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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

NEPH $7.72 — (NASDAQ)

May 12, 2020

	2017 A	2018 A	2019 A	***2020 E***	***2021 E***
Revenue (in millions)	$3.8	$5.7	$10.3	***$11.5***	***$21.4***
Earnings (loss) per share	($0.14)	($0.50)	($0.45)	***($0.50)***	***($0.40)***

52-Week range	$11.35 – $4.42	Fiscal year ends:	December
Shares outstanding a/o 05/01/20	9.0 million	Revenue/shares (ttm)	$1.38
Approximate float	4.2 million	Price/Sales (ttm)	5.6X
Market Capitalization	$69.3 million	Price/Sales (2021) E	3.3X
Tangible Book value/shr	$1.03	Price/Earnings (ttm)	NMF
Price/Book	7.5X	Price/Earnings (2021) E	NMF

All per share figures adjusted for a 1-9 reverse stock split effective 7/9/19.

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 our Speculative Buy rating but reducing our 12-month price target to $13.50 per share from $15.50 per share due primarily to near-term COVID-19 conditions.

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. However, sales are likely to be muted in 2Q/3Q 2020 until US hospitals and dialysis centers resume normal operations once the COVID-19 pandemic eases. We anticipate growth to resume in 4Q20 due to pent up demand.

In 2020 the company is launching a series of pathogen detection systems, PluraPath™, DialyPath™, and SequaPath™. During the 2Q20/3Q20 period, the company will be laying the groundwork to aid its customer base utilizing these devices as the US economy reopens and testing of previously closed water systems will be necessary. We anticipate a significant revenue ramp in 2021.

NEPH reported** (on 05-7-20) **a 1Q20 loss of ($0.13) per share on 43% sales growth to $2.5 million. We projected a loss of ($0.12) per share on sales of $2.7 million. The 1Q19 loss was ($0.20) per share on sales of $1.8 million.

For 2020, we project a net loss of $4.5 million or ($0.50) per share on 11.1% revenue growth to $11.5 million. We previously projected a loss of $2.5 million or ($0.28) per share on sales of $15 million. Our reduced forecast reflects the impact of the COVID-19 pandemic primarily in 2Q/3Q 2020, with a move toward more normal operations for its customer base of US hospitals in 4Q20.

For 2021, we project a net loss of $3.6 million or ($0.40) per share on revenue growth of 86.6% to $21.4 million. We previously projected a loss of $1.4 million or ($0.15) per share on sales of $21.7 million. Our forecast reflects increased customer penetration at US hospital/dialysis centers, resumption of recurring revenue from existing customers that previously postponed filter purchases in 2020, as well as a significant revenue ramp from its pathogen detection systems. Our reduced EPS forecast is due primarily to higher than anticipated costs to support revenue growth.

Please view our Disclosures pages 14 – 16.

Appreciation Potential

Maintaining our Speculative Buy rating but reducing our 12-month price target to $13.50 per share from $15.50 per share due primarily to near-term COVID-19 conditions. Our price target should be supported by a resumption in revenue growth (as COVID-19 conditions ease) in the company's customer base (primarily hospitals and dialysis centers), increasing recurring revenues from existing customers in 2021, as well as a significant sales ramp from the company's three pathogen detection systems.

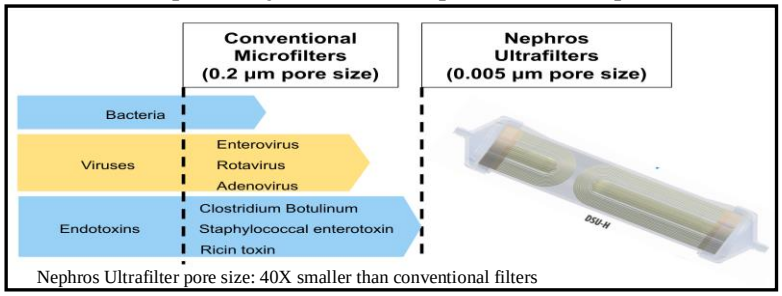
Our rating reflects anticipated growth from the company newest division (Pathogen Detection) that has significant potential given the current COVID-19 pandemic environment. In 2020, the company is launching its first three pathogen detection systems (PluraPath, DialyPath, and SequaPath) all three systems will compete in the approximately $8 billion global water testing market. 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 $13.50 per share implies shares could appreciate approximately 75% over the next twelve months. According to Yahoo Finance (a/o 5/11/20), the average trailing twelve-month and 2021 price-to-sales multiples for companies in the Healthcare Equipment and Supplies sectors are 4.3X (prior was 3.7X) and 3.98X (prior was 3.7X), respectively, on estimated 2021 sales growth of 7.3%. NEPH's trailing twelve-month and 2021 price-to-sales multiples are 5.6X (prior was 6.6X) and 3.3X (prior was 4.3X), respectively, on estimated 2021 sales per share growth of 84.1%. We anticipate investors are likely to accord a sales multiple that approaches double that of the industry due primarily to NEPH's sales growth compared to industry, restrained by COVID-19 pandemic conditions. We applied a sales multiple of 7X (prior was 7.5X) to our 2021 sales per share forecast of $2.37, discounted for execution risks, to obtain a year ahead price target of approximately $13.50 per share.

