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Research Report – Update

Investors should consider this report as only a single factor in making their investment decision.

Nephros, Inc.

Rating: Speculative Buy

Howard Halpern

March 5, 2020

NEPH $8.88 — (NASDAQ)

	2017 A	2018 A	2019 A	*2020 E*	*2021 E*
Revenue (in millions)	$3.8	$5.7	$10.3	***$15.0***	***$21.7***
Earnings (loss) per share*	($0.14)	($0.50)	($0.45)	***($0.28)***	***($0.15)***

52-Week range*	$11.35 – $3.69	Fiscal year ends:	December
Shares outstanding a/o 02/20/20	9.0 million	Revenue/shares (ttm)*	$1.37
Approximate float	7.0 million	Price/Sales (ttm)	6.5X
Market Capitalization	$80 million	Price/Sales (2021) E**	4.3X
Tangible Book value/shr*	$0.58	Price/Earnings (ttm)	NMF
Price/Book	15.3X	Price/Earnings (2021) E	NMF

All per share figures adjusted for a 1-9 reverse stock split effective 7/9/19. **Based on 10.5 million fully diluted shares

Nephros Inc., headquartered in South Orange, NJ, is a commercial stage company that develops and sells high performance water purification products and pathogen detection systems to the medical and commercial markets. The company's 62.5% owned subsidiary, Specialty Renal Products, is a development stage company focused on improving therapies for patients with renal disease.

Key Investment Considerations:

Maintaining Speculative Buy rating and 12-month price target of $15.50 per share.

Nephros has substantial growth potential within the water filtration and pathogen detection markets with their portfolio of high performance water purification products and pathogen detection systems. Growth should be driven by increased penetration of US hospitals and dialysis centers, and increased usage from existing customers. We estimate NEPH has an approximate 5% penetration of the 12,000 US hospital/dialysis centers.

In 2020 the company plans on launching a series of pathogen detection systems into its current customer base. The systems include PluraPath™, DialyPath™, and SequaPath™. The incremental revenue from customer acceptance of these offering should support our growth forecast to 2021.

NEPH's Specialty Renal Products subsidiary's 2nd generation Hemodiafiltration (a form of renal replacement therapy) system, once FDA 510(k) clearance is received, has the potential to generate annual revenue of $15 million with only 1% market penetration.

NEPH reported (on 02-26-20) a 2019 loss of ($0.45) per share on an 81.7% sales increase to $10.3 million. We projected a loss of ($0.58) per share on sales of $9.7 million. The 2018 loss was ($0.50) per share on sales of $5.7 million.

For 2020, we project a net loss of $2.5 million or ($0.28) per share on 45.2% revenue growth to $15 million. We previously projected a loss of $2.6 million or ($0.33) per share on sales of $15.3 million. Our loss per share forecast reflects a 1 million share increase in average shares to 9 million due to a common stock offering.

For 2021, we project a net loss of $1.4 million or ($0.15) per share on revenue growth of 44.8% to $21.7 million. Our forecast reflects increased customer penetration at US hospital/dialysis centers, maintaining at least a 90% customer retention rate, increases in recurring revenue from existing customers, as well as incremental revenue from its pathogen detection systems and renal device.

Please view our Disclosures pages 15 – 17.

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Appreciation Potential

Maintaining Speculative Buy rating and 12-month price target of $15.50 per share. Our price target should be supported by growth in the company's customer base (primarily hospitals and dialysis centers), increasing recurring revenues from existing customers, as well as incremental sales from the company's launch of pathogen detection systems. The first system launched (January 2020) was PluraPath, a real-time, portable, water pathogen detection system.

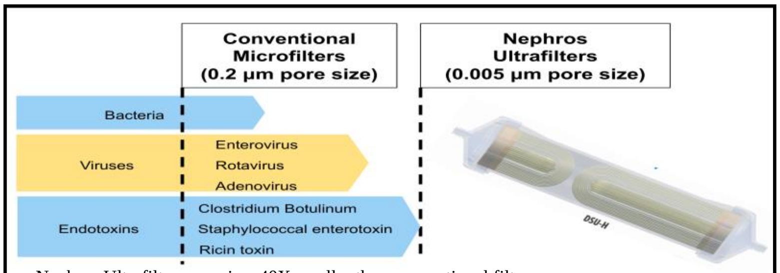
Our rating reflects anticipated growth from Nephros' commercial water purification product portfolio that includes high performance filters and ultrafilters (filters with pore size below 0.01 microns), as well as from its AETHER® brand of water filters to expand its market to include companies in the hospitality/foodservice industries. Our rating should be reinforced once its Specialty Renal Products subsidiary receives FDA 510(k) clearance for its 2nd generation Hemodiafiltration (a form of renal replacement therapy that removes more middle-molecular-weight solutes) system. NEPH anticipates submitting the 2nd generation Hemodiafiltration product for 510(k) clearance in the summer of 2020.

Our 12-month price target of $15.50 per share implies shares could appreciate in excess of 70% over the next twelve months. According to Thomson Reuters, the average trailing twelve-month and 2021 price-to-sales multiples for companies in the Healthcare Equipment and Supplies sectors are 3.7X (unchanged) and 3.7X, respectively, on estimated 2021 sales growth of 5.5%. NEPH's trailing twelve-month and 2021 price-to-sales multiples are 6.6X (prior was 7.1X) and 4.3X, respectively, on estimated 2021 sales growth of 44.7%. We anticipate investors are likely to accord a sales multiple that more than doubles the industry due primarily to nearly 45% sales growth for NEPH compared to 5.5% for the industry. We applied a sales multiple of 7.5X (prior was 8X) to our 2021 fully diluted sales per share forecast of $2.08 (based on 10.5 million fully diluted shares), to obtain a year ahead price target of approximately $15.50 per share.

A higher valuation of Nephros is likely to be supported by rapid sales growth (i.e., approximately 56.4% annualized total revenue growth to 2021 from 2016), a narrowing of operating losses, launching of its pathogen detection system (PluraPath™, DialyPath™, and SequaPath™) and receiving FDA 510(k) clearance for its 2nd generation Hemodiafiltration system in 2020. In 2021, we forecast NEPH's operating losses narrowing to $1.1 million from nearly $3.2 million in 2019 and an estimated $2.1 million in 2020. The company's cash burn should narrow to $161,000 in 2020 from an estimated $850,000 in 2020 and $1.7 million in 2019.

