

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 \$0.70 — (OTC BB)

September 24, 2007

	FY 2005A	FY 2006A	FY 2007E	FY 2008E
Revenues (in millions)	\$22.8	\$27.9	\$31.6	\$36.2
Earnings (loss) per share	(\$0.09)	\$0.03	\$0.01	\$0.02
52 - Week range	\$1.10 – \$0.59		Fiscal year ends:	December
Shares outstanding as of August 14, 2007	25.3 million		Revenue/share (ttm)	\$1.22
Approximate float	13.6 million		Price/Sales (ttm)	0.58X
Market Capitalization	\$17.7 million		Price/Sales (2008)E	0.53X
Tangible Book value/share as June 30, 2007	\$0.41		Price/Earnings (ttm)	NA
Price/Book	1.7X		Price/Earnings (2008)E	31.5X

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 a rating of Speculative Buy on Derma Sciences, Inc. (OTC BB: DSCI) with a 12-month price target of \$1.00. We consider the stock suitable for risk tolerant investors, as sustainable profit gains hinge on acceptance of new products and the company's ability to leverage its expenses.

With the April, 2007 anniversary of the Western Medical acquisition, sales comparisons will become more difficult. Excluding the contribution of new products, we project organic revenue gains of at least 8% to 9% through next year, a rate that should accelerate with the launch of new products. Substantive revenue contributions by new products should be evident by 1Q08, by which time Manuka honey should gain traction.

The OEM business, roughly half of revenue, is driving a large measure of top-line growth but yields lower gross margins than products manufactured by the company for its own distribution.

Second quarter results were released on August 15, 2007. Operating expenses have increased more rapidly than revenue due partly to support of product launch and sales force expansion plans. However, much of the increase in expenses is not sales or marketing related. Until the gap between sales gains and expense increases narrows significantly, profitability is not likely to improve.

We have reduced our 2008 earnings estimate to \$0.02 per share (fully taxed) from \$0.03, slightly trimming our gross margin projection and increasing our operating expense estimates.

Our forecasts for new product performance are relatively modest. If new product gains accelerate more than we have projected, the stock price could range beyond our target. The company's balance sheet should show improvement through 2008, with cash flow providing ample coverage of the company's needs.

** 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. 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.

The company manufactures advanced wound care and wound closure products in its own facilities. Production of most 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 and generated cash flow that the company is using to support commercialization of high-margin in-licensed products.

The company has rationalized its production 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 has increased its use of contractors in China to perform more costly sterilization processes.

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 significantly raised Derma Sciences' run rate and margins.

Recent and pending new product launches could improve sales growth and improve profitability. Sales of silver alginate dressings, which were launched in September, 2006, have started to ramp. The Manuka honey product, cleared by the FDA in July, 2007, is targeted for launch by October, 2007.

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 based largely on the following:

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, was launched in September, 2006. The Manuka Honey-based product, arguably the most promising in the pipeline, is targeted for release in 4Q07. 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.

In March, 2007, the company obtained a license to distribute a line of therapeutic devices for the treatment of chronic venous insufficiency, deep vein thrombosis prevention, venous ulcers, lymphedema, and other conditions that require compression therapy. An April, 2007 agreement with Quick-Med Technologies, Inc. licensed Quick-Med's NIMBUS™ antimicrobial technology to the company on an exclusive basis in North America for use in certain wound care products, including conforming gauze, gauze sponges, gauze bandage rolls, gauze packing strips, oil emulsion acetate and Unna Boot dressings.

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.

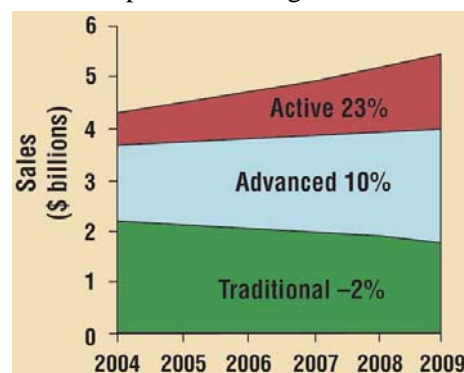
Consolidated production In-house manufacturing of advanced wound care products has been largely consolidated in Canada. The company is making increasing use of contractors in China to manufacture and sterilize its basic wound care products. Derma Sciences brought production of its wound closure products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

Contract manufacturing Roughly half of Derma Sciences' 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