A higher valuation of Nephros is likely to be supported by rapid sales growth (i.e., approximately 56% 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 $3.3 million from an estimated $4.1 million in 2020. The company's cash burn should narrow to $2.1 million in 2021 from an estimated $3.1 million in 2020.

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

Divisions

Water Filtration - Division

Resumption of growth as COVID-19 pandemic conditions ease should be driven by increased sales of the company's high performance water purification for medical facilities (primarily hospitals and dialysis centers) and eventually 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 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.

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 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.

Pathogen Detection - Division

This new division has significant growth potential given the current COVID-19 pandemic environment. In 2020, the company is launching its first three pathogen detection systems (PluraPath – launched in January, DialyPath – launching in 2Q20, and SequaPath – launching in 2H20) all products will compete in the approximately $8 billion global water testing market. In the first few weeks after the PluraPath offering was launched in January 2020, sales to customers reached nearly $20,000 before the COVID-19 pandemic shutdown sales efforts. Once COVID-19 pandemic conditions ease, a significant ramp in sales is expected.

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.

The company's SequaPath system allows for building a biome (a large naturally occurring community of flora and fauna occupying a major habitat) mapping service. While the company initially was to focus sales to hospital customers of their strategic partners, the COVID-19 pandemic has changed its path to the market. Its strategic partners are likely to use the SequaPath system for its commercial customer base as previously shuttered office buildings, stadiums, and arenas reopen. Prior to reopening water system of facilities, they will need to be tested and mapped for potential contamination. The company plans on releasing White-papers detailing the proper use and utility of the SequaPath system.

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.

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.

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%, as well as reduce system costs by 95%. The new system should eliminate nightly maintenance and be easier to operate. The 2nd generation HDF system should be more efficient and marketable since 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 COVID-19 pandemic impact has negatively impacted NEPH's operations. Our forecast expects diminished sales through 3Q20. We anticipate a significant rebound in 4Q20 and a rapid acceleration of sales growth in 2021, as COVID-19 conditions enable company's end-users to return to more normal operations.

Near term conditions in 2Q/3Q 2020 should cause the company to experience decreased demand for its medical filtration products, which are targeted primarily to hospital customers. The decrease in near-term demand is due primarily to customers shifting their focus to matters related to the COVID-19 pandemic and de-prioritizing unrelated matters. These priority shifts are causing delays in expected orders in both new and existing customers, as well as the inability of sales personnel to meet with new potential customers due to shelter-in-place and other orders issued to address the spread of Covid-19 virus. The company's commercial filtration products, which are primarily targeted at the hospitality and food service markets, have seen a decrease in demand, due to the closure of many hotels and restaurants.

Once the COVID-19 pandemic crisis fades, the company should experience some positive impacts on demand for all its offerings, due especially to increased global awareness of infectious pathogens and the serious problems they cause. While purchase decisions for infection control filtration have been deferred, the pent up demand should result in strong order flow in 4Q20 and throughout 2021. The company's news division, Pathogen Detection Systems should experience strong demand due primarily to unoccupied buildings, including office buildings and hotels that will need to be reoccupied. Extended periods of low, or no water flow through building piping creates opportunities for biofilm propagation which is a problem the company's strategic partners are trained to eradicate. Commercial filtration products should also see increasing demand once hotels, casinos, and restaurants re-open. A significant growth driver in 2020 will be the resumption of sales meetings at new customer sites.

