



Nephros, Inc. (OTCBB: NEPH), Target Price: \$1.65)

Based in River Edge, NJ, Nephros, Inc. (OTCBB: NEPH “Nephros”) is a commercial stage medical device company, with innovative filtration products targeting large market opportunities including hospital infection control and advanced renal care. Nephros was founded by two healthcare professionals associated with Columbia University Medical Center / New York Presbyterian Hospital to develop a hemodiafiltration (HDF) device as an alternative to hemodialysis. Nephros has developed proprietary technology to accomplish this goal, and in addition to commercializing an HDF System, Nephros has also developed advanced filtration devices for a variety of applications where ultrapure filtration is of potential value. We see several potential catalysts ahead for Nephros in 2016E driven by new products, expanded distribution and the potential to reach a key milestone of cash flow breakeven.

Investment Highlights

2015 ends on a positive note

Nephros ended 2015 with positive 4Q15 results. Revenues grew over 40% YoY to reach \$0.51mn, versus \$0.34mn in the year ago period. For the year, revenues grew by 11% despite a pause in 3Q15 due to customer concerns about an FDA warning letter (which has since been resolved following a successful on-premise audit in February). Indeed FY15 revenues reached \$1.94mn, versus \$1.75mn in FY14. FY15 EPS came in at (\$0.09), versus our estimate of (\$0.08) and FY14 EPS of (\$0.31), while Nephros ended the year with cash on hand of \$1.2mn and no debt.

Strong Ultrafilter sales in shift to product-focused strategy

Nephros management continued to report strength in Ultrafilter product sales in 4Q15, which we view as a key figure to watch in order to gage the continuing health of the company’s go-to-market strategy. The company reported Ultrafilter product sales growth of over 90% YoY in 2015, driven primarily by sales into hospitals for infection control. Ultrafilter sales into the dialysis space, a key strategic area, grew by 40%. Overall product revenues grew to \$1.79mn versus \$0.91mn in 2014, in line with the company’s strategy to focus on product sales. This growth was offset by declines in license and royalty revenue from \$0.83mn to \$0.15mn.

New Products to drive results in 2016; targeting cash flow

Nephros management guided for 1Q16 revenues to exceed \$0.55mn, which would represent mid-single digit sequential growth from the December quarter. Importantly, the company restated its prior goal of targeting cash flow generation by the end of 2016. If achieved, we would view this as a major accomplishment by the company. In addition to continued penetration of existing products, we also see several new product catalysts for 2016. Nephros already began shipping fiber membranes to new partner Biocon 1, LLC for commercial use in the company’s advanced AETHER® filtration products in the food service industry. Nephros also announced that it launched the **SSUmini**, an FDA 510(k) cleared, economical solution for hemodialysis quality water. The company is hopeful that it will receive FDA clearance for two additional products, the **S100** point of use microfilter, and the **EndoPur™** endotoxin filter cartridge for hemodialysis water quality, in time to launch by the end of 2Q16.

Maintain price target of \$1.65

We are leaving our price target for Nephros unchanged at this time at \$1.65. We view Nephros as an attractive high risk / high reward investment opportunity in the medical instruments industry with several potential catalysts in 2016E stemming from new products, new market penetration, and guidance for reaching cash flow breakeven during 2016.

Stock Details (4/1/16)

OTCBB:	NEPH
Sector / Industry	Healthcare /Medical Instruments
Price target	\$1.65
Recent share price	\$0.32
Shares o/s (mn)	48.6
Market cap (in \$mn)	15.5
52-week high/low	\$0.80 / \$0.20

Source: Thomson Reuters, SeeThruEquity Research

Key Financial (\$mn, unless specified)

	FY14	FY15A	FY16E
Revenues	1.7	1.9	3.6
EBITDA	(2.5)	(3.2)	(1.8)
EBIT	(2.7)	(3.4)	(2.0)
Net Income	(7.4)	(3.1)	(2.0)
EPS (\$)	(0.31)	(0.09)	(0.04)