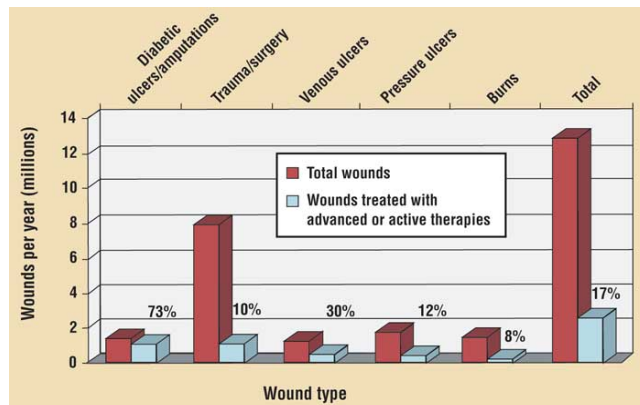
According to a January 2006 article entitled *The Future of Wound Care* in *MX*, a periodical specializing in market and strategy analyses of the medical device industry, the US market for wound care products was slightly over \$4 billion in 2004. The largest segment of the market is traditional, or 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, particularly 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.



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.

New Product Potential

Manuka Honey This advanced wound care product, which will be marketed as MEDIHONEY™, was cleared by the FDA in July, 2007 as a dressing for wounds and burns. The product was cleared by Canadian regulatory authorities in June, 2007 as an antimicrobial dressing. Manufacturing of MEDIHONEY is underway; the product should be ready for launch by October, 2007. The company plans to file two more 510K applications seeking FDA clearance of a hydrocolloid with honey, and honey in a tube.

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 long-term demand for the product, in our view, is more likely to fall within the \$20 million to \$50 million range.

At a presentation during the May, 2007 European Wound Management Association, results of a 100+-patient study that compared the healing effects of Manuka honey and Smith + Nephew's IntraSite Gel, a standard hydrogel, were presented by a lead investigator. In a multicenter, prospective, randomized trial, venous leg ulcers were treated, in conjunction with compression therapy, once or twice weekly for four weeks, with follow-up care for another eight weeks. At the conclusion of the treatment period, the mean wound area covered with slough (necrotic tissue in the process of separating from healthy tissue) measured 29% in Manuka honey-treated patients vs. 43% in patient treated with IntraSite Gel. According to the study, a reduction of 50% or more in slough after four weeks was associated with a higher probability of healing at 12 weeks.

MOBILITY-1™ A November, 2005 study by medical market research firm Windover Information estimated the US market for compression therapy and pressure reduction/relief products at \$1.1 billion and projected an market growth of around 4% a year, a rate that would increase the size of the market to \$1.6 billion by 2014. This market figure includes compression devices in general and includes compression bandages and stockings, mattress overlays and replacements, and specialty beds, as well as pneumatic compression devices. Compressions devices are known to reduce the risk of deep vein thrombosis, the venous insufficiency that can lead to venous stasis ulcers and lower limb amputations in patients who are poor risks for surgical revascularization.

The MOBILITY-1 is a powered, intermittent pneumatic compression boot that is FDA-approved (510-K) for the treatment of lymphedema (localized fluid retention caused by a poorly functioning lymphatic system) and chronic venous insufficiency (CVI). The MOBILITY-1 is unique in that it is small enough, thanks to a light, compact compressor, to enable effective treatment of ambulatory patients. This system was developed for patients who require more than simple compression bandages but for large, stationary compression systems are not practical. The company plans to seek regulatory clearance for the treatment of deep vein thrombosis and post-surgical pain.

The MOBILITY-1 should be launched as soon as reimbursement codes acceptable for Medicare/Medicaid beneficiaries are approved. Approval of reimbursement codes, which will require small (15 to 20 patients) clinical trials that demonstrate improved blood flow, is expected by 4Q07. Management believes that presently, there is only one approved mobile compression boot, which was developed for deep vein thrombosis patients, on the market.

In May, 2007, the company announced that the FDA cleared the MOBILITY-1 boot and compressor device for the treatment of chronic venous insufficiency, deep vein thrombosis prevention, venous ulcers, lymphedema, and other conditions that require compression therapy, including the enhancement of blood circulation during recovery from coronary artery bypass graft surgery and orthopedic hip and knee replacements. The company already has regulatory clearance for the sale of the compression boot.