Operations – 2020

We project revenue increasing 11.1% to $11.5 million (prior was $15 million) due primarily to sales diminishing in 2Q/3Q 2020 stemming from the COVID-19 pandemic, partly offset by 1Q/4Q 2020 sales growth primarily from existing customer and revenue from its pathogen detection offerings. Our forecast still includes a small amount of revenue from the company's 2nd generation Hemodiafiltration device, which could occur in 4Q20 after FDA clearance is received, which should be after the 510(k) submission during the summer of 2020.

Gross profit should increase 6.6% to $6.5 million reflecting revenue growth, offset by gross margin contraction to 56.5% compared to 58.9% in 2019.

We project the operating loss increasing to $4.1 million from $3.2 million in 2019 as operating expense margin increases to 91.9% from 89.4% in 2019. We anticipate operating expenses increasing by 14.2% to $10.6 million to support current operations and future sales growth opportunities such as its pathogen detection systems. We project SG&A expense increasing 33.2% to $8.2 million due primarily to higher marketing initiatives in 2H20 to support the growth of newly launched products. We anticipate R&D expense decreasing $827,000 to $2.3 million.

Non-operating interest expense should decrease to $162,000 compared to $195,000 due to lower debt balances. We project a net loss of $4.5 million or ($0.50) per share. We previously projected a net loss of $2.5 million or ($0.28) per share. The increase in our loss per share forecast reflects lower than anticipated sales due to the COVID-19 pandemic.

Finances – 2020
We project cash burn of $3.1 million and an increase in working capital of $131,000. Net proceeds of approximately $6.8 million from the issuance of common stock should cover cash used in operations of $3.2 million, capital expenses and the repayment of debt. Cash should increase by $3.5 million to $7.7 million at December 31, 2020.

Operations – 2021
We project revenue increasing 86.6% to $21.4 million (prior was $21.7 million) reflecting pent up demand from the company's existing customer base due to the COVID-19 pandemic and resumption of obtaining new customers, as well as a significant contribution from 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 92.8% to $12.5 million reflecting revenue growth and gross margin expansion to 58.4% compared to an estimated 56.5% in 2020.

We project the operating loss narrowing to $3.3 million from an estimated loss of $4.1 million in 2020 as operating expense margin improves to 73.7% from an estimated 91.9% in 2020. We anticipate operating expenses increasing by 49.6% to $15.8 million to support sales growth from all three divisions. We project SG&A expense increasing 57.7% to $12.9 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 $537,000 to $2.8 million.

Non-operating interest expense should decrease to $80,000 compared to an estimated $162,000 due to lower debt balances. We project a net loss of $3.6 million or ($0.40) per share. We previously projected a net loss of $1.4 million or ($0.15) per share. The increase in our net loss forecast reflects higher operating costs than previously anticipated.

Finances – 2021
We project cash burn of $2.1 million and an increase in working capital of $815,000. The increase in working capital is due primarily to increases in receivables, partly offset by an increase in payables. Cash used in operations of $2.9 million, capital expenses and the repayment of debt should decrease cash by nearly $4 million to $3.7 million at December 31, 2021.

1Q20 Results

1Q20
Total revenue increased 43% to $2.5 million compared to $1.8 million in the year-ago period. Revenue growth was due primarily to increased product sales to existing customers. The Covid-19 pandemic did impact customer availability for sales meetings. Revenues from new customers were approximately 8% compared to a historical average of 37% over the previous four quarters.

Gross profit increased 49.4% to nearly $1.5 million compared to $998,000 reflecting higher sales and gross margins expansion to 59% from 56.4% in the year-ago period. The improvement in gross margin was due primarily to a decrease in expense related to inventory reserves for expiring items and physical count adjustments.

Operating expenses increased 9.5% to $2.5 million from $2.3 million in 1Q19. SG&A expenses increased 29.7% to nearly $2 million compared to $1.5 million in the year-ago period due primarily to increased headcount, investments in the company's pathogen detection, renal products, as well as sales and marketing, and logistics (supply chain transportation). Additional costs include increased regulatory fees associated with listing on the NASDAQ.

