

## Initial Research Report

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

### Derma Sciences, Inc.

**Rating: Speculative Buy**

Juan Noble

July 10, 2006

**DSCI \$0.82 — (OTC BB)**

	FY 2003A	FY 2004A	FY 2005A	FY 2006E
Total revenues (in millions)	\$17.9	\$19.9	\$23.4	\$27.4
Earnings (loss) per share	\$ - -	(\$0.25)	(\$0.07)	\$0.02

52 - Week range	\$0.97 – \$0.41	Fiscal year ends:	December
Shares outstanding <small>as of May 1, 2006</small>	22.906 million	Revenue/shares (ttm)	\$0.93
Trading float	12.31 million	Price/Sales (ttm)	0.88X
Insiders	74%	Price/Sales (2006)E	0.79X
Tangible Book value/share <small>as of March 31, 2006</small>	\$0.30	Price/Earnings (ttm)	NA
Price/Book	2.67X	Price/Earnings (2006)E	41.0X

*Derma Sciences, Inc. (DSCI) manufactures wound care, wound closure fasteners and skin care products for sale to healthcare institutions, physicians' offices, home healthcare agencies and pharmacies, mainly in the US and Canada.*

#### **Key Investment Highlights:**

*We are initiating coverage of Derma Sciences, Inc. (OTC BB: DSCI) with a Speculative Buy rating and a 12-month price target of \$0.95. In our view, revenue gains and improved operating efficiency can drive modest profit growth in 2006. Based on that performance, investors could accord the stock a valuation of 0.9X 2006 sales, raising the market value of the stock to \$0.95 per share during the year ahead. That price target implies stock price appreciation of more than 15%.*

*For 2006, we project modest revenue growth and margin improvement that could restore profitability that Derma Science has not seen since 2003. 2006 operating results that match or exceed our operating projections could signal a trend which, if sustained, could lead to more consistent profitability and a higher stock valuation.*

*The acquisition in April 2006 of Western Medical's assets could potentially increase annual revenue by more than \$6 million. The production of the Western product line will be absorbed by the company's manufacturing facilities, offering synergy that could improve margins for 2006.*

*A rise in production volumes, supported in part by increases in the company's OEM business, and the increasing concentration of sterilization operations in China should improve manufacturing efficiency and help drive gross margin improvement.*

*During the past three years, receivables and inventory management has improved significantly, increasing cash flow and reducing the need for bank borrowings. An April 2006 sale of common stock enabled the company to maintain the improved debt balance it had achieved as of the end of 1Q06.*

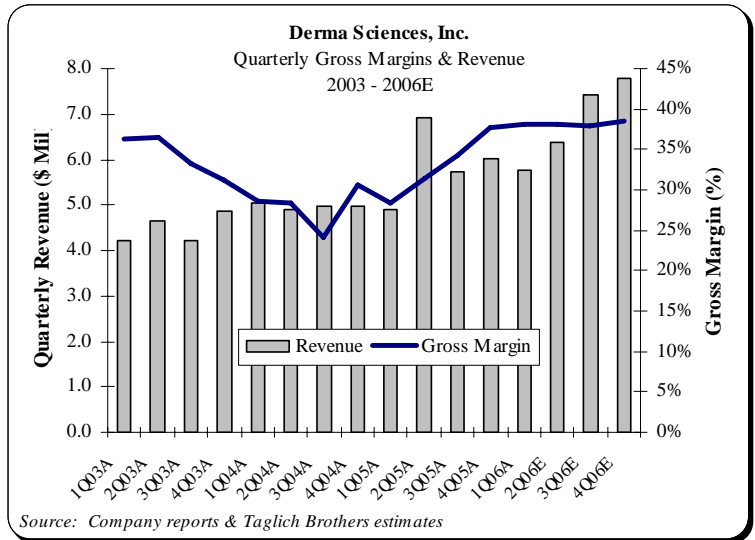
*\* Please view our disclaimer located on page 18.*

**Overview**

Derma Sciences, Inc. (OTC BB), headquartered in Princeton, New Jersey, was established in 1984 to manufacture and market wound care products used to treat pressure ulcers (bed sores), diabetic ulcers, surgical incisions and serious burns. For 2006, wound care products will account for an estimated 86% of revenue. Derma Sciences also manufactures wound closure and fastener devices, and a line of skin care products. The product line is sold mainly through distributors in the US and Canada to end users such as nursing homes and acute care hospitals, with some sales made to clinics and physicians' offices.

Pressure ulcers, also known as decubitus ulcers or bed sores, represent Derma Sciences' largest end market. These sores are common in patients who are confined for long periods to beds or wheelchairs. Unremitting pressure on the skin caused by body weight against the surface of a bed or chair can reduce blood flow to the site, leading to skin cell death and ulceration that can, if inadequately treated, destroy nearby bone and organ tissue. Efforts to prevent or slow this progression, particularly in nursing home and hospital patients, underlie the demand for wound care products.

Since 1996, acquisitions have expanded Derma Sciences' product line and manufacturing base. During the past few years, the company has rationalized its manufacturing assets with a view to improving gross margins. In-house production is limited mainly to basic and advanced wound care products that are manufactured in Canada and in China. Besides concentrating production of commoditized, low-margin product lines at the lower-cost China plant, Derma Sciences is increasing its use of China contractors to perform more costly sterilization processes.



Production of around half of the company's products – wound closure and fastener devices, skin care products and some wound care products - is outsourced. Contract manufacturing of wound care products for other large distributors, while yielding lower gross margins, has improved absorption of manufacturing overhead.

While most of the company's product line is relatively mature and slow growing, efforts are underway to in-license new high-value wound care products. Three new products targeted for launch during the next 12 to 18 months could potentially contribute to growth by expanding product lines, enhancing differentiation, improving margins and facilitating the sell-through of established products.

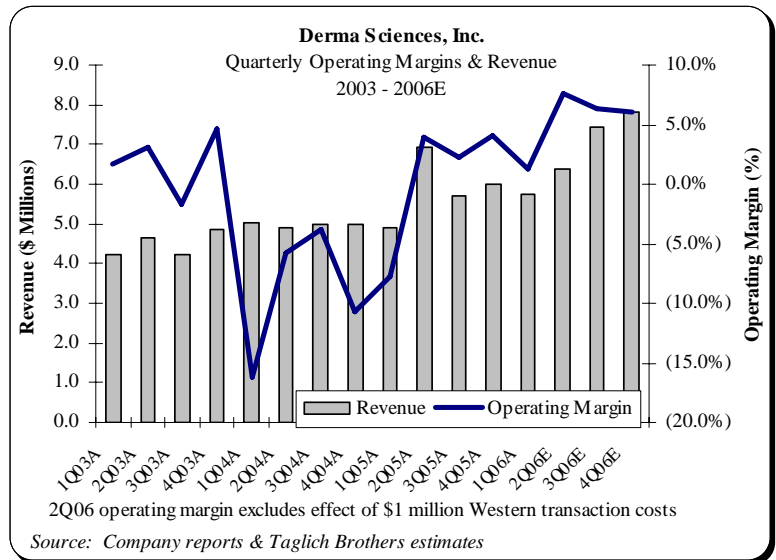
In April 2006, Derma Sciences raised \$5.9 million from a common stock private placement managed by Taglich Brothers. Those proceeds, augmented with some bank financing, were used to acquire the assets of Western Medical, a manufacturer of pressure products used widely in wound care. This acquisition could significantly raise Derma Sciences' run rate and margins, potentially enabling the company to achieve a profit for 2006.

Due to consolidation of production facilities, outsourcing and contract manufacturing for healthcare supply distributors and other manufacturers, gross margins have improved steadily since they bottomed out in 2004 after a slide influenced by several factors. In 2004, the company transferred the manufacturing of the business acquired from Kimberly Clark to Canada, incurring expenses to move and install the equipment. Relocation to the Canada facility also required the purchase of new tools, validation of manufacturing processes and the start-up of production lines. Initiating production of a 40-product OEM line for McKesson also involved large costs incurred to purchase dies, establish packaging facilities and start up production lines.