Overview

Nephros Inc., headquartered in South Orange, New Jersey, is a commercial-stage water purification company that develops and sells high performance water solutions to the medical and commercial markets. The company's medical products are mostly classified as ultrafilters, and are primarily used in hospitals for the prevention of infection from water-borne pathogens (legionella, pseudomonas, and others), and in dialysis centers for the removal of biological contaminants from water and bicarbonate concentrate. Since the company's ultrafilters capture contaminants as small as 0.005 microns in size (see picture on the right), they minimize exposure to a wide variety of bacteria, viruses, fungi, parasites, and endotoxins.



Nephros Ultrafilter pore size: 40X smaller than conventional filters

Growth Platforms

<u>Water Filtration</u>

Growth should be driven by increased sales of the company's high performance water purification for medical facilities (primarily hospitals and dialysis centers) and commercial facilities (anywhere there is a need for filtration and purification of water for consumption, such as ice machines and soft drink dispensers).

The primary purpose of NEPH's products in a medical setting is the filtration of water for washing and drinking in order to enhance infection control. The company's filters produce water that is suitable for wound cleansing, cleaning of equipment used in medical procedures, and washing of surgeons' hands, etc. Sales growth should primarily be driven by increased penetration of US hospitals and dialysis centers, the company's primary customer base, as well as experiencing increased usage from existing customers – increased recurring revenues from replacement of previously installed products at the end of their life cycle. We estimate NEPH has an approximate 5% penetration of the 12,000 US hospital/dialysis centers.

The company's product portfolio of high performance water purification filter/ultrafilters have obtained FDA 510 (k) clearance and are marketed as either a dual-stage or single stage product, and/or in-line for protection from water borne pathogens. Nephro's filters provide a longer product life cycle compared to conventional filters, thus reducing the annual cost of ownership as replacement frequency is less and labor costs are lower. As a consequence, there are fewer physical trips into high-risk areas of a hospital such as intensive care units, neonatal intensive care units, and burn and transplant units. NEPH's offerings are used to filter potable water that feed ice machines, sinks and showers, and sources that clean medical equipment, such as endoscope washers and surgical room humidifiers.

The company anticipates the addition of Legionella (a pathogenic group of gram-negative bacteria) risk prevention measures to Centers for Medicare & Medicaid Services (CMS) site inspections of hospitals and long term care facilities should increase the focus of infection control personnel and facilities engineers across the hospital industry. This focus should provide an opportunity for the company to market and expand its customer base within US hospitals and dialysis centers.

In dialysis centers, Nephros' sells FDA 510(k) cleared ultrafilters that are designed to be used to filter water or bi-carbonate used in providing hemodialysis (a dialysis machine and a special filter called an artificial kidney, or a dialyzer, used to clean a patient's blood) quality water or bicarbonate concentrate. The devices are not a complete water treatment system, but serve to remove biological contaminants. The company's ultrafilters are sold to be used in water lines and bicarbonate concentrate lines leading into dialysis machines and as a filter for portable reverse osmosis machines. The products can last up to 12-months.

The company has FDA 510(k) clearance to market its EndoPur 0.005-micron cartridge ultrafilter. The product offers single-stage protection from bacteria, viruses, and endotoxins and can last up to 12-months. It is primarily used to filter water following treatment with a reverse osmosis (RO) system typical in large RO systems that can provide ultrapure water to an entire dialysis clinic.

For the commercial market, the company manufactures and sells water filters that improve the taste and odor of water, as well as reducing biofilm, bacteria, and scale build-up in equipment. The company's products are marketed to healthcare facilities, food service, hospitality, and convenience stores, under both the NanoGuard® and AETHER® brands.

The commercial NanoGuard product line provides ultrafiltration (0.005-micron) technology that filters bacteria and viruses from water. The 2018 acquisition of the Aether brand of filters expanded the company's product line and increased its water filtration and purification technologies to include improving odor, taste, and reducing scale and heavy metals from filtered water. The Aether filtration systems are primary sold to hotels, convenience stores, and quick service restaurants, which are new verticals for the company's offerings. The primary competition for Aether products is 3M's Cuno® brand and Pentair's Everpure® brand. In 2019, incremental revenue from the sale of Aether products was approximately $738,000.

Pathogen Detection

In January 2020, Nephros announced it launched its first pathogen detection system, called PluraPath. PluraPath is a portable, real-time system designed to provide actionable data for infection control teams (primarily in a hospital setting) on up to 15 different pathogens from a single water sample, in approximately one hour. The benefits of this pathogen detection system is it will be possible to map and track the changes to levels of multiple bacterial and viral pathogens in a building's water system on a real-time basis, at cost levels equivalent to assays that take 24-72 hours or more. The company anticipates use of this system will enable infection control teams to quickly assess approximate levels of a broad array of pathogens in their water systems, and optimally focus their secondary disinfection efforts and point-of-use filtration. Initially the company will be working with strategic distributors to provide capability demonstrations to medical facilities across the country.

In development are two additional pathogen detection systems. The DialyPath pathogen detection system will provide a real-time testing solution for the dialysis market. The system will be similar to its PluraPath real-time, portable, water pathogen detection system but also includes a gram-negative DNA marker test and tests for six different gram-negative bacteria. The system is designed to provide data on two test samples in one run in less than one hour. The pathogen detection and endotoxin estimation system is targeted to be launched during the summer of 2020. Also under development is the SequaPath system and building biome (a large naturally occurring community of flora and fauna occupying a major habitat) mapping service. Initially the company will be focused on the hospital customers of their strategic partners.

Specialty Renal Products

Nephros was founded based on its 1st generation Hemodiafiltration HDF device. The company's 1st generation device was developed as an alternative dialysis modality that combines the benefits of standard hemodialysis and HF into a single therapy by clearing toxins using both diffusion and convection. This first-generation product is the only US Food and Drug Administration 510(k) cleared medical device that enables nephrologists to provide HDF treatment to patients with end stage renal disease. HDF is a form of renal replacement therapy that when compared with standard hemodialysis, removes more middle-molecular-weight solutes. While HDF is not widely used in the US, it is used in Europe.

In 2018, a new subsidiary was formed, Specialty Renal Products, Inc. (which is 62.5% owned by NEPH) to develop its second-generation Hemodiafiltration (HDF) system. The 2nd generation HDF system has been constructed and is being funded through funds directly raised by the subsidiary. Once FDA 510(k) clearance is received, marketing of the new HDF system will commence in the US. Submission of the 510(k) is expected in the summer of 2020.

The goal of the 2nd generation HDF system is to reduce setup and changeover times by 90%, space requirements by at least 80%, and system costs by 95%. The new system should also eliminate nightly maintenance and be easier to operate. In order to make the 2nd generation HDF more efficient and marketable to dialysis healthcare facilities, it is being designed as an attachment to an existing hemodialysis (HD) machine. The 2nd generation device needs disposable filters and tube sets in order to operate.