The increase in operating expense was offset in part by a decrease in R&D expenses of $193,000 to $563,000. The decrease in total R&D expense was due to reduced spending on the development of the company's 2nd generation HDF product in its renal product segment (a $210,000 decrease to $201,000) and reduced spending on pathogen detection devices since the devices are launching in 2020 (a $74,000 decrease to $52,000), partly offset by an increase in new water filter development (a $91,000 increase to $310,000). D&A expense was $46,000 compared to $50,000 in 1Q19. Operating expenses also included a change in fair value of contingent consideration of approximately $42,000 compared to $10,000 in the year-ago period due to lower than planned revenue performance of commercial filtration products.

Non-operating expense was $72,000 compared to $48,000 in the year-ago period. Interest expense, net of interest income decreased to $42,000 from $46,000 in the year-ago period. Other expense increased to $30,000 compared to $2,000 in 1Q19.

The net loss was $1.2 million or ($0.13) per share after a non-controlling interest loss of $59,000 compared to a loss of $1.4 million or ($0.20) per share after non-controlling interest loss of $59,000. We projected a net loss of $1.1 million or ($0.12) per share on revenue of $2.7 million.

Finances

In 1Q20, cash burn was $857,000 with a $983,000 increase in working capital resulting in cash used in operations of $1.8 million. The increase in working capital was due primarily to increases in receivables and inventory, partly offset by increases in payables and accruals. Cash used in operations, acquisition costs, and repayment of debt was more than covered by the issuance of nearly $6.8 million in common stock. Cash increased by nearly $4.8 million to nearly $9 million at March 31, 2020.

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 March 31, 2020, the outstanding balance was $495,000 and the annual interest rate was 6.75%. 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 March 31, 2020, the principal balance was $768,000 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.

On April 24, 2020, the NEPH received a loan of nearly $479,000 from the Coronavirus Aid, Relief and Economic Security Act (CARES Act). In connection with the loan, the company issued a $479,000 promissory note that

matures on April 24, 2022 and bears interest at a rate of 1.0% per annum. The company intends to use the entire amount for qualifying expenses, which may allow for certain amounts of the loan to be forgiven.

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.

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.

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. In 2020, the company is launching three new pathogen detection system (PluraPath – launched in January, DialyPath – launching in 2Q20, and SequaPath – launching in 2H20) all products 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 March 31, 2020, the company's accumulated deficit was $128.4 million, up from $127.3 million in 2019 and $124.2 million in 2018. Losses are likely to continue through our forecast period. The lack of profitability could result in the company's inability to execute its growth strategy and diminish its operations.

COVID-19 Pandemic
The COVID-19 global pandemic presents concerns that may dramatically affect the company's ability to conduct normal business operations (such as acquiring new customers or receiving orders from existing customers) effectively. While the trajectory of the COVID-19 pandemic remains uncertain, it is likely that NEPH's operations, including sales to new and existing customers, may be directly affected in 2Q/3Q 2020.

Supply Chain
The COVID-19 pandemic 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. However, to mitigate a potential disruption, the company is increasing inventory levels in order to lessen any type of potential future disruptions.

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 Nephros' 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.

Shareholder Control

All executive officers and directors own 8.2% of the outstanding voting stock (March 25, 2020). Two large investors own 47% 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 May 11, 2020, volume increased to nearly 19,500. The company has a float of approximately 4.2 million shares and shares outstanding of 9 million.

