

NovaBay Pharmaceuticals, Inc.
Form 10-Q
May 14, 2015

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2015

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission file number 001-33678

NOVABAY PHARMACEUTICALS, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of incorporation or
organization)

68-0454536
(I.R.S. Employer Identification No.)

5980 Horton Street, Suite 550, Emeryville CA 94608

(Address of principal executive offices) (Zip Code)

Registrant's Telephone Number, Including Area Code: (510) 899-8800

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2). Yes No

As of May 4, 2015, there were 61,198,437 shares of the registrant's common stock outstanding.

NOVABAY PHARMACEUTICALS, INC.

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Unless the context requires otherwise, all references in this report to “we,” “our,” “us,” the “Company” and “NovaBay” refer to NovaBay Pharmaceuticals, Inc. and its subsidiaries.

NovaBay[®], NovaBay Pharma[®], Avenova[™], NeutroPhase[®], CellerRx[®], AgaNase[®], Aganocide[®], AgaDerm[®], Neutrox[™] and Going Beyond Antibiotics[™] are trademarks of NovaBay Pharmaceuticals, Inc. All other trademarks and trade names are the property of their respective owners.

PART I**FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****NOVABAY PHARMACEUTICALS, INC.****CONSOLIDATED BALANCE SHEETS**

<u>(in thousands, except par value)</u>	March 31, 2015 (unaudited)	December 31, 2014 (Note 2)
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 5,598	\$ 5,429
Accounts receivable	283	273
Inventory	492	521
Prepaid expenses and other current assets	1,223	729
Total current assets	7,596	6,952
Property and equipment, net	408	436
Other assets	151	149
TOTAL ASSETS	\$ 8,155	\$ 7,537
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Current liabilities:		
Accounts payable	\$ 2,178	\$ 1,865
Accrued liabilities	1,095	1,055
Deferred revenue	425	425
Total current liabilities	3,698	3,345
Deferred revenues - non-current	1,993	2,000
Deferred rent	176	171
Warrant liability	139	173
Total liabilities	6,006	5,689
Stockholders' equity:		
Preferred stock, \$0.01 par value; 5,000 shares authorized; none outstanding at March 31, 2015 and December 31, 2014	—	—
Common stock, \$0.01 par value; 120,000 shares authorized at March 31, 2015 and December 31, 2014; 61,113 and 51,650 issued and outstanding at March 31, 2015 and December 31, 2014, respectively	611	516
Additional paid-in capital	77,725	72,879

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Accumulated deficit during development stage	(76,187)	(71,547)
Total stockholders' equity	2,149	1,848
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 8,155	\$ 7,537

The accompanying notes are an integral part of these consolidated financial statements.

NOVABAY PHARMACEUTICALS, INC.**CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS****(unaudited)**

<u>(in thousands, except per share data)</u>	Three Months Ended March 31,	
	2015	2014
Sales:		
Product revenue	\$492	\$188
Cost of goods sold	148	130
Gross profit	344	58
Other revenue:		
License, collaboration and distribution revenue	6	38
Other revenues	40	62
Total other revenue	46	100
Operating expenses:		
Research and development	1,641	2,548
Sales, general and administrative	3,410	1,708
Total operating expenses	5,051	4,236
Operating loss	(4,661)	(4,078)
Non-cash gain on changes in fair value of warrants	34	520
Other income (expense), net	(11)	(7)
Loss before provision for income taxes	(4,638)	(3,565)
Provision for income taxes	(2)	—
Net loss	(4,640)	(3,565)
Change in unrealized gains on available-for-sale securities	—	2
Comprehensive loss	\$(4,640)	\$(3,563)
Net loss per share:		
Basic and diluted	\$(0.09)	\$(0.08)
Shares used in per share calculations:		
Basic and diluted	54,371	45,338

The accompanying notes are an integral part of these consolidated financial statements.

