



Nephros, Inc.

(OTCBB: NEPH), Target Price: \$1.65)

We initiate coverage on Nephros, Inc. (OTCBB: NEPH “Nephros”) with a price target of \$1.65 per share. Based in River Edge, NJ, Nephros is a commercial stage medical device company with two core product lines: 1) the Hemodiafiltration (HDF) System for advanced renal replacement therapy for end-stage renal disease patients; and 2) UltraPure Filters for medical, commercial, military and recreational use. We see Nephros as an attractive speculative investment in the medical device industry with a differentiated product targeting two large markets.

INVESTMENT HIGHLIGHTS

High performance filters to drive growth in 2015

Nephros has developed a proprietary line of high performance filters, called **ultrafilters**, which have applications in hospitals for purification and dialysis centers for the removal of biological contaminants from water, bicarbonate concentrate and/or blood. Its filters are the only FDA-cleared water filter labeled for infection control in a hospital, making them an ideal tool to combat the spread of healthcare associated infections (HAI), which account for approximately 1.7mn infections and 99,000 deaths annually, according to the CDC. Nephros received FDA clearance for the **DSU-H** and **SSU-H** ultrafilters in October, and launched commercial efforts this January. The company has amassed an impressive group of distributors, with immediate results, as it reported record product sales in 1Q15. We expect ultrafilters to drive 2015E results, as there are over 1mn filter locations in the 6,000 US-based hospitals – representing a \$400mn opportunity for Nephros.

Nephros is also commercializing its ultrafilter technology for use in dialysis centers. Its **DSU-D** and **SSU-D** ultrafilters have been cleared for use in hemodialysis by the FDA, under a CE mark in Europe, and by Health Canada. There are over 125,000 possible filter locations in 6,600 dialysis centers across the United States, representing a \$45mn market opportunity. Nephros has already signed key distribution agreements in this area, and we expect see ultrafilters sold into the dialysis market to contribute noticeably to growth by 2016E. Longer term, Nephros is developing market-specific ultrafilter products for use in commercial, military, and recreational activities. In March the company announced that it had licensed its military-grade line of water purifiers, the **HydraGuard**, to CamelBak, the global leader in hands-free hydration gear.

Powerful upside potential from on-line HDF commercialization

In addition to filters, Nephros has created a novel, on-line mid-dilution Hemodiafiltration (HDF) System for use with dialysis machines for the treatment of chronic renal failure patients. The HDF System offers substantive advantages versus hemodialysis and hemofiltration, positioning Nephros favorably as it enters the \$47.5Bn market for end stage renal disease. Importantly, Nephros has the only FDA-cleared on-line HDF system, which is a key point of strategic differentiation in our view. The company has begun discussions with dialyzer industry leaders DaVita Kidney Care and the Renal Research Institute of Fresenius Medical Care to evaluate possible commercial opportunities. Combined, DaVita and Fresenius control nearly 2/3 of the US dialysis market, with over 4,300 clinics between them. Nephros is aggressively pursuing commercial partners for the HDF, and its management estimates that the opportunity is over \$1Bn if its HDF system is adopted by either DaVita or Fresenius. With ongoing discussions with both of these industry behemoths, we see HDF as offering the potential for creating substantial value to Nephros.

New CEO and Chair to lead company into commercialization

On April 15, 2015, Nephros appointed Daron Evans as President and CEO, and Lawrence Centella as Chairman. Evans has been a Nephros Director since 2013 and replaces acting CEO Dr. Paul Mieyal, who will remain on

the Board. Evans brings over 20 years of financial leadership and operational experience to guide Nephros through product commercialization, having most recently served as Managing Director of PoC Capital LLC and CFO of Nile Therapeutics until it merged with Capricor Therapeutics (CAPR) in 2013.

Initiate coverage with a price target of \$1.65

Our analysis indicates a fair value estimate of \$1.65 per share (detailed on page 10), implying an upside of 118.4% from the recent price of \$0.76. We view Nephros as an attractive high risk / high reward investment opportunity in the medical instruments industry.

Stock Details (5/26/2015)

OTCBB:	NEPH
Sector / Industry	Healthcare /Medical Instruments
Price target	\$1.65
Recent share price	\$0.76
Shares o/s (mn)	30.4
Market cap (in \$mn)	23.1
52-week high/low	\$1.29 / \$0.49

Source: Bloomberg, SeeThruEquity Research

Key Financials (\$mn unless specified)

	FY14	FY15E	FY16E
Revenues	1.7	2.9	5.4
EBITDA	(2.5)	(2.2)	(1.3)
EBIT	(2.7)	(2.4)	(1.5)
Net income	(7.4)	(1.4)	(1.6)
EPS (\$)	(0.31)	(0.05)	(0.05)

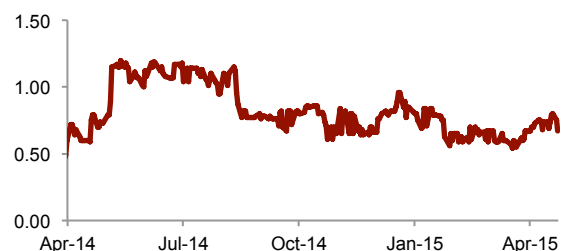
Source: SeeThruEquity Research

Key Ratios

	FY14	FY15E	FY16E
Gross margin (%)	68.6	69.0	69.0
Operating margin (%)	(152.7)	(85.0)	(28.5)
EBITDA margin (%)	(140.3)	(78.0)	(24.6)
Net margin (%)	(421.7)	(49.8)	(29.4)
P/Revenue (x)	13.2	8.0	4.3
EV/Revenue (x)	13.0	7.9	4.2

Source: SeeThruEquity Research

Share Price Performance (\$, LTM)



Source: Bloomberg

SUMMARY TABLE

Figure 1. Summary Table (As of May 26, 2015)

