

Research Report- Update

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

Derma Sciences, Inc.

Rating: Speculative Buy

Juan Noble

DSCI \$0.75 — (OTC BB)

September 12, 2006

	FY 2005A	FY 2006E	FY 2007E	FY 2008E
Total revenues (in millions)	\$23.4	\$29.0	\$32.0	\$36.2
Earnings (loss) per share	(\$0.07)	\$0.03*	\$0.05*	\$0.07*
52 - Week range	\$0.97 – \$0.41	Fiscal year ends:	December	
Shares outstanding as of July 31, 2006	22.906 million	Revenue/share (ttm)	\$1.09	
Trading float	12.31 million	Price/Sales (ttm)	0.69X	
Insiders	74%	Price/Sales (2007)E	0.54X	
Tangible Book value/share as of June 30, 2006	\$0.33	Price/Earnings (ttm)	NA	
Price/Book	2.27X	Price/Earnings (2007)E	15.0X	

*assumes earnings are fully taxed at an estimated rate of 40%.

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 Considerations:

We are maintaining an investment rating of Speculative Buy on Derma Sciences, Inc. (OTC BB: DSCI) and raising our price target to \$1.25 per share from \$0.95. In our view, revenue and profitability gains are about to accelerate. Based on a strong outlook, investors should, within the next 12 months, accord the stock a valuation based on profitability and earnings growth potential.

By our estimates, the company will regain profitability in 2006 based on stronger internal growth, the Western Medical acquisition and margin gains. New products and continued improvement in manufacturing efficiency should lend added support to profit growth through 2007. By 2008, the same factors, plus leveraging of operating expenses, should drive earnings growth further.

Our forecasts do not factor in the revenue and profit contribution of new products, notably Manuka honey, which could lend significant upside to our forecasts by 2008. Should that upside gain better visibility during the next several months, the stock's price could exceed our target.

The company's balance sheet should show continuous improvement through 2008. By our projections, strong cash flow will obviate the need for borrowings and additional equity financing by next year and enable Derma Sciences to build a sizable cash position by the end of 2008.

Barring the need for higher than expected higher working capital and capital support the manufacturing and distribution of new products, the company should be in a position to finance more acquisitions by late 2008.

** Please view our disclaimer located on page 12.*

Overview

Derma Sciences, Inc. (OTC BB: DSCI), headquartered in Princeton, New Jersey, was established in 1984 to manufacture and market wound care products used to treat chronic wounds – pressure ulcers (bed sores), diabetic ulcers and venous insufficiency ulcers – and acute wounds such as surgical incisions and serious burns. For 2006, wound care products will, by our estimates, account for almost 90% 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.

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.

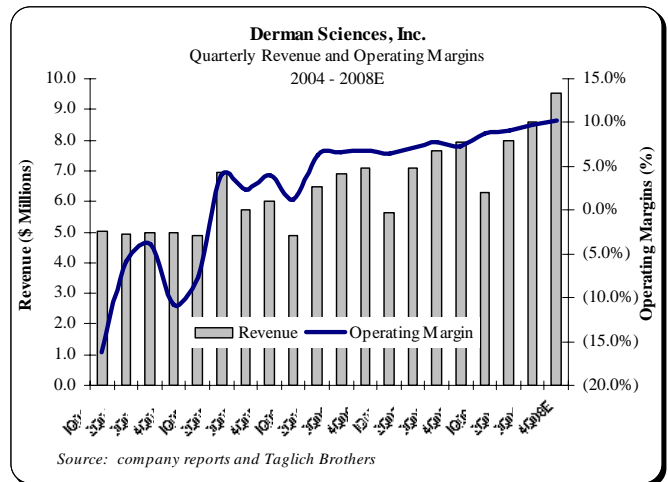
Derma Sciences, Inc. Major Acquisitions		
Company	Date	Product Lines
Genetic Laboratories Wound Care, Inc.	Sep 1998	fasteners, securement devices & suture strips.
Sunshine Products, Inc.	Nov 1998	skin care shampoos, lotions, soaps
Dumex Medical, Inc.	Aug 2002	wound care & related devices
Kimberly Clark Corp. (wound care assets)	Jan 2004	wound care/closure & fasteners
Western Medical, Inc. (certain assets)	Apr 2006	compression, support & protective dressings

Source: Derma Sciences

The company manufactures advanced wound care and wound closure products in its own facilities. Production of its basic wound care and skin 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. The company has a number of products in development, which, if commercialized, 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. These 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 should significantly raise Derma Sciences’ run rate and margins.



Consolidation of production facilities, outsourcing and contract manufacturing for healthcare supply distributors and other manufacturers steadily improved gross margins since they bottomed out in 2004 after a slide influenced by the transfer of acquired manufacturing assets to Canada and the startup of OEM production capability.