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

	FY17A	FY18A	FY19A	1Q20A	**FY20E**	**FY21E**
ASSETS						
Current assets:						
Cash	$ 2,194	$ 4,581	$ 4,166	$ 8,962	**$ 7,694**	**$ 3,731**
Accounts receivable, net	836	1,452	1,045	1,597	**1,116**	**1,785**
Investment in lease, net	20	-	-	-	**-**	**-**
Inventory, net	674	1,864	2,562	3,649	**2,954**	**2,973**
Prepaid expenses and other current assets	85	276	526	601	**459**	**536**
Total current assets	3,809	8,173	8,299	14,809	**12,223**	**9,025**
Property and equipment, net	52	91	81	76	**80**	**84**
Investment in lease, net and operating lease right-of-use assets	39	-	1,106	1,253	**1,253**	**1,253**
Intangible assets	-	590	548	538	**548**	**548**
Goodwill	-	748	759	759	**759**	**759**
License and supply agreement, net	1,072	938	804	770	**748**	**700**
Other assets	11	18	32	89	**89**	**89**
Total assets	$ 4,983	$ 10,558	$ 11,629	$ 18,294	**$ 15,700**	**$ 12,458**
LIABILITIES AND STOCKHOLDERS' EQUITY						
Current liabilities:						
Secured revolving credit facility	711	991	560	495	**500**	**250**
Secured note payable	-	195	211	215	**249**	**269**
Accounts payable	872	836	959	1,575	**1,110**	**1,239**
Accrued expenses	218	396	136	308	**308**	**428**
Contingent consideration	-	236	300	203	**300**	**-**
Operating lease liabilities	-	-	262	312	**312**	**262**
Deferred revenue	70	-	-	-	**-**	**-**
Total current liabilities	1,871	2,654	2,428	3,108	**2,779**	**2,448**
Secured note payable, net	-	843	613	553	**364**	**95**
CARES Act - promissory note	-	-	-	-	**479**	**-**
Equipment financing debt, net	-	-	10	9	**10**	**10**
Contingent consideration, net	-	263	-	-	**-**	**-**
Long-term operating lease liabilities	-	-	889	988	**988**	**988**
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**	**9**
Additional paid-in capital	122,973	127,873	131,934	138,953	**139,558**	**140,658**
Accumulated other comprehensive income	77	71	65	64	**64**	**65**
Retained earnings (accumulated deficit)	(121,106)	(124,153)	(127,332)	(128,430)	**(131,590)**	**(134,955)**
Total stockholders' equity	1,950	3,798	4,675	10,596	**8,041**	**5,777**
Noncontrolling interest	-	3,000	3,014	3,040	**3,040**	**3,140**
Total liabilities and stockholders' equity	$ 4,983	$ 10,558	$ 11,629	$ 18,294	**$ 15,700**	**$ 12,458**
SHARES OUT	55,293	7,180	8,059	9,017	**9,035**	**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**
Revenue - includes product and license, royalty, other	$ 3,809	$ 5,687	$ 10,334	**$ 11,479**	**$ 21,425**
Cost of sales	1,517	2,484	4,250	**4,993**	**8,920**
Gross Profit	2,292	3,203	6,084	**6,486**	**12,505**
Operating Expenses:					
Research and development	1,002	1,539	3,090	**2,263**	**2,800**
Depreciation and amortization	218	163	186	**181**	**140**
Selling, general, and administrative	3,298	4,517	6,119	**8,150**	**12,850**
Change in fair value of contingent consideration	-	-	(156)	**(42)**	-
Total Operating Expenses	4,518	6,219	9,239	**10,552**	**15,790**
Operating Income (loss)	(2,226)	(3,016)	(3,155)	**(4,066)**	**(3,285)**
Loss on extinguishment of debt	-	(199)	-	-	-
Interest (expense) income	(298)	(168)	(195)	**(162)**	**(80)**
Other income (expense)	(74)	(35)	(54)	**(30)**	**-**
Total Other Income (expense)	(372)	(402)	(249)	**(192)**	**(80)**
Pre-Tax Income (loss)	(2,598)	(3,418)	(3,404)	**(4,258)**	**(3,365)**
Income Tax Expense (Benefit)	(1,789)	(93)	(225)	**-**	**-**
Net income (loss)	(809)	(3,325)	(3,179)	**(4,258)**	**(3,365)**
Undeclared deemed dividend - Non-controlling interest	-	(77)	(241)	**(239)**	**(240)**
Net income (loss) - attributable to Nephros, Inc.	$ (809)	$ (3,402)	$ (3,420)	**$ (4,497)**	**$ (3,605)**
Earning (loss) per share	$ (0.14)	$ (0.50)	$ (0.45)	**$ (0.50)**	**$ (0.40)**
Avg Shares Outstanding	5,882	6,847	7,542	**8,924**	**9,053**
EBITDA - Adjusted - includes renal subsidiary	$ (1,216)	$ (1,734)	$ (1,235)	**$ (2,955)**	**$ (1,685)**
Margin Analysis					
Gross margin	60.2%	56.3%	58.9%	**56.5%**	**58.4%**
Research & Development	26.3%	27.1%	29.9%	**19.7%**	**13.1%**
Selling, general, and administrative	86.6%	79.4%	59.2%	**71.0%**	**60.0%**
Operating margin	(58.4%)	(53.0%)	(30.5%)	**(35.4%)**	**(15.3%)**
Pre-tax margin	(68.2%)	(60.1%)	(32.9%)	**(37.1%)**	**(15.7%)**
Tax rate	68.9%	2.7%	6.6%	**0.0%**	**0.0%**
YEAR / YEAR GROWTH					
Total Revenues	64.2%	49.3%	81.7%	**11.1%**	**86.6%**