NOVABAY PHARMACEUTICALS, INC.**CONSOLIDATED STATEMENTS OF CASH FLOWS****(unaudited)**

	Three Months Ended	
	March 31, 2015	2014
<u>(in thousands)</u>		
Cash flows from operating activities:		
Net loss	\$(4,640)	\$(3,565)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	41	70
Net realized loss on sales of short-term investments	—	9
Loss (gain) on disposal of property and equipment	(1)	2
Stock-based compensation expense for options and stock issued	265	245
to employees and directors		
Stock-based compensation expense for options, warrants and stock issued to non-employees	20	32
Non-cash gain on changes in fair value of warrants	(34)	(520)
Changes in operating assets and liabilities:		
(Increase) decrease in accounts receivable	(47)	524
(Increase) decrease in inventory	29	76
(Increase) decrease in prepaid expenses and other assets	(491)	(71)
Increase (decrease) in accounts payable and accrued liabilities	357	(1,152)
Increase (decrease) in deferred revenue	(6)	(66)
Net cash used in operating activities	(4,507)	(4,416)
Cash flows from investing activities:		
Purchases of property and equipment	(14)	(12)
Proceeds from disposal of property and equipment	37	—
Purchases of short-term investments	—	(3,512)
Proceeds from maturities and sales of short-term investments	—	1,200
Net cash provided by (used in) investing activities	23	(2,324)
Cash flows from financing activities:		
Proceeds from common stock issuances	—	40
Proceeds from exercise of options and warrants	—	5
Proceeds from financing, net of costs	4,653	6,511
Net cash provided by financing activities	4,653	6,556
Change in cash and cash equivalents	169	(184)

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Cash and cash equivalents, beginning of period	5,429	10,500
Cash and cash equivalents, end of period	\$5,598	\$10,316

The accompanying notes are an integral part of these consolidated financial statements.

NOTE 1. ORGANIZATION

NovaBay Pharmaceuticals, Inc. (“we,” “NovaBay” or the “Company”) is a biopharmaceutical company focused on the development and commercialization of its non-antibiotic anti-infective products.

The Company was incorporated under the laws of the State of California on January 19, 2000, as NovaCal Pharmaceuticals, Inc. We had no operations until July 1, 2002, on which date we acquired all of the operating assets of NovaCal Pharmaceuticals, LLC, a California limited liability company. In February 2007, we changed our name from NovaCal Pharmaceuticals, Inc. to NovaBay Pharmaceuticals, Inc. In August 2007, we formed two subsidiaries—NovaBay Pharmaceuticals Canada, Inc., a wholly-owned subsidiary incorporated under the laws of British Columbia (Canada), which was formed to conduct research and development in Canada which was dissolved in July 2012, and DermaBay, Inc., a wholly-owned U.S. subsidiary, which may explore and pursue dermatological opportunities. In June 2010, we changed the state in which we are incorporated (the Reincorporation), and are now incorporated under the laws of the State of Delaware. All references to “we,” “us,” “our,” or “the Company” herein refer to the California corporation prior to the date of the Reincorporation, and to the Delaware corporation on and after the date of the Reincorporation. We currently operate in four business segments; see Note 10 for further details.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (U.S. GAAP) and are expressed in U.S. dollars.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, DermaBay, Inc. All inter-company accounts and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in accordance with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. These estimates include useful lives for property and equipment and related depreciation calculations, estimated amortization period for payments received from product development and license agreements as they relate to revenue recognition, assumptions for valuing options and warrants, and income taxes. Actual results could differ from those estimates.

Cash, Cash Equivalents and Short-Term Investments

The Company considers all highly liquid instruments with a stated maturity of three months or less at the date of purchase to be cash and cash equivalents. Cash and cash equivalents are stated at cost, which approximates their fair value. As of March 31, 2015, the Company's cash and cash equivalents were held in financial institutions in the United States and include deposits in money market funds, which were unrestricted as to withdrawal or use.

The Company classifies all highly liquid investments with a stated maturity of greater than three months at the date of purchase as short-term investments. Short-term investments generally consist of municipal and corporate debt securities. The Company has classified its short-term investments as available-for-sale. The Company does not intend to hold securities with stated maturities greater than twelve months until maturity. In response to changes in the availability of and the yield on alternative investments as well as liquidity requirements, the Company occasionally sells these securities prior to their stated maturities. These securities are carried at fair value, with the unrealized gains and losses reported as a component of other comprehensive income (loss) until realized. Realized gains and losses from the sale of available-for-sale securities, if any, are determined on a specific identification basis. A decline in the market value below cost of any available-for-sale security that is determined to be other-than-temporary results in a revaluation of its carrying amount to fair value and an impairment charge to earnings, resulting in a new cost basis for the security. No such impairment charges were recorded for the periods presented. The interest income and realized gains and losses are included in other income (expense), net within the consolidated statements of operations and comprehensive loss. Interest income is recognized when earned.