Before gross margins reached their trough in 2004, they had been shrinking since the prior year. Sales of the high-margin Dermagran line were declining even as sales of lower-margin OEM products were rising. As a result, gross margins contracted on largely flat revenue. Operating margins have moved largely in tandem with gross margins, improving as Derma Sciences recovered from the disruptive effects of the Kimberly Clark and McKesson production line start-ups in 2004. While OEM sales are an increasing proportion of revenue, Dermagran revenue has stabilized. We project largely stable gross margins and a slight improvement in operating expense leverage through 2006.

**Recent Developments**

Acquisition – In April 2006, the company acquired, for \$6.5 million, certain assets (mainly accounts receivable and inventory) and assumed trade payables from Western Medical, Inc., a closely held manufacturer of specialty medical textile compression, support and protective dressings. Western’s products will be combined with Derma Sciences’ wound care line. The company estimates roughly \$1 million in transaction costs. While none of Western’s administrative infrastructure was acquired in the purchase, Derma Sciences covered certain Western employees’ salaries through May 2006 and has entered into a sales and marketing agreement with a Western affiliate which will be paid \$120,000 during the next year.



The acquisition will add roughly \$6.6 million (Western’s 2005 revenue) to Derma Sciences’ annual revenue, contributing an estimated \$4.5 million to its 2006 sales. The Western acquisition should support an improvement in profitability; Western’s 2005 gross margin was roughly 39%, well above Derma Sciences’ gross margin for that year. Western’s 2005 pre-tax margin was reported at 11%, also well above Derma Sciences’ for 2005. None of Western’s manufacturing or administrative infrastructure was included in the transaction; those functions are being absorbed by Derma Sciences. With effective integration, most of the gross profit on Western’s revenue could eventually drop down to the operating income line, significantly improving profitability.

By management’s preliminary estimate, roughly half of the Western asset purchase cost of \$6.5 million will be allocated to goodwill, with most of the rest split between amortizable intangibles and working capital. Management targeted completion of the Western business integration by June 1, 2006.

Potential Major New Product – Under an exclusive five-year licensing agreement signed with Comvita New Zealand Ltd., the company will produce and distribute Manuka Honey-based wound care products in North and South America. Currently under FDA 510K review, the honey-based product could be a major product. It is supported by intellectual property and will be positioned as an alternative to or adjunctive treatment with silver anti-microbial wound healing products. The widely used silver-based wound care products can be toxic, limiting their usefulness. Honey’s wound healing mechanism is not known but it is non-toxic and is potentially useful in wound healing as well as debridement. A first-to-market advantage and widespread uptake might make this honey-based product a significant contributor to revenue growth.

New Common Stock Sale – The Western acquisition was financing largely with proceeds from a common stock sale of 10.6 million shares that raised \$5.9 million in net proceeds, bringing total proceeds raised in common stock sales since 2003 to \$10.2 million. The 10.6 million shares raised in the April 2006 common stock sale practically doubled the number of shares outstanding.

*New Debt Financing* – Derma Sciences took on a \$1 million term loan at prime+5% interest, payable monthly through April, 2009. Proceeds from this loan were earmarked for the Western acquisition, which was also financed in part with a \$0.5 million three-year promissory note payable to Western Medical. The company currently has a \$2 million revolving line of credit facility established with the same US institution that extended the term loan that partially financed the Western acquisition. When that term loan is paid, the line of credit will expand to \$3.5 million.

### ***1Q06 Operating Results***

Derma Sciences earned net income of \$57,000 for 1Q06, less than \$0.01 per share, vs a loss of (\$0.02) per share for the year-earlier quarter. Stock-based compensation charged to the quarter was nominal (\$24,000). Sales were up 18%, driven by the wound care business, which benefited not only from larger volume but also a gross margin improvement based in part on the shift of production of low-margin products to China.

Higher wound care volume was also due to an increase in contract manufacturing volume, which, despite its lower margin, supported a gross margin gain as it improved absorption of manufacturing overhead. The overall gross margin was up dramatically but as the company was unable to leverage its operating expenses in 1Q, the operating margin for the period did not expand commensurately.

G&A expense was at its highest, both in absolute dollar and in margin terms, in two years, a consequence of several factors that do not correlate with sales, including stock option expenses, a broad increase in levels of compensation effective January 2006, more frequent travel to and from China and the hiring last year of a director of logistics. We project, in dollar terms, a roughly comparable quarterly G&A expense rate for the rest of 2006, with slightly higher figures in 2H06 to reflect costs incurred in implementing Sarbanes-Oxley requirements.

The company ended 1Q06 with a largely depleted cash position, which shrunk to only \$70,000 from more than \$1 million at the beginning of the period. Most of the drain stemmed from a sizable increase in inventory since the end of 2005. Despite the large increase in inventory, turnover was in line with the improved rates noted in 2005. The company's debt position, considerably improved between 2003 and 2005, improved slightly since the end of 2005.

### ***Product Lines***

Derma Sciences product line is broken down into three groups – wound care, wound closure and fastener, and skin care. Wound care, by far the largest product group, will account for an estimated 86% of sales in 2006, up from 82% in 2005. The wound care line is made up of advanced and basic wound care products.

Advanced wound care – These include silver, calcium alginate, hydrogel, hydrocolloid and foam dressings. Most are sterile dressings that have anti-microbial, moisture retentive or moisture promoting properties. Advanced wound care products, which are offered in various dimensions, are designed to protect a wound from infection from external sources, maintain a moist environment and absorb secretions from the wound site. Most conform and adhere to a wound site, and reduce friction and shear. Some advanced wound care products come in ointment, foam or liquid spray form.

Basic wound care – The basic wound care line includes burn care products and dressings, most with a silver lining that serves as an antimicrobial barrier. These are traditional wound care products such as sponges, bandages, gauze pads, wound or incision packing strips and tapes. Some basic wound care products – dressing and retention tape – are used to treat burns.

Derma Sciences has two minor product lines, sales of which have declined considerably during the past few years. Wound care/fasteners and skin care products will account for an estimated 14% of revenue in 2006.

Wound closure and fasteners – Wound closure strips are sterile latex-free porous strips that are adhesive. This line includes devices designed to hold various types of catheters, tubes, wound drainage systems and multi-port IV systems in place.

Skin care – These are various cleansers, moisturizers, deodorizers and moisture barriers.

A comprehensive list of Derma Sciences' products is appended to this report (Appendix A).

### ***Product Applications***

Derma Sciences' wound care products are widely used in the treatment of bed sores but efforts are being made to enlarge its presence in the end markets for the treatment of burns, diabetic and venous ulcers, and in the prevention of infection in surgical incisions.

Bed sores (also know as pressure or decubitus ulcers) are ulcers that form when a patient, due to confinement to a bed or wheelchair, is in one position so long that the circulation in the skin is reduced by the pressure, particularly over a bone close to the surface. The skin then breaks down and an open sore develops. Bed sores are classified in stages I through IV, depending on severity, which ranges from redness and soreness on a patch of skin to deep infections with erosion of adjoining muscles, bones, tendons or joints.

Bed sores can be irritated by exposure to urine and other substances on the skin. Most pressure sores develop on the lower body – over the sacrum, along the spinal column and on the buttocks, heels and between the knees. Bed sores can be difficult to treat and tend to heal slowly. If inadequately treated, bed sores can lead to tissue breakdown and infection in adjacent areas, including bone and organs, and in the blood. So preventive measures, such as changing the patient's position frequently and cleansing potential problem areas, are encouraged.

Venous ulcers, also known as stasis leg ulcers, are shallow wounds that form as a consequence of venous insufficiency, a condition resulting from a deficiency in the valves within veins that help maintain blood flow toward the heart. These valve defects allow some blood to back up in the vein, slowing circulation and causing fluid to seep out of the backed up veins into the surrounding area. This seepage leads to tissue breakdown and, subsequently, ulcers. Venous skin ulcers usually develop on either side of the lower leg between the bottom of the calf and the ankle.

Diabetic ulcers form when blood vessel damage, a consequence of diabetes, lead to skin ulcers that may not be immediately detected due to diabetic neuropathy. While the myriad effects of diabetes pose many more threats than skin ulcers, the ulcers must be managed as they are often signal a precursor of amputation, the need for which may be reduced with effective skin care and wound management.

### ***Market Opportunity***

In a 2005 report, the Kolorama Information division of Market Research, Inc., a commercial research organization, estimated the 2004 worldwide wound care market for bed sores at \$3.3 billion, a figure that is projected to rise to \$5.0 billion by 2009. That market includes high-value products, including biologicals like artificial skin, collagen and growth factors. But the majority of the products consumed in this market are wound care products such as Derma Sciences'.