Operating margins have moved largely in tandem with gross margins as the company recovered from the 2004 production disruptions. Revenue gains, manufacturing efficiency improvements and leveraging of operating expenses should drive the earnings growth that we project through 2008.

Product Lines

Derma Sciences sells wound care, wound closure and fastener, and skin care products.

Advanced wound care – ointments, silver dressings, calcium alginate dressings, hydrogel dressings, hydrocolloid dressings and foam dressings.

Basic wound care – gauze dressings, packing strips, impregnated gauze dressings, abdominal pads, laparotomy sponges, burn dressings and bandages.

Wound closure and fasteners – wound closure strips and a variety of catheter fasteners. Includes devices designed to hold various types of catheters, tubes, wound drainage systems and multi-port IV systems in place.

Skin care – bath sponges, skin cleansers, soaps, hair and body washes and moisturizers.

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. Tyco International (Kendall Tyco division) and Medical Action Industries also compete in the basic wound care market. In addition to the bigger firms, there are also a number of firms that 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.

Strategy

Derma Sciences' 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.

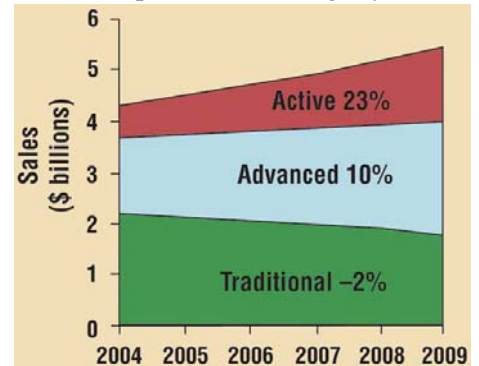
In-licensing New products figure prominently in the company's plans to expand revenue and improve its profitability. The company aims to launch several new in-licensed advanced wound care products during the next year or so. The first, a silver alginate topical dressing, could be launched shortly. The Manuka Honey-based product, arguably the most promising in the pipeline, is targeted for release in early 2007. Aside from extending the company's lines and improving margins, new, differentiated products could create a sell-through effect that would stimulate sales of more established products.

Consolidated production In-house manufacturing of advanced wound care products has been largely consolidated in Canada. The company is making increasing use of contractors in China to manufacture and sterilize its basic wound care products. In 2006, Derma Sciences will take the production of its wound closure products in-house, achieving economies that are expected to improve this product line's profitability in 2007.

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 lower SG&A expenses associated with it and it supports margin improvement by absorbing manufacturing overhead.

Market Opportunity

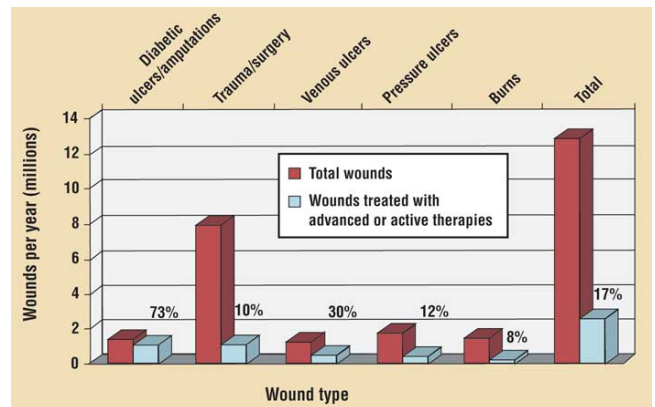
According to a January 2006 article entitled *The Future of Wound Care* in MX, a periodical specializing in market and strategy analyses of the medical device industry, the US market for wound care products was slightly over \$4 billion in 2004. The largest segment of the market is traditional, or basic, wound care products, mainly dry bandages and dressings, is estimated at around \$2.0 billion. Advanced wound care products, a segment estimated at \$1.5 billion, includes hydrogels, hydrocolloids, foams and alginates, which attempt to accelerate the healing of chronic wounds by promoting a moist environment. The rest of the market consists of roughly \$0.5 billion in active products that contribute to healing with bioactive compounds or enhance the body’s ability to heal itself. Active products include collagen and artificial growth factors.



The projected five-year annual growth rates for each of these segments vary significantly. Sales of largely low-margin commoditized traditional, or basic, wound care products are projected to decline an average 2% a year through 2009 due mainly to lack of product innovation and displacement by advanced wound care products. Increasing use as first-line wound care therapy and demographic trends are expected to contribute to a 10% CAGR in advanced wound care product sales.

Active wound care products are projected to grow the fastest, driven by the same factors as advanced wound care products. Rather than displace older wound care therapies, active wound care products such as collagen, tissue regeneration products and more effective delivery of older compounds will expand the market by meeting previously unmet patient needs. The MX article projects that by 2009, the US wound care market will have expanded to around \$5.6 billion, driven by growth in the advanced and active product market segment to \$2.3 billion and \$1.5 billion, respectively, offsetting a decline in the traditional product segment to around \$1.8 billion.