Share data		B/S data (As of fiscal 1Q15)		Key personnel:	
Recent price:	\$0.76	Total assets:	2.6mn	CEO:	Daron Evans
Price target:	\$1.65	Total debt:	0.0mn	Chairman	Larry Centella
52-week range:	1.29 / 0.49	Equity:	(5.4mn)		
Average volume:*	10,366	W/C:	(0.3mn)		
Market cap:	\$23.1mn	ROE:	NM		
Book value/share:	(\$0.18)	ROA:	NM		
Cash/share	\$0.01	Current ratio:	0.8X		
Dividend yield:	0.00%	Asset turnover:	0.8x		
Risk profile:	High / Speculative	Debt/Cap:	0.0%		

* three month average volume (number of shares)

FY December	Estimates				Valuation	
	Rev (\$mn)	EBITDA (\$mn)	EPS (\$)	P/Rev (x)	EV/Rev (x)	P/E (x)
2013	1.7	(3.1)	0.08	13.3x	13.1x	9.0x
2014	1.7	(2.5)	(0.31)	13.2x	13.0x	NM
1Q15A	0.5	(0.8)	0.01	10.6x	10.4x	23.7x
2Q15E	0.5	(0.8)	(0.03)	11.1x	10.9x	NM
3Q15E	0.9	(0.4)	(0.01)	6.6x	6.5x	NM
4Q15E	0.9	(0.4)	(0.01)	6.2x	6.1x	NM
2015E	2.9	(2.2)	(0.05)	8.0x	7.9x	NM
2016E	5.4	(1.3)	(0.05)	4.3x	4.2x	NM
2017E	10.9	1.3	0.03	2.1x	2.1x	25.1x

Source: SeeThruEquity Research

INVESTMENT THESIS

Based in River Edge, NJ, Nephros Inc. (OTCBB: NEPH, "Nephros") is a commercial stage medical device company that specializes in developing high performance liquid purification filters with applications in the medical, commercial, military and recreation markets. Nephros was founded in 1997 by healthcare professionals affiliated with Columbia University Medical Center / New York Presbyterian Hospital with a goal of developing and commercializing an alternative method to hemodialysis (HD), which remains a critical market for the company today. Indeed, Nephros has since developed an advanced high performance line of filters, called **ultrafilters**, which are primarily used in dialysis centers for the removal of biological contaminants from water, bicarbonate concentrate and/or blood. Nephros has engaged major distributors to capitalize on its FDA-cleared ultrafilters for applications in both hospitals and dialysis centers. The ultrafilters offer durability and performance advantages versus conventional microfilters, and Nephros believes that the market opportunity for US hospitals alone is over \$400mn.

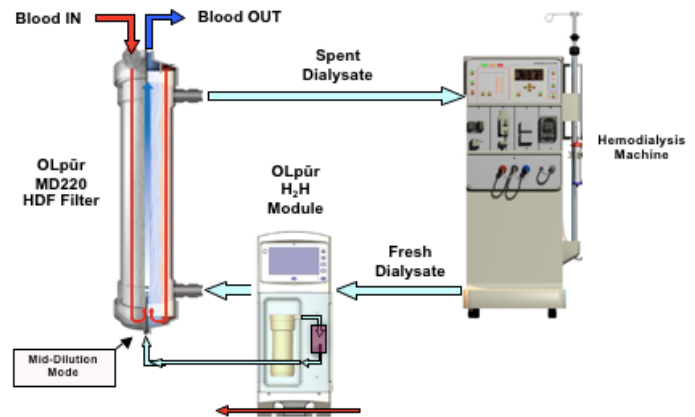
In addition to filters, Nephros has created an innovative, on-line mid-dilution **Hemodiafiltration (HDF) System** for use with dialysis machines for the treatment of chronic renal failure patients. The HDF System offers substantive advantages versus hemodialysis and hemofiltration, positioning Nephros well to enter the \$47.5Bn market for end stage renal disease. The company has the only FDA-cleared on-line HDF system, and has begun discussions with dialyzer industry leaders DaVita Kidney Care and the Renal Research Institute of Fresenius Medical Care evaluating possible commercial opportunities. Combined, DaVita and Fresenius control nearly 2/3 of the US dialysis market, with over 4,300 clinics between them. Nephros is aggressively pursuing commercial partners for the HDF, and its management team estimates that its opportunity is over \$1Bn if the HDF is adopted by DaVita or Fresenius.

We see 2015 as having the potential to be a breakout year for Nephros. Nephros has already made significant progress on its commercial strategy, developing multiple products based on its proprietary filtration technology targeting medical, commercial, military and recreational end markets. Further, with FDA clearance for the use **DSU-H** and **SSU-H** ultrafilters in hospital settings granted in 4Q14, Nephros has now acquired the necessary regulatory clearance for all product lines in its major end markets, leaving the company well situated to for growth and execution as it enters 2015.

Hemodiafiltration (HDF) System a differentiated approach to advanced renal therapy

In our view, the largest potential for Nephros stems from its on-line, mid-dilution HDF System, which we see as a novel approach to a large market. The Nephros HDF System includes the **OLpür H2H HDF Module** and **OLpür MD 220 Hemodiafilter**, and is cleared by the FDA to market for use with a UF controlled hemodialysis machine that provides ultrapure dialysate for the treatment of patients with chronic renal failure. The system is the only on-line, hemodiafiltration (HDF) system cleared by the FDA for providing advanced renal replacement therapy for end-stage renal disease patients.

Hemodiafiltration (HDF) offers better performance – particularly for diffusion of larger molecular weight toxins – at a similar cost when compared to high flux hemodialysis. Further, when compared to hemofiltration, the current standard of care for end stage renal failure in the US, HDF offers improved survival of up to 35% and enhanced clearance of middle and large MW toxins. Mid-dilution HDF accomplishes this by combining activities present in hemofiltration and hemodialysis. That is, HDF uses a convective-type driving force in addition to the diffusional driving force of standard hemodialysis to push uremic plasma water across the membrane. The process requires the addition of a sterile substitute fluid to be infused back into the blood to replace the flow of uremic plasma water that was pushed across the membrane. With existing solutions on the market, the challenge with HDF has been controlling where and how this substitute fluid is re-infused; this has typically required a stand-alone HDF machine, increasing the cost and complexity of the procedure.