The broad US market statistics discussed here are nationwide figures but the company's core markets (in the US) are in the Northeast, Midwest and Southeast, principally in the large-population, high-density markets of New York, Pennsylvania, Illinois and Ohio.

The US Dept of Health and Human Services Agency for Healthcare Research and Quality reported that the number of bed sore cases in US hospitals increased from 280,000 in 1993 to 455,000 in 2003 (latest available). Compared to the 34.7 million US hospital discharges reported for 2003 by the CDC, the number of bed sore cases seems relatively low. However, as patients age 65 and older accounted for 72% of all bed sore cases (while accounting for only 38% of hospital discharges), demographic trends suggest that the number of bed sore cases is likely to increase during the years ahead as the elderly segment of the US population grows larger.

Bedsore are quite common in nursing homes. According to the American Medical Directors Association, an organization of medical directors and physicians specializing in long-term care, almost 10% of nursing home patients in the US have pressure ulcers. The CDC's National Center for Health Statistics counted 1.63 million US nursing home residents in 1999, up from 1.28 million in 1977. If that rate of increase has been sustained, there are now around 1.76 million nursing home residents in the US, of which an estimated 10%, or 176,000 patients, have bed sores. Nursing home and acute care hospital bed sore cases total an estimated 630,000 patients.

The American Medical Directors Association estimates bed sore prevalence rates, depending on the individual nursing home, of 2.5% to 24%, a range that suggests that there is ample room for improvement in the management of pressure ulcers. With widespread efforts to reduce bed sore prevalence rates, sales of wound care products should continue to rise.

### ***Competition***

The largest competitors in the advanced wound care market include some who are leaders in a number of healthcare markets, such as Johnson & Johnson, Bristol-Myers Squibb (Convatec division) and Smith & Nephew. Johnson & Johnson also competes in the basic wound care market, as do Tyco International (Kendall Tyco division) and Medical Action Industries. In addition to the bigger firms, there are also a number of firms who market generic wound care products.

While there are high-value products in wound care, the market trades largely in high-volume commoditized products characterized by tight pricing and relatively narrow margins. The larger competitors can bring much larger resources to bear on distribution. Also, they may have broader product lines that lend themselves to bundling (and more aggressive pricing) than small firms.

Disadvantages of scale might arguably be offset to a degree by the concentration of Derma Sciences' US markets in New York, Pennsylvania, Illinois and Ohio, where the company's products are well entrenched. The Dermagran® line of advanced wound and skin care products, the company's original product line, and its wound closure strips, remain well accepted and still account for almost \$6 million in annual revenue. But the organic growth of those product lines has been very modest, forcing the company to seek acquisitions and develop products through in-licensed products.

*Field Feedback* – A few clinicians and wound care organizations familiar with Derma Sciences provided us with comments on the company's product line relative to those of its competitors. We note that our feedback is anecdotal and does not lend itself to conclusions as solid as a larger systematic study would. Respondents' comments are distilled here to provide additional perspective.

Clinicians using Derma Sciences' products, particularly the Dermagran line, found them easy to apply and effective in treating bed sores. The Dermagran line is competitively priced and is differentiated to a degree by vitamin and mineral content that promotes healing. One respondent with prior positive experience with Dermagran is now employed by an organization that does not currently use Derma Sciences' products but is evaluating them with a view to making a vendor selection. So far, the company's products' cost and healing properties are viewed as competitive. The one overview offered during our contacts noted satisfaction with Derma Sciences' product line but observed that the company's product lines, largely commoditized, lacked faster-growing, more profitable high-value products due to a lack of investment in R&D spending.

**Strategy**

Derma Science’s growth strategy is dictated in large measure by two considerations. The company is a relatively small firm in a market dominated by competitors with a much larger presence. Wound care represents a market where product lines tend to be largely commoditized. To achieve profitability and sustainable growth, the company has to broaden and differentiate its product line, and reduce its cost structure. With that in mind, Derma Sciences has pursued the following:

Acquisitions – Since 1996, Derma Sciences has made five acquisitions that have expanded its product line, extended its market coverage into Canada and strengthened its manufacturing base. Some acquisitions, however, proved costly as they were integrated, leading to operating losses despite the growth in revenue. In 2004, the cost of consolidating the acquired Kimberly Clark plant and moving it to Canada compressed margins, as did the startup of contract manufacturing for McKesson. But by 2005, the effect of those non-recurring events had passed, enabling Derma Sciences to earn an operating profit of \$270,000 vs. an operating loss of \$1.82 million the year before. The Sunshine Products business has been unprofitable due to a considerable decline in the sale of its skin care line.

<b>Derma Sciences, Inc.</b> Major Acquisitions		
Company	Date	Product Lines
Genetic Laboratories Wound Care, Inc.	Sep 1998	fasteners, securement devices & suture strips.
Sunshine Products, Inc.	Nov 1998	skin care shampoos, lotions, soaps
Dumex Medical, Inc.	Aug 1998	wound care & related devices
Kimberly Clark Corp. (wound care assets)	Jan 2004	wound care/closure & fasteners
Western Medical, Inc. (certain assets)	Apr 2006	compression, support & protective dressings

*Source: Derma Sciences*

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In-licensing – New product development is based on in-licensing agreements rather than internal R&D work. The company aims to launch new in-licensed advanced wound care products during the next year. The first, a silver aginate topical dressing, could be launched shortly. The Manuka Honey-based product is targeted for release by 3Q. Aside from extending the company’s lines, new, differentiated products could create a sell-through effect that would stimulate sales of more established products.

Consolidated production –In-house manufacturing of advanced and basic wound care products has been consolidated in Canada and China. Production at the Texas plant acquired with the Kimberly Clark purchase was transferred to Canada, where all contract manufacturing is done. As the Western Medical purchase did not include manufacturing assets, production of Western’s product line will be brought in-house with the aim of margin improvement through manufacturing consolidation. Capital expenditures for 2006 are projected to be significantly larger than they were in 2005.

Contract manufacturing – Roughly 15% of Derma Science’s revenue is contributed by contract manufacturing for several accounts, including two large distributors, McKesson Corp. and Cardinal Health Inc., and the wound care business of Smith & Nephew PLC. While gross margins on the OEM business are lower than the company’s average, there are fewer SG&A expenses associated with it and it supports margin improvement by absorbing manufacturing overhead.

**Outlook & Projections**

Without the sales contribution of the acquired Western Medical business, 2006 revenue growth comparisons, particularly in 2Q06, could appear difficult due to rising rebates in the trade, unusually high 2Q05 revenue stemming from inventory filling in connection with the initiation in that quarter of an exclusive distribution agreement in Canada and further weakening in the sales wound closure/fastener and skin care products. The Canadian distributor’s inventory buildup added roughly \$1.74 million to 2Q05 revenue. The skin care business is projected to continue operating largely at a loss; we believe that a reasonable offer for this business would be accepted. Its valuation has declined significantly since it was acquired, forcing the company to write off \$91 million in 2005 as impaired goodwill. But modest organic revenue growth for 2006, the contribution of the Western Medical business, the rollout of new in-licensed products and operating margin improvement could,

Derma Sciences, Inc.

before the effects of acquisition-related costs and stock-based compensation, potentially lead to a profitable 2006. Costs relating to the Western acquisition are estimated by management at roughly \$1 million.

*Operating Projections* - By our estimates, Derma Sciences will earn \$0.02 per share, or \$0.06 per share before the effect of \$1 million in acquisition transaction costs and stock-based compensation, for 2006. That per share figure reflects dilution stemming from the April 2006 issuance of 10.6 million common shares. Revenue from the acquired Western Medical business, roughly \$6.6 million, should contribute significantly to this year's sales. However, the organic growth we project for this year will be modest (4%) and the Western contribution to 2006 revenue is likely to make sales comparisons difficult in 2007.