As a chart accompanying the MX article illustrates, the largest end market for wound care products consists of trauma and surgical patients, which account for almost three-quarters of the estimated 13 million wounds treated in the US every year. With the exception of diabetic ulcers/amputations, all wound care end markets, by type of wound, are treated mainly with traditional products. The disparity between the proportions of wounds treated with traditional vs. advanced or active products suggests ample opportunity for market penetration by advanced and active products.



Derma Sciences’ product breakdown is more heavily weighted in traditional products than the overall industry. Setting aside estimated advanced product sales, combined sales of traditional and advanced products for 2004 \$3.6 billion, of which almost 60% consisted of traditional product sales. For 1H06, Derma Sciences’ basic (traditional) products accounted for almost three-quarters of its wound care sales. The company’s commercialization of advanced wound care products could narrow that gap and bring its basic-advanced breakdown closer into line with that of the industry.

Manuka Honey

A Manuka honey-based advanced wound care product currently under 510(K) review at the FDA is arguably the most promising of the new products the company plans to launch. Honey was largely displaced by antibiotics during the 1940s but interest in honey was sustained through the years and has heightened due to the persistence of chronic wounds as well as increasing difficulties with antibiotic-resistant infections in the hospital environment. Honey-based wound care products are already approved for hospital use by the Ministry of Health in the UK. With US regulatory clearance, the company's medical-grade honey wound care product could gain wide acceptance.

At a price midway between those of hydrocolloid and silver dressings, we estimate the average revenue potential per chronic wound case at around \$400, with estimated revenue per case lower for acute wounds due to a shorter duration of treatment. At those rates, and only one course of treatment for each of the 13 million wounds treated each year, the US market opportunity for Manuka honey could theoretically range as high as \$2.1 billion a year. However, peak demand for the product, in our view, is more likely to fall within the \$20 million to \$50 million range.

The company's honey product is derived from the flower of the Manuka bush native to New Zealand. Manuka honey's healing properties are attributed not only to the hydrogen peroxide created in honey by bee-injected enzymes but also to an as yet undefined unique element that has been named "unique Manuka factor" or UMF. The UMF factor is believed to enhance honey's anti-microbial properties. It may also account for the ability to promote easier removal of necrotic tissue from pressure ulcers, burns, and other wounds. As honey is not toxic, as the silver widely used in wound dressings is, it could serve as a prophylactic at the beginning of treatment and extend its application over the full course of the treatment, enhancing its revenue potential.

Increasing visibility, clinical advantages and a first-to-market position with a proprietary FDA-approved product should give Derma Sciences a competitive advantage. There have been numerous studies – many are outlined in the May 2006 issue of the International Journal of Lower Extremity Wounds – which document honey treatment outcomes superior to those achieved with widely used wound care products. Results of the largest such study so far (almost 400 patients), the Honey As Adjuvant Therapy for Leg Ulcers Trial (HALT), as yet unpublished, were presented at the May 2006 meeting of the European Wound Management Association.

Patients in the treatment group of the HALT trial had wounds treated with calcium alginate dressing impregnated with honey; the comparison group patients' wounds were treated with a dressing chosen by clinicians. The primary end point of the trial was the proportion of patients whose treated wounds healed at 12 weeks. Secondary end points included length of time to healing, change in ulcer area, infection incidence, costs per healed ulcer and quality of life factors. The study results have not yet been published but management reports that the patients treated with Manuka honey dressings scored better than comparison group patients on healing and infection rates, and in quality of life measurements.

Recent Developments

New Equity Financing On August 3, 2006, the company privately sold 2,000,000 shares at \$0.75 per share for a total purchase price of \$1.5 million, to Comvita New Zealand Limited (New Zealand). The stock may not be reoffered or resold without being registered or without an exemption from registration requirements. The \$1.5 million purchase price of the stock will be paid as follows: \$500,000 in cash upon execution of the purchase agreement and a \$1.0 million promissory note bearing interest at 2.5% per annum payable in full not later than February 13, 2007.

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. It could also see wide use as a prophylaxis in the treatment of surgical wounds. A first-to-market advantage and widespread uptake might make this honey-based product a significant contributor to revenue growth.

2Q06 Results

Operating Results In 2Q06, the company earned a net profit of \$331,000, or \$0.01 per share, vs. a profit of \$158,000, or \$0.01 per share, for the year earlier quarter. Despite a year-on-year doubling in profit, per share results appear unchanged due to the sharp increase in shares stemming from an equity offering in April 2006. Results for 2Q06 brought net income for 1H06 to \$388,000, or \$0.02 per share, vs. a net loss of \$55,000 for the first half of last year.

