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Zacks Small-Cap Research

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Innovus Pharmaceuticals (INNV-OTC)

INNV: Positive steps – raising target

We are raising our target from $3.44 to $4.20. Our new target is based on a 10-year DCF with a WACC of 12%. We reduced our WACC from 13% to 12% to reflect the recent improvement in debt financing costs along with continued evidence that the Company has made significant improvements in the past year towards a sustainable growth strategy.

OUTLOOK

In the past year, Innovus Pharmaceuticals has made significant progress to address what we initially viewed as weaknesses in the story. The Company now has extensive metrics to guide decision making resulting in more effective marketing campaigns, reduced working investment needs and a significant reduction in financing costs. While the share price has suffered during the past year, we believe the Company is largely through this important transition and now has a solid foundation for consistent improvement going forward.

Current Price (08/13/19)	$1.78
Valuation	**$4.20**

SUMMARY DATA

52-Week High	**$17.16**
52-Week Low	**$1.35**
One-Year Return (%)	**-89.36**
Beta	**2.22**
Average Daily Volume (sh)	**3,601**
Shares Outstanding (mil)	**3**
Market Capitalization ($mil)	**$5**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**0**
Insider Ownership (%)	**13**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**150.8**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using TTM EPS	**N/A**
P/E using 2019 Estimate	**N/A**
P/E using 2020 Estimate	**N/A**
Zacks Rank	**N/A**

Risk Level	**N/A,**
Type of Stock	**Small-Growth**
Industry	**Med-Drugs**
Zacks Rank in Industry	**N/A**

ZACKS ESTIMATES

Revenue
(millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2018	4.5 A	7.3 A	7.4 A	4.8 A	24.0 A
2019	5.4 A	6.8 A	6.9 E	6.9 E	26.0 E
2020	6.7 E	7.5 E	7.7 E	8.1 E	30.0 E
2021					32.4 E

Earnings per share

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2018	-$1.03 A	-$0.94 A	-$1.20 A	-$0.99 A	-$4.16 A
2019	-$0.81 A	-$0.66 A	-$0.53 A	-$0.54 A	-$2.54 E
2020	-$0.47 E	-$0.38 E	-$0.37 E	-$0.33 E	-$1.55 E
2021					-$1.13 E

Zacks Projected EPS Growth Rate - Next 5 Years % **N/A**

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INVESTMENT SUMMARY

When we initiated coverage on Innovus Pharmaceuticals (10/2/18), we saw significant opportunity in its broad product line particularly when its multi-pronged marketing program began to leverage operating expenditures. However, we wanted INNV to show that it could maintain its strategic focus and meet clear, pressure-tested, operating targets in order to reduce financing costs and gain a stable, buy-and-hold investor base. Based on recent results, we believe Innovus Pharmaceuticals has made significant progress to address what we initially viewed as weaknesses in the story. The Company now has extensive metrics to guide decision making resulting in more effective marketing campaigns, reduced working investment needs and a significant reduction in financing costs. While the share price has suffered during the past year, we believe the Company is largely through this important transition and now has a solid foundation for consistent improvement going forward.

Recent results

Innovus announced 2Q19 results on 8/13/19. Results signaled continued focus on informed, profitable growth, rather than aiming for the fastest top-line growth possible. The steps taken in 2018 to fill its team with financial and marketing/operating expertise while building out internal controls and executive information systems places the Company in a much stronger position, strategically and financially.

Revenues for the quarter totaled $6.8 million, up nearly $1.5 million sequentially. While revenues were down on a year-to-year basis by $0.5 million, marketing expense fell by nearly 50% to $2.9 million from $5.5 million in 2Q18. This change is particularly notable when comparing sequential changes between the first and second quarters of 2018 with the first and second quarters of 2019. The table below shows that in 2018, $2.2 million in incremental marketing resulted in a $2.4 million gain in product sales. By contrast, in 2019, $0.3 million incremental marketing spend resulted in a $1.4 million increase in product sales.

Exhibit 1: Incremental sales from marketing spend

($ mil)	2018			2019		
	1Q	2Q	Change	1Q	2Q	Change
Marketing expense	3.3	5.5	2.2	2.6	2.9	0.3
Revenues	4.5	7.0	2.4	5.2	6.6	1.4

Source: Company filings, Zacks Investment Research estimates.

Product gross margins were largely stable in 2Q19 at 64% of product sales compared with 66% in 1Q19. However, the Company expects improvement in COGs by moving fulfillment for the Canadian market from California to Canada.

Sales and marketing expense was 42% of sales compared with 48% in 1Q19 and 76% a year ago. As discussed above, this improvement stems from better marketing metrics and a focus on investing in the most profitable sales channels.

General and administrative expense totaled $2.7 million in 2Q19, (40% of revenues), up from $1.9 million (26%) in the year earlier period; however spending rose only $0.3 million sequentially. The year-to-year increase reflects payroll expenses for additional operating executives but also increased professional fees in the quarter. We do not anticipate any significant new investment in G&A in the next few years, so we anticipate G&A will come down as a percent of revenues from here.

Innovus announced new financing of $1 million in straight debt at 10%. This is notable, as Innovus has relied on high-cost convertible debt. We see the new loan as independent confirmation of the Company's improving financial outlook.

Finally, the Company has substantially moderated cash used in operations in recent quarters. In 2Q19, CFFO was c. $(0.7) million, largely flat with Q119 numbers. As we've noted, better inventory management is a key driver of CFFO improvement. The company has about 120 days of inventory on hand, compared with 202 days a year ago. The number remains somewhat inflated due to large minimum orders for certain products (such as Fluticare), which are being worked down. Overall, we believe there is more room to improve inventory turns.

We are pulling in our near-term estimates slightly while raising our valuation target based on what we view as important, positive progress in the Innovus story. For 2019, our revenue estimate goes from $30.7 million, to $26.0 million, reflecting more moderate growth trajectory. We are predicting a loss of $(2.54) per share, compared with our previous estimate of $(1.69), primarily due to the impact of more modest sales on overhead expense.

Our valuation goes from $4.20 from $3.44. Our 10-year DCF model builds to sales of approximately $66 million by 2028. We model terminal sales with an EBIT margin of 10% and a 30% tax rate. We assume a terminal growth rate of 2% and use a 12% WACC (down from 13%).

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