Nephros has designed and patented the Nephros OLpür H2H Hemodiafiltration Module for on-line HDF, which is the only FDA-cleared on-line HDF system available in the United States – a key differentiator in our view. The Nephros H2H solution is a programmable medical device that can administer on-line HDF therapy while the dialysis machine continues to control and monitor the basic treatment functions. Importantly the H2H is a small module and is designed to work with existing hemodialysis machines, so practitioners do not have to purchase a stand-alone hemodiafiltration machine, nor do they have to replace their existing dialysis machines.



Hemodiafiltration (HDF) System targets a large potential market

As we noted, at this time Nephros offers the only FDA-cleared on-line HDF system of its kind available in the United States. Nephros is actively seeking a commercialization partner for this product line. So far Nephros has disclosed two significant potential relationships with leading companies in the dialysis market,

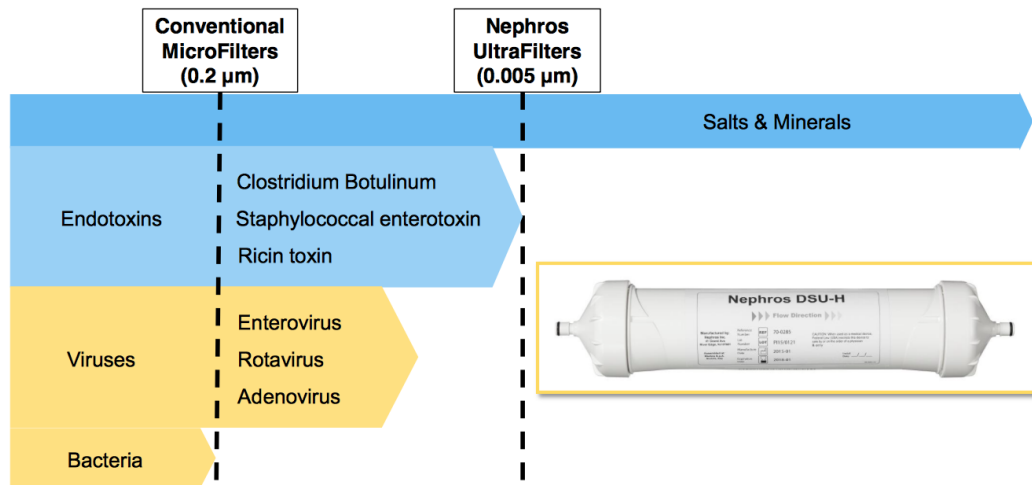
DaVita and the Renal Research Institute – a division of Fresenius Medical Care. Nephros management estimates that its addressable market opportunity is \$1Bn+ if it is able to gain traction with either of these potential commercial partners. DaVita is in the process of evaluating validation data of the system following treatments performed last year at its North Colorado Springs Clinic. Nephros management expects DaVita to continue to evaluate HDF during 2015. In March, Nephros announced that the Renal Research Institute, a division of Fresenius Medical Care, was also conducting an evaluation of its on-line HDF system in one of its clinics. Nephros is actively seeking a commercialization partner for its proprietary on-line mid-dilution HDF treatments, and we have hopes for an announcement during the next twelve months.

In Europe, Nephros has commercialized its MD220 Hemodiafilter with Bellco. The agreement with Bellco expires in 2021 and includes modest fixed royalties beginning in 2015, as well as minimum order quantities, in exchange for granting Bellco exclusive rights to market the product in Europe, Korea, Mexico, Brazil, China and the Netherlands.

Significant opportunity for high performance ultrafilters in hospital market

Last October Nephros received 510(k) clearance from the FDA to market its **DSU-H** and **SSU-H** ultrafilters as medical devices in hospital settings. This is a significant opportunity for the company, as there are approximately 6,000 hospitals and over 1mn hospital filter locations in the United States, while very few hospitals have water filtration systems. Meanwhile, Healthcare Associated Infections (HAI) are a growing problem. According to the Centers for Diseases Control (CDC), healthcare associated infections account for approximately 1.7mn infections and 99,000 deaths annually, costing \$4.5Bn - \$6.5Bn per year. Many of these HAIs are waterborne, including Norovirus, Legionella, and Pseudomonas, among others.

Nephros is well positioned to address this problem – which its management estimates is a \$400mn market opportunity in the US alone. The Nephros DSU-H and SSU-H ultrafilters are high performance and have significantly finer filtration than conventional microfilters, and can capture contaminants as small as 0.005 microns versus 200nm, which is the standard of its competitors – minimizing patient exposure to harmful bacteria, viruses, parasites, and endotoxins.



Source: Company investor materials

In fact, Nephros has the only FDA-cleared water filter labeled for infection control in a hospital. Its proprietary hollow fiber technology optimizes what it believes are the three critical elements to superior filter performance: Filtration, Filter Life, and Flow Rate. Nephros has actively been pursuing commercialization efforts in this area and commenced its formal launch in January 2015 through a distribution network that includes Chem-Aqua, Garratt Callahan, H-O-H, Water Technology, and Total Quality Medical. Nephros reported 1Q15 results on May 15 2015, with record product sales of \$0.5mn driven by strong initial uptake of the ultrafilter products in the hospital market. 1Q15 product sales were the highest in the company’s history, growing by 140% YoY over 1Q14. In the results update, management also indicated that 2Q15 was tracking well, having already surpassed 2Q14 product sales just mid-way through the quarter.

Proprietary high performance filter technology has many applications

Although we expect the best chance of short-term value creation at Nephros to stem from its novel HDF systems and ultrafilter products sold into the hospital market, we see several other attractive market opportunities for the company’s proprietary filter technology. First, Nephros has developed dialysis filtration products DSU-D and SSU-D that have been cleared for use by the FDA for use in the more than 6,600 dialysis centers in the US. There are approximately 125,000 dialysis center filter locations in the US, which represents a market opportunity of \$45mn, according to Nephros management. Although it may take more stringent standards and heightened awareness of the importance of purified dialysis water to catalyze this market, Nephros is ready to target this opportunity now from a distribution and regulatory approval standpoint. The company’s products have been cleared by the FDA, under a CE mark in Europe, and by Health Canada. Nephros has also signed distribution agreements in with MarCor Purification (a Cantel company), Ameriwater (a division of Suez Degremont), and TQ Medical.