Concentrations of Credit Risk and Major Partners

Financial instruments which potentially subject us to significant concentrations of credit risk consist primarily of cash and cash equivalents and short-term investments. The Company maintains deposits of cash, cash equivalents and short-term investments with three highly-rated, major financial institutions in the United States.

Deposits in these banks may exceed the amount of federal insurance provided on such deposits. The Company does not believe it is exposed to significant credit risk due to the financial position of the financial institutions in which these deposits are held. Additionally, the Company has established guidelines regarding diversification and investment maturities, which are designed to maintain safety and liquidity.

During the three months ended March 31, 2015, revenues were derived from one collaboration partner, service revenues and sales of NeutroPhase. During the three months ended March 31, 2014, revenues were derived from one collaboration partner, two distribution partners, service revenues and sales of NeutroPhase.

As of March 31, 2015, 46% and 13% of accounts receivable were derived from two distribution partners. As of December 31, 2014, 41% and 18% of accounts receivable were derived from two distribution partners.

Fair Value of Financial Assets and Liabilities

Financial instruments, including cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities are carried at cost, which management believes approximates fair value due to the short-term nature of these instruments. Our warrant liability is carried at fair value.

The Company measures the fair value of financial assets and liabilities based on U.S. GAAP guidance which defines fair value, establishes a framework for measuring fair value, and requires disclosures about fair value measurements.

Under U.S. GAAP, fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. A fair value hierarchy is also established, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. There are three levels of inputs that may be used to measure fair value:

Level 1 – quoted prices in active markets for identical assets or liabilities;

Level 2 – quoted prices for similar assets and liabilities in active markets or inputs that are observable;

Level 3 – inputs that are unobservable (for example cash flow modeling inputs based on assumptions).

Inventory

Inventory is comprised of (1) raw materials and supplies, such as bottles, packaging materials, labels, boxes, pumps; (2) goods in progress, which are normally unlabeled bottles; and (3) finished goods.

Inventory is stated at the lower of cost or market value determined by the first-in, first-out method.

Property and Equipment

Property and equipment are stated at cost, less accumulated depreciation and amortization. Depreciation is calculated using the straight-line method over the estimated useful lives of the related assets of five to seven years for office and laboratory equipment, three years for software and seven years for furniture and fixtures. Leasehold improvements are depreciated over the shorter of seven years or the lease term.

The costs of normal maintenance, repairs, and minor replacements are charged to operations when incurred.

Impairment of Long-Lived Assets

The Company accounts for long-lived assets in accordance with U.S. GAAP, which requires that companies consider whether events or changes in facts and circumstances, both internally and externally, may indicate that an impairment of long-lived assets held for use are present. Management periodically evaluates the carrying value of long-lived assets and has determined that there was no impairment as of all periods presented. Determination of recoverability is based on the estimate of undiscounted future cash flows resulting from the use of the asset and its eventual disposition. In the event that such cash flows are not expected to be sufficient to recover the carrying amount of the asset, the assets are written down to their estimated fair values and the loss is recognized in the statements of operations.

Comprehensive Income (Loss)

ASC 220, *Comprehensive Income* requires that an entity's change in equity or net assets during a period from transactions and other events from non-owner sources be reported. The Company reports unrealized gains and losses on its available-for-sale securities as other comprehensive income (loss).