Clearance to sell the compressor should allow MOBILITY-1 to compete more effectively with other standard intermittent compression. These therapy devices require an electronic compressor, the US market for which is estimated at \$40 million. MOBILITY-1 can deliver therapy outside the home, making it competitive in the \$80 million static compression dressings market. Launch of the MOBILITY-1 is targeted for 4Q07.

Recent Developments

Manuka Honey Product Approvals On July 23, 2007, Derma Sciences announced the FDA's clearance to market API-MED™ Active Manuka Honey Absorbent Dressing. This is the first honey-based product to be cleared in the US for the management of wounds and burns.

On June 14, 2007, the company announced that Health Canada cleared the company's line of API-MED Antimicrobial Dressings with Active Manuka Honey for marketing as Class II devices.

Second Quarter 2007 Results

Operating Results In 2Q, the company incurred a loss of \$110,000, essentially breakeven on a per share basis, on revenue of \$7.5 million, vs. a profit of \$346,000, or \$0.01 per share, on revenue of \$7.1 million for the year-earlier quarter. We had projected breakeven 2Q earnings per share (a loss of \$120,000), on revenue of \$8.2 million. Sales for the quarter were up 5%; excluding \$364,000 in sales contributed by Western Medical (acquired April, 2006), and around \$60,000 in one-time sales of residual wound closure-specialty securement products in connection with the discontinuance of a private label agreement, sales for 2Q were down 1%.

2Q sales reflect continuing gains in private label sales, and another drop in skin care product sales stemming from competitive pressure. Excluding the one-time sales, core wound closure-specialty securement revenue was flat.

Derma Sciences, Inc.

Sales for 2Q included \$160,000 in sales (vs. \$100,000 in 1Q) of silver alginate, which was launched in September, 2006.

Gross margin for 2Q widened to 35.7% from 34.5%, due mainly a favorable shift in product mix, which included more specialty fixation devices, and reductions in the manufacture costs of traditional wound care products. Excluding the sales contributed by the Western Medical acquisition, 2Q gross margin would have been 35.3%.

Operating expenses for 2Q were up sharply, led by marketing expenses that increased due mainly to compensation costs relating to an employee promotion in 2006 and the February, 2007 hiring of a director of clinical affairs. G&A expenses were up due to share based compensation, bonuses, director fees, travel expenses and investor/public relations expenses. Sales expenses increased due mainly to recruitment costs relating to sales

	Quarter ending June		△ 3 mos ending 3/31	
	2007	2006	\$	%
Distribution	208	174	34	19.3%
Marketing	380	128	252	197.7%
Sales	680	550	130	23.7%
G&A	1,322	1,125	197	17.5%
Total	2,590	1,977	613	31.0%

force expansion and the relocation of the company's customer service function to its headquarters. Increases in operating expenses for 1H07 were due essentially to the same factors driving the rise in expenses for the second quarter; 1H G&A expenses included higher audit, accounting and tax fees, and Sarbanes-Oxley consulting fees.

Results for 2Q brought the company's loss for 1H07 to \$249,000, or (\$0.01) per share, vs. a profit of \$374,000, or \$0.02 per share for the first half of 2006. Sales were up 23%; excluding the revenue contribution of Western Medical and the one-time sale of wound closure-specialty securement devices, sales for 1H were up an estimated 9%, of which almost three percentage points were contributed by the \$258,000 in sales of the silver alginate product. The rest of the sales gain for 1H07 was attributed to increases in private label sales, which were partly offset by the continuing decline in skin care product sales.

	6 months ending Jun		△ '07 v '06		Six month margins	
	2007	2006	\$	%	2007	2006
Skin care	0.45	0.59	(0.14)	(24.1%)		
Total Sales	15.43	12.59	2.83	22.5%		
Cost of sales	9.96	8.23	1.72	20.9%		
Gross Profit	5.47	4.36	1.11	25.5%	35.5%	34.6%
Operating expenses						
Distribution	0.44	0.33	0.10	30.8%	2.8%	2.6%
Marketing	0.67	0.27	0.40	148.1%	4.3%	2.1%
Sales	1.24	1.06	0.18	17.3%	8.0%	8.4%
G&A	3.04	2.18	0.86	39.3%	19.7%	17.3%
Operating expenses	5.38	3.84	1.54	40.1%	34.9%	30.5%
Operating income (loss)	0.09	0.52	(0.43)	NM	0.6%	4.1%
Goodwill impairment loss						
Interest exp (income) net	0.10	0.19	(0.09)	(49.1%)		
Other exp (income)	0.05	(0.05)	0.10	NM		
Pre-tax profit (loss)	(0.06)	0.37	(0.43)	NM	(0.4%)	NM
Income taxes	0.19	0.00	0.19	NM	1.2%	NM
Net income (loss)	(0.25)	0.37	(0.62)	NM	(1.6%)	NM
Avg. shares out. (mil)	22.25	16.57				
EPS - diluted	(0.01)	0.02				
<i>Source: company reports</i>						