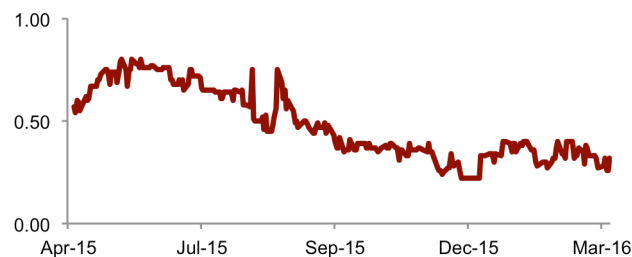
Source: SeeThruEquity Research

Key Ratios

	FY14	FY15A	FY16E
Gross margin (%)	68.6	54.5	69.0
Operating Margin (%)	(152.7)	(176.0)	(57.6)
EBITDA margin (%)	(140.3)	(165.1)	(51.3)
Net margin (%)	(421.7)	(158.8)	(57.6)
P/Revenue (x)	8.9	8.0	4.4
EV/Revenue (x)	8.1	7.3	4.0

Source: SeeThruEquity Research

Share Price Performance (\$, LTM)



QUARTERLY FINANCIAL SUMMARY

Figure 1. Income Statement Summary

Figures in \$, unless specified	4Q15	4Q14	FY 2015	FY 2014
Product	467	149	1,790	914
YoY growth	213.42%		95.84%	
License & Royalty	44	193	154	834
YoY growth	-77.20%		-81.53%	
Total Revenue	511	342	1,944	1,748
YoY growth	49.42%		11.21%	
Cost of Goods	258	126	884	549
Gross Profit	253	206	1,060	1,199
Gross Margin	49.51%	60.23%	54.53%	68.59%
Research & Development	244	260	826	781
Depreciation & Amortization	53	53	212	217
Selling & Administrative	892	693	3,443	2,870
Operating Expenses	1,189	1,006	4,481	3,868
YoY growth	18.19%		15.85%	
Operating Income	-936	-790	-3,421	-2,669
Operating Margin %	-183.17%	-230.99%	-175.98%	-152.69%
Other items, net	1	-454	333	-4,702
YoY growth			NM	
Net income	-935	-1,244	-3,088	-7,371
Foreign currency adjustments	0	0	1	1
Comprehensive income	-936	-1,245	-3,089	-7,373
EPS, Basic	-0.02	-0.04	-0.09	-0.31
Avg. Shares Outstanding EPS, Diluted	-0.02	-0.04	-0.09	-0.31
Avg Shares Outstanding in period	46,750	31,100	34,781	23,817

Source: Company Form 10Q, SeeThruEquity Research

ADDITIONAL NOTES

Looking forward after quarterly results affected by now resolved regulatory concerns

- Product sales drive 49% growth in 4Q15:** In 4Q15, Nephros reported revenue of \$0.51mn, versus \$0.34mn in the year ago period. Products contributed the majority of revenues, inline with the company's transition over the last year, coming in at \$0.47mn, or 91.3% of revenues. For the year, Nephros grew its top line by 11.9%, with revenue of \$1.94mn versus \$1.75mn in FY14. For the year, product revenues increased to \$1.79mn from 0.91mn in FY14. Revenues from license and royalties came in at \$0.15 in FY15, versus \$0.83mn in FY14, in line with the strategy articulated by management.
- Strength in Ultrafilter product sales:** Nephros management continued to report strength in ultrafilter product sales, which we view as a key figure to watch in order to gage the continuing health of the company. The company reported Ultrafilter product sales growth of over 90% YoY in 2015, driven primarily by sales into hospitals for infection control. Ultrafilter sales into the dialysis space grew by 40%.
- Balance Sheet Review:** Nephros ended the year with cash on hand of \$1.25mn and no debt. The company had positive working capital of \$1.51mn and a current ratio of 2.6x at the end of FY15. Nephros also had positive shareholder's equity of \$2.66mn, an improvement versus (\$5.68mn) in the year ago period.
- During 2015 the company raised \$3.8mn through a PIPE transaction in May as well as the discounted exercise of warrants. We were encouraged to see the company complete this move, which resulted in a cleared balance sheet heading into 2016E. Nephros had 48.6mn shares outstanding as of March 18, 2016.