<b>Derma Sciences, Inc.</b>										
<b>Sales &amp; Margins By Product Line</b>										
<b>2005 - 2006E</b>										
	2 0 0 5					2 0 0 6				
	1QA	2QA	3QA	4QA	2005A	1QA	2QE	3QE	4QE	2006E
<b>Product Line Net Sales</b>										
Wound care	3.87	5.88	4.68	4.93	19.37	4.88	5.43	6.52	6.83	23.66
Wound closure and fasteners	0.63	0.67	0.66	0.72	2.68	0.59	0.64	0.62	0.69	2.54
Skin care	0.39	0.38	0.37	0.35	1.50	0.28	0.31	0.30	0.28	1.17
<b>Total</b>	<b>4.89</b>	<b>6.93</b>	<b>5.71</b>	<b>6.01</b>	<b>23.55</b>	<b>5.76</b>	<b>6.38</b>	<b>7.44</b>	<b>7.80</b>	<b>27.37</b>
<b>YoY % Change in sales</b>										
Wound care	7%	70%	25%	29%	33%	26%	(8%)	39%	38%	22%
Wound care ex Western						26%	(29.2%)	5.0%	5.0%	(1.1%)
Wound closure and fasteners	(34%)	(29%)	(9%)	1%	(20%)	(6%)	(5%)	(5%)	(5%)	(5%)
Skin care	(15%)	(26%)	(28%)	(21%)	(23%)	(29%)	(20%)	(20%)	(20%)	(20%)
<b>Total</b>	<b>(3%)</b>	<b>41%</b>	<b>15%</b>	<b>21%</b>	<b>18%</b>	<b>18%</b>	<b>(8%)</b>	<b>30%</b>	<b>30%</b>	<b>16%</b>
<b>Product Line Gross Margins</b>										
Wound care	28%	33%	34%	39%	34%	39%	39%	39%	39%	39%
Wound closure and fasteners	50%	51%	51%	52%	51%	49%	50%	50%	50%	50%
Skin care	1%	(26%)	6%	(8%)	(7%)	(1%)	(1%)	(1%)	(1%)	(1%)
<b>Total</b>	<b>28%</b>	<b>31%</b>	<b>34%</b>	<b>38%</b>	<b>33%</b>	<b>38%</b>	<b>38%</b>	<b>38%</b>	<b>39%</b>	<b>38%</b>

Source: Company reports and Taglich Brothers estimates

Western Medical's gross margins, slightly higher than Derma Sciences' pre-acquisition gross margin, bode well for an improvement in profitability, as does Western Medical's pre-tax margin, which was significantly better than the company's for 2005. Larger production volumes – Derma Sciences is taking over the production of the Western Medical line - should also help raise the company's gross margin. None of Western's infrastructure was acquired so the purchase should also have the effect, before acquisition-related costs, of improving expense margins. The divestment of the skin care business would arguably improve profitability. While Derma Sciences is not actively seeking a buyer at this time, we believe that a reasonable offer for the skin care line would be accepted. Operating income gains will be partly offset by higher interest expenses stemming from additional debt taken on to provide some financing for the Western Medical purchase.

Our preliminary estimate of 2007, before the effect of stock-based compensation, is \$0.06 per share. If the skin care business is divested, and the Western acquisition is more synergistic than our estimates imply, earnings for 2007 could be higher. That estimate is based on organic revenue growth of 4%, led by the wound care line, and a slight improvement in gross margin and operating expense leverage.

As the company had US NOL carryforwards of \$8.9 million at the end of 2005, we have not factored income taxes into our 2006 or 2007 operating projections.

*Financial Position & Cash Flow* – Management of principal trading assets has improved considerably during the past three years, with DSOs reduced by more than half and inventory turnover rates increased significantly. Better turnover rates in receivables and inventory in 2005 improved cash flow to a point where the company was able to reduce its bank borrowings. Our cash flow projections for 2006 are based in part on DSO and inventory turnover staying at rates seen in 2005 and 1Q06. Despite the relatively high level of capital expenditures anticipated by management for 2006 (around \$800,000 vs. \$220,000 for 2005), cash flow should be strong enough, by our estimates, to reduce line of credit use late in the year.

Borrowings are up again due to an additional \$1 million in bank debt and a \$500,000 note taken on in April 2006 to help finance the Western Medical purchase. Of the \$6.6 million purchase price, \$6.0 million was paid in cash raised through the sale of common stock (\$5.9 million net proceeds), \$1 million in bank term borrowings and a \$0.5 million note payable to Western Medical. At time of the stock sale, Derma Sciences received a \$1.0 million term loan, proceeds from which were applied to the purchase of Western Medical.

Debt facilities consist of a \$2 million US three-year revolving line and a \$685,000 Canadian revolving line that is renewable annually. In connection with the Western Medical purchase, the company's US credit agreement was amended to include a \$1 million term loan on which interest-only payments are payable through September 2006. After that, the rest of the term loan is payable in 28 monthly interest+principal installments payable.

The positive cash flow we project for the rest of the 2006 should enable the company to enlarge its cash position by the end of the year despite relatively heavy capital expenditures for the year. 2006's cash flow and the increase in shareholders' equity should underlie a continuing improvement in debt ratios throughout the year.

## **Management**

The following are Derma Science's executive officers:

**Edward J. Quilty** Chief Executive Officer since November, 1996, Chairman since May, 1996 and Director since March, 1996. Has over 30 years of experience in the healthcare industry primarily in strategic planning, management and sales and marketing. November 1995 - May, 2000 Chairman, Palatin Technologies, Inc., a publicly traded biopharmaceutical company. November, 1996 - May, 2000 held CEO position at both Derma Sciences and Palatin Technologies, Inc. July, 1994 - November, 1995, President and CEO, MedChem Products, Inc., a publicly traded specialty medical products company acquired by C. R. Bard in November, 1995. March, 1992 - July, 1994 President and CEO, Life Medical Sciences, Inc., a publicly traded specialty medical products (including wound healing agents) company. The assets of Life Medical Sciences were purchased by MedChem Products, Inc. January, 1987 - September, 1991 Vice President – Sales and Marketing, later Executive Vice President (in which capacity he shared the office of the President) with McGaw Laboratories, a pharmaceutical and medical device company. From 1974 held several sales, marketing and management positions with Baxter/American Hospital Supply Corporation. Director of the MedTech Group, a privately held medical products company. BS 1973, Missouri State University. MBA 1987, Ohio University.

**John E. Yetter, CPA** Vice President and Chief Financial Officer August, 2000. Prior to joining the company, held senior financial positions with Bristol-Myers Squibb Company. Prior to Bristol-Myers Squibb, held several supervisory financial positions with Cooper Industries, Inc., Price Waterhouse and Hulse Manufacturing Company. Member of the American Institute of Certified Public Accountants and the New York Society of Certified Public Accountants. BS Accounting 1975, Boston College.

**Robert C. Cole** Recently appointed Executive Vice President for Sales of the Company. Was Vice President – Sales and Marketing since January, 2003. Prior to joining Derma Sciences, held a variety of executive sales positions with B. Braun Medical and predecessor firms beginning in 1974, most recently as Vice President, Sales, Eastern Zone. BS Biology, 1974, St. Vincent's College.

**Frederic Eigner** Executive VP for Operations. Also General Manager of the Canadian subsidiary, Derma Sciences Canada Inc., since March, 2005. Previously VP for Operations of Derma Sciences Canada Inc. since

August, 2002. Prior to its acquisition by Derma Sciences, held several positions with Dumex Medical Inc. from 1992 until August 2002, most recently as Executive VP. Prior to Dumex Medical, held several executive manufacturing positions with The Kendall Company (1980 – 1992) most recently as Director of Manufacturing. BS Industrial Engineering, 1975, High Technical School (Slovenia). MS Chemical Engineering, 1980, University of Maribor (Slovenia), MBA 2000, University of Toronto.

**Barry J. Wolfenson** Vice President, Marketing and Business Development. February 2004 - February 2006 Director of Marketing. Prior to joining the Derma Sciences, held several sales and marketing positions with Bristol-Myers Squibb from 2001, most recently as Marketing Manager, Bristol-Myers Squibb Conva-Tec division. Prior to Bristol-Myers Squibb, operated an entrepreneurial venture and was an account executive with Anderson Consulting. BS Economics 1989, Franklin and Marshall College. MBA 2001, University of Michigan.