We also see potential for Nephros’s proprietary filtration products in the military, commercial and recreational markets. In November 2014, the company submitted an individual water purification device containing Nephros’s proprietary ultrafilter technology as part of a US Army RFI for standard issue personal hydration kits for soldiers in the field. The company’s durable, military-grade filter is called the HydraGuard, and Nephros expects to submit an RFP during the first half of 2015. The company has stated that it believes the opportunity for military-grade filters could ultimately be as much as \$30mn for the company.

In the interim, we were impressed to see that Nephros licensed the HydraGuard to CamelBak, a global leader in personal hydration gear and inventor of the hands-free hydration category. We see CamelBak as a good match for Nephros, which provides the company an opportunity to monetize the HydraGuard product while it focuses on its core medical markets.

Strong IP Portfolio supports proprietary filtration technology

Nephros’ ultrafilter technology is backed by a strong intellectual property (IP) portfolio. The company has 21 patented inventions covering applications for water (6) and blood (15) filtration. The water patent position is headlined by its DSU patent for water filtration, which is issued in the US, Mexico, Israel, Japan, and Australia and is in application for the rest of the world. This patent does not expire until 2026, proving a long runway for monetization. The company’s other patents cover portable filter designs with integral pump as well as pending patents related to integrity testing, filter design, and a flush pump feature. Nephros also has a wealth of patents covering blood filtration, including issued patents for the MD220 filter and H2H Module in the US, EU, Japan, Canada, Brazil, Russia, India and China, among other countries. The company also has been issued patents covering aspects of mid-dilution, HDF and infusion fluids.



Source: Company investor materials, SeeThruEquity Research

COMPETITIVE LANDSCAPE

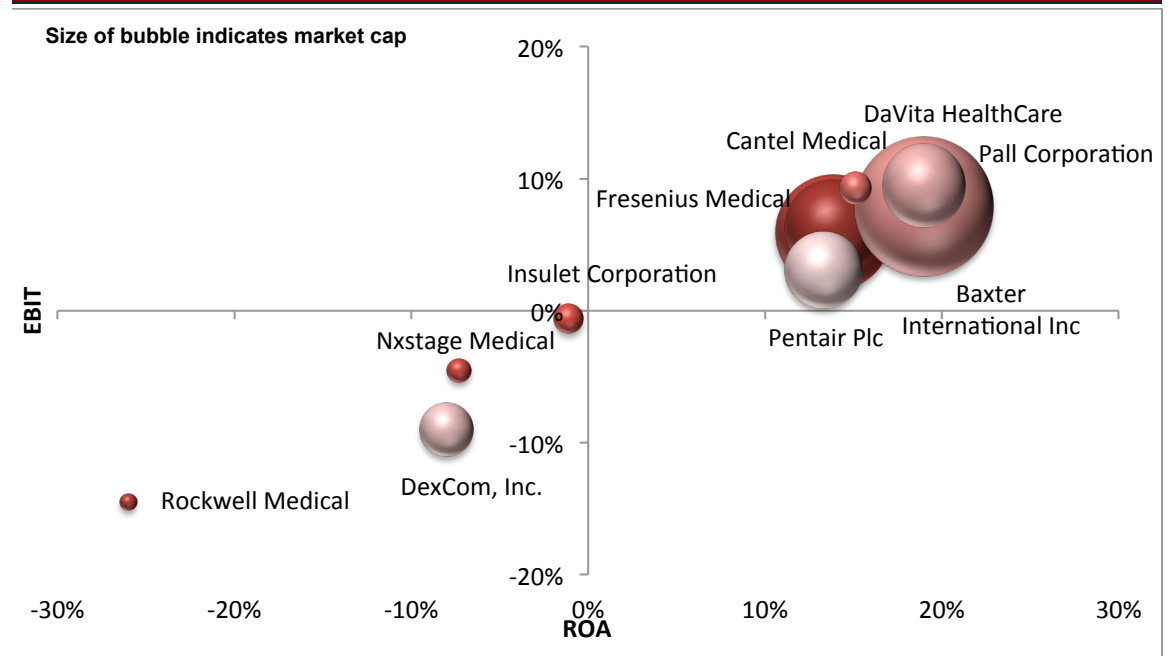
Nephros is a medical instrument company focused on the water filtration market as well as the dialyzer and renal replacement markets. These large markets are characterized by a high level of competition, with many participants that have greater access to financial resources, stronger brand recognition and wider sales distribution. Over 400,000 patients receive hemodialysis per year in the United States, and the total expenditures on end-stage renal disease (ESRD) totaled \$47.5Bn in 2010.

In the dialyzer and renal replacement markets, Nephros faces intense competition from a variety of large international competitors. The company is competing with a product differentiation strategy, with a goal to compete based on its ability to meet the specific, clinical needs of physicians and nephrologists, improve patient outcomes, and remain cost-effective. Nephros competes with suppliers of ESRD supplies and services including Fresenius Medical Care AG and Baxter (via subsidiary Gambro), currently two of the primary machine manufacturers in hemodialysis and makers of dialysis products including Asahi Kasei Medical Co., Nipro Medical Corp, and Terumo Medical Corp., among others.

The water filtration market also represents a large market opportunity, as there are over 1mn filter locations across approximately 6,000 hospitals in the United States alone. In the water filtration market, Nephros faces well-entrenched participants including the Pall Corporation, which manufactures end-point water filtration systems, as well as 3M Systems, and Siemens. Nephros has a limited operating history in this market but is seeking to compete with a differentiation strategy by designing user-friendly products with superior performance and reliability. The company's hollow fiber membrane provides 5nm filtration, compared to the 20nm filtration, which is the standard of its competitor.