Revenue Recognition

License and collaboration revenue is primarily generated through agreements with strategic partners for the development and commercialization of the Company's product candidates. The terms of the agreements typically include non-refundable upfront fees, funding of research and development activities, payments based upon achievement of certain milestones and royalties on net product sales. In accordance with revenue recognition criteria under U.S. GAAP, the Company analyzes its multiple element arrangements to determine whether the elements can be separated. The Company performs its analysis at the inception of the arrangement and as each product or service is delivered. If a product or service is not separable, the combined deliverables are accounted for as a single unit of accounting and revenue is recognized over the performance obligation period. Revenue is recognized when the following criteria have been met: persuasive evidence of an arrangement exists; delivery has occurred and risk of loss has passed; the seller's price to the buyer is fixed or determinable; and collectability is reasonably assured.

Assuming the elements meet the revenue recognition guidelines the revenue recognition methodology prescribed for each unit of accounting is summarized below:

Upfront Fees—The Company defers recognition of non-refundable upfront fees if it has continuing performance obligations without which the technology licensed has no utility to the licensee. If the Company has performance obligations through research and development services that are required because its know-how and expertise related to the technology is proprietary, or can only be performed by the Company, then such up-front fees are deferred and recognized over the period of the performance obligations. The Company bases the estimate of the period of performance on factors in the contract. Actual time frames could vary and could result in material changes to their results of operations.

Funded Research and Development— Revenue from research and development services is recognized during the period in which the services are performed and is based upon the number of full-time-equivalent personnel working on the specific project at the agreed-upon rate. This revenue approximates the cost incurred. Reimbursements from collaborative partners for agreed-upon direct costs including direct materials and outsourced, or subcontracted, pre-clinical studies are classified as revenue and recognized in the period the reimbursable expenses are incurred. Payments received in advance are recorded as deferred revenue until the research and development services are performed or costs are incurred.

Milestones—Substantive milestone payments are considered to be performance bonuses that are recognized upon achievement of the milestone only if all of the following conditions are met: the milestone payments are non-refundable; achievement of the milestone involves a degree of risk and was not reasonably assured at the inception of the arrangement; substantive effort is involved in achieving the milestone; the amount of the milestone is

reasonable in relation to the effort expended or the risk associated with achievement of the milestone; and a reasonable amount of time passes between the up-front license payment and the first milestone payment as well as between each subsequent milestone payment. If any of these conditions are not met, the milestone payments are deferred and recognized as revenue over the term of the arrangement as we complete our performance obligations.

Royalties—The Company recognizes royalty revenues from licensed products upon the sale of the related products.

Product Sales—The Company sells NeutroPhase, CelleRx and Avenova through a limited number of distributors. The Company generally records product sales upon shipment to distributors if title and risk of loss pass to the distributors at the time of shipment. Otherwise, the Company records product sales upon shipment to final customers.

Cost of Goods Sold

Cost of goods sold includes third party manufacturing costs, shipping costs, cost of samples and other costs of goods sold. Cost of goods sold also includes any necessary allowances for excess inventory that may expire and become unsalable. The Company did not record an allowance for excess inventory as of March 31, 2015.

Research and Development Costs

The Company charges research and development costs to expense as incurred. These costs include salaries and benefits for research and development personnel, costs associated with clinical trials managed by contract research organizations, and other costs associated with research, development and regulatory activities. The Company uses external service providers to conduct clinical trials, to manufacture supplies of product candidates and to provide various other research and development-related products and services. Research and development expenses under the collaborative agreements approximate the revenue recognized, excluding milestone and upfront payments received under such arrangements.

Patent Costs

Patent costs, including legal expenses, are expensed in the period in which they are incurred. Patent expenses are included in general and administrative expenses in the consolidated statements of operations and comprehensive loss.

Stock-Based Compensation

The Company accounts for stock-based compensation under the provisions of ASC 718, *Compensation-Stock Compensation*. Under the fair value recognition provisions, stock-based compensation expense is measured at the grant date for all stock-based awards to employees and directors and is recognized as expense over the requisite service period, which is generally the vesting period. Non-employee stock-based compensation charges are amortized over the vesting period on a straight-line basis. For stock options granted, the fair value of the stock options is estimated using a Black-Scholes-Merton option pricing model. See Note 8 for further information regarding stock-based compensation expense and the assumptions used in estimating that expense.

Income Taxes

The Company accounts for income taxes under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is recognized if it is more likely than not that some portion or the entire deferred tax asset will not be recognized.