## ***Risks***

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

*Execution* Revenue growth hinges largely on the company's success in securing productive in-licensing agreements that can build a product pipeline, making accretive acquisitions that can be smoothly integrated and maintaining organic growth. There are inherent integration risks that could degrade profitability. Also, acquired businesses do not necessarily make the desired contribution. Sunshine Products is an example. The sales performance of Sunshine's products has deteriorated since they were acquired, resulting in a large goodwill impairment charge in 4Q05. While driven in part by revenue gains, profit improvement will depend on success at improving manufacturing efficiency and reducing operating expense margins.

In light of the company's operating history, execution risks appear high. Derma Sciences has suffered through periods of largely flat organic growth, relying heavily on acquisitions, all of which come with inherent integration risks, to expand its revenue. While a degree of risk can be anticipated, this risk, in hindsight, appears somewhat acute in this case. The Sunshine Products purchase is an example of a troublesome acquisition.

Rising sales volume generally can lead to improved operating expense leverage, which is evident in 2004-2005 comparisons. But stalled organic growth, which the company has experienced in the past, could preclude a narrowing in operating expense margins.

*Competition* Aside from the large companies mentioned earlier, there are a number of smaller firms whose generic products compete with those of Derma Sciences. With organic growth relatively difficult to achieve, the company needs to refresh and enrich its sales mix. The company's current inclination, probably based on financial necessity, precludes internal R&D, leaving in-licensing and technology purchases as the only means refreshing the product line with high-value products. But internal R&D would be constrained by relatively thin capitalization. What's more, industry leaders are likely to be perceived by potential licensors as more attractive collaborators, limiting the company's access to possible sources of new product opportunities.

The absence of a robust internal product development effort has margin as well as sales growth implications. With limited ability to enrich its sales mix with high value products, the company's competitiveness could slip and gross margin could stagnate. Should the lower-margin OEM business, currently around 15% of sales, become a more prominent component of the revenue mix, gross margins could decline.

*Capitalization* Through 2004, Derma Sciences' balance sheet was somewhat leveraged due partly to an inability to expand equity through profit generation. Small common stock sales improved the balance sheet slightly in 2004 and 2005 but the largest expansion in its capital base came from the sale last April 1, 2006 of 10.6 million common shares. Limited capital has constrained the company's ability to finance its external growth efforts and in the absence of a considerable improvement in profits (and cash flow), Derma Sciences may have to return to the markets.

The company's debt ratios have narrowed considerably during the past three years and by the end of 2005, Derma Sciences looked somewhat conservatively capitalized. However, the improvement in debt balance has been achieved almost solely through sales of common stock. April's common stock sale improved debt balance considerably, but did so at a high price. The sale was highly dilutive, practically doubling the number of shares outstanding. Until the company begins earning (and retaining) profits, substantive internally driven increases in capitalization are not likely.

Microcap Concerns Shares of DSCI have risks common to the stocks of other microcap (which we define as market capitalizations of \$250 mil or less) companies. These risks often underlie stock price discounts from the valuations of larger-capitalization stocks. Liquidity risk, typically caused by small trading floats and very low trading volume, can lead to large spreads and high volatility in stock price. The Company has approximately 12.3 million shares in the float. On average, approximately 22,800 shares are traded daily.

Federal Reserve/FOMC - The Federal Reserve raised the Discount Rate and its target rate for Fed Funds several times during the past year or so. At this writing, fears of further rate increases triggered by inflation concerns are having a depressive market effect that could be amplified in the case of microcap stocks such as Derma Sciences. To the extent that further increases lie ahead, equity valuations are likely to could suffer.

Miscellaneous Risks The Company's financial results and equity values are subject to other risks and uncertainties known and unknown, including but not limited to competition, operations, financial markets, regulatory risk, and/or other events. These risks may cause actual results to differ from expected results.

### ***Investment Recommendation***

**We have rated Derma Sciences a Speculative Buy and have a 12-month price target of \$0.95.** The risk factors discussed above, particularly execution risk, will bear on stock price valuation, as will its recent history of weak profitability. As the company's core product lines are relatively mature and commoditized, organic revenue growth prospects are modest. But manufacturing efficiency gains and better control of operating expenses should improve gross and operating margins, respectively. So should synergisms from the integration of the Western Medical business.

If the company's results for 2Q06 and 3Q06 point to at least modest revenue and profitability gains for the full year, investors will, in our view, accord DSCI a valuation multiple of 0.9X of sales. We note that the purchase price for Western Medical was 0.98X its 2005 revenue of \$6.6 million. Western's 2005 gross margin was slightly higher than Derma Sciences'; its pre-tax margin of roughly 11% was significantly better.

A valuation of 0.9 times 2006 revenue would imply valuation of roughly \$25 million, or \$0.95 per share, during the next year. That target, which approximates the stock's 52-week high, implies year-ahead stock price appreciation of more than 15%. Should 2006 results raise investors' confidence in the company's ability to sustain organic sales growth and margin improvement, the stock's valuation multiple could be higher.

## Appendix A – Product Lines

### Wound Care Product Line

#### *Primary Dressings - Wound Care*

Dermagran® Ointment

Topical ointment with a lanolin odor, packaged in both jars and tubes. Active ingredient: aluminum hydroxide gel. Used to manage stage I pressure and venous ulcers, incisions, burns and other skin irritations.

Dermagran® Spray

Colorless, odorless liquid, packaged in opaque plastic bottles with pump spray nozzles. Active ingredient: zinc acetate. Used to manage stage I pressure and venous ulcers, incisions, burns and other skin irritations.

Dermagran® Hydrophilic Wound Dressing

Advanced zinc hydrogel formulation impregnated in gauze pad. Used for the management of stages II through IV pressure sores, diabetic ulcers, venous stasis ulcerations, thermal burns, surgical incisions and superficial lacerations, cuts or abrasions. Also packaged in tubes and sold as Dermagran®-B Hydrophilic Wound Dressing.

#### *Primary Dressings - Hydrocolloid Dressings*

Primacol Hydrocolloid Dressing

Sterile, transparent, hydrocolloid dressing packaged in various sizes to accommodate different uses. Used to protect the wound from outside contamination such as bacteria, fecal matter, or urine. Available in the following configurations: Primacol Bordered Hydrocolloid Dressing, Primacol Thin Hydrocolloid Dressing, Primacol Specialty Hydrocolloid Dressing – Sacral and Primacol Specialty Hydrocolloid Dressing – Heel and Elbow.

#### *Primary Dressings - Calcium Alginate Dressings*

Algicell Calcium Alginate Dressing

Sterile dressing containing alginate ropes. Used for the absorption of moderate to large amounts of wound exudate and management of minor bleeding.

#### *Primary Dressings - Hydrogel Dressings*

AquaSite Amorphous Hydrogel Dressing

Clear sterile gel packaged in bellows and tubes. Used for filling wounds, while keeping them moist, and absorbing small to moderate amounts of wound exudate.

AquaSite Impregnated Dressing

Sterile, gauze dressing (either non-woven or sponge) impregnated with absorbent hydrogel. Used for packing wounds and treating lightly exuding, partial or full thickness wounds.

#### *Primary Dressings - Foam Dressings*

HydroCell Foam Dressing

Sterile polyurethane foam sheet with protective film. Used to protect the wound from outside contaminants. Available in adhesive and non-adhesive forms in the following configurations: HydroCell Adhesive Foam Dressing and HydroCell Thin Adhesive Foam Dressing.

SorbaCell Foam Dressing

Sterile foam dressing used to absorb exudate while cushioning and protecting the wound.

**Wound Care Product Line (continued)**

***Secondary Dressings - Bandages***

Conforming Bandages	Stretch gauze bandages used as secondary dressing for wrapping legs and arms and to hold dressings in place. Available in the following configurations: Dutex® 100% Cotton 2 Ply Conforming Bandage – Non-Sterile and Sterile, Durlax® Bandage Rolls – Non Sterile and Sterile, DuForm® Knitted Synthetic Conforming Bandage – Non-Sterile and Sterile, DuForm® Synthetic Conforming Bandage and DuFlex® Woven Synthetic Conforming Bandage – Non-Sterile and Sterile.
Gazetex® Bandage Rolls – Non Sterile and Sterile	Washed low-linting woven gauze rolls. Used for wrapping or packing large and deep wounds.
Compression Bandaging Systems	Latex free systems of multiple layers used for graduated compression on venous leg ulcers. The Company’s bandaging systems are available in the following configurations: DuBoot Two-Layer Paste Compression Bandaging System, TresFlex Three-Layer Compression Bandaging System and DuFore Four Layer Compression Bandaging System.
UnnaPress® Paste Bandage	Latex free bandage (with or without calamine lotion). Used for maintaining a moist wound environment, resisting edema formation, and protecting the wound from external contamination and mechanical disruption during the healing process.
ElasTive Elastic Adhesive Bandage	Latex free, non-allergenic, adhesive bandage made of 100% cotton. Used to conform to body contours without restriction.
DuSor Elastic Bandage Premium and Economy	Latex free, cotton-wrapped bandage with heat resistant rubber strands. Used for firm compression and vascular and muscle support. Available in premium and economy versions as well as with a velcro closure (“PrimaCare Elastic Bandage with Velcro Closure”).