Projections

Basis of Forecast

The primary growth driver is an expansion of the company's reseller network, which in turn should increase the company's customers for its portfolio of high performance water purification products. The leverage that the company should experience from a growing number of customers using its products is that once a defined replacement cycle exists (depending on the type of product purchased), a recurring revenue stream should be sustained during our forecast period. In 2019 recurring revenue was $6.4 million or approximately 62% of total revenue.

In February 2020, NEPH announced it anticipates revenue of at least $14.5 million with the potential of reaching $15.5 million. Revenue growth should be being driven by hospital customers, distribution partnerships, and the launch of pathogen detection systems. Also, driving growth are increased sales as the company products are used to respond to water borne disease outbreaks in hospitals.

We anticipate the company's core operations in 2020 and 2021 are likely to maintain or even exceed breakeven on a cash basis. However, the investments being made in the Specialty Renal Products subsidiary and spending to develop and launch its waterborne pathogen detection systems should result in operating losses of $2.1 million and cash burn of $850,000 in 2020. In 2021, we forecast operating losses narrowing to $1.1 million, with cash burn of approximately $161,000.

We anticipate gross margin expansion to 59.6% in 2021, up from an estimated 59.2% in 2020 and 58.9% in 2019. The gross margin improvement should be due primarily to the increase in recurring revenue from the replacement lifecycle of the company's high performance water purification products.

In 2021, we project operating expenses of $14 million, up from an estimated $11 million in 2020 due primarily to costs associated with the launch and development of NEPH's waterborne pathogen detection systems and its 2nd generation renal device.

Operations – 2020

We project revenue increasing 45.2% to $15 million (prior was $15.3 million) due primarily to the company's customer base expanding to include companies within the food service, convenience store, and hospitality industries, as well as the January 2020 launch of its PluraPath real-time, portable, water pathogen detection system into its existing hospital customers. We also anticipate a higher base of recurring revenue due primarily to rapid sales growth in 2H19 and a 94% customer retention rate. The small revenue decrease from our prior forecast is due to less revenue from the company's 2nd generation Hemodiafiltration device, that could start generating revenue in 4Q20 after FDA clearance is received, which should be after the 510(k) submission during the summer of 2020.

Gross profit should increase 46% to $8.9 million reflecting revenue growth and gross margin expansion to 59.2% compared to 58.9% in 2019. The improvement in gross margin primarily reflects an increase in recurring revenue from existing customers.

We project the operating loss narrowing to $2.1 million from $3.2 million in 2019 as operating expense margin improves to 73.4% from an estimated 89.4% in 2019. We anticipate operating expenses increasing by 19.2% to $11 million to support sales growth. We project SG&A expense increasing 26.7% to $7.8 million due primarily to higher compensation costs and the implementation of marketing initiatives to support the growth of newly launched products. We anticipate flat R&D expense of $3.1 million.

Non-operating interest expense should decrease to $120,000 compared to $195,000 due to lower debt balances. We project a net loss of $2.5 million or ($0.28) per share. We previously projected a net loss of $2.6 million or ($0.33) per share. The change in our loss per share forecast reflects a higher than anticipated average share count of 9 million compared to 8 million previously.

Finances – 2020

We project cash burn of $850,000 and an increase in working capital of $1.5 million. The increase in working capital is due primarily to increases in inventory and receivables. Net proceeds of approximately $6.8 million from the issuance of common stock should cover cash used in operations of $2.3 million, capital expenses and the repayment of debt. Cash should increase by $3.4 million to $7.6 million at December 31, 2020.

Operations – 2021

We project revenue increasing 44.8% to $21.7 million reflecting the company's expanding customer base, an increase in recurring revenue, as well as growth in the company's pathogen detection devices (PluraPath, DialyPath, and SequaPath). The company's 2nd generation Hemodiafiltration device should have revenue growth assuming after FDA clearance is received.

Gross profit should increase 45.4% to $12.9 million reflecting revenue growth and gross margin expansion to 59.6% compared to an estimated 59.2% in 2020.

We project the operating loss narrowing to $1.1 million from an estimated loss of $2.1 million in 2020 as operating expense margin improves to 64.5% from an estimated 73.4% in 2020. We anticipate operating expenses increasing by 27.1% to $14 million to support sales growth. We project SG&A expense increasing 37.4% to $10.7 million due primarily to higher compensation costs and marketing initiatives to support the growth of products launched in 2020. We anticipate R&D expense increasing $100,000 to $3.2 million.

Non-operating interest expense should decrease to $80,000 compared to an estimated $120,000 due to lower debt balances. We project a net loss of $1.4 million or ($0.15) per share.

Finances – 2021
We project cash burn of $161,000 and an increase in working capital of $923,000. The increase in working capital is due primarily to increases in receivables and inventory, partly offset by an increase in payables. Cash used in operations of $923,000, capital expenses and the repayment of debt should decrease cash by $1.7 million to $5.9 million at December 31, 2021.

2019 and 4Q19 Results

2019
Total revenue increased 81.7% to $10.3 million compared to $5.7 million in the year-ago period. Revenue growth was due primarily to a quarterly customer retention rate of approximately 94%, new customer site acquisition averaging at least one per day, a 142% increase in the company's disease outbreak response business, and approximately $738,000 of incremental commercial revenue driven by the Aether acquisition. Recurring revenue from the company's customer base accounted for approximately $6.4 million, or 62% of total revenues.

Gross profit increased 89.9% to $6.1 million compared to $3.2 million reflecting sales growth and expansion of gross margin to 58.9% from 56.3% in the year-ago period. Gross margin expansion was due primarily to a volume discount from its manufacturer of approximately $135,000 and decreases of approximately $113,000 in inventory reserves for expiring items and physical count inventory adjustments.

Operating expenses increased 48.6% to $9.2 million from $6.2 million in 2018. Total R&D expenses for the water filtration and renal product segments combined increased to nearly $3.1 million from $1.5 million. The doubling of total R&D expense was due primarily to the development of the company's pathogen detection systems and increased headcount associated with filter research and development, as well as increased spending on the development of the company's 2nd generation HDF product in its renal product segment (a $642,000 increase to nearly $1.4 million). R&D in the water filtration segment increased to $1.7 million from $808,000 in 2018.