In the following graphic we examined key size and profitability metrics for a group of competitors and peer companies of Nephros. Our peer group includes large companies in the dialyzer space such as DaVita HealthCare, Gambro (now Baxter), and Fresenius Medical Care, as well as small and medium sized peer companies including Rockwell Medical, Cantel Medical, and Nxstage Medical, among others. We also examined the margins of leading companies in the water filtration markets, such as Pall Corporation and Pentair. We found that while margins can be negative in the early stages of growth, established players with proprietary products and distribution can evolve to have very attractive margin structures in these industries.

Figure 2. ROA vs. EBIT– NEPH Peers



Source: Thompson Financial, Company filings, SeeThruEquity Research

FINANCIALS AND FUTURE OUTLOOK

Revenue / License forecast

Nephros is an emerging company in the early stages of commercialization and our forecast assumes the company can execute on its sales and distribution plans. The company reported in 1Q15 results released on May 15, 2015 that the initial uptake of its ultrafilters for hospitals was performing well, and that 1Q15 was the best quarter in the company's history in terms of product sales. Nephros has also engaged two large players in the dialysis market, DaVita and Fresenius, as potential partners for commercializing its HDF system in the United States. Our model assumes the company is able to find a substantive commercial partner in the United States by the end of calendar 2015E, with related revenues becoming material by 2017E and growing thereafter.

Our sales model for Nephros is primarily driven by: 1) our growth forecast for filtration products sold into the medical and dialysis markets, 2) our assumption that Nephros will find a commercial HDF partner in the United States by the end of the calendar year, with growth thereafter; and 3) modest growth assumptions in other areas such as international licensing and opportunities in the recreational / commercial markets. Our model forecasts revenue to grow to \$2.87mn in 2015E from \$1.95mn in 2014, with the majority of the growth stemming from the official launch of water purification products for hospitals in the United States. In 2016E, we have modeled revenues to grow to \$5.4mn, up 88.2% YoY. Our primary growth assumptions in 2016E are initial HDF revenues from a US commercial partnership and deeper penetration into the hospital and dialysis filtration markets.

Figure 3. NEPH Estimated Revenue Drivers

Fiscal Period	2015E	2016E	2017E	2018E	2019E	2020E
Filtration Products	2.0	3.6	6.2	9.7	14.9	19.8
HDF – US	0.5	1.2	4.0	7.2	12.0	18.6
Intl, Licensing & Other	0.4	0.6	0.8	1.1	1.4	1.7
Total	2.9	5.4	10.9	18.0	28.3	40.1

Source: SeeThruEquity Research, estimates in millions USD

Margins/Expenses

We have forecast Nephros's gross profit margins to expand as the company's revenue grows, moving from 68.6% in 2014 to 75% by the end of our forecast period. We expect the company will report an operating loss in 2015E and 2016E before sales growth in 2017E enables the company to become profitable. We have modeled high incremental profitability for each new dollar of revenue for Nephros, with operating margins improving from negative (78.0%) in 2015E to 10.2% in 2017E and reaching the mid-30% range by the end of our forecast period in 2021E. Our model assumes SG&A moves declines as a percentage of revenue from 164% in 2014 to 118% in 2015E before moving to 46% in 2017E and 33% by the end of our forecast period.

We have assumed Nephros does not pay material cash taxes during our forecast period. The company has a large potential tax shield for when it becomes net income positive. As of the end of federal 2014, Nephros had state and federal net operating loss carryforwards of \$92.9mn and foreign net operating loss carryforwards of \$8.1mn. These NOLs will expire at various times between 2014 and 2026 unless utilized.

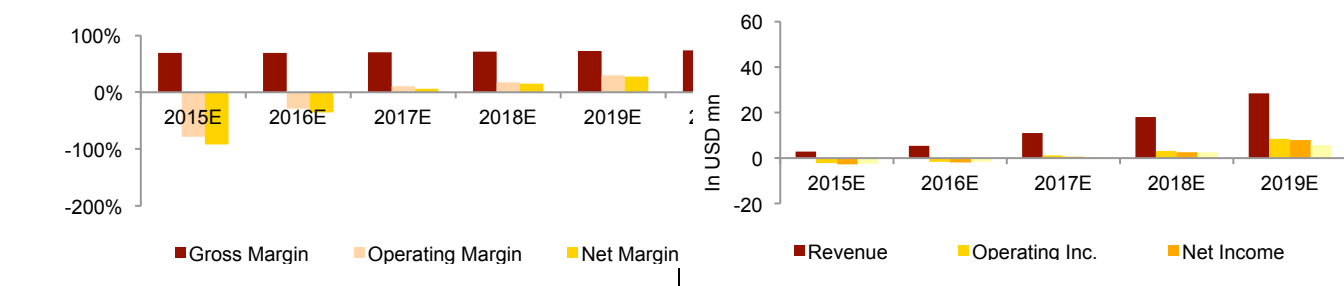
Our EPS forecast is (\$0.05) in 2015E and (\$0.05) in 2016E, before turning positive with \$0.03 in 2017E. This is a significant improvement from (\$0.31) in 2014, though we note 2014 included significant non-cash charges of (\$4.3mn) related to the change in fair value of warrant liabilities.

Balance Sheet & Financial Liquidity

We see the balance sheet and financial liquidity as a material item to watch for Nephros. The company's independent auditor, Withum Smith+Brown PC, issued a going concern opinion with its 2014 audited financial statements. Nephros ended fiscal 1Q15 with cash on hand of \$4.3mn and a current ratio of 0.8x. The company used (\$2.5mn) in cash from operating activities in 2014, and we expect it to use cash again in 2015 due to our expectation of high operating expenses and low revenues in 2015.

Mitigating this risk somewhat in the short run is a recent private offering announced by the company in May, in which Nephros raised \$1.2mn from a 1.8mn share sale at \$0.67. The transaction also included the issuance of 0.9mn five-year warrants priced at \$0.85 per share, another potential source of capital if exercised.