Common Stock Warrant Liabilities

For warrants where there is a deemed possibility that the Company may have to settle the warrants in cash, the Company records the fair value of the issued warrants as a liability at each balance sheet date and records changes in the estimated fair value as a non-cash gain or loss in the consolidated statement of operations and comprehensive loss. The fair values of these warrants have been determined using the Binomial Lattice (“Lattice”) valuation model. The Lattice model provides for assumptions regarding volatility, call and put features and risk-free interest rates within the total period to maturity. These values are subject to a significant degree of judgment on the part of the Company.

Net Income (Loss) per Share

The Company computes net income (loss) per share by presenting both basic and diluted earnings (loss) per share (EPS).

Basic EPS is computed by dividing net income (loss) available to common shareholders by the weighted average number of common shares outstanding during the period. Diluted EPS gives effect to all dilutive potential common shares outstanding during the period including stock options and warrants, using the treasury stock method, using the if-converted method. In computing diluted EPS, the average stock price for the period is used in determining the number of shares assumed to be purchased from the exercise of stock options or warrants. Potentially dilutive common share equivalents are excluded from the diluted EPS computation in net loss periods since their effect would be anti-dilutive. During the three months ended March 31, 2015 and March 31, 2014, there was no difference between basic and diluted net loss per share due to the Company's net losses. The following table sets forth the calculation of basic EPS and diluted EPS:

(in thousands, except per share amounts)	Three Months Ended March 31,	
	2015	2014
Net loss	\$(4,640)	\$(3,565)
Basic shares	54,371	45,338
Add: shares issued upon assumed exercise of stock options and warrants	—	—
Diluted shares	54,371	45,338
Basic and diluted net loss per share	\$(0.09)	\$(0.08)

The following outstanding stock options and stock warrants were excluded from the diluted net loss per share computation as their effect would have been anti-dilutive:

	Three Months Ended March 31,	
(In thousands)	2015	2014
Stock options	8,429	7,547
Stock warrants	21,339	6,165
	29,768	13,712

Recent Accounting Pronouncements

There have been no recent accounting pronouncements or changes in accounting pronouncements during the three months ended March 31, 2015, as compared to the recent accounting pronouncements described in the Company's Form 10-K for the year ended December 31, 2014, that are of significance or potential significance to the Company.

NOTE 3. FAIR VALUE MEASUREMENTS

The Company measures the fair value of financial assets and liabilities based on authoritative guidance which defines fair value, establishes a framework consisting of three levels for measuring fair value, and requires disclosures about fair value measurements. Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date.

The Company's cash equivalents and investments are classified within Level 1 or Level 2 of the fair value hierarchy because they are valued using quoted market prices in active markets, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency. The types of investments that are generally classified within Level 1 of the fair value hierarchy include money market securities. The types of investments that are generally classified within Level 2 of the fair value hierarchy include corporate securities, certificates of deposits and U.S. government securities.

The Company's warrant liability is classified within level 3 of the fair value hierarchy because the value is calculated using significant judgment based on our own assumptions in the valuation of this liability.

The following table presents the Company's assets and liabilities measured at fair value on a recurring basis as of March 31, 2015:

Fair Value Measurements Using

(in thousands)	Balance at March 31, 2015	Quoted Prices in Active Markets for Identical Items (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
Cash equivalents	\$5,598	\$ 5,598	\$ —	\$ —
Total assets	\$5,598	\$ 5,598	\$ —	\$ —
Liabilities				
Warrant liability	\$ 139	\$ —	\$ —	\$ 139
Total liabilities	\$ 139	\$ —	\$ —	\$ 139

For the three month period ended March 31, 2015, as a result of the fair value adjustment of the warrant liability, the Company recorded a non-cash gain on a decrease in the fair value of \$34,000, in its consolidated statement of operations and comprehensive loss. See Note 6 for further discussion on the calculation of the fair value of the warrant liability.