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 A	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**
Revenue - includes product and license, royalty, other	$ 1,769	$ 2,309	$ 3,095	$ 3,161	$ 10,334	$ 2,529	$ 2,000	$ 2,950	$ 4,000	**$ 11,479**	$ 4,150	$ 4,675	$ 6,100	$ 6,500	**$ 21,425**
Cost of sales	771	942	1,276	1,261	4,250	1,038	860	1,295	1,800	**4,993**	1,750	1,940	2,565	2,665	**8,920**
Gross Profit	998	1,367	1,819	1,900	6,084	1,491	1,140	1,655	2,200	**6,486**	2,400	2,735	3,535	3,835	**12,505**
Operating Expenses:															
Research and development	756	793	777	764	3,090	563	550	550	600	**2,263**	700	700	700	700	**2,800**
Depreciation and amortization	50	48	44	44	186	46	45	45	45	**181**	35	35	35	35	**140**
Selling, general, and administrative	1,503	1,403	1,787	1,426	6,119	1,950	1,500	2,200	2,500	**8,150**	2,650	2,850	3,600	3,750	**12,850**
Change in fair value of contingent consideration	(10)	(9)	(94)	(43)	(156)	(42)	-	-	-	**(42)**	-	-	-	-	-
Total Operating Expenses	2,299	2,235	2,514	2,191	9,239	2,517	2,095	2,795	3,145	**10,552**	3,385	3,585	4,335	4,485	**15,790**
Operating Income (loss)	(1,301)	(868)	(695)	(291)	(3,155)	(1,026)	(955)	(1,140)	(945)	**(4,066)**	(985)	(850)	(800)	(650)	**(3,285)**
Loss on extinguishment of debt	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Interest (expense) income	(46)	(46)	(48)	(55)	(195)	(42)	(40)	(40)	(40)	**(162)**	(20)	(20)	(20)	(20)	**(80)**
Other income (expense)	(2)	(28)	(1)	(23)	(54)	(30)	-	-	-	**(30)**	-	-	-	-	-
Total Other Income (expense)	(48)	(74)	(49)	(78)	(249)	(72)	(40)	(40)	(40)	**(192)**	(20)	(20)	(20)	(20)	**(80)**
Pre-Tax Income (loss)	(1,349)	(942)	(744)	(369)	(3,404)	(1,098)	(995)	(1,180)	(985)	**(4,258)**	(1,005)	(870)	(820)	(670)	**(3,365)**
Income Tax Expense (Benefit)	-	-	-	(225)	(225)	0 -	-	-	-	-	-	-	-	-	-
Net income (loss)	(1,349)	(942)	(744)	(144)	(3,179)	(1,098)	(995)	(1,180)	(985)	**(4,258)**	(1,005)	(870)	(820)	(670)	**(3,365)**
Undeclared deemed dividend - Non-controlling interest	(59)	(61)	(60)	(61)	(241)	(59)	(60)	(60)	(60)	**(239)**	(60)	(60)	(60)	(60)	**(240)**
Net income (loss) - attributable to Nephros, Inc.	$ (1,408)	$ (1,003)	$ (804)	$ (205)	$ (3,420)	$ (1,157)	$ (1,055)	$ (1,240)	$ (1,045)	**$ (4,497)**	$ (1,065)	$ (930)	$ (880)	$ (730)	**$ (3,605)**
Earning (loss) per share	$ (0.20)	$ (0.14)	$ (0.10)	$ (0.03)	$ (0.45)	$ (0.13)	$ (0.12)	$ (0.14)	$ (0.12)	**$ (0.50)**	$ (0.12)	$ (0.10)	$ (0.10)	$ (0.08)	**$ (0.40)**
Avg Shares Outstanding	7,130	7,388	7,703	7,949	7,542	8,590	9,030	9,035	9,040	**8,924**	9,045	9,050	9,055	9,060	**9,053**
EBITDA - Adjusted - includes renal subsidiary	$ (880)	$ (522)	$ (209)	$ 376	$ (1,235)	$ (815)	$ (655)	$ (840)	$ (645)	**$ (2,955)**	$ (585)	$ (450)	$ (400)	$ (250)	**$ (1,685)**
Margin Analysis															
Gross margin	56.4%	59.2%	58.8%	60.1%	58.9%	59.0%	57.0%	56.1%	55.0%	**56.5%**	57.8%	58.5%	58.0%	59.0%	**58.4%**
Research & Development	42.7%	34.3%	25.1%	24.2%	29.9%	22.3%	27.5%	18.6%	15.0%	**19.7%**	16.9%	15.0%	11.5%	10.8%	**13.1%**
Selling, general, and administrative	85.0%	60.8%	57.7%	45.1%	59.2%	77.1%	75.0%	74.6%	62.5%	**71.0%**	63.9%	61.0%	59.0%	57.7%	**60.0%**
Operating margin	(73.5%)	(37.6%)	(22.5%)	(9.2%)	(30.5%)	(40.6%)	(47.8%)	(38.6%)	(23.6%)	**(35.4%)**	(23.7%)	(18.2%)	(13.1%)	(10.0%)	**(15.3%)**
Pre-tax margin	(76.3%)	(40.8%)	(24.0%)	(11.7%)	(32.9%)	(43.4%)	(49.8%)	(40.0%)	(24.6%)	**(37.1%)**	(24.2%)	(18.6%)	(13.4%)	(10.3%)	**(15.7%)**
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%	43.0%	(13.4%)	(4.7%)	26.5%	**11.1%**	64.1%	133.8%	106.8%	62.5%	**86.6%**