Sales for the quarter were up 6.5%, vs. our projected 8% decline. Unusual transactions mask a stronger internal growth rate. 2Q05 revenue included \$1.84 million in pipeline filling sales to a Canadian distributor and 2Q06 included \$1.3 million in sales added by Western Medical, which was acquired last April. Excluding those figures, revenue growth for 2Q06 was up 20%. Revenue growth for the quarter was driven mainly by advanced wound care sales to OEM customers. OEM wound care gains were partly offset by slight decreases in basic wound care, wound closure and skin care product sales.

Gross margin for the quarter were up significantly, rising to 37% in 2Q06 from 31% in the year-earlier quarter. The improvement, driven by wound care products, was attributed to higher production volumes and better manufacturing efficiency. Gross margins in the wound closure and skin care businesses narrowed slightly. Although the company did not leverage its operating expenses for 2Q, its operating margin widened considerably due to the rise in its gross margin. Sales and G&A expense for the quarter increased significantly due to several factors, including higher sales support activity in Canada, consulting fees and one-time costs relating to Western Medical, the hiring of an additional sales representative and board members' stock-based compensation.

Cash Flow and Balance Sheet 2Q cash flow activity was substantial due mainly to a \$5.8 million equity offering and the \$6.0 acquisition of Western Medical. Cash generated by operations was largely responsible for the \$1 million 2Q increase in cash, a gain that enabled the company to reverse the previous quarter's decrease in cash. The company's debt ratios increased slightly during 2Q06 (vs. the end of 1Q06) while liquidity ratios improved during the period.

Outlook & Projections

Operating Projections – We have raised our 2006 revenue projection to \$29 million from \$27 million in light of the company's 2Q performance, which indicates that growth momentum has been regained more rapidly than we anticipated. We have increased our earnings estimate for 2006 to \$0.06 per share from \$0.02 per share. The 2006 estimate reflects dilution stemming from the issuance of almost 13 million common shares so far this year.

Revenue from the acquired Western Medical business, which had a run rate of roughly \$6.6 million, should contribute significantly to this year's sales growth, which we estimate at 23%. Excluding Western Medical's revenue contribution to 2006 sales and the pipeline filling effect seen in 2Q05, we project revenue growth of around 12%, up from our earlier internal 2006 sales growth estimate of 5%.

By our estimates, the company's gross margin for 2006 will widen to almost 38%, up from 2005's 33%, due to Western Medical's higher gross margins (around 39% for 2005) and improved manufacturing efficiency. We do not project leveraging of operating expenses for this year but the improvement in the gross margin should improve the company's operating margin for 2006 considerably.

Our estimates for 2007 show a lower revenue growth reflecting more difficult sales comparisons after the April 2007 anniversary of the Western Medical acquisition. Discounting the Western contribution, 2007 revenue should be up more than 9%, with wound care gains offset in part by the slower gains or declines we project for wound closure and skin care products. Our revenue forecast does not include any substantive contribution from new products, sales of which could push revenue up higher than we have estimated.

We project further gross margin improvement for 2007 based mainly on higher volumes and better manufacturing efficiency. The level of operating expenses we project implies a leveraging of operating expenses that will support operating margin gains for 2007. The net operating loss carryforwards available at the end of 2005 will have, by our estimates, used up by 3Q07 so we have projected an effective income tax rate of 40% from that point on.

Our preliminary estimates for 2008 project a 13% rise in sales, all of it from internal growth, as well as further gross margin improvement. Leveraging of operating expenses should also contribute to operating margin gains in 2008. Based on those improvements, earnings per share should rise to \$0.07, up from an estimated fully taxed \$0.05 per share for 2007.

Our projections for 2007 and 2008 have not factored in the potential contribution of the Manuka honey product. Timing of its launch – FDA clearance could be received by early next year – is still uncertain and revenue estimates could vary widely depending mainly on anticipated ramp and market penetration rates. By our estimates, for every percentage point of the market opportunity, as we've measured it, that Derma Sciences captures, it could, at the improved margin rates we've forecasted, earn net profit of roughly \$1.25 million or \$0.04 per share. If for example, we were to model a ramp starting in 2Q07 to a 1% penetration rate by 4Q08, Manuka honey's revenue addition to our forecast for 2007 and 2008, respectively, would be, by our estimates, \$1.7 million and \$5.2 million. At those sales levels, Manuka honey could add roughly \$0.06 to 2007 earnings and \$0.17 to 2008 earnings.

Financial Position & Cash Flow – At the level of projected profits and the rates of receivables and inventory turnover we forecast, the company should generate almost \$5 million in cash from operations in 2007. By our estimates, capital expenditures and debt payments will offset some of the internal cash increases but the company should end 2007 with an estimated \$4.5 million in cash, lighter debt than it started the year with and stronger liquidity. With stronger cash flow, borrowings under bank lines of credit should be unnecessary.