SG&A expenses increased 35.5% to $6.1 million from $4.5 million due primarily to increases in headcount (an increase of $889,000), professional and marketing fees (an increase of $243,000), stock-based compensation (an increase of $198,000), travel expenses (an increase of $67,000), and increased other expenses related to rent and expanded warehouse capabilities (an increase of $216,000). The increases were offset in part by a reduction in legal expense related to the 2018 formation of SPR (renal products) subsidiary.

D&A expense was $186,000 versus $163,000 in 2018. The company had a change in fair value of contingent consideration of approximately $156,000 due to lower than expected lower than expected Aether performance.

Non-operating expense was $249,000 compared to $402,000 in the year-ago period. Interest expense increased to $195,000 from $168,000 due primarily to accretion of contingent consideration, offset in part by lower debt balances. Other expense increased to $54,000 compared to $35,000 in 2018 due primarily to foreign currency transaction losses. The year ago period had loss on extinguishment of debt expense of $199,000 compared to none in 2019.

The net loss was $3.4 million or ($0.45) after a non-controlling interest loss of $241,000 compared to a loss of $3.4 million or ($0.50) per share. In 2018, there was a non-controlling interest loss of $77,000. Average shares increased to 7.5 million from 6.8 million in 2018. We projected a net loss of $4.4 million or ($0.58) per share on revenue of $9.7 million.

4Q19
Total revenue increased 96.1% to $3.2 million compared to $1.6 million in the year-ago period.

Gross profit nearly doubled to $1.9 million compared to $954 million reflecting higher sales and gross margin expansion to 60.1% from 59.2% in the year-ago period.

Total operating expenses increased 30.2% to $2.2 million from $1.7 million. R&D expenses increased 40% to $764,000 and SG&A expenses increased 30% to $1.4 million. D&A expense was $44,000 compared to $40,000 in 4Q18.

Non-operating expense was $78,000 compared to $28,000 in the year-ago period. Interest expense increased to $55,000 from $25,000 due primarily to the accretion of contingent consideration.

The net loss was $205,000 or ($0.03) after a non-controlling interest loss of $61,000 compared to a loss of $725,000 or ($0.09) per share. In 4Q18, there was a non-controlling interest loss of $61,000.

Finances
In 2019, cash burn was $1.7 million with a $580,000 increase in working capital resulting in cash used in operations of $2.3 million. The increase in working capital was due primarily to an increase in inventory and prepaid expenses. Cash used in operations, acquisition costs, and repayment of debt was more than offset by nearly $2 million in gross proceeds from the issuance of common stock and $752,000 in cash from the exercise of warrants and stock options. Cash decreased by $415,000 to $4.2 million at December 31, 2019.

Capital Structure
On August 17, 2017, the company entered into a loan agreement with Tech Capital, providing for a secured asset-based revolving credit facility of up to $1 million, which is payable monthly based on the average daily outstanding balance at a rate equal to 3.5% plus the prime rate per annum (prime rate will not be less than 4.25%). At December 31, 2019, the outstanding balance was $560,000 and the annual interest rate was 8.25%. NEPH granted to Tech Capital a first priority security interest in its assets, including its accounts receivable and inventory, to secure all of its obligations. In December 2018, the party's entered into a first modification to the agreement which increased the senior secured asset-based revolving credit facility from to $2.5 million from $1 million.

On March 27, 2018, NEPH entered into a secured promissory note with Tech Capital, LLC for a principal amount of approximately $1.2 million. At December 31, 2019, the principal balance was $825,000 million. The note matures on April 1, 2023 and the unpaid principal accrues annual interest at 8%.

In February 2020, the company sold 937,500 shares of common stock at $8.00 per share for aggregate proceeds of $7.5 million (net proceeds after underwriting discounts and offering expenses were nearly $6.8 million). The shares were offered pursuant to an effective shelf registration statement. Proceeds will be used for working capital and general corporate purposes.

Market Briefs

Hospitals
A 2019 statistical report published by the American Hospital Association estimates there are over 6,200 hospitals with approximately 931,000 beds that are staffed. Growth in US hospitals and beds are likely to be attributable to the aging US population, as demand for hospital services should increase.

According to the US Office of Disease Prevention and Health Promotion, healthcare associated infections (HAI) at any given time affect approximately 1 out of every 25-hospital patients. These infections can lead to the loss of life and is estimated to cost the US health care system billions of dollars each year. One cause of HAI's is from waterborne bacteria and viruses. Bacteria and viruses can be present in the aging infrastructure of a healthcare facilities plumbing system. One strategic benefit that has the potential to benefit Nephros' efforts to sell its products to US hospitals (currently we estimate the company has 600 hospital customers) was the issuance in 2017 by the Center for Clinical Standards and Quality at the Centers for Medicare and Medicaid Services (CMS) in which CMS surveyors will review policies, procedures, and reports documenting water management implementation results to verify that facilities are compliant with existing requirements.

The US Office of Disease Prevention and Health Promotion's Healthy People 2020 initiative is driving additional awareness regarding HAI. HAIs occur in all types of care settings, including acute care hospitals, ambulatory surgical centers, dialysis facilities, outpatient care, and long-term care facilities such as nursing homes and rehabilitation facilities. The Healthy People 2020 initiative reflects the commitment of the US Department of Health and Human Services (HHS) to prevent HAIs.

Dialysis Centers

Dialysis clinics need to have dedicated water purification systems to produce water and bicarbonate concentrate, two essential ingredients for making dialysate (the liquid that removes waste material from the blood). According to the American Journal of Kidney Diseases, there are approximately 6,300 dialysis clinics in the United States. According to 2015 statistics from the National Institute of Diabetes and Digestive and Kidney Diseases, there are more than 661,000 Americans afflicted with kidney failure, of which 468,000 individuals are on dialysis, and roughly 193,000 live with a functioning kidney transplant. Nephros estimates there are over 100,000 hemodialysis machines in operation in the US. NEPH's 2nd generation HDF offering should be marketed as an upgrade to existing hemodialyis machines, thus avoiding a large capital investment for a whole new HDF machine from larger competitors.

Hospitality/Food Services

IBISWorld has an all-encompassing report for what they call the US Accommodation and Food Services industry, which is primarily comprised of companies in the hospitality (hotels, casinos, etc.) and food services (restaurants, convenience stores, etc.). IBISWorld anticipates the number of establishments in 2025 for this industry of more than 1.3 million, up from under 1.1 million in 2018. While growth is good, the overall number of establishments is key to Nephros' growth as they have very little penetration in the market. A small increase in hospitality/food service customers should make a significant impact to top line results.