Figure 4. Key Performance Indicators of NEPH, FY15E–19E



Source: Company filings, SeeThruEquity Research

VALUATION

We utilize discounted cash flow (DCF) analysis and peer group multiples to value Nephros. Nephros is in the early stages of commercialization, and therefore the company has negative earnings and low revenues relative to our future expectations. Therefore we added more weighting to our DCF valuation methodology than our peer group multiple analysis.

Our blended valuation, which combines these two methodologies, yields a fair value of \$1.65 per share. Relative to the recent price of \$0.76, our target of \$1.65 represents upside potential of 118.4%.

DCF

We expect Nephros will use cash in 2015E and 2016E as the company invests in commercializing its products and operating expenses are higher than emerging revenues. We have modeled the company to begin generating positive income beginning in fiscal 2017E. We have also forecast that Nephros will be able to generate free cash flow after capital spending beginning in 2017E and have assumed minimal capital spending requirements as the company has manufacturing partners and should not require large capital expenditures.

We project free cash flow to move from (\$3.3mn) in FY15E to (\$1.3mn) in 2016E before turning positive at \$0.8mn in FY17E. Thereafter we have assumed rapid growth in free cash flow as the company should benefit from high earnings leverage. We have generally assumed the company invests cash in working capital given our growth assumptions.

We discounted cash flows at a weighted average cost of capital of 16.0% and assumed a terminal growth rate of 3.5% at the end of FY2021E to arrive at an enterprise value of \$55.4mn. We adjusted for the cash balance of \$0.4mn as of 1Q15, arriving at a fair value of \$1.84 per share.

Figure 5. Discounted Cash Flow Analysis

\$000	FY15E	FY16E	FY17E	FY18E	FY19E	FY20E	FY21E
EBIT	(2,440)	(1,537)	1,121	3,054	8,365	13,349	18,921
Less: Tax	0	0	0	0	0	0	3,774
NOPLAT	(2,440)	(1,537)	1,121	3,054	8,365	13,349	15,147
Changes in working capital	(947)	150	(130)	(56)	(2,327)	(1,793)	(451)
Depreciation & Amort.	200	208	225	243	262	283	306
Capex	(100)	(150)	(379)	(650)	(715)	(787)	(865)
FCFF	(3,287)	(1,329)	836	2,590	5,585	11,053	14,136
Discount factor	0.92	0.79	0.68	0.59	0.51	0.44	0.38
PV of FCFE	(3,017)	(1,052)	571	1,525	2,836	4,841	5,340
Sum of PV of FCFE							11,045
Terminal cash flow							117,515
PV: Terminal cash flow							44,393
Enterprise value							55,438
Less: Debt							0
Add: Cash							367
Equity value							55,805
Outstanding shares (mn)							30.4
Fair value per share (\$)							1.84
Summary conclusions	Key assumptions						
DCF FV (\$ per share)	1.84		Beta		1.5		
Recent price (\$ per share)	0.76		Cost of equity		16.0%		
Upside (downside)	142.7%		Cost of debt (post tax)		6.0%		
WACC	16.0%		Terminal Growth Rate		3.5%		

Source: SeeThruEquity Research

Figure 6. Sensitivity of Valuation – WACC vs. Terminal Growth Rate

		WACC (%)				
		15.0%	15.5%	16.0%	16.5%	17.0%
Terminal growth rate (%)	2.50%	1.93	1.82	1.71	1.62	1.53
	3.00%	2.00	1.88	1.77	1.67	1.58
	3.50%	2.08	1.95	1.84	1.73	1.63
	4.00%	2.17	2.03	1.90	1.79	1.69
	4.50%	2.26	2.11	1.98	1.86	1.75
	5.00%	2.36	2.20	2.06	1.93	1.81

Source: SeeThruEquity Research

Peer Group Valuation

We compared Nephros with publicly traded peers operating in the company's core markets of filtration and solutions for dialysis, as well as other emerging medical companies whose products utilize innovation to improve therapeutic treatments.

We considered mature competitors and peers with multi-billion dollar market capitalizations, such as DaVita HealthCare (DVA), Fresenius Medical Care (FMS), Baxter Inc. (BAX), and Pall Corporation (PLL), as well as small and medium-sized growth companies such as Rockwell Medical, Inc. (RMTI), Nxstage Medical, Inc. (NXTM), CorMedix, Inc. (CRMD) and DexCom DXCM), among others

We arrived at a fair value range of \$0.92 to \$0.93 per share based on EV/Revenue and P/Sales multiples of selected peers. We chose forward revenue multiples due to the fact that Nephros has not yet reached profitability. For EV/Revenue, we considered a target multiple of 5.1x our 2016E estimated revenue of \$5.4mn to arrive at a fair value of \$0.93 per share. Similarly, we used a P/Revenue multiple of 5.2x our 2016E revenue forecast to arrive at a fair value of \$0.92. We used multiples with a 33% premium to the peer group average multiple for each metric given that Nephros is in an earlier stage of growth and we have modeled higher percentage growth for Nephros than is expected for the majority of the peer group. We excluded the largest and smallest multiples of the peer group for the analysis so as not to skew results.

Figure 7. Comparable Valuation (Data as of 5/13/15)

Company	Mkt cap (\$ mn)	EV/Revenue(x)		Price/Sales (x)	
		FY15E	FY16E	FY15E	FY16E
DaVita HealthCare Partners Inc.*	17,406	1.8x	1.7x	1.3x	1.2x
Fresenius Medical Care AG & Co. KGAA	25,783	2.0x	1.9x	1.5x	1.4x
Rockwell Medical	499	6.4x	3.6x	7.2x	4.0x
Nxstage Medical, Inc.	1,029	3.0x	2.7x	3.1x	2.8x
Insulet Corporation	1,553	5.1x	4.3x	5.1x	4.4x
Baxter International Inc.	37,063	2.9x	2.8x	2.4x	2.3x
Pall Corporation	13,212	3.8x	3.7x	4.7x	4.5x
DexCom, Inc.	5,374	14.5x	10.6x	14.8x	10.8x
Pentair Plc	11,315	2.2x	2.2x	1.8x	1.7x
Cantel Medical	1,927	3.6x	3.2x	3.5x	3.1x
CorMedix, Inc.*	187	555.2x	149.3x	583.0x	156.8x
Average (*Excludes CRMD, DVA)		4.8x	3.9x	4.9x	3.9x
Nephros, Inc.	23	7.5x	4.0x	7.9x	4.2x
Premium (discount)		54.7%	3.0%	61.9%	8.7%