Debt facilities currently consist of a \$3.5 million US three-year revolving line and a \$717,000 Canadian revolving line that is renewable annually. They company may borrow on the US line to a maximum of 85% of eligible receivables and 55% of eligible inventory. Advances on the Canadian line can go up to 75% of eligible receivables plus the lesser of \$358,000 or 40% of eligible inventory. In connection with the Western Medical purchase, the took out a \$1 million term loan payable in 29 monthly installments of \$27,800 beginning October 2006, with a final payment of \$154,000 in April 2009.

Cash from operations should increase further in 2008 despite the higher tax burden and the larger working capital requirements imposed by higher sales. As we project no significant outflows other than capital expenditures, the company's cash position should strengthen further in 2008. With an estimated year-end cash position of almost \$6 million and minimal debt, the company's improved financial flexibility should allow financing of more acquisitions. Should sales rise much more sharply than we have forecasted, larger working capital demands and capital expenditures could absorb more cash than we have projected.

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. While driven in part by revenue gains, profit improvement will depend on success at improving manufacturing efficiency and reducing operating expense margins.

Regulatory Several new products are or will be going through the FDA's clearance process. Sales growth momentum will depend to some degree on the launch of new products. To the extent that new products reviews may be protracted, sales growth could be slower than anticipated. New products planned for launch during the next year or so are subject to the 510(K) review process, which entails lower hurdles, e.g., no clinical trials, than the Pre-Market Approval (PMA) process.

Competition Aside from the large companies mentioned earlier, there are a number of smaller firms whose generic products compete with those of Derma Sciences.

Dilution An April 2006 common stock sale of 10.6 million shares increased the number of shares outstanding to roughly 23 million, more than three times the number outstanding at the end of 2003. The company recently announced an agreement to sell two million common shares to Comvita New Zealand Limited.

In an S-3 amendment filed with the SEC on July 26, 2006, the company reported that up to 18.1 million common shares could be issued due to conversion of convertible preferred stock and the exercise or vesting of warrants, options and restricted stock awards. There were 22.9 million common shares outstanding as of July 31, 2006.

Capitalization Limited capital has been a constraint on the ability to finance the external growth that has been a major element in growth strategy.

Microcap Concerns Shares of DSCI have risks common to the stocks of other microcap (which we define as market capitalizations of \$250 million 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 33,200 shares are traded daily.

Federal Reserve/FOMC - Prior to August 8, 2006, when the Federal Reserve decided to hold the Discount Rate and its target rate for Fed Funds unchanged, the Fed had raised those rates 17 times since mid-2004. To the extent that further rate increases may lie ahead, equity valuations, particularly those of smaller capitalization stock, could suffer.

Foreign Risks The company relies heavily on facilities and sources in Canada and China for its production. Its supply sources could be subject in varying degrees to disruption stemming from changes in economic or political conditions, currency exchange rates, regulations and other factors.

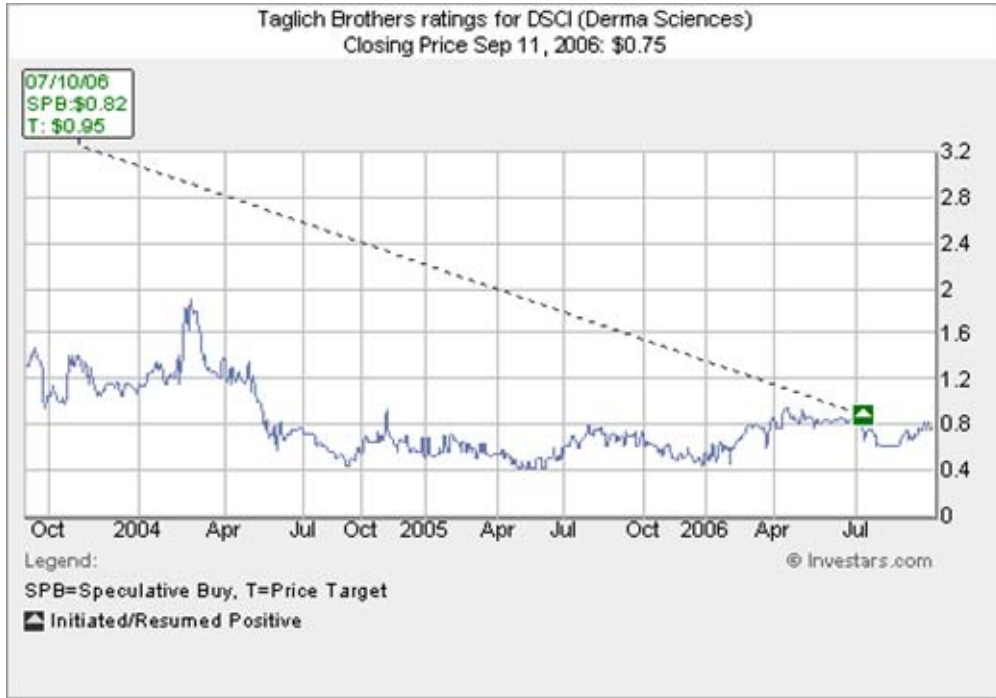
Miscellaneous Risks The Company's financial results and equity values are subject to other risks and uncertainties known and unknown, including but not limited to competition, operations, financial markets, regulatory risk, and/or other events. These risks may cause actual results to differ from expected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