***Operating Room Sponges***

Laparotomy Sponges – Non-sterile and Sterile, X-Ray Detectable	Pre-washed or non-washed low lint, X-Ray detectable sponges used to absorb blood and other fluids during surgery.
DuPaque Non-Sterile and Sterile X-Ray Detectable Gauze Sponges	Opaque sponge made of 100% USP fine mesh absorbent cotton with folded edges. Used to absorb blood and other fluids during surgery. Includes an X-Ray detectable mono-filament thread.

***Secondary Dressings - Abdominal Pads***

DuPad® Sealed-End Abdominal Pads – Non-Sterile and Sterile	Sealed-end, absorbent secondary dressing used to absorb and disperse wound exudate.
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***Secondary Dressings - Burn Dressings***

DuPress Sterile Burn Dressing	Gauze dressing filled with cellulose. Used to absorb large amounts of fluids and minimize trauma and adherence to the wound.
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## Wound Care Product Line (continued)

### *Secondary Dressings - Wound Cleansing Products*

Sterile Water or Saline

Sterile water or saline packaged in plastic squirt bottles for use in wound cleansing.

### *Other*

Enteral Feeding Systems

Enteral feeding systems distributed by Derma Canada and sold exclusively in Canada. Used to administer nutrients to patients unable to feed themselves through normal means.

## Wound Closure and Fastener Product Line

Suture Strip and Strip Plus® Wound Closure Strips Latex-free, sterile, flexible, moisture resistant wound closure strips made of a macroporous non-woven polyamide and adhesive. Used in surgical and wound closure procedures.

Shur Strip® Wound Closure Strips

Shur Strips provide an alternative to our Suture Strips that are more similar to the market leading brand. Shur Strips are latex free sterile skin closure strips that are made of a porous, non-woven backing coated with a pressure-sensitive, hypoallergenic adhesive. These strips are rigid thereby keeping wound edges securely together to maximize wound healing.

UC Strip® Catheter Tubing Fastener

Latex-free, flexible, moisture resistant, one-piece catheter/tubing fastener made of a macroporous non-woven polyamide with adhesive. Used to secure urinary and gastrostomy catheter tubing to the patient.

Cath-Strip® Recloseable Catheter Fastener

Latex-free, flexible, moisture resistant multi-use recloseable catheter fastener with adhesive. Used with urinary catheters, gastrostomy and jejunostomy tubes, wound drainage systems, central line catheters, and multi-port IVs.

## Skin Care Product Line

### *Skin Care and Personal Hygiene Products*

Soft Wash Bathing Sponge

Latex-free, no rinse, single use bath sponge impregnated with a gentle soap and moisturizers.

Optima Bath Additive

Bath additive or after-bath moisturizer enhanced with acetylated lanolin alcohol. Used to lubricate and soften the skin.

Hydro-soft Skin Conditioner

Concentrated blend of skin emollients and gentle skin cleansers for moisturizing and conditioning the skin. Used in whirlpool and hydrotherapy units.

Hair and Skin Cleansers and Washes

The Company has various hair and skin cleansers/washes: Swash Conditioning Shampoo and Body Wash, Therabath Hair and Skin Cleanser, Bathe Away® Hair and Skin Cleanser and ApriVera® Hair and Skin Cleanser with AloeVera, Primaderm® Anti-Dandruff Shampoo, Primaderm No Rinse Shampoo and Body Wash and fragrance free Primaderm Body and Hair Cleanser.

**Skin Care Product Line (continued)**

***Skin Conditioners and Moisturizers***

Skin Care Lotion

Lotion to moisturize and soften the skin.

Primaderm® Skin Protectant Lotion with 3% Dimethicone

Greaseless and non-staining dry skin moisturizer designed to prevent and relieve chapped and cracked skin.

***Incontinence Products***

In-Between® Perineal Spray Skin Cleanser

An odor eliminating skin cleanser used to cleanse the entire perineal skin area.

Dermagran® 3-N-1

High foaming, pH balanced all-over body cleanser. Used as a no rinse perineal/skin cleanser and shampoo. Contains cleansing agents designed to dissolve fecal soils resulting from incontinence. Enhanced with Aloe Vera and other emollients to soothe and moisturize delicate and fragile skin. Contains zinc and Vitamin B6 to optimize skin integrity.

Dermagran® GP General Skin Protectant Ointment

An ointment containing allantoin and aloe vera gel. Used as a moisture barrier on external skin areas where repeated exposure to body excrements and exudates may cause skin break down. May be used as skin barrier on friction points.

Dermagran® BC Perineal Protectant Ointment

An ointment consisting of a non-greasy formulation based upon the Company's proprietary Zinc-Nutrient and balanced pH technology. Used as a protectant against minor skin irritations due to moisture, urine, feces and perspiration.

***Skin Protectants***

Dermagran® AF Antifungal Ointment

An ointment containing miconazole nitrate and the Company's Zinc-Nutrient and balanced pH technology. Used for maintaining healthy skin and providing a long-acting barrier against moisture. Miconazole nitrate is used to treat jock itch, ringworm and athlete's foot.

***Sanitizing Products***

Mysotrol® No rinse Hand Sanitizer

Waterless, no rinse hand sanitizer containing ethyl alcohol. Provides germicidal and virucidal action and meets OSHA protocol for a healthcare personnel handwash while reducing the risk of nosocomial infections.

Antibacterial Soap

An antibacterial soap containing chloroxylenol used to reduce nosocomial infections including both gram-positive and gram-negative organisms as well as yeast and fungus in institutional environments.

Bacti-Guard Antibacterial Hand Soap

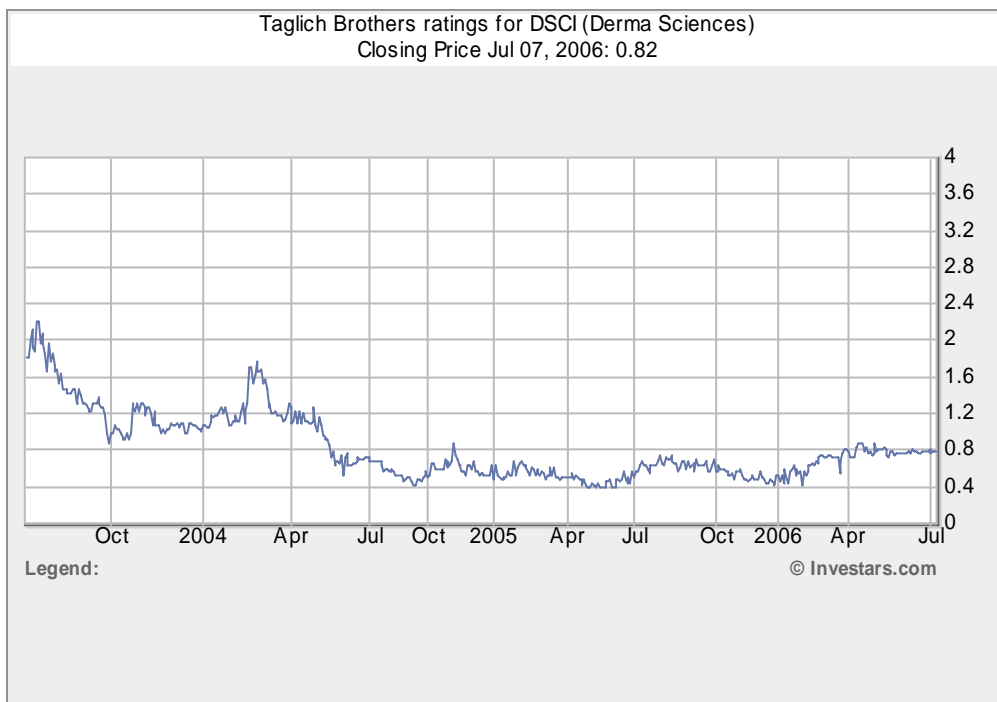
An antibacterial hand soap containing triclosan, aloe vera and glycerin. Used to reduce nosocomial infections including both gram-positive and gram-negative organisms, as well as yeast and fungus in institutional environments.