Competitive Landscape

The water filtration market has well established companies that manufacture point-of-use microfiltration products such as Pall Corporation (a subsidiary of Danaher Corporation), and that manufacture the Cuno® and Everpure® brands of water filtration and purification products, such as 3M and Pentair, respectively. Nephros competes within the water filtration market by developing and marketing products that are designed to meet critical and specific customer needs more effectively than devices on the market. The company's new PluraPath pathogen detection system (launched in January 2020) will compete in the approximately $8 billion global water testing market. Portable, real-time water testing, is a new market, with few competitors, however, the company has identified Spartan Bioscience as a potential competitor.

The markets in which the company sells its commercial dialysis center products are highly competitive. The competition includes publicly traded companies such as Baxter International Inc., Fresenius Medical Care AG, Asahi Kasei Medical Co. Ltd., Terumo Medical Corporation and Toray Medical Co., Ltd., and international companies not publicly traded in the US such as B. Braun Melsungen AG, Nipro Medical Corporation Ltd., and Nikkiso Co., Ltd.

The company's 62.5% owned subsidiary, Specialty Renal Products, a development stage company focused on improving therapies for patients with renal disease, faces intense competition within the dialyzer and renal replacement therapy market. The company's success in this market will be dependant on its ability to meet the clinical goals of nephrologists, improve patient outcomes, and remain cost-effective for payers. The company competes with other suppliers of End-Stage Renal Disease (ESRD) therapies, supplies, and services. Suppliers include publicly traded companies Fresenius Medical Care AG and Baxter International, Inc., who are two of the primary machine manufacturers in hemodialysis.

Risks

In our view, these are the principal risks underlying the stock.

Operating Losses

Nephros Inc. has yet to turn profitable. At December 31, 2019, the company's accumulated deficit was $127.3 million, up from $124.2 million in 2018. Losses are likely to continue but diminish through our forecast period. In 4Q19, the company's water filtration business segment's net loss narrowed to $144,000 from $272,000 in the year-ago period. The lack of profitability could result in the company's inability to execute its growth strategy and diminish its operations.

Compliance

The company's operations have a significant compliance burden under the FDC Act (set of laws giving authority to the US Food and Drug Administration (FDA) to oversee the safety of food, drugs, medical devices, and cosmetics) and other applicable statutes and regulations which govern the testing, labeling, storage, record keeping, distribution, sale, marketing, advertising and promotion of Nephro's medically approved products. A violation of the FDC Act or other regulatory requirements at any time during or after the product development and/or approval process could subject NEPH to enforcement actions by the FDA or other agencies.

Product Liability

The production, marketing and sale of kidney dialysis and water-filtration products have liability risks in the event of product failure or claim of harm caused by the products operation. Voluntary recalls could subject the company to claims or proceedings by consumers, the FDA or other regulatory authorities, which would adversely impact future sales and revenues. Also, meritless claims of product liability may be costly to defend against. While the company does have product liability insurance, it may not be able to maintain this insurance on acceptable terms or at all.

Regulatory Approval

NEPH cannot ensure that any existing product(s) that have not yet been approved, or any new products developed in the future, will be approved for marketing. The clearance and/or approval processes are lengthy and uncertain and can require substantial financial resources, as well as management's time and effort. As a result, the company's global sales efforts may be slow to materialize and could drain financial resources to continue the development of new products for sale in the US.

Intellectual Property

Success depends in part on the ability to protect the intellectual property for its technology through patents. NEPH will only be able to protect its products and methods from unauthorized use by third parties to the extent that the products and methods developed are covered by valid and enforceable patents or are effectively maintained as trade secrets. The company has been granted 12 US patents that will expire at various times through 2027, assuming they are properly maintained. The company has two pending patent applications in the US that relate to a range of filter technologies.

Licensing Agreement

In 2012, Nephros entered into a licensing and supply agreement with Medica S.p.A., an Italy-based medical product manufacturing company for the marketing and sale of certain filtration products based upon their proprietary Medisulfone ultrafiltration technology. The license and supply agreement with Medica expires on December 31, 2025. During the period (April 2014 through December 31, 2025), the company will pay Medica a royalty rate of 3% of net sales of the filtration products sold.

510(k) Regulations

Before a new medical device can be introduced to the market, FDA clearance of a pre-market notification under Section 510(k) of the FDC Act or FDA clearance of a pre-market approval application under Section 515 of the FDC Act must be obtained. A 510(k) clearance will be granted if the submitted information establishes that the proposed device is substantially equivalent to a legally marketed medical device or to a medical device for which the FDA has not called for pre-market approval under Section 515. The Section 510(k) pre-market clearance process is generally faster and simpler than the Section 515 pre-market approval process. The company's filters and ultrafilters are medical devices that have gone through the 510(k) approval process.

Any devices cleared through the 510(k) process, modifications or enhancements that could significantly affect the safety or effectiveness of the device or that constitute a major change to the intended use of the device will require a new 510(k) pre-market notification submission. If the company seeks to obtain Section 510(k) pre-market clearance for any of its new or modified devices or filtration products, it would need to submit another 510(k) pre-market notification that could be costly and time consuming and may divert financial and management resources from products already approved and generating revenue in the US.

Supply Chain

The 2020 coronavirus outbreak in Italy may impact the company's supply chain, which could adversely affect sales and revenues if NEPH is unable to obtain sufficient inventory of products.

The company currently sources substantially all of its products from Medica, which is located in Italy. The extent to which the coronavirus impacts the company's results will depend on future developments, which are highly uncertain and cannot be predicted, including new information which may emerge concerning the severity of the coronavirus and the actions to contain the coronavirus or treat its impact, among others. However, to mitigate a potential disruption, the company is increasing inventory levels in order to lessen any type of potential future disruptions.

Shareholder Control

All executive officers and directors own 6.8% of the outstanding voting stock (March 2019). Two large investors own 56% of NEPH's outstanding voting stock. These owners could greatly influence the outcome of matters requiring stockholder approval, which decisions may or may not be in the best interests of the other shareholders.

Miscellaneous Risk

The company's financial results and equity values are subject to other risks and uncertainties, including competition, operations, financial markets, regulatory risk, and/or other events. These risks may cause actual results to differ from expected results.

Trading Volume

Based on our calculations, the average daily-volume in 2019 was 8,000 shares. During the three months to March 4, 2020, volume increased to nearly 12,700. The company has a float of approximately 7 million shares and shares outstanding of 9 million as of February 20, 2020.