Investment Recommendation

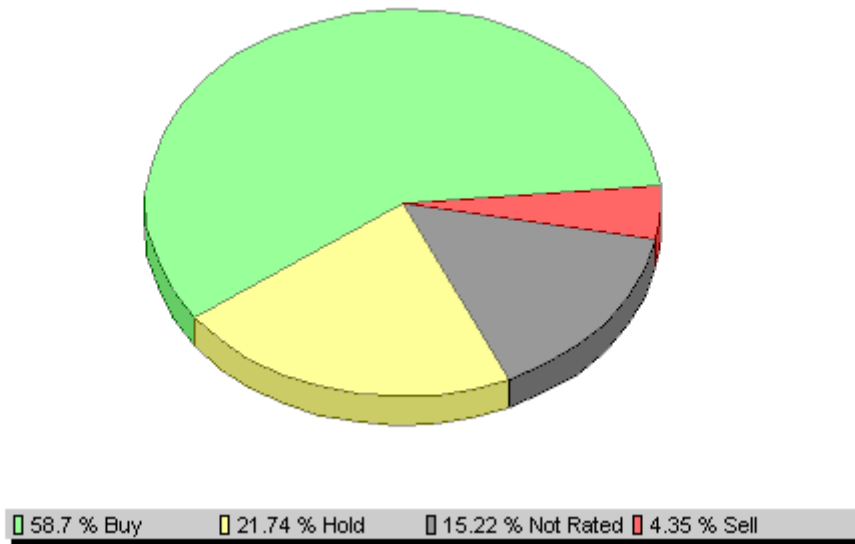
We are maintaining our rating of Speculative Buy and are increasing our 12-month price target to \$1.25 per share from \$0.95. In light of our outlook for improved profitability from 2006 on, our valuation now rests on earnings rather than revenue multiples. Between 2006 and 2008, earnings, on a fully taxed basis, are projected to rise more than 45% a year, albeit off a small base. Within the next year, we believe the stock's price will discount a 20% three-year earnings CAGR that reflects a growth rate that moderates as bases for profit comparisons grow larger.

According to Capital IQ, stocks in the medical equipment/appliance industry trade on average at a price-to-(forward) earnings growth ratio (PEG) of 1.38. We believe that being a microcap stock, DSCI is likely to trade at

at a PEG of 1.0 on (one-year) forward earnings. If in 12 months, the market discounts a 20% growth rate, a PEG ratio of 1.0 would value DSCI at 20X 2008 earnings of \$0.07 per share, or \$1.40. We have discounted that figure by 10% to yield a 12-month value, giving us a price target of around \$1.25. Our valuation and price target do not take into account the potential revenue contribution of new products - Manuka honey and others - or their potential sell-through effects. To the extent that new products lift revenue beyond the levels in our forecasts, the company's earnings outlook and valuation multiple are likely to shift upward.



Taglich Brothers Current Ratings Distribution



Investment Banking Services for Companies Covered in the Past 12 Months		
<u>Rating</u>	<u>#</u>	<u>%</u>
Buy	1	3.57%
Hold	0	0
Sell	0	0
Not Rated	1	6.67%

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.

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)

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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
2006 – 2007E
(\$ Millions, Except Per Share Amounts)