Source: Bloomberg, SeeThruEquity Research;

RISK CONSIDERATIONS

Financial Solvency

We see access to new capital to fund growth as a key risk for Nephros. In our analysis we have assumed that Nephros will be able to raise fresh capital as needed to fund growth, and on terms that are palatable to holders of common equity. The company will be unable to meet the sales and growth forecasts in this report if it is unable to raise sufficient capital. Mitigating this risk somewhat in the short run is a recent private offering announced by the company in May, in which Nephros raised \$1.2mn from a 1.8mn share sale at \$0.67. The transaction also included the issuance of 0.9mn five-year warrants priced at \$0.85 per share, another potential source of capital if exercised.

Nephros ended 1Q15 with cash on hand of \$0.4mn and a shareholder's deficit of (\$5.4mn). The company also reported an accumulated deficit of \$113.9mn. The company reported a net loss of (\$7.4mn) in 2014, including substantive non-cash charges, and we would expect it to continue to incur additional losses in the future due to the high level of operating expenses, up-front expenditures, including the cost of clinical trials. Nephros used (\$2.5mn) in cash from operating activities in 2014, and (\$3.6mn) during 2013.

Competition

Nephros operates in the water filtration market and dialyzer and renal replacement markets. The company faces competitors with greater access to financial resources, brand recognition and sales distribution channels. In the water filtration market, Nephros faces well-entrenched participants including the Pall Corporation, 3M Systems, and Siemens. The dialyzer and renal replacement markets are characterized by intense competition, including suppliers of end stage renal disease supplies and services like Fresenius Medical Care AG and Baxter, and makers of dialysis products including Asahi Kasei Medical Co., Nipro Medical Corp, and Terumo Medical Corp., among others.

Concentration Risk

Nephros has exposure to risks associated with customer concentration. Dependence on a small number of customers increases risk of sales volatility and the potential for pricing pressure, given the relatively strong negotiating position of the large customers. In 2014 and 2013, three customers accounted for 78% and 86% of Nephros' revenues, respectively.

Going Concern

The company's independent auditors, Withum Smith+Brown PC, have raised doubt as to its ability to continue as a going concern. We have assumed in our analysis that Nephros will be able to raise additional funding as necessary to complete its growth plans on terms that are palatable for holders of common equity. The company reported a net loss of (\$7.4mn) in fiscal 2014 and used (\$2.5mn) in cash from operations during the same period. As of 1Q15, the company had an accumulated deficit of (\$113.9mn).

Dilution potential

We expect Nephros to raise fresh capital by the issuance of equity instruments, including common equity, preferred equity, options and warrants, among others. Holders of common equity may have their positions diluted over time as the company raises new capital.

Regulation & Litigation Risk

Nephros operates in a highly regulated industry, which is characterized by regulatory costly and time-consuming approval procedures. In the US, the Food and Drug Administration (FDA) regulates the manufacture and marketing of medical devices. Approval in the United States does not guarantee that devices will secure regulatory approval in other countries. Additionally, Nephros may potentially be subject to litigation resulting from a voluntary product recall of its POU and DSU in-line ultrafilters used in hospital treatment applications. In May 2015 the company received a warning letter from the FDA requesting additional clarifying documentation related to a 2013 483 the company received following an inspection at its facility. We understand the notice is largely procedural and do not expect it to result in a significant event for the company if it responds in a timely and appropriate matter, but nonetheless note that it represents a risk.

Large Shareholder Control

The Board of Directors, management team, and Lambda (the company's largest shareholder) control approximately 50% of the common shares outstanding - and 60% on a fully diluted basis. Consequently Lambda has the ability to exert significant influence over the company, and may have interests that differ from other stockholders.

Management Team

Daron Evans– President & Chief Executive Officer

Mr. Evans is a life sciences executive with over 20 years of financial leadership and operational experience. Mr. Evans is currently the Managing Director of PoC Capital, an operational consulting and software development firm, a Director on the Board of Zumbro Discovery, an early stage company developing a novel therapy for resistant hypertension, and a Director on the Board of Designtra, an architectural products e-commerce market place. Mr. Evans was most recently Chief Financial Officer of Nile Therapeutics, Inc., from 2007 until its merger with Capricor, Inc. in November 2013. From 2004 to 2007, he held various roles at Vistakon, Inc. and Scios, Inc., both divisions of Johnson & Johnson Corp. Mr. Evans was a co-founder and President of Applied Neuronal Network Dynamics, Inc. from 2002 to 2004. From 1995 to 2002, Mr. Evans served in various roles at consulting firms Arthur D. Little and Booz Allen & Hamilton. Mr. Evans is the author of four U.S. patents. Mr. Evans received his Bachelor of Science in Chemical Engineering from Rice University, his Master of Science in Biomedical Engineering from a joint program at the University of Texas at Arlington and Southwestern Medical School and his MBA from the Fuqua School of Business at Duke University.

Larry Centella, Chairman of the Board

Mr. Centella has served as a director of Nephros since January 2001. Mr. Centella served as President of Renal Patient Services, LLC, a company that owned and operated dialysis centers, and served in such capacity from June 1998 to 2014. From 1997 to 1998, Mr. Centella served as Executive Vice President and Chief Operating Officer of Gambro Healthcare, Inc., an integrated dialysis company that manufactured dialysis equipment, supplied dialysis equipment and operated dialysis clinics. From 1993 to 1997, Mr. Centella served as President and Chief Executive Officer of Gambro Healthcare Patient Services, Inc. (formerly REN Corporation). Prior to that, Mr. Centella served as President of COBE Renal Care, Inc., Gambro Hospital, Inc., LADA International, Inc. and Gambro, Inc. Mr. Centella is also the founder of LADA International, Inc. Mr. Centella received his B.S. from DePaul University.