Whirlpool/Hard Surface Detergent/Disinfectant

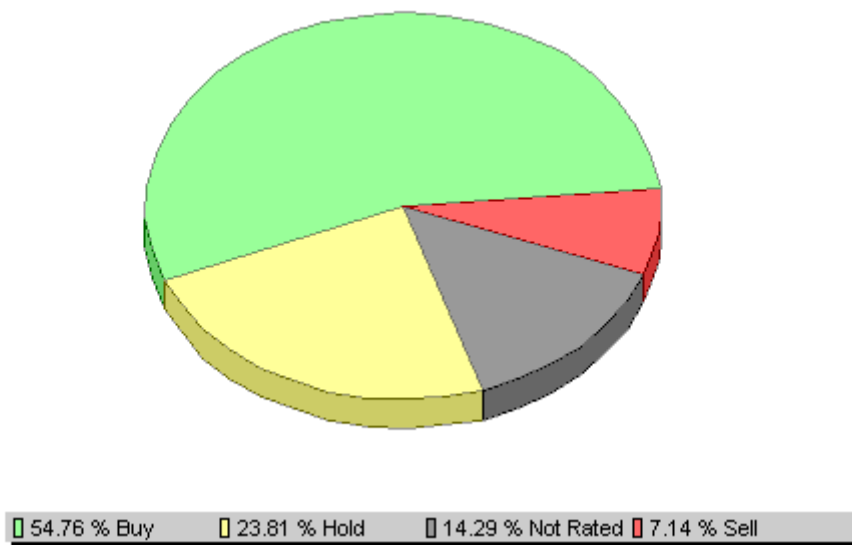
A detergent used specifically for cleaning hard surfaces and whirlpool units in nursing homes, hospitals and other institutions. Also effective as a bactericide, mildewstat, sanitizer, virucide and fungicide in the presence of organic soil (5% blood serum).

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Source: Company reports



Taglich Brothers Current Ratings Distribution



<b>Investment Banking Services for Companies Covered in the Past 12 Months</b>		
<u>Rating</u>	<u>#</u>	<u>%</u>
Buy	1	3.45%
Hold	0	0
Sell	0	0
Not Rated	1	7.14%

### Meaning of Ratings

#### Buy

We believe the Company is undervalued relative to its market and peers. We believe its risk reward ratio strongly advocates purchase of the stock relative to other stocks in the marketplace. Remember, with all equities there is always downside risk.

#### Speculative Buy

We believe that the long run prospects of the Company are positive. We believe its risk reward ratio advocates purchase of the stock. We feel the investment risk is higher than our typical “buy” recommendation. In the short run, the stock may be subject to high volatility and continue to trade at a discount to its market.

#### Neutral

We will remain neutral pending certain developments.

#### Underperform

We believe that the Company may be fairly valued based on its current status. Upside potential is limited relative to investment risk.

#### Sell

We believe that the Company is significantly overvalued based on its current status. The future of the Company's operations may be questionable and there is an extreme level of investment risk relative to reward.

### **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.**

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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.

**Public Companies mentioned in this report:**

Baxter International Inc.	(BAX)
Birstol Myers Squibb Co.	(BMY)
C. R. Bard	(BCR)
Cardinal Health Inc.	(CAH)
Johnson & Johnson	(JNJ)
Kimberly Clark Corp.	(KMB)
McKesson Corp	(MCK)
Medical Action Industries, Inc.	(MDCI)
Smith & Nephew PLC	(SNN)
Tyco International Ltd.	(TYC)

\* The information and statistical data contained herein have been obtained from sources, which we believe to be reliable but in no way are warranted by us as to accuracy or completeness. We do not undertake to advise you as to changes in figures or our views. This is not a solicitation of any order to buy or sell. Taglich Brothers, Inc. is fully disclosed with its clearing firm, Pershing, LLC, is not a market maker and does not sell to or buy from customers on a principal basis. The above statement is the opinion of Taglich Brothers, Inc. and is not a guarantee that the target price for the stock will be met or that predicted business results for the company will occur. There may be instances when fundamental, technical and quantitative opinions contained in this report are not in concert. We, our affiliates, any officer, director or stockholder or any member of their families may from time to time purchase or sell any of the above-mentioned or related securities. Analysts and members of the Research Department are prohibited from buying or selling securities issued by the companies that Taglich Brothers, Inc. has a research relationship with, except if ownership of such securities was prior to the start of such relationship, then an Analyst or member of the Research Department may sell such securities after obtaining expressed written permission from the Director of Research. In April 2006, Taglich Brothers underwrote an offering of 7,548,064 Derma Sciences' common shares at \$0.60 per share and 1,887,016 warrants exercisable at \$1.00 per share. Taglich Brothers employees acquired 754,806 warrants, distributed as follows: Michael Taglich (194,312), Robert Taglich (194,312), Vincent Palmieri (100,000), Michael Brunone (52,000), Douglas Hailey (44,182), Richard Oh (30,000), Robert Schroeder (20,000) and Russell Bernier (20,000). The remaining 100,000 warrants will be distributed among investment banking staff prior to the end of 2006. As of the date of this report, the following officers of the firm owned or controlled restricted common shares and additional warrants acquired through their participation in the April 2006 private placement of Derma Sciences common shares: Michael Taglich (416,966 shares; 145,700 warrants) and Robert Taglich (416,664 shares; 104,166 warrants). All research issued by Taglich Brothers, Inc. is based on public information. The company paid a monetary engagement fee of \$21,000 (USD) for the first year of creation and dissemination of research reports and will pay a monthly monetary fee of \$1,750 (USD) to Taglich Brothers, Inc. for these services after the first year.

**I, Juan Noble, 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.**

Derma Sciences, Inc.  
Quarterly Income Statements  
2005 – 2006E  
(\$ Millions, Except Per Share Amounts)

	2 0 0 5					2 0 0 6				
	1QA	2QA	3QA	4QA	2005A	1QA	2QE	3QE	4QE	2006E
Sales	4.89	6.93	5.71	6.01	23.55	5.76	6.38	7.44	7.80	27.37
Cost of sales	3.51	4.76	3.75	3.74	15.76	3.56	3.94	4.62	4.79	16.92
Gross Profit	1.39	2.17	1.96	2.27	7.79	2.19	2.44	2.82	3.00	10.45
Operating expenses										
Distribution	0.35	0.34	0.39	0.49	1.56	0.42	0.32	0.48	0.55	1.76
Marketing	0.10	0.13	0.09	0.10	0.42	0.14	0.16	0.17	0.19	0.66
Sales	0.46	0.48	0.46	0.52	1.91	0.51	0.54	0.61	0.64	2.30
G&A	0.86	0.95	0.89	0.92	3.63	1.06	0.96	1.08	1.13	4.22
Acquisition-related costs							1.00			1.00
Operating expenses	1.76	1.90	1.83	2.02	7.52	2.12	2.98	2.34	2.51	9.96
Operating income (loss)	(0.38)	0.27	0.13	0.24	0.27	0.07	(0.54)	0.48	0.49	0.49
Goodwill impairment loss				0.91	0.91					
Interest expense - net	0.08	0.10	0.08	0.08	0.34	0.08	0.05	0.04	0.03	0.19
Other exp (income)	(0.17)	0.02	0.01	0.06	(0.07)	(0.07)				(0.07)
Pre-tax profit (loss)	(0.30)	0.16	0.04	(0.81)	(0.91)	0.06	(0.59)	0.44	0.46	0.37
Income taxes										
Net income (loss)	(0.30)	0.16	0.04	(0.81)	(0.91)	0.06	(0.59)	0.44	0.46	0.37
Avg. shares out. (mil)	12.01	14.75	15.80	12.29	12.22	15.66	26.28	26.28	26.28	23.62
Earnings per share - diluted	(0.02)	0.01	0.00	(0.07)	(0.07)	0.00	(0.02)	0.02	0.02	0.02
Margin analysis										
Gross margin	28.4%	31.3%	34.3%	37.8%	33.1%	38.1%	38.2%	37.9%	38.5%	38.2%
Distribution	7.1%	4.9%	6.8%	8.1%	6.6%	7.2%	5.0%	6.5%	7.0%	6.4%
Marketing	2.0%	1.9%	1.6%	1.7%	1.8%	2.5%	2.5%	2.3%	2.5%	2.4%
Sales	9.3%	6.9%	8.0%	8.7%	8.1%	8.8%	8.5%	8.3%	8.3%	8.4%
G&A	17.7%	13.8%	15.6%	15.3%	15.4%	18.4%	15.0%	14.5%	14.5%	15.4%
Operating income (loss)	(7.7%)	3.9%	2.3%	4.0%	1.1%	1.2%	(8.5%)	6.4%	6.3%	1.8%
Net income (loss)	(6.1%)	2.3%	0.8%	(13.6%)	(3.9%)	1.0%	(9.2%)	5.9%	5.9%	1.4%