	2 0 0 6					2 0 0 7				
	1QA	2QA	3QE	4QE	2006E	1QE	2QE	3QE	4QE	2007E
Sales	5.76	7.39	7.82	8.04	29.00	6.50	8.04	8.58	8.90	32.03
Cost of sales	3.56	4.67	4.85	4.94	18.03	3.98	4.93	5.24	5.41	19.55
Gross Profit	2.19	2.72	2.97	3.10	10.98	2.52	3.12	3.35	3.50	12.48
Operating expenses										
Distribution	0.42	0.45	0.51	0.56	1.94	0.42	0.48	0.54	0.55	1.99
Marketing	0.14	0.13	0.18	0.20	0.65	0.15	0.20	0.19	0.22	0.77
Sales	0.51	0.55	0.64	0.66	2.36	0.55	0.68	0.71	0.73	2.67
G&A	1.06	1.12	1.11	1.13	4.42	0.97	1.19	1.24	1.34	4.74
Operating expenses	2.12	2.25	2.44	2.55	9.37	2.10	2.55	2.68	2.85	10.17
Operating income (loss)	0.07	0.46	0.52	0.55	1.60	0.42	0.57	0.67	0.65	2.31
Interest expense (income) net	0.08	0.11	0.04	0.03	0.26	0.01	(0.00)	(0.01)	(0.01)	(0.02)
Other exp (income)	(0.07)	0.02			(0.05)					
Pre-tax profit (loss)	0.06	0.33	0.48	0.51	1.39	0.41	0.57	0.67	0.66	2.33
Income taxes								0.06	0.27	0.32
Net income (loss)	0.06	0.33	0.48	0.51	1.39	0.41	0.57	0.62	0.40	2.00
Avg. shares out. (mil)	15.66	26.28	27.78	27.80	24.38	27.85	27.90	27.95	28.00	27.93
Earnings per share - diluted	0.00	0.01	0.02	0.02	0.06	0.01	0.02	0.02	0.01	0.07
Fully taxed EPS (@ 40%)	0.00	0.01	0.01	0.01	0.03	0.01	0.01	0.01	0.01	0.05
Margin analysis										
Gross margin	38.1%	36.8%	37.9%	38.5%	37.8%	38.8%	38.8%	39.0%	39.3%	39.0%
Distribution	7.2%	5.0%	6.5%	7.0%	6.7%	6.5%	6.0%	6.3%	6.2%	6.2%
Marketing	2.5%	2.5%	2.3%	2.5%	2.2%	2.3%	2.5%	2.3%	2.5%	2.4%
Sales	8.8%	8.5%	8.3%	8.3%	8.2%	8.5%	8.4%	8.3%	8.3%	8.3%
G&A	18.4%	15.0%	14.3%	14.0%	15.3%	15.0%	14.8%	14.5%	15.0%	14.8%
Operating income (loss)	1.2%	6.3%	6.7%	6.8%	5.5%	6.5%	7.1%	7.8%	7.3%	7.2%
Net income (loss)	1.0%	4.5%	6.2%	6.4%	4.8%	6.4%	7.1%	7.2%	4.5%	6.3%
Net income (fully taxed)	0.6%	2.7%	3.7%	3.8%	2.9%	3.8%	4.3%	4.7%	4.5%	4.4%

Source: Company reports and Taglich Brothers estimates

Derma Sciences, Inc.
Annual Income Statements
2004 – 2008E
(\$ Millions, Except Per Share Amounts)

	<u>FY2004A</u>	<u>FY2005A</u>	<u>FY2006E</u>	<u>FY2007E</u>	<u>FY2008E</u>
Sales	19.89	23.55	29.00	32.03	36.15
Cost of sales	14.34	15.76	18.03	19.55	21.59
Gross Profit	5.55	7.79	10.98	12.48	14.56
Operating expenses					
Distribution	1.43	1.56	1.94	1.99	2.18
Marketing	0.37	0.42	0.65	0.77	0.83
Sales	1.90	1.91	2.36	2.67	2.93
G&A	3.67	3.63	4.42	4.74	5.17
Total	7.38	7.52	9.37	10.17	11.11
Operating income	(1.82)	0.27	1.60	2.31	3.45
Goodwill impairment loss	--	0.91	--	--	--
Interest expense (income) - net	0.23	0.34	0.26	(0.02)	(0.12)
Other (expense)/ income	0.29	(0.07)	(0.05)	0.00	0.00
Pre-tax profit	(2.34)	(0.91)	1.39	2.33	3.57
Income taxes				0.32	1.43
Net income	(2.34)	(0.91)	1.39	2.00	2.14
Avg. shares out. (mil)	9.42	12.22	24.38	27.93	29.25
Earnings per share	(0.25)	(0.07)	0.06	0.07	0.07
Fully taxed EPS (@ 40%)			0.03	0.05	
Margin analysis					
Gross margin	27.9%	33.1%	37.8%	39.0%	40.3%
Distribution	7.2%	6.6%	6.7%	6.2%	6.0%
Sales/marketing	11.4%	9.9%	10.4%	10.7%	10.4%
G&A	18.5%	15.4%	15.3%	14.8%	14.3%
Operating income	(9.2%)	1.1%	5.5%	7.2%	9.6%
Pre-tax income	(11.8%)	(3.9%)	4.8%	7.3%	9.9%
Net income	(11.8%)	(3.9%)	4.8%	6.3%	5.9%
Net income - fully taxed			2.9%	4.4%	5.9%
Income tax rate				13.8%	40.0%

Source: Company reports and Taglich Brothers estimates

Derma Sciences, Inc.
Balance Sheets
2004 – 2008E
(\$ Millions)