(in thousands)	Warrant liability
Fair value of warrants at December 31, 2014	\$ 173
Adjustment to fair value at March	(34)

31, 2015

Total warrant

liability at March

\$ 139

31, 2015

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NOTE 4. INVENTORY

Inventory consisted of the following:

(in thousands)	March 31, 2015	December 31, 2014
Raw materials and supplies	\$ 260	\$ 260
Goods in process	184	184
Finished goods	48	77
Total inventory	\$ 492	\$ 521

NOTE 5. COMMITMENTS AND CONTINGENCIES*Operating Leases*

The Company leases laboratory facilities and office space under an operating lease which will expire on October 31, 2020. Rent expense was approximately \$256,000 and \$255,000 for the three months ended March 31, 2015 and 2014, respectively.

The Company's monthly rent payments fluctuate under the master lease agreement. In accordance with U.S. GAAP, the Company recognizes rent expense on a straight-line basis. The Company records deferred rent for the difference between the amounts paid and recorded as expense.

Directors and Officers Indemnity

As permitted under Delaware law and in accordance with its bylaws, the Company shall indemnify its officers and directors for certain events or occurrences while the officer or director is or was serving at its request in such capacity. The term of the indemnification period is for the officer's or director's lifetime. The maximum amount of potential

future indemnification is unlimited; however, the Company has a director or officer insurance policy that limits its exposure and may enable them to recover a portion of any future payments. The Company believes the fair value of these indemnification agreements is minimal. Accordingly, no liability has been recorded for these agreements as of March 31, 2015.

In the normal course of business, the Company provides indemnifications of varying scope under agreements with other companies, typically its clinical research organizations, investigators, clinical sites, suppliers and others. Pursuant to these agreements, the Company generally indemnifies, holds harmless, and agrees to reimburse the indemnified parties for losses suffered or incurred by the indemnified parties in connection with use or testing of its products or product candidates or with any U.S. patent or any copyright or other intellectual property infringement claims by any third party with respect to their products. The term of these indemnification agreements is generally perpetual. The potential future payments the Company could be required to make under these indemnification agreements is unlimited. Historically, costs related to these indemnification provisions have been immaterial. The Company also maintains various liability insurance policies that limit its exposure. As a result, the Company believes the fair value of these indemnification agreements is minimal. Accordingly, no liabilities have been recorded for these agreements as of March 31, 2015.

Legal Matters

From time to time, the Company may be involved in various legal proceedings arising in the ordinary course of business. There are no matters at March 31, 2015, that, in the opinion of management, would have a material adverse effect on the Company's financial position, results of operations or cash flows.

NOTE 6. WARRANT LIABILITY

In July 2011, the Company sold common stock and warrants in a registered direct financing. As part of this transaction, 3,488,005 warrants were issued with an exercise price of \$1.33 and were exercisable on January 1, 2012, and expire on July 5, 2016. The terms of the warrants require registered shares to be delivered upon each warrant's exercise and also require possible cash payments to the warrant holders (in lieu of the warrant's exercise) upon specified fundamental transactions involving the Company's common stock, such as in an acquisition of the Company. Under ASC 480, "Distinguishing Liabilities from Equity" ("ASC 480"), the Company's ability to deliver registered shares upon an exercise of the warrants and the Company's potential obligation to cash-settle the warrants if specified fundamental transactions occur are deemed to be beyond the Company's control. The warrants contain a provision where the warrant holder would have the option to receive cash, equal to the Black-Scholes fair value of the remaining unexercised portion of the warrant, as cash settlement in the event that there is a fundamental transaction (contractually defined to include various merger, acquisition or stock transfer activities). Due to this provision, ASC 480 requires that these warrants be classified as liabilities. The fair values of these warrants have been determined using the Binomial Lattice ("Lattice") valuation model, and the changes in the fair value are recorded in the consolidated statement of operations and comprehensive loss. The Lattice model provides for assumptions regarding volatility and risk-free interest rates within the total period to maturity. In addition, after January 5, 2012, and if the closing bid price per share of the common stock on the principal market equals or exceeds \$2.66 for any ten trading days (which do not

need to be consecutive) in a period of fifteen consecutive trading days, the Company has the right to require the exercise of one-third of the warrants then held by the warrant holders, which would result in gross proceeds to the Company of approximately \$1.5 million.