The gross margin for 1H07 was up to 35.5%; excluding the contribution of Western Medical's business, the gross margin for the period would have been 32.2%. Gross margin improvement was driven mainly by larger volumes, improved manufacturing efficiency and lower negotiated material costs in Canada. Canadian gross margin improvement was offset in part by a less favorable product mix in the US, where the increase in lower margin private label sales volume eroded gross margins.

Finances In 2Q, cash dropped by more than half to \$790,000. Additions to inventory (\$630,000) and reductions in accounts payable (\$460,000) far exceeded the \$220,000 in cash throw off from operations. Inventory was around \$100,000 higher than normal, reflecting higher production rates aimed at replenishing stocks that were reduced as a result of facility-improvement related 2H06 downtime in Canada. Management reported that inventory was being reduced over the next three to six months and that turnover was targeted at 4X. Capital expenditures of around \$140,000 accounted for the rest of cash outflows for the period.

For 1H07, additions of \$1.4 million to working capital, mainly a \$2 million buildup in inventory, exceeded the \$1.3 million in cash generated by operations. Capital expenditures and debt repayments accounted for another \$420,000 in outflows that reduced cash by \$500,000 in the first half of the year.

Restatement of 2006 and 9-Month 2006 Financial Reports On March 27, 2007, the company announced that its consolidated financial statements for the year ended December 31, 2005 and for each of the quarters from June 30, 2005 through September 30, 2006 were being restated due to the accounting treatment of a fee payable in connection with the five-year Canadian distribution agreement the company signed in May, 2005. This distribution fee was classified as an operating expense but the company has since determined that it should be an adjustment to gross sales in arriving at net sales, similar to trade rebates and other adjustments to gross sales. The company also concluded that the distribution fee should be accrued and expensed at the time of sale to the distributor. Previously, it was expensed when billed by the distributor to the company.

The restatement had the effect of deepening the company's 2005 loss to \$1.1 million, or (\$0.09) per share, from \$909,000, or (\$0.07) per share. The restatement reduced nine-month 2006 sales from \$21.0 million to \$20.2 million; it will also reduce gross profit by the same amount. Reported earnings for the nine-month period were unchanged.

Debt facilities currently consist of a \$3.5 million US three-year revolving line and a \$469,000 Canadian revolving line that is renewable annually. The 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 \$375,000 or 40% of eligible inventory. The company's Canadian lender granted a term loan in connection with Derma Sciences' August, 2002 acquisition of Dumex. That term loan is payable in monthly principal+interest payments. The same lender also granted the company a \$644,000 non-revolving term line of credit to finance equipment purchases and upgrades to the company's Canadian manufacturing facility. As of June 30, 2007, neither of the company's lines of credit was in use. Part of the purchase price for Western Medical was a \$500,000 promissory note payable in quarterly interest payments of \$15,000 with the principal in April 2009.

Outlook & Projections

Operating Projections – For 2007, we project net income of \$220,000 million, or \$0.01 per share, on revenue of \$31.6 million. Our revenue projection for 2007 is largely unchanged (it has been adjusted mainly to reflect 1Q07 results), as is our gross margin projection.

Our 2007 revenue forecast of \$32 million is based on sales growth of 8% to 9% roughly the same internal growth rate seen in 2006, for existing product lines and a gain of around \$2.0 million in revenue contributed by new products – Manuka honey, the MOBILITY-1 intermittent pneumatic compression system and ALGICELL Ag calcium alginate wound dressing. Between the revenue contribution of new products and gains from existing ones, we project revenue growth of \$4 million, or 13%, for 2007.

We project a gross margin improvement for 2007 based mainly on higher volumes, better manufacturing efficiency and wider margins earned on new products targeted for launch. We project an increase in 2007 operating expenses to \$10.7 million from \$8.3 million to reflect mainly heavier spending across the board. The company hired a Director of Clinical Affairs in February, 2007. With the aim of more intensively covering 1,000 wound care clinics, the company plans to field 15 sales representatives by the end of 2007 (up from four at the end of 2006) and double that figure by the end of 2008. We had previously believed that G&A expense comparisons would be easier in 2007, as 2006 G&A included consulting expenses and personnel costs relating to the integration of Western Medical. But 1H07 results show a rise in expenses that do not necessarily relate to an increase in sales but rather to a higher level of administrative activity.