	FY2004	FY2005	2Q06A	FY2006E	FY2007E	FY2008E
A S S E T S						
Current assets						
Cash & equivalents	0.05	1.11	1.05	1.63	3.53	5.87
Accts receivable	2.60	1.23	1.38	1.61	1.78	2.01
Note receivable - Comvita				1.00		
Inventory	4.93	3.87	5.52	6.01	6.52	7.20
Prepayments & other	0.18	0.21	0.27	0.40	0.45	0.53
Total current assets	7.76	6.41	8.22	10.66	12.28	15.60
Fixed assets (net)	3.66	3.39	4.05	3.43	3.24	3.03
Goodwill	1.11	0.20	3.77	3.77	3.77	3.77
Intangibles	0.38	0.30	2.18	2.52	1.96	1.64
Other assets	0.13	0.30	0.24	0.40	0.45	0.53
Total assets	13.05	10.60	18.45	20.78	21.70	24.57
LIABILITIES & EQUITY						
Current liabilities						
Line of credit borrowings	2.82	1.08	0.90	1.00		
Long-term debt (curr)	0.25	0.29	0.55	0.62	0.59	0.16
Note payable (curr)				0.02	0.02	0.02
Accounts payable	1.25	1.20	1.30	1.40	1.52	1.68
Accruals & other	0.59	0.49	0.52	0.56	0.62	0.74
Total current liabilities	4.91	3.06	3.27	3.60	2.75	2.60
Long-term debt	0.87	0.39	1.50	0.59		
Note payable						
Other long-term liabilities	0.05	0.10	0.11	0.15	0.16	0.19
Common shareholders' equity	7.22	7.05	13.58	16.43	18.78	21.79
Total liabilities & equity	13.05	10.60	18.45	20.78	21.70	24.57
Days sales outstanding	47.7	19.0	20.0	20.0	20.0	20.0
Inventory turnover	2.9	4.1	2.8	3.0	3.0	3.0
Days payables outstanding	31.8	27.7	29.8	27.7	27.7	27.7
Quick ratio	0.5	0.8	0.7	0.9	1.9	3.0
Current ratio	1.6	2.1	2.5	3.0	4.5	6.0
Total debt to equity	55%	25%	22%	13%	3%	1%
Total debt to tangible equity	69%	27%	39%	22%	5%	1%
LTD/capitalization	13%	9%	13%	7%	3%	1%

Source: Company reports and Taglich Brothers estimates

Derma Sciences, Inc.
Cash Flow Statements
2004 – 2008E
(\$ Millions)

	2004A	2005A	2Q06A	2006E	2007E
Operating Activities					
Net income (loss)	(2.34)	(0.91)	0.33	1.39	2.00
Adjustments:					
Depreciation	0.32	0.49	0.15	0.60	0.67
Amortization - intangible assets	0.12	0.08	0.11	0.29	0.32
Amortization - deferred financing costs	0.09	0.07	0.03	0.08	0.08
Provision for bad debts and rebates	0.02	1.20	0.54	1.35	1.08
Provision for inventory obsolescence	0.20	0.29	(0.09)	(0.01)	0.10
Goodwill impairment loss	0.00	0.91			
Loss on disposal - fixed assets	0.27	0.07			
Deferred rent expense	0.05	0.04	0.00	0.02	0.02
Employee stock option expense		0.02	0.06	0.18	0.15
Gain on settlement of accts pay			0.00	(0.06)	
Net change in working capital	0.15	0.69	(0.09)	(3.04)	(0.59)
Net cash provided by (used in) operating activities	(1.12)	2.96	1.04	0.79	3.83
Investing Activities					
Acquisition of Western Medical			(6.00)	(6.00)	
Business/product rights acquisition costs	(1.94)	(0.05)	(0.61)	(0.66)	
Capital expenditures	(1.03)	(0.22)	(0.25)	(0.83)	(1.00)
Proceeds - sale of fixed assets	0.00	0.03			
Net cash used in investing activities	(2.97)	(0.24)	(6.86)	(7.49)	(1.00)
Financing Activities					
Net change in bank line of credit	1.35	(1.68)	0.04	(0.08)	(1.00)
Proceeds from note receivable			1.00	1.00	1.00
Deferred financing costs	(0.09)	(0.12)	(0.05)	(0.05)	
Long-term debt (repayments) proceeds	(0.21)	(0.45)	(0.07)	(0.98)	(0.98)
Note payable (repayment) proceeds				0.02	(0.02)
Proceeds (net) from issuance of stock	2.66	0.52	5.82	7.32	
Net cash (used in) provided by financing activities	3.71	(1.72)	6.74	7.23	(1.00)
Effect of exchange rate changes on cash	(0.00)	0.06	0.06	0.06	
Net increase (decrease) in cash/equivalents	(0.39)	1.06	0.98	0.53	1.84
Cash and cash equivalents					
Beginning of period	0.44	0.05	0.07	1.11	1.69
End of period	0.05	1.11	1.05	1.63	3.53

Source: Company reports and Taglich Brothers estimates