The key assumptions used to value the warrants were as follows:

<u>Assumption</u>	March 31,	
	2015	2014
Expected price volatility	60 %	70 %
Expected term (in years)	1.26	2.26
Risk-free interest rate	0.34%	0.56%
Dividend yield	0.00%	0.00%
Weighted-average fair value of warrants	\$0.04	\$0.38

NOTE 7. STOCKHOLDERS' EQUITY

On July 5, 2011, the Company closed a registered direct offering for the sale of 4,650,675 units (The "July 2011 Registered Direct Financing"), each unit consisting of (i) one share of common stock and (ii) one warrant to purchase 0.75 of a share of common stock (or a total of 3,488,005 shares), at a purchase price of \$1.11 per unit. The warrants will be exercisable 180 days after issuance for \$1.33 per share and will expire five years from the date of issuance. All of the shares of common stock and warrants issued in the offering (and the shares of common stock issuable upon exercise of the warrants) were offered pursuant to a shelf registration statement filed with, and declared effective by, the Securities and Exchange Commission. The shares of common stock and the warrants were immediately separable and were issued separately, but were purchased together in the July 2011 Registered Direct Offering. The Company raised a total of \$5.2 million from the July 2011 Registered Direct Financing, or approximately \$4.6 million in net proceeds after deducting underwriting commissions of \$288,000 and other offering costs of \$244,000.

On December 6, 2012, the Company closed a public offering for the sale of 5,900,000 shares of common stock and 5,900,000 warrants to purchase 0.75 of a share of common stock (or a total of 4,425,000 shares), at a purchase price of \$1.25 per share with associated warrant. The warrants were immediately exercisable for \$1.50 per share and will expire one year from the date of issuance. All of the shares of common stock and warrants issued in the offering (and the shares of common stock issuable upon exercise of the warrants) were offered pursuant to a shelf registration statement filed with, and declared effective by, the Securities and Exchange Commission. The shares of common stock and the warrants were immediately separable and were issued separately, but were purchased together. The Company raised a total of \$7.4 million from this offering, or approximately \$6.6 million in net proceeds after deducting underwriting commissions of \$479,000 and other offering costs of \$240,000.

On November 14, 2013, the Company entered into an At-The-Market Offering Agreement ("2013 ATM Agreement"), with Ascendant Capital Markets ("Ascendant"), as its agent, and filed a prospectus supplement to its shelf registration

statement, pursuant to which the Company may offer and sell shares of our common stock having an aggregate offering price of up to \$5.0 million from time to time.

On October 16, 2014, the Company entered into an At-The-Market Offering Agreement (the “2014 ATM Agreement”, the “Agreement”) with Ascendant under which we may offer and sell our common stock having aggregate sales proceeds of up to \$10.0 million from time to time through Ascendant as our sales agent. Sales of our common stock through Ascendant are made by means of ordinary brokers’ transactions on NYSE MKT or otherwise at market prices prevailing at the time of sale, in block transactions, or as otherwise agreed upon by us and Ascendant. Ascendant uses commercially reasonable efforts to sell our common stock from time to time, based upon instructions from us (including any price, time or size limits or other customary parameters or conditions we may impose). We pay Ascendant a commission of 3.0% of the gross sales proceeds of any common stock sold through Ascendant under the Agreement. We have also provided Ascendant with customary indemnification rights. In connection with the Agreement we terminated the At-The-Market Offering Agreement with Ascendant dated November 13, 2013.

We are not obligated to make any sales of common stock under the Agreement. The offering of shares of the Company’s common stock pursuant to the Agreement will terminate upon the earlier of (i) the sale of all common stock subject to the Agreement, or (ii) termination of the Agreement in accordance with its terms.

The common stock is being offered and sold pursuant to the Company’s effective shelf registration statement on Form S-3 and an accompanying prospectus (Registration Statement No. 333-180460) declared effective by the SEC on May 1, 2012 (the “Registration Statement”) and a prospectus supplement filed with the SEC on October 16, 2014.