For 2008, we project a profit of \$610,000, or \$0.02 per share, on revenue of \$36.2 million. We had previously projected 2008 earnings of \$0.03 per share but we have narrowed our gross margin gain forecast and increased our operating expense projection for the year.

Our 2007 and 2008 earnings per share projections are not directly comparable. Our 2007 estimate consist of largely untaxed earnings. By our estimates, the company will have utilized all of its net operating loss carryforwards by the end of 2007, making earnings fully taxable from that point. Untaxed 2008 earnings per share would be \$0.04 per share vs. \$0.01 for 2007.

We project a 2008 revenue gain of \$4.5 million, or 15%, based on internal growth or around 8% with the rest of the increase contributed by new products. We also project gross margin improvement based on the same factors that we believe will increase margins in 2007. By our estimates, 2008 operating expenses will be leveraged - we see only selling expenses rising in line with revenue – enabling the company to widen its operating margin to 3.5% from an estimated 1.7% for 2007.

Manuka honey was cleared by the FDA in July, 2007. Manufacturing is underway and the product should be launched by October, 2007. 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 that Derma Sciences captures, it could, at the improved margin rates we have forecasted, earn net profit of roughly \$1.25 million or \$0.04 per share.

In September 19, 2006, the company announced FDA approval of ALGICELL™ Ag calcium alginate wound dressing with antimicrobial silver, a topical antimicrobial for advanced wound management. According to the company, ALGICELL Ag is made up of 1.4% ionic form silver, the ideal level to achieve maximum antimicrobial effectiveness without harming healthy tissue, and a blend of mannuronic and guluronic alginic acids. The silver in ALGICELL Ag is in a controlled release formulation offering ongoing protection and extended wear-times.

The MOBILITY-1 intermittent pressure compression system is already cleared for marketing and will be launched as reimbursement codes are established.

Financial Position & Cash Flow At the level of profit we project for 2007, the company will throw off (before changes in working capital) \$2.1 million in cash, almost all of which will be consumed by increases in working capital. Capital expenditures and debt repayments of around \$800,000 each, slightly offset by cash from operations, will reduce cash by around \$480,000 for the year with a closing cash balance of \$800,000.

Due to higher projected profits, 2008 operations should throw off cash of \$3 million which, by our estimates, should cover additions to working capital, capital expenditures and debt repayment, and increase cash by \$580,000 for the year.

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 control operating expenses stringently enough so that revenue gains can drive earnings growth.

Regulatory Several new products are or will be going through US (FDA) and Canadian clearance processes. 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. Some new products planned

for launch in the US during the next year or so are subject to the 510(K) review process, which entails lower hurdles (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. In addition, the company sold two million common shares to Comvita New Zealand Limited in August, 2006. As of June 30, 2007, up to 15.4 million common shares were potentially issuable upon the conversion, exercise or vesting of outstanding convertible preferred stock, warrants, options and restricted stock awards. As of August 14, 2007, there were 25.3 million shares outstanding. Earnings per share will be significantly diluted by these derivative securities regardless of whether they are converted, exercised or issued, potentially weakening the stock's price.

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 13.6 million shares in the float. On average, approximately 9,800 shares are traded daily.