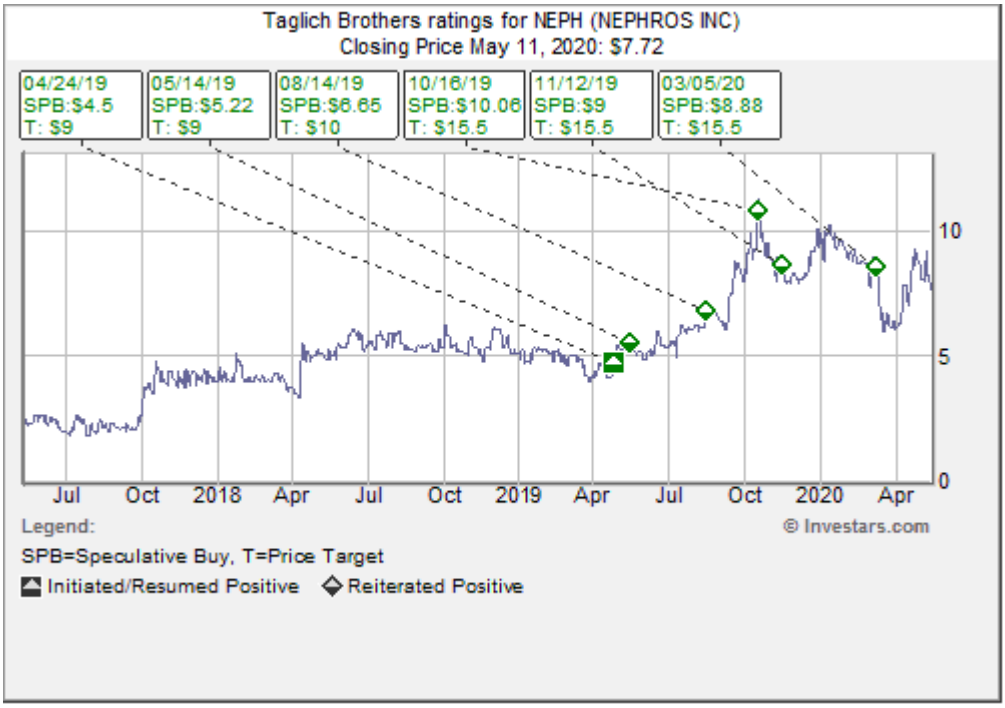
Source: Company reports and Taglich Brothers estimates