Nephros, Inc.
Consolidated Balance Sheets
FY2017 – FY2021E
(in thousands)

	FY17A	FY18A	FY19A	**FY20E**	**FY21E**
ASSETS					
Current assets:					
Cash	$ 2,194	$ 4,581	$ 4,166	**$ 7,590**	**$ 5,936**
Accounts receivable, net	836	1,452	1,045	**1,583**	**2,232**
Investment in lease, net	20	-	-	**-**	**-**
Inventory, net	674	1,864	2,562	**3,497**	**3,904**
Prepaid expenses and other current assets	85	276	526	**600**	**652**
Total current assets	3,809	8,173	8,299	**13,270**	**12,724**
Property and equipment, net	52	91	81	**85**	**90**
Investment in lease, net and operating lease right-of-use assets	39	-	1,106	**1,348**	**1,348**
Intangible assets	-	590	548	**548**	**548**
Goodwill	-	748	759	**750**	**740**
License and supply agreement, net	1,072	938	804	**804**	**804**
Other assets	11	18	32	**30**	**30**
Total assets	$ 4,983	$ 10,558	$ 11,629	**$ 16,835**	**$ 16,284**
LIABILITIES AND STOCKHOLDERS' EQUITY					
Current liabilities:					
Secured revolving credit facility	711	991	560	**500**	**250**
Secured note payable	-	195	211	**249**	**269**
Accounts payable	872	836	959	**1,020**	**1,220**
Accrued expenses	218	396	136	**150**	**434**
Contingent consideration	-	236	300	**300**	**-**
Operating lease liabilities	-	-	262	**262**	**262**
Deferred revenue	70	-	-	**-**	**-**
Total current liabilities	1,871	2,654	2,428	**2,481**	**2,436**
Secured note payable, net	-	843	613	**364**	**95**
Equipment financing debt, net	-	-	10	**10**	**10**
Contingent consideration, net	-	263	-	**-**	**-**
Long-term operating lease liabilities	-	-	889	**889**	**889**
Unsecured long-term note payable, net	954	-	-	**-**	**-**
Long-term portion of deferred revenue	208	-	-	**-**	**-**
Stockholders' equity:					
Common stock,$.001 par value; authorized 90,000,000 shares;	6	7	8	**9**	**9**
Additional paid-in capital	122,973	127,873	131,934	**139,699**	**140,499**
Accumulated other comprehensive income	77	71	65	**65**	**65**
Retained earnings (accumulated deficit)	(121,106)	(124,153)	(127,332)	**(129,582)**	**(130,718)**
Total stockholders' equity	1,950	3,798	4,675	**10,191**	**9,855**
Noncontrolling interest	-	3,000	3,014	**2,900**	**3,000**
Total liabilities and stockholders' equity	$ 4,983	$ 10,558	$ 11,629	**$ 16,835**	**$ 16,284**
SHARES OUT	55,293	7,180	8,059	**9,025**	**9,050**

Source: Company reports and Taglich Brothers estimates

Nephros, Inc.
Annual Income Statement
FY2017 – FY2021E
(in thousands)

	FY17 A	FY18 A	FY19 A	**FY20 E**	**FY21 E**
Total Revenue - Product and License, royalty, other	$ 3,809	$ 5,687	$ 10,334	**$ 15,000**	**$ 21,719**
Total Cost of sales	1,517	2,484	4,250	**6,120**	**8,785**
Gross Profit	2,292	3,203	6,084	**8,880**	**12,934**
Operating Expenses:					
Research and development	1,002	1,539	3,090	**3,100**	**3,200**
Depreciation and amortization	218	163	186	**160**	**140**
Selling, general, and administrative	3,298	4,517	6,119	**7,750**	**10,650**
Change in fair value of contingent consideration	-	-	(156)	-	-
Total Operating Expenses	4,518	6,219	9,239	**11,010**	**13,990**
Operating Income (loss)	(2,226)	(3,016)	(3,155)	**(2,130)**	**(1,056)**
Loss on extinguishment of debt	-	(199)	-	-	-
Interest (expense) income	(298)	(168)	(195)	**(120)**	**(80)**
Other income (expense)	(74)	(35)	(54)	-	-
Total Other Income (expense)	(372)	(402)	(249)	**(120)**	**(80)**
Pre-Tax Income (loss)	(2,598)	(3,418)	(3,404)	**(2,250)**	**(1,136)**
Income Tax Expense (Benefit)	(1,789)	(93)	(225)	-	-
Net income (loss)	(809)	(3,325)	(3,179)	**(2,250)**	**(1,136)**
Undeclared deemed dividend - Non-controlling interest	-	(77)	(241)	**(240)**	**(240)**
Net income (loss) - attributable to Nephros, Inc.	$ (809)	$ (3,402)	$ (3,420)	**$ (2,490)**	**$ (1,376)**
Earning (loss) per share	$ (0.14)	$ (0.50)	$ (0.45)	**$ (0.28)**	**$ (0.15)**
Avg Shares Outstanding	5,882	6,847	7,542	**9,018**	**9,151**
EBITDA - Adjusted - includes renal subsidiary	$ (1,216)	$ (1,734)	$ (1,235)	**$ (430)**	**$ 544**
Margin Analysis					
Gross margin	60.2%	56.3%	58.9%	**59.2%**	**59.6%**
Research & Development	26.3%	27.1%	29.9%	**20.7%**	**14.7%**
Selling, general, and administrative	86.6%	79.4%	59.2%	**51.7%**	**49.0%**
Operating margin	(58.4%)	(53.0%)	(30.5%)	**(14.2%)**	**(4.9%)**
Pre-tax margin	(68.2%)	(60.1%)	(32.9%)	**(15.0%)**	**(5.2%)**
Tax rate	68.9%	2.7%	6.6%	**0.0%**	**0.0%**
YEAR / YEAR GROWTH					
Total Revenues	64.2%	49.3%	81.7%	**45.2%**	**44.8%**

Source: Company reports and Taglich Brothers estimates

Nephros, Inc.
Income Statement Model
Quarters FY2019A – 2021E
(in thousands)