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

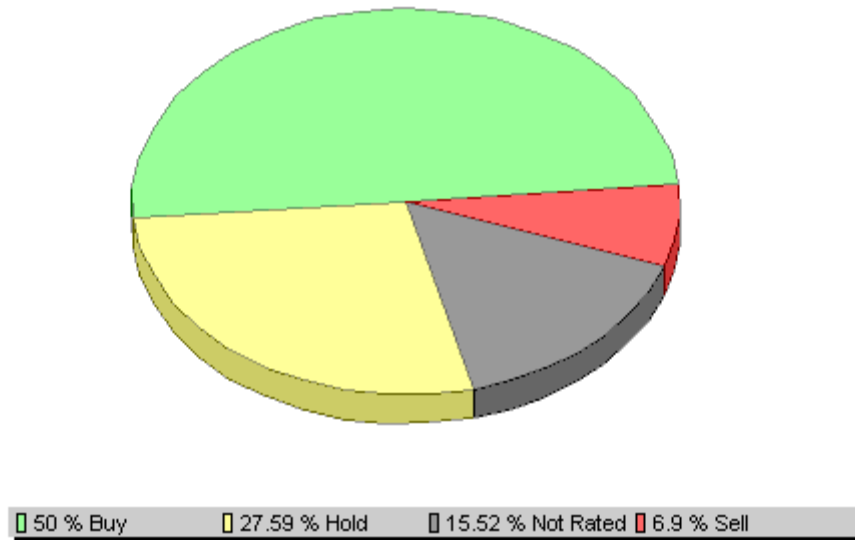
We are maintaining a rating of Speculative Buy on Derma Sciences, Inc. (OTC BB: DSCI) with a 12-month price target of \$1.00. We consider the stock suitable for risk tolerant investors, as sustainable profit gains hinge on acceptance of new products and the company's ability to leverage its expenses. Despite the potential for revenue gains based on the rollout of new products later this year, our view on prospects for a significant improvement in profitability has moderated as expenses have not been leveraged to the extent that we projected earlier.

According to Capital IQ, microcap stocks in the medical instruments/supplies industry for which data is available show no meaningful aggregate earnings multiple, as the group is projected to show a loss in the year ahead. On a price to (trailing) sales basis, the group is trading at 15X sales, a valuation clearly inappropriate at this time. In the absence of more conventional metrics, we would value the stock at around 30 times estimated 2009 earnings, our preliminary projection for which is \$0.04 per share. That estimate is based on 15% revenue growth for the year, a slight gross margin gain and operating expense leverage that would increase the operating margin to almost 5%. A multiple of 30 on 2009 earnings of \$0.04 gives us a target of \$1.20 per share, which we have discounted by 20% to arrive at a 12-month target of \$1.00.

We believe that a relatively mature growth stock is typically valued at 15X to 20X earnings. The multiple we use to establish a target is significantly larger as it values the stock at a point from which earnings could accelerate sharply, then moderate as year-on-year comparisons become more realistic. When they do, the stock's P-E should narrow to the 15X to 20X range.



Taglich Brothers Current Ratings Distribution



Investment Banking Services for Companies Covered in the Past 12 Months		
Rating	#	%
Buy	0	0
Hold	1	5.56%
Sell	0	0
Not Rated	0	0

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.	(NYSE:BAX)	McKesson Corp	(NYSE: MCK)
Birstol Myers Squibb Co.	(NYSE: BMY)	Medical Action Industries, Inc.	(NYSE: MDCl)
C. R. Bard	(NYSE: BCR)	Quick-Med Technologies, Inc.	(Nasdaq: QMDT)
Cardinal Health Inc.	(NYSE: CAH)	Smith & Nephew PLC	(NYSE: SNN)
Johnson & Johnson	(NYSE: JNJ)	Tyco International Ltd.	(NYSE: TYC)
Kimberly Clark Corp.	(NYSE: KMB)		

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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.
Annual Income Statements
2005 – 2008E
(\$ Millions, Except Per Share Amounts)

Year ending December 31:	<u>2005A</u>	<u>2006A</u>	<u>2007E</u>	<u>2008E</u>
Sales	22.80	27.89	31.57	36.20
Cost of sales	<u>15.76</u>	<u>18.24</u>	<u>20.32</u>	<u>23.21</u>
Gross Profit	7.04	9.65	11.25	12.99
Operating expenses				
Distribution	1.01	0.71	0.84	0.91
Marketing	0.42	0.64	1.23	1.27
Sales	1.91	2.14	2.53	2.90
G&A	<u>3.63</u>	<u>4.85</u>	<u>6.11</u>	<u>6.65</u>
Total	6.97	8.34	10.71	11.71
Operating income	0.08	1.31	0.54	1.27
Goodwill impairment loss	0.91	0.20	--	--
Interest expense (income) - net	0.34	0.37	0.24	0.26
Other (expense)/ income	(0.07)	(0.05)	0.00	0.00
Pre-tax profit	(1.10)	0.79	0.30	1.01
Income taxes		<u>0.12</u>	<u>0.07</u>	<u>0.40</u>
Net income	(1.10)	0.67	0.22	0.61
Avg. shares out. (mil)	12.22	24.41	25.56	27.25
Earnings per share	(0.09)	0.03	0.01	0.02
Margin analysis				
Gross margin	30.9%	34.6%	35.6%	35.9%
Distribution	4.4%	2.5%	2.7%	2.5%
Sales/marketing	10.2%	10.0%	11.9%	11.5%
G&A	15.9%	17.4%	19.4%	18.4%
Operating income	0.3%	4.7%	1.7%	3.5%
Pre-tax income	(4.8%)	2.8%	0.9%	2.8%
Net income	(4.8%)	2.4%	0.7%	1.7%
Effective income tax rate		15.0%	24.7%	40.0%