Shane Sullivan – Director of U.S. Sales

Mr. Sullivan has spent nearly two decades in sales leadership roles in the healthcare, life science and biopharmaceutical industry. He brings industry experience, an extensive professional network and strong customer focus to our team at Nephros. Prior to joining Nephros, he led the sales team at Saxton Bradley with a focus on the healthcare and scientific market. Before Saxton Bradley, Mr. Sullivan was the Western Regional Sales Manager at Thermo Scientific (NYSE:TMO). While there, he led the \$175 million laboratory furnishings and airflow products division to ten consecutive double digit increases in the Western Region. His extensive work within the architectural design, engineering, specifying, and contracting communities significantly contributed to their sales on a national level. Prior to Thermo, Mr. Sullivan worked at Applied Instruments, where he represented a variety of equipment manufacturers focused on solutions for the healthcare, life science and bio pharmaceutical research markets. At Applied Instruments, he helped grow their business, establish stronger roots for their organization in the region and developed a strong understanding of the distribution market. Prior, at MDT Castle, he led the launch and direct sales efforts of their life science and pharmaceutical sterilization business. His sales efforts ultimately contributed to the merger that formed Getinge-Castle. Mr. Sullivan earned his undergraduate degree in Business Administration from the University of Southern California.

Gregory Collins, Ph.D – Vice President of R&D

Prior to Nephros, Dr. Collins was R&D Program Manager with National Medical Care (now Fresenius Medical Care). He also worked as a scientist for ITW MiniGrip and consultant to FoxS Labs, (Division of Puritan-Bennet). Dr. Collins has 14 issued patents in the areas of hemodiafiltration and water purification and serves as scientific reviewer for NIH (SBIR) grant applications. Dr. Collins received his PhD in bio-engineering from the University of California, San Diego and his B.S. in chemical engineering from Arizona State University. Mr. Jon Niedermaier is currently a senior Chief Financial Officer with The Brenner Group, a position he has held since October 2014. He currently also serves as Chief Financial Officer of Pristine Sun, LLC on a contract basis. Prior to his employment with The Brenner Group, Mr. Niedermaier acted as Chief Financial Officer of PureWave Networks, Inc., a wireless technology company, from November 2013 to July 2014. Prior to PureWave Networks, Inc., Mr. Niedermaier worked as the Chief Financial Officer at Neato Robotics, Inc. from April 2012 through March 2013 and at Tigo Energy, Inc. from April 2011 through April 2012. From 2002 through 2010, Mr. Niedermaier worked at ADC Telecommunications, Inc., and had the title of Vice President, GM immediately prior to his departure. Mr. Niedermaier began his career at KPMG. Mr. Niedermaier holds a B.S. in Business Administration and Accounting from Wayne State University.

FINANCIAL SUMMARY

Figure 8. Income Statement

Figures in \$mn unless specified	FY13	FY14	FY15E	FY16E	FY17E	FY18E
Revenue	1.7	1.7	2.9	5.4	10.9	18.0
YoY growth	24.5%	24.5%	24.5%	88.2%	102.7%	64.2%
Cost of Sales	0.9	0.5	0.9	1.7	3.3	5.0
Gross Profit	0.8	1.2	2.0	3.7	7.7	12.9
Margin	48.4%	68.6%	69.0%	69.0%	70.0%	72.0%
Operating expenses	4.2	3.9	4.4	5.3	6.5	9.9
EBIT	(3.3)	(2.7)	(2.4)	(1.5)	1.1	3.1
Margin	(190.6%)	(152.7%)	(85.0%)	(28.5%)	10.2%	17.0%
EBITDA	(3.1)	(2.5)	(2.2)	(1.3)	1.3	3.3
Margin	(177.8%)	(140.3%)	(78.0%)	(24.6%)	12.3%	18.3%
Other income/ (expense)	4.6	(4.7)	1.0	(0.1)	(0.1)	(0.1)
Profit before tax	1.3	(7.4)	(1.4)	(1.6)	1.1	3.0
Tax	0.0	0.0	0.0	0.0	0.0	0.0
Net income	1.3	(7.4)	(1.4)	(1.6)	1.1	3.0
Margin	76.0%	(421.7%)	(49.8%)	(29.4%)	9.8%	16.7%
EPS (per share)	0.08	(0.31)	(0.05)	(0.05)	0.03	0.08

Source: SeeThruEquity Research

Figure 9. Balance Sheet

Figures in \$mn, unless specified	FY13	FY14	FY15E	FY16E	FY17E	FY18E
Current assets	1.0	1.7	3.9	6.0	8.5	12.9
Other assets	1.9	1.7	1.6	1.5	1.7	2.1
Total assets	2.9	3.4	5.5	7.5	10.1	15.0
Current liabilities	3.5	1.2	2.0	3.2	4.1	5.4
Other liabilities	3.1	7.8	8.0	8.0	8.0	8.0
Shareholders' equity	(3.7)	(5.7)	(4.5)	(3.6)	(2.0)	1.6
Total liab and shareholder equity	2.9	3.4	5.5	7.5	10.1	15.0

Source: SeeThruEquity Research

Figure 10. Cash Flow Statement

Figures in \$mn, unless specified	FY13	FY14	FY15E	FY16E	FY17E	FY18E
Cash from operating activities	(3.6)	(2.5)	(1.7)	(0.7)	1.7	3.8
Cash from investing activities	0.0	0.0	(0.1)	(0.2)	(0.4)	(0.7)
Cash from financing activities	4.1	3.2	2.3	2.0	0.0	0.0
Net inc/(dec) in cash	0.5	0.7	0.5	1.1	1.3	3.1
Cash at beginning of the year	0.0	0.6	1.3	1.8	2.9	4.3
Cash at the end of the year	0.6	1.3	1.8	2.9	4.3	7.4

Source: SeeThruEquity Research

About Nephros, Inc.

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

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

For more information about Nephros and its products, the company's website can be found www.nephros.com.



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