	Q1 19 A	Q2 19 A	Q3 19 A	Q4 19 A	FY19 A	Q1 20 E	Q2 20 E	Q3 20 E	Q4 20 E	**FY20 E**	Q1 21 E	Q2 21 E	Q3 21 E	Q4 21 E	**FY21 E**
Total Revenue - Product and License, royalty, other	$ 1,769	$ 2,309	$ 3,095	$ 3,161	$ 10,334	$ 2,675	$ 3,400	$ 4,375	$ 4,550	**$ 15,000**	$ 3,630	$ 4,700	$ 6,588	$ 6,800	**$ 21,719**
Total Cost of sales	771	942	1,276	1,261	4,250	1,225	1,385	1,725	1,785	**6,120**	1,600	1,900	2,585	2,700	**8,785**
Gross Profit	998	1,367	1,819	1,900	6,084	1,450	2,015	2,650	2,765	**8,880**	2,030	2,800	4,003	4,100	**12,934**
Operating Expenses:															
Research and development	756	793	777	764	3,090	775	775	775	775	**3,100**	800	800	800	800	**3,200**
Depreciation and amortization	50	48	44	44	186	40	40	40	40	**160**	35	35	35	35	**140**
Selling, general, and administrative	1,503	1,403	1,787	1,426	6,119	1,600	1,850	2,200	2,100	**7,750**	2,150	2,350	3,050	3,100	**10,650**
Change in fair value of contingent consideration	(10)	(9)	(94)	(43)	(156)	-	-	-	-	-	-	-	-	-	-
Total Operating Expenses	2,299	2,235	2,514	2,191	9,239	2,415	2,665	3,015	2,915	**11,010**	2,985	3,185	3,885	3,935	**13,990**
Operating Income (loss)	(1,301)	(868)	(695)	(291)	(3,155)	(965)	(650)	(365)	(150)	**(2,130)**	(955)	(385)	118	165	**(1,056)**
Loss on extinguishment of debt	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Interest (expense) income	(46)	(46)	(48)	(55)	(195)	(30)	(30)	(30)	(30)	**(120)**	(20)	(20)	(20)	(20)	**(80)**
Other income (expense)	(2)	(28)	(1)	(23)	(54)	-	-	-	-	-	-	-	-	-	-
Total Other Income (expense)	(48)	(74)	(49)	(78)	(249)	(30)	(30)	(30)	(30)	**(120)**	(20)	(20)	(20)	(20)	**(80)**
Pre-Tax Income (loss)	(1,349)	(942)	(744)	(369)	(3,404)	(995)	(680)	(395)	(180)	**(2,250)**	(975)	(405)	98	145	**(1,136)**
Income Tax Expense (Benefit)	-	-	-	(225)	(225)	-	-	-	-	-	-	-	-	-	-
Net income (loss)	(1,349)	(942)	(744)	(144)	(3,179)	(995)	(680)	(395)	(180)	**(2,250)**	(975)	(405)	98	145	**(1,136)**
Undeclared deemed dividend - Non-controlling interest	(59)	(61)	(60)	(61)	(241)	(60)	(60)	(60)	(60)	**(240)**	(60)	(60)	(60)	(60)	**(240)**
Net income (loss) - attributable to Nephros, Inc.	$ (1,408)	$ (1,003)	$ (804)	$ (205)	$ (3,420)	$ (1,055)	$ (740)	$ (455)	$ (240)	**$ (2,490)**	$ (1,035)	$ (465)	$ 38	$ 85	**$ (1,376)**
Earning (loss) per share	$ (0.20)	$ (0.14)	$ (0.10)	$ (0.03)	$ (0.45)	$ (0.12)	$ (0.08)	$ (0.05)	$ (0.03)	**$ (0.28)**	$ (0.11)	$ (0.05)	$ 0.00	$ 0.01	**$ (0.15)**
Avg Shares Outstanding	7,130	7,388	7,703	7,949	7,542	9,010	9,015	9,020	9,025	**9,018**	9,030	9,035	9,040	9,500	**9,151**
EBITDA - Adjusted - includes renal subsidiary	$ (880)	$ (522)	$ (209)	$ 376	$ (1,235)	$ (540)	$ (225)	$ 60	$ 275	**$ (430)**	$ (555)	$ 15	$ 518	$ 565	**$ 544**
Margin Analysis															
Gross margin	56.4%	59.2%	58.8%	60.1%	58.9%	54.2%	59.3%	60.6%	60.8%	**59.2%**	55.9%	59.6%	60.8%	60.3%	**59.6%**
Research & Development	42.7%	34.3%	25.1%	24.2%	29.9%	29.0%	22.8%	17.7%	17.0%	**20.7%**	22.0%	17.0%	12.1%	11.8%	**14.7%**
Selling, general, and administrative	85.0%	60.8%	57.7%	45.1%	59.2%	59.8%	54.4%	50.3%	46.2%	**51.7%**	59.2%	50.0%	46.3%	45.6%	**49.0%**
Operating margin	(73.5%)	(37.6%)	(22.5%)	(9.2%)	(30.5%)	(36.1%)	(19.1%)	(8.3%)	(3.3%)	**(14.2%)**	(26.3%)	(8.2%)	1.8%	2.4%	**(4.9%)**
Pre-tax margin	(76.3%)	(40.8%)	(24.0%)	(11.7%)	(32.9%)	(37.2%)	(20.0%)	(9.0%)	(4.0%)	**(15.0%)**	(26.8%)	(8.6%)	1.5%	2.1%	**(5.2%)**
Tax rate	0.0%	0.0%	0.0%	61.0%	6.6%	0.0%	0.0%	0.0%	0.0%	**0.0%**	0.0%	0.0%	0.0%	0.0%	**0.0%**
YEAR / YEAR GROWTH															
Total Revenues	79.6%	69.0%	79.5%	96.1%	81.7%	51.2%	60.2%	41.4%	43.9%	**45.2%**	35.7%	38.2%	50.6%	49.5%	**44.8%**

Source: Company reports and Taglich Brothers estimates

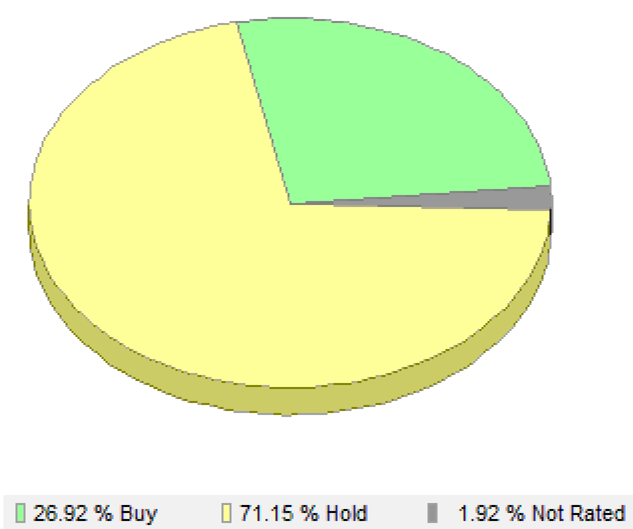
Nephros, Inc.
Cash Flow Statement
FY2017 – FY2021E
(in thousands)