Source: Company reports and Taglich Brothers estimates

Derma Sciences, Inc.
Quarterly Income Statements
2007E – 2008E
(\$ Millions, Except Per Share Amounts)

	2 0 0 7					2 0 0 8				
	1QA	2QA	3QE	4QE	2007E	1QE	2QE	3QE	4QE	2008E
Sales	7.97	7.46	8.31	7.83	31.57	8.53	9.45	9.20	9.03	36.20
Cost of sales	5.16	4.80	5.35	5.02	20.32	5.50	6.07	5.89	5.76	23.21
Gross Profit	2.80	2.67	2.97	2.81	11.25	3.03	3.38	3.31	3.27	12.99
Operating expenses										
Distribution	0.23	0.21	0.21	0.20	0.84	0.21	0.24	0.23	0.23	0.91
Marketing	0.29	0.38	0.29	0.27	1.23	0.30	0.33	0.32	0.32	1.27
Sales	0.56	0.68	0.67	0.63	2.53	0.68	0.76	0.74	0.72	2.90
G&A	1.72	1.32	1.54	1.53	6.11	1.62	1.70	1.61	1.72	6.65
Operating expenses	2.79	2.59	2.71	2.62	10.71	2.81	3.02	2.90	2.98	11.71
Operating income (loss)	0.01	0.08	0.26	0.19	0.54	0.21	0.35	0.41	0.29	1.27
Goodwill impairment loss										
Interest exp(income) net	0.05	0.05	0.07	0.07	0.24	0.07	0.07	0.07	0.06	0.26
Other exp (income)	0.03	0.02								
Pre-tax profit (loss)	(0.07)	0.00	0.19	0.12	0.30	0.14	0.29	0.35	0.23	1.01
Income taxes	0.07				0.07	0.06	0.12	0.14	0.09	0.40
Net income (loss)	(0.14)	0.00	0.19	0.12	0.22	0.09	0.17	0.21	0.14	0.61
Avg. shares out. (mil)	25.25	25.26	25.75	26.00	25.56	26.50	27.00	27.50	28.00	27.25
Earnings per share - diluted	(0.01)	0.00	0.01	0.00	0.01	0.00	0.01	0.01	0.00	0.02
Margin analysis										
Gross margin	35.2%	35.7%	35.7%	35.9%	35.6%	35.5%	35.8%	36.0%	36.3%	35.9%
Distribution	2.9%	2.8%	2.5%	2.5%	2.7%	2.5%	2.5%	2.5%	2.5%	2.5%
Marketing	3.6%	5.1%	3.5%	3.5%	3.9%	3.5%	3.5%	3.5%	3.5%	3.5%
Sales	9.0%	9.0%	9.5%	8.5%	8.0%	8.1%	8.0%	7.9%	7.9%	8.0%
G&A	21.6%	17.7%	18.6%	19.5%	19.4%	19.0%	18.0%	17.5%	19.0%	18.4%
Operating income (loss)	0.1%	1.0%	3.1%	2.4%	1.7%	2.5%	3.8%	4.5%	3.3%	3.5%
Net income (loss)	(1.7%)	0.1%	2.3%	1.5%	0.7%	1.0%	1.8%	2.3%	1.5%	1.7%
Net income (fully taxed)	(0.5%)	0.0%	1.4%	0.9%	0.6%	1.0%	1.8%	2.3%	1.5%	1.7%

Source: Company reports and Taglich Brothers estimates

Derma Sciences, Inc.
Balance Sheets
2005 – 2008E
(\$ Millions)