Source: Company reports and Taglich Brothers estimates

Derma Sciences, Inc.  
Annual Income Statements  
2003 – 2006E  
(\$ Millions, Except Per Share Amounts)

	<u>FY2003A</u>	<u>FY2004A</u>	<u>FY2005A</u>	<u>FY2006E</u>
Sales	17.94	19.89	23.55	27.37
Cost of sales	11.80	14.34	15.76	16.92
Gross Profit	6.14	5.55	7.79	10.45
Operating expenses				
Distribution	--	1.43	1.56	1.76
Marketing	--	0.37	0.42	0.66
Sales	--	1.90	1.91	2.30
G&A	--	3.67	3.63	4.22
Acquisition-related costs	--	--	--	1.00
Total	6.06	7.38	7.52	9.96
Operating income	0.08	(1.82)	0.27	0.49
Goodwill impairment loss	--	--	0.91	--
Interest expense - net	0.26	0.23	0.34	0.19
Other (expense)/ income	(0.21)	0.29	(0.07)	(0.07)
Pre-tax profit	0.02	(2.34)	(0.91)	0.37
Income taxes				
Net income	0.02	(2.34)	(0.91)	0.37
Avg. shares out. (mil)	10.80	9.42	12.22	23.62
Earnings per share	0.00	(0.25)	(0.07)	0.02
Margin analysis				
Gross margin	34.2%	27.9%	33.1%	38.2%
Sales/marketing	--	7.2%	6.6%	6.4%
G&A	--	1.9%	1.8%	2.4%
Operating income	0.4%	(9.2%)	1.1%	1.8%
Pre-tax income	0.1%	(11.8%)	(3.9%)	1.4%
Net income	0.1%	(11.8%)	(3.9%)	1.4%

Source: Company reports and Taglich Brothers estimates

Derma Sciences, Inc.  
Balance Sheets  
2003 – 2006E  
(\$ Millions)

As of December 31:	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2 0 0 6</u>	<u>1QA</u>	<u>Yr-end E</u>
<b>A S S E T S</b>						
Current assets						
Cash & equivalents	0.44	0.05	1.11	0.07	1.04	
Accts receivable	2.63	2.60	1.23	1.30	1.73	
Inventory	4.00	4.93	3.87	4.74	4.79	
Prepayments & other	0.35	0.18	0.21	0.34	0.39	
Total current assets	<u>7.42</u>	<u>7.76</u>	<u>6.41</u>	<u>6.45</u>	<u>7.95</u>	
Fixed assets (net)	1.08	3.66	3.39	3.31	3.43	
Goodwill	1.11	1.11	0.20	0.20	3.70	
Intangibles	0.12	0.38	0.30	0.28	1.91	
Other assets	0.19	0.13	0.30	0.32	0.39	
Total assets	<u>9.93</u>	<u>13.05</u>	<u>10.60</u>	<u>10.57</u>	<u>17.38</u>	
<b>LIABILITIES &amp; EQUITY</b>						
Current liabilities						
Line of credit borrowings	1.36	2.82	1.08	0.85	0.50	
Long-term debt (curr)	0.18	0.25	0.29	0.29	0.62	
Note payable (curr)					0.02	
Accounts payable	0.73	1.25	1.20	1.50	1.48	
Accruals & other	0.31	0.59	0.49	0.39	0.55	
Total current liabilities	<u>2.59</u>	<u>4.91</u>	<u>3.06</u>	<u>3.03</u>	<u>3.16</u>	
Long-term debt	0.85	0.87	0.39	0.31	0.59	
Note payable					0.45	
Other long-term liabilities		0.05	0.10	0.11	0.14	
Common shareholders' equity	6.49	7.22	7.05	7.12	13.03	
Total liabilities & equity	<u>9.93</u>	<u>13.05</u>	<u>10.59</u>	<u>10.57</u>	<u>17.38</u>	
Days sales outstanding	53.4	47.7	19.0	20.4	20.0	
Inventory turnover	2.9	2.9	4.1	3.6	4.0	
Days payables outstanding	22.6	31.8	27.7	32.3	27.7	
Quick ratio	1.2	0.5	0.8	0.5	0.9	
Current ratio	2.9	1.6	2.1	2.1	2.5	
Total debt to equity	37%	55%	25%	20%	13%	
Total debt to tangible equity	45%	69%	27%	22%	23%	
LTD/capitalization	14%	13%	9%	8%	9%	

Source: Company reports and Taglich Brothers estimates

Derma Sciences, Inc.  
Cash Flow Statements  
2002 – 2006  
(\$ Millions)

	<u>FY2003A</u>	<u>FY2004A</u>	<u>FY2005A</u>	<u>F Y 2 0 0 6</u>	
				<u>1QA</u>	<u>Full Yr E</u>
<b>Operating Activities</b>					
Net income (loss)	0.02	(2.34)	(0.91)	0.06	0.37
Adjustments:					
Depreciation	0.16	0.32	0.49	0.14	0.61
Amortization - intangible assets	0.09	0.12	0.08	0.02	0.21
Amortization - deferred financing costs	0.07	0.09	0.07	0.02	0.08
Provision for bad debts and rebates	0.11	0.02	1.20	0.27	1.08
Provision for inventory obsolescence	0.05	0.20	0.29	0.02	0.10
Goodwill impairment loss		0.00	0.91		
Loss on disposal - fixed assets	0.00	0.27	0.07		
Deferred rent expense		0.05	0.04	0.01	0.02
Employee stock option expense	0.06		0.02	0.04	0.15
Gain on settlement of accts pay				(0.06)	(0.06)
Net change in working capital	(1.47)	0.15	0.69	(1.12)	(1.58)
Net cash provided by (used in) operating activities	(0.92)	(1.12)	2.96	(0.61)	0.98
<b>Investing Activities</b>					
Business/product rights acquisition costs	(0.11)	(1.94)	(0.05)	(0.05)	(6.55)
Capital expenditures	(0.09)	(1.03)	(0.22)	(0.08)	(0.83)
Proceeds - sale of fixed assets		0.00	0.03		
Net cash used in investing activities	(0.20)	(2.97)	(0.24)	(0.13)	(7.38)
<b>Financing Activities</b>					
Net change in bank line of credit	(0.82)	1.35	(1.68)	(0.23)	(0.58)
Deferred financing costs	(0.03)	(0.09)	(0.12)		
Long-term debt (repayments) proceeds	(0.20)	(0.21)	(0.45)	(0.07)	0.54
Note payable (repayment) proceeds					0.47
Proceeds (net) from issuance of stock	1.13	2.66	0.52		5.90
Net cash (used in) provided by financing activities	0.08	3.71	(1.72)	(0.30)	6.33
Effect of exchange rate changes on cash	(0.02)	(0.00)	0.06	(0.00)	
Net increase (decrease) in cash/equivalents	(1.06)	(0.39)	1.06	(1.04)	(0.07)
<b>Cash and cash equivalents</b>					
Beginning of period	1.50	0.44	0.05	1.11	1.11
End of period	0.44	0.05	1.11	0.07	1.04

Source: Company reports and Taglich Brothers estimates