For the year ended December 31, 2013, the Company sold 289,492 shares for gross proceeds of \$378,000, or approximately \$352,000 in net proceeds after deducting offering costs and commissions of \$26,000. For the year ended December 31, 2014, the Company sold 1.3 million shares for gross proceeds of \$1.2 million, or approximately \$1.1 million in net proceeds after deducting offering costs and commissions of \$81,000. For the three months ended March 31, 2015, the Company sold 189,709 shares for gross proceeds of \$118,000, or approximately \$107,000 in net proceeds after deducting offering costs and commissions of \$11,000. Under the terms of the 2014 and 2013 ATM Agreement, the Company paid to Ascendant 3% of the gross proceeds of all sales made under these agreements.

On December 2, 2013 the Company entered into a stock purchase agreement with Pioneer to purchase five million shares of NovaBay stock at \$1.14 per share, resulting in cash proceeds to NovaBay of \$5.7 million. In April 2013, the Company also sold 300,000 shares to W&M Carpenter III Trust FBO F Feichter IV for net proceeds of \$375,000.

On March 25, 2014, the Company closed a public offering for the sale of 5,600,000 units, each unit consisting of (i) one share of common stock and (ii) one warrant to purchase 0.25 of a share of common stock (or a total of 1,400,000 shares), at a purchase price of \$1.20 per unit. The warrants were immediately exercisable for \$1.56 per share and will expire eighteen months from the date of issuance. All of the shares of common stock and warrants issued in the offering (and the shares of common stock issuable upon exercise of the warrants) were offered pursuant to a shelf registration statement filed with, and declared effective by, the Securities and Exchange Commission. The shares of common stock and the warrants were immediately separable and were issued separately, but were purchased together. The Company raised a total of \$6.7 million from this offering, or approximately \$6.0 million in net proceeds after deducting underwriting commissions of \$470,000 and other offering costs of \$211,000.

On March 3, 2015, the Company entered into a securities purchase agreement for the sale of its common stock and warrants in a private placement for net proceeds of approximately \$4.5 million. Investors purchased 9,273,332 units consisting of one share of the Company's common stock and two warrants to purchase an additional share and three-quarters share of common stock, respectively. The first warrant, totaling rights to 9,273,332 shares, which is exercisable beginning on the date six months after the date of issuance, entitles the holder to purchase one share of common stock at a price of \$0.60 per share, and includes a provision for forced conversion if the common stock trades at or above \$1.10 for 10 out of 20 consecutive trading days. This warrant will expire, unless exercised, 15 months following the date of issuance. The second warrant, totaling rights to 6,955,000 shares, entitles the holder to purchase three-quarters of one share of common stock at a price of \$0.65 per share, and is exercisable beginning on the date six months after the date of issuance. This warrant expires five and one half years from closing, unless exercised. In connection with the securities purchase agreement, the Company also issued a warrant to the placement agent, totaling rights to 185,466 shares, which entitles the holder to purchase one share of common stock at a price of \$0.65 per share, and is exercisable beginning on March 6, 2015. This warrant expires 60 months from issuance, unless exercised.

In April 2015, the registration statement on Form S-3 associated with the Company's March 2015 private placement has been declared effective by the U.S. Securities and Exchange Commission (SEC). The registration of these shares causes them to be eligible for open trading in the stock market.

Stock Warrants

In March 2014, 1,400,000 warrants were issued in connection with March 2015 financing. These warrants were issued with an exercise price of \$1.56 and expire on September 25, 2015. These outstanding warrants were fully exercisable at September 30, 2014.

In March 2015, 16,413,798 warrants were issued in connection with March 2015 financing. The first warrant, totaling rights to 9,273,332 shares, is exercisable beginning on the date six months after the date of issuance with an exercise price of \$0.60 per share and expires 15 months following the issuance. The second warrant, totaling rights to 6,955,000 shares, is exercisable beginning on the date six months after the date of issuance with an exercise price of \$0.65 per share and expires five and one half years from closing. The third warrant, totaling rights to 185,466 shares, is exercisable beginning on March 6, 2015 with an exercise price of \$0.65 per share and expires 60 months from issuance.

NOVABAY PHARMACEUTICALS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

The details of all outstanding warrants as of March 31, 2015, are as follows:

(in thousands, except per share data)	Warrants	Weighted-Average Exercise Price
Outstanding at December 31, 2014	4,925	\$ 1.42
Warrants issued	16,414	\$ 0.62
Outstanding at March 31, 2015	21,339	\$