Year Ending December 31: A S S E T S	2005A	2006A	2QA	2007E	2008E
Current assets					
Cash & equivalents	1.11	1.29	0.77	0.80	1.39
Accts receivable	0.93	2.27	1.92	2.63	3.02
Inventory	3.87	4.68	6.96	5.81	6.63
Prepayments & other	0.21	0.28	0.40	0.32	0.36
Total current assets	6.11	8.51	10.04	9.56	11.40
Fixed assets (net)	3.39	4.13	4.53	4.07	4.33
Goodwill	0.20	2.44	2.44	2.44	2.44
Intangibles	0.30	3.20	2.92	3.06	2.70
Other assets	0.30	0.22	0.22	0.39	0.45
Total assets	10.30	18.51	20.16	19.53	21.32
LIABILITIES & EQUITY					
Current liabilities					
Line of credit borrowings	1.08				
Long-term debt (curr)	0.29	0.34	0.28	0.06	
Note payable (curr)					
Accounts payable	1.10	1.65	1.52	1.69	1.93
Accruals & other	0.49	0.76	1.70	0.81	0.93
Total current liabilities	2.96	2.75	3.50	2.57	2.86
Long-term debt	0.39	0.55	0.64	0.49	0.51
Other long-term liabilities	0.10	0.11	0.41	0.14	0.17
Deferred tax liability		0.13			
Common shareholders' equity	6.85	14.98	15.61	16.32	17.78
Total liabilities & equity	10.30	18.51	20.16	19.52	21.32
Days sales outstanding					
Days sales outstanding	14.9	29.3	22.5	30.0	30.0
Inventory turnover					
Inventory turnover	4.1	3.5	3.5	3.5	3.5
Days payables outstanding					
Days payables outstanding	25.5	27.7	27.7	27.7	27.7
Quick ratio					
Quick ratio	0.7	1.3	0.8	1.3	1.5
Current ratio					
Current ratio	2.1	3.1	2.9	3.7	4.0
Total debt to equity					
Total debt to equity	26%	6%	6%	3%	3%
Total debt to tangible equity					
Total debt to tangible equity	28%	9%	9%	5%	4%
LTD/capitalization					
LTD/capitalization	9%	6%	6%	3%	3%

Source: Company reports and Taglich Brothers estimates

Derma Sciences, Inc.
Cash Flow Statements
2005 – 2008E
(\$ Millions)

Year Ending December 31:	2005A	2006A	2QA	2007E	2008E
Operating Activities					
Net income (loss)	(0.91)	0.67	(0.11)	0.06	0.61
Adjustments:					
Depreciation	0.49	0.61	0.19	0.69	0.57
Amortization - intangible assets	0.08	0.40	0.14	0.55	0.42
Amortization - deferred financing costs	0.07	0.09	0.02	0.07	0.08
Provision for bad debts and rebates	1.20	0.31	(0.00)	0.53	1.08
Provision for discounts/returns		0.02	(0.26)		
Provision for inventory obsolescence	0.29	0.07	0.01	0.09	0.10
Goodwill impairment loss	0.91	0.20			
Loss on disposal - fixed assets	0.07	0.02			
Deferred rent expense	0.04	0.01	(0.01)	0.00	0.02
Employee stock option expense	0.02	0.18		0.08	0.15
Share based compensation			0.14		
Restricted stock charges		0.03			
Gain on settlement of accts pay		(0.06)			
Deferred tax provision		0.11	0.11		
Net change in working capital	0.69	(0.66)	(0.84)	(1.92)	(0.94)
Net cash provided by (used in) operating activities	2.96	2.00	(0.62)	0.15	2.10
Investing Activities					
Acquisition of Western Medical		(6.00)			
Business/product rights acquisition costs	(0.05)	(0.77)	(0.05)		
Capital expenditures	(0.22)	(0.93)	(0.14)	(0.77)	(1.00)
Proceeds - sale of fixed assets	0.03	0.01			
Net cash used in investing activities	(0.24)	(7.69)	(0.19)	(0.77)	(1.00)
Financing Activities					
Net change in bank line of credit	(1.68)	(1.08)	0.00	0.00	0.00
Proceeds from note receivable		1.00			
Deferred financing costs	(0.12)	(0.05)			
Long-term debt (repayments) proceeds	(0.45)	(1.30)	(0.08)	(0.79)	(0.51)
Proceeds (net) from issuance of stock	0.52	7.28			
Net cash (used in) provided by financing activities	(1.72)	5.86	(0.08)	(0.79)	(0.51)
Effect of exchange rate changes on cash	0.06	0.01	0.07		
Net increase (decrease) in cash/equivalents	1.06	0.18	(0.82)	(0.48)	0.58
Cash and cash equivalents					
Beginning of period	0.05	1.11	1.61	1.29	0.80
End of period	1.11	1.29	0.79	0.80	1.39

Source: Company reports and Taglich Brothers estimates