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

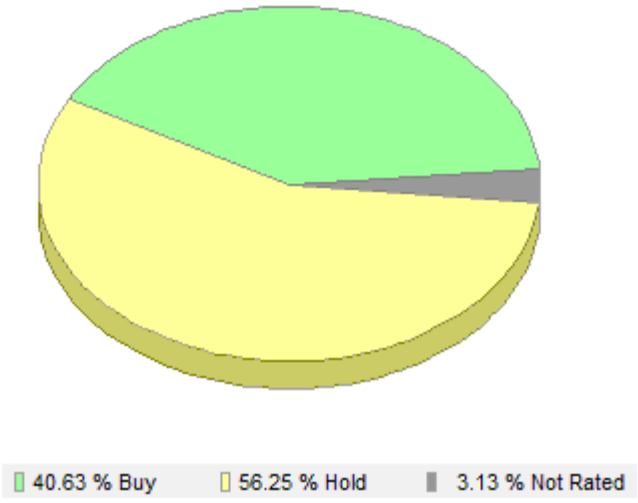
	FY2017A	FY2018A	FY2019A	1Q20A	**FY2020E**	**FY2021E**
Cash Flows from Operating Activities						
Net Income (loss)	$ (809)	$ (3,325)	$ (3,179)	$ (1,098)	**$ (4,258)**	**$ (3,365)**
Depreciation of property and equipment	28	29	24	5	**20**	**20**
Amortization of license and supply agreement	190	134	176	45	**181**	**140**
Non-cash stock-based comopensation, including stock options/restricted stock	772	985	1,332	222	**1,000**	**1,100**
Loss on extinguishment of debt	-	199	-	-	-	-
Inventory reserve	-	70	37	1	**1**	-
Change in fair value of contingent consideration	-	-	(156)	(42)	**(45)**	-
Accretion of contingent consideration	-	-	51	8	**8**	-
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	2	**2**	-
Cash earnings (burn)	316	(1,810)	(1,696)	(857)	**(3,091)**	**(2,105)**
Changes In:						
Accounts receivable	(416)	(391)	392	(552)	**(71)**	**(669)**
Inventory	(195)	(1,082)	(735)	(1,088)	**(392)**	**(19)**
Prepaid expenses and other current assets	30	(284)	(265)	(80)	**67**	**(76)**
Other assets	(10)	-	30	(51)	**(57)**	-
Accounts payable	268	(130)	119	614	**151**	**129**
Accrued expenses	-	35	(121)	174	**172**	**120**
Deferred revenue	(70)	-	-	-	-	**(300)**
(Increase)/decrease in Working Capital	(393)	(1,852)	(580)	(983)	**(131)**	**(815)**
Net cash provided by Operations	(77)	(3,662)	(2,276)	(1,840)	**(3,222)**	**(2,920)**
Cash Flows from Investing Activities						
Purchase of property and equipment	-	-	(14)	-	**(15)**	**(15)**
Aether Acquisition, net	-	(991)	(137)	-	-	-
Cash Flows from Investing Activities	-	(991)	(151)	-	**(15)**	**(15)**
Cash Flows from Financing Activities						
Proceeds from issuance of common stock, net	1,179	3,778	1,992	6,771	**6,771**	-
CARES Act - promissory note	-	-	-	-	**479**	**(479)**
Net proceeds (repayment) from secured revolving credit facility	711	280	(431)	(65)	**(260)**	-
Principal payments on finance lease liability	-	-	-	(1)	**(1)**	
Net proceeds (repayment) from equipment financing	-	-	12	(1)	**(1)**	-
Proceeds from sale of subsidiary preferred shares to noncontrolling interest	-	3,000	-	-	-	-
Payments on secured note payable	-	(149)	(214)	(56)	**(211)**	**(249)**
Payment of contingent consideration	-	-	(94)	(63)	**(63)**	**(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	53	**53**	-
Net cash provided (used) by Financing	1,990	7,047	2,017	6,638	**6,767**	**(1,028)**
Effect of exchange rates	6	(7)	(5)	(2)	**(2)**	-
Net change in Cash	1,919	2,387	(415)	4,796	**3,528**	**(3,963)**
Cash Beginning of Period	275	2,194	4,581	4,166	**4,166**	**7,694**
Cash End of Period	$ 2,194	$ 4,581	$ 4,166	$ 8,962	**$ 7,694**	**$ 3,731**

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

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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.