066	926	3,835
2009	1,211	1,481	1,221	1,475	5,388
2010E	1,847	1,672	1,613	2,360	7,492

**Earnings per Share**

	June	September	December	March	Total
2004					(\$1.87)
2005					(4.22)
2006					(5.60)
2007					(3.71)
2008	(0.42)	(0.44)	(0.40)	(0.34)	(1.60)
2009	(0.33)	(0.43)	(0.21)	(0.13)	(1.09)
2010E	(0.18)	(0.08)	(0.05)	(0.04)	(0.34)

**Revenues by Geography**

Revenues by Geographic area (FYE March)	2006	2007	2008	2009	2010E	2011E	2012E	2013E
United States	\$109	\$140	\$1,151	\$1,271	\$2,050	\$4,750	\$9,800	\$13,800
Veterinary					1,250	2,500	5,000	6,800
Oral/Dental					0	250	1,000	1,500
Prescription (Includes acne, wound care)					500	1,000	2,800	4,000
Over-the-counter					300	1,000	1,000	1,500
Mexico	1,788	2,513	2,118	3,273	4,450	6,400	8,000	9,000
Prescription					3,200	4,200	5,000	6,000
Over-the-counter					1,250	2,200	3,000	3,000
India	0	604	83	116	150	600	900	1,500
China	0	0	0	159	250	800	1,200	2,500
Europe and other	69	422	483	269	600	1,250	1,600	2,500
<b>Total</b>	\$1,966	\$3,679	\$3,835	\$5,388	\$7,500	\$13,800	\$21,500	\$29,300

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

## Important Disclosures:

### Price Chart:



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

Initiated – August 17, 2009 – Target \$4.50

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Ratings Distribution	Company Coverage		Investment Banking	
	# of Companies	% of Total	# of Companies	% of Totals
Buy	11	79%	5	45%
Neutral	3	21%	2	67%
Sell	0	0%	0	0%
Total	14	100%	7	50%

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

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