- **Positive Outlook, targeting positive cash flow by the end of 2016E:** Nephros issued encouraging guidance for 2016E, which we view as a positive for the company. Nephros management expects total revenue for the March quarter to surpass \$550,000 – representing over 7% sequential growth – and the company believes it can be cash flow positive by the end of 2016. For FY16, our model forecasts a loss of (\$0.04) on revenues of \$3.6mn.
- Impressively, CEO Daron Evans reiterated his goal for the company to become cash flow positive by the end of 2016E. We would view Nephros becoming cash flow positive as a major company milestone, if accomplished. Nephros has stated that its cash flow breakeven point is \$1.8mn in quarterly sales, delivering \$0.9mn of gross profit per quarter.
- **Nephros passes FDA audit:** In terms of the regulatory concerns that affected the company during 2015, Nephros appears to have made marked progress. According to management the company “expended focused effort” towards reviewing and improving its quality systems following the receipt of a warning letter from the FDA last May. Since our last update on the company, Nephros disclosed that the company “successfully completed” an on-site FDA audit.
- While the focus at the company is on reaching cash flow breakeven from the sale of ultrafilter sales, Nephros also continues to advance its on-line mid-dilution hemodiafiltration (“HDF”) system for use with a hemodialysis machine for the treatment of patients with end stage renal disease. This is an area we consider important to its medium to long term growth prospects, and we were encouraged to learn from the company about the potential for deploying their HDF system at a second site, and the potential for generating publishable data.

Progress continues on new products

- Nephros continued to advance intriguing new products – including new non-medical commercial market penetration with its integration into AETHER® Water Systems to food service industry through partner Biocon 1, LLC. The products will be used for purification in ice machines, coffee stations, and soda fountains in the food industry. Nephros announced that it had made the first shipment of bacteria control filter cartridges with fiber membranes in March 2016.
- The company also made progress on the medical front, announcing that the **SSUmini**, an FDA 510(k) cleared, economical solution to provide hemodialysis quality water as a polish filter for smaller, portable reverse osmosis (“RO”) systems and to provide hemodialysis quality bicarbonate concentrate for dialysis clinics with centralized bicarbonate systems, was launched in March 2016.
- Looking ahead, the company has two additional new products slated for a potential 2016 launch, pending regulatory approval. These include the **S100** Point of Use microfilter and the **EndoPur™** Endotoxin Filter Cartridge. Nephros submitted a supplemental package to the FDA about the S100 on March 8, 2016, in response to a request for additional information in December, and hopes to be in a position to launch the product in 2Q16.
- The EndoPur™ endotoxin cartridge filter provides ultrafiltration of the water in a dialysis clinic's RO loop. Management believes the cartridge qualifies for a special 510(k) device modification process, which has a 30 day review timeline, because it conforms to the design controls of the DSU-D and has the same intended use. The company is hopeful it will also be able to launch the EndoPur™ by the end of 2Q16E, assuming it receives FDA clearance.

Maintaining price target for Nephros

- We are maintaining our price target of \$1.65 for Nephros at this time. We view Nephros as an attractive high risk / high reward investment opportunity in the medical instruments industry.
- We see several potential catalysts for Nephros in 2016E stemming from new product launches, expanding its market reach, and new sales and distribution activities. Additionally, we would consider it a major accomplishment if the company is able to grow while also achieving its goal of becoming cash flow positive by the end of the year.

About Nephros, Inc.

Nephros is a commercial stage medical device company that develops and sells high performance liquid purification filters, as well as a hemodiafiltration system for the treatment of patients with end stage kidney disease. Its filters, which it calls ultrafilters, are primarily used in dialysis centers and hospitals for the removal of biological contaminants from water, bicarbonate concentrate and/or blood.

Nephros was founded in 1997 by healthcare professionals affiliated with Columbia University Medical Center/New York-Presbyterian Hospital to develop and commercialize a hemodiafiltration system, an alternative method to hemodialysis. Since its founding, the company has extended its filtration technologies to meet the demand for liquid purification in other areas, in particular water purification.

For more information about Nephros and its products, please visit the company's website at www.nephros.com.

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