	FY2017A	FY2018A	FY2019A	**FY2020E**	**FY2021E**
Cash Flows from Operating Activities					
Net Income (loss)	$ (809)	$ (3,325)	$ (3,179)	**$ (2,250)**	**$ (1,136)**
Depreciation of property and equipment	28	29	24	**20**	**20**
Amortization of license and supply agreement	190	134	176	**180**	**155**
Non-cash stock-based comopensation, including stock options/restricted stock	772	985	1,332	**1,200**	**800**
Loss on extinguishment of debt	-	199	-	-	-
Inventory reserve	-	70	37	-	-
Change in fair value of contingent consideration	-	-	(156)	-	-
Accretion of contingent consideration	-	-	51	-	-
Provision for bad debt expense	-	40	15	-	-
Amortization of debt discount	116	34	-	-	-
Loss on disposal of equipment	-	10	-	-	-
Loss on capital lease termination	-	11	-	-	-
Loss on foreign currency transactions	19	3	4	-	-
Cash earnings (burn)	316	(1,810)	(1,696)	**(850)**	**(161)**
Changes In:					
Accounts receivable	(416)	(391)	392	**(538)**	**(649)**
Inventory	(195)	(1,082)	(735)	**(935)**	**(407)**
Prepaid expenses and other current assets	30	(284)	(265)	**(74)**	**(52)**
Other assets	(10)	-	30	**2**	-
Accounts payable	268	(130)	119	**61**	**200**
Accrued expenses	-	35	(121)	**14**	**284**
Deferred revenue	(70)	-	-	-	**(300)**
(Increase)/decrease in Working Capital	(393)	(1,852)	(580)	**(1,470)**	**(923)**
Net cash provided by Operations	(77)	(3,662)	(2,276)	**(2,320)**	**(1,085)**
Cash Flows from Investing Activities					
Purchase of property and equipment	-	-	(14)	**(15)**	**(20)**
Aether Acquisition, net	-	(991)	(137)	-	-
Cash Flows from Investing Activities	-	(991)	(151)	**(15)**	**(20)**
Cash Flows from Financing Activities					
Proceeds from issuance of common stock, net	1,179	3,778	1,992	**6,765**	-
Issuance costs - common stock	-	-	-	**(735)**	-
Net proceeds (repayment) from secured revolving credit facility	711	280	(431)	**(60)**	-
Net proceeds (repayment) from equipment financing	-	-	12	-	-
Proceeds from sale of subsidiary preferred shares to noncontrolling interest	-	3,000	-	-	-
Payments on secured note payable	-	(149)	(214)	**(211)**	**(249)**
Payment of contingent consideration	-	-	(94)	-	**(300)**
Proceeds from issuance of secured note	-	1,187	-	-	-
Repayment of unsecured long-term not payable	-	(1,187)	-	-	-
Proceeds from exercise of warrants and stock options	100	138	752	-	-
Net cash provided (used) by Financing	1,990	7,047	2,017	**5,759**	**(549)**
Effect of exchange rates	6	(7)	(5)	-	-
Net change in Cash	1,919	2,387	(415)	**3,424**	**(1,654)**
Cash Beginning of Period	275	2,194	4,581	**4,166**	**7,590**
Cash End of Period	$ 2,194	$ 4,581	$ 4,166	**$ 7,590**	**$ 5,936**

Source: Company reports and Taglich Brothers estimates

Price Chart

Taglich Brothers Current Ratings Distribution



Investment Banking Services for Companies Covered in the Past 12 Months

Rating	#	%
Buy	1	5
Hold		
Sell		
Not Rated	1	50

Important Disclosures

As of the date of this report, we, our affiliates, any officer, director or stockholder, or any member of their families do not have a position in the stock of the company mentioned in this report. Taglich Brothers, Inc. does not currently have an Investment Banking relationship with the company mentioned in this report and was not a manager or co-manager of any offering for the company with in the last three years.

All research issued by Taglich Brothers, Inc. is based on public information. In March 2019, the company paid Taglich Brothers a monetary fee of $4,500 (USD) representing payment for the creation and dissemination of research reports for three months. Three-months after publication of the initial report, the company will begin paying Taglich Brothers a monthly monetary fee of $1,500 (USD) for the creation and dissemination of research reports for a minimum of twelve-months.

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Analyst Certification

I, Howard Halpern, the research analyst of this report, hereby certify that the views expressed in this report accurately reflect my personal views about the subject securities and issuers; and that no part of my compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in this report.

Public Companies mentioned in this report:

Asahi Kasei Corporation	(OTC: AHKSY)	3M Company	(NYSE: MMM)
Baxter International Inc.	(NYSE: BAX)	Pentair plc	(NYSE: PNR)
Danaher Corporation	(NYSE: DHR)	Terumo Corporation	(OTC: TRUMY)
Fresenius Medical Care AG & Co.	(NYSE: FMS)	Toray Industries, Inc.	(OTC: TRYIY)

Meaning of Ratings

Buy – The growth prospects, degree of investment risk, and valuation make the stock attractive relative to the general market or comparable stocks.

Speculative Buy – Long-term prospects of the company are promising but investment risk is significantly higher than it is in our BUY-rated stocks. Risk-reward considerations justify purchase mainly by high risk-tolerant accounts. In the short run, the stock may be subject to high volatility and could continue to trade at a discount to its market.

Neutral – Based on our outlook the stock is adequately valued. If investment risks are within acceptable parameters, this equity could remain a holding if already owned.

Sell – Based on our outlook the stock is significantly overvalued. A weak company or sector outlook and a high degree of investment risk make it likely that the stock will underperform relative to the general market.

Discontinued – Research coverage discontinued due to the acquisition of the company, termination of research services (includes non-payment for such services), diminished investor interest, or departure of the analyst.

Some notable Risks within the Microcap Market

Stocks in the Microcap segment of the market have many risks that are not as prevalent in Large-cap, Blue Chips or even Small-cap stocks. Often it is these risks that cause Microcap stocks to trade at discounts to their peers. The most common of these risks is liquidity risk, which is typically caused by small trading floats and very low trading volume which can lead to large spreads and high volatility in stock price. In addition, Microcaps tend to have significant company-specific risks that contribute to lower valuations. Investors need to be aware of the higher probability of financial default and higher degree of financial distress inherent in the microcap segment of the market.

From time to time our analysts may choose to withhold or suspend a rating on a company. We continue to publish informational reports on such companies; however, they have no ratings or price targets. In general, we will not rate any company that has too much business or financial uncertainty for our analysts to form an investment conclusion, or that is currently in the process of being acquired.