Trickle Research

Every raging river, every great lake, every deep blue sea starts … with a trickle

Q1-F19 Earnings Update, Target Decrease and Allocation Increase

sgblocks

SG Blocks, Inc.

(NASDAQ: SGBX)

https://www.sgblocks.com/

Report Date: 05/16/19

12- 24 month Price Target: *$3.15

Allocation: *5

Closing Stock Price at Initiation (Closing Px: 02/27/19): $2.84

Closing Stock Price at Allocation Increase and Target Decrease (Closing Px: 05/15/19): $.98

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Disclosure: Portions of this report are excerpted from SG Blocks's filings, website(s), presentations or other public collateral. We have attempted to identify those excerpts by *italicizing* them in the text.

Being a microcap analyst requires the acceptance that you will likely spend considerable portions of your career being wrong. Most microcaps tend to be early stage/nascent businesses, often operating in either niche portions of larger industries or industries that are emerging themselves, so visibility, especially when it comes to foreseeable quarterly performance is often poor. That makes projecting such things difficult, and frankly, in the big picture often somewhat irrelevant. We use the term "somewhat" because, while we tend to view the longer-term trend/traction of the business to be the major point of focus, for those companies that are burning cash, quarterly numbers are *quite* relevant, because they give us a sense of the potential for future dilution to fund losses (hopefully on the way to profits) which is of course germane to the valuation and price target conclusions. Moreover, in those cases, an inability to raise additional capital provides a considerable backdrop for the potential failure of the business altogether.

The scenario above is particularly salient to those of us who cover stocks with under $50 million market caps (so-called "nanocaps") because again, the visibility does not really lend itself to "hitting" quarterly projections. As a result, many companies in this space have varying approaches and philosophies about providing guidance given that lack of visibility, and one would generally assume that a reluctance by many to provide such guidance is simply an honest assessment by management that near term earnings/revenue visibility is so difficult that *even they*, the folks running the business on a hourly basis, don't feel comfortable projecting those outcomes. As we said, different companies have different approaches to that, but in general, we find that to be the "default" position. That is, if you can't provide guidance based on reasonably visible outcomes, don't provide it at all. With that in mind, we have a few critiques of SGBX.

Specifically, our coverage of SGBX is less than 3 months old, so we may be overreacting a bit here, but to this point it has been a disaster. In retrospect, we often consternate over putting out any new coverage in the first quarter of any calendar year because it typically means we are initiating the coverage right in front of two major data events; the filing of a year-end 10K for the prior year, which for fiscal yearend December 31 reporters is March 31, as well as the filing of the Q1 10Q, due May15. All things considered, it probably makes sense to at least see the 10K before we put out new research, but again, given our mantra that the numbers one quarter to the next are not really our major focus, we don't typically see the point in waiting around for a few more weeks to initiate a story we view as playing out over the next two or three years. However, we also say that with the caveat that we don't expect those year end results to be *substantially* different that we anticipate, especially when the Company has gone to the trouble of providing guidance therein. With that in mind, here is our specific frustration with SGBX.

Prior to the releases of the fiscal year end 2018 results the Company provided guidance in multiple presentations for yearend revenues of $12 million to $16 million. On the third quarter 2018 earnings call on November 14th, 2018 which keep in mind was only about 90 days or so before our initiation and only 30 days or so before the year end, management was asked specifically about the guidance to which they answered, *"In terms of the revenue guidance, we are not giving specific revenue guidance. But we do expect, if you look at our run rate through the first three months – first nine months of the year, we still expect to be cash flow break-even for the fourth quarter. We should give you a fairly good idea about the anticipated revenue for that quarter"*. So here is the perplexing part about that response. One could look at the response and perhaps conclude that their sudden unwillingness to address guidance specifically should perhaps have been a red flag to tell all of us that they weren't going to meet the original guidance of $12 to $16 million for fiscal 2018. However, the narrative also suggests that they intended to be cash flow break even for the 4th quarter. We submit, we don't know the exact number that's required for them to be "cash flow breakeven" but we have a pretty good sense that it's around $7 million per quarter. So then if we assume $7 million in the 4th quarter that would have brought them in at something around $13,000,000 for the year which would have been within the range of their guidance. Incidentally, we did not project $7 million in Q4F18, but rather only $4.1 million, and *we were still too high* by about $1.8 million. Clearly, the Company should certainly have known on November 28th 2018 that the fiscal year ending roughly one month later was not going to be in the same zip code as their guidance. That is disappointing, actually maddening, no matter how one spins it. Again, we accept the inexactness of our pursuits here, but we don't think it is unreasonable to expect management guidance to at least be in the realm of actual results.

Our second bone of contention regarding numbers and guidance relate to the Company's "backlog". Recognize, we have followed the SGBX story for some time now, having seen the Company present on multiple past occasions. We submit, we have always been intrigued by the technology as well as some of the progress they have demonstrated around the concept. Among other things, certainly some of that progress has manifested itself in the considerable backlog the Company has been reporting over the past few quarters. For instance, on the Q3 2018 call (November 28, 2018) the Company noted that the "backlog" was *"over $100 million"* and they expected it to be *"over $120 million by year end (2018)"*. They also noted that the current "pipeline" was *"comfortably over $200 million"*. Aside from our enthusiasm for the technology and associated business in the context of what we saw/see as emerging themes that may support that, we were also encouraged by the backlog relative to both prior financial performance and the prevailing market capitalization of the stock. To put that into perspective, (just prior to our initiation), their corporate presentation noted a "*construction backlog of ~$127 million as of December 3, 2018"*, which they anticipated they would exhaust through the end of 2020. That effectively meant that they anticipated generating $130 million of revenue in 2019 and 2020 combined, which would have compared to (anticipated revenues from the two prior years (2017 and 2018) of under $20 million, or a 6X+ increase in revenues. Put another way, the backlog (which again they expected to realize over the next two years) *was over 10X the market cap of the stock at the time we initiated the coverage.* These two items combined, the business plan/technology, and the stated backlog relative to the valuation of the stock, formed the basis of our enthusiasm and ultimately our initiation of the shares.

So here is what we have learned since that time.

In spite having recognized Q4F18 revenues of just $2.3 million, the backlog has been restated to roughly $96 million (or approximately $30 million less than the stated backlog from their January 2019 presentation). Obviously, some projects have been moved out of backlog. We think some of that was related to the Los Angeles school project but apparently, another large piece of business was moved out of "backlog", which begs the question (one we asked on the call) what exactly constitutes "backlog". We are still not sure we understand the answer to what it is, but we think we understand what it is not. Clearly, it is not business that is certain to transpire, and even that which eventually does may not do so in the time frames the Company's guidance anticipates. For instance, as we understand it, there are considerable portions of the current backlog that still do not have closed financial commitments, which we think suggests measurable risks that these projects may not come to fruition. More objectively, over the past few weeks we have seen backlog reduced by over 20% and at the same time we have seen the anticipated time frame for the realization of even that reduced amount from the end of 2020 to the middle of 2021. (That realization has also pushed their anticipated time frame for cash flow breakeven from the end of 2018 to the end of 2019). Frankly, all of this calls into question the reliability/visibility of the backlog metric in general, which might explain the market's reluctance to price that into the shares. Obviously, the street figured that out before we did. What is perhaps most disappointing about that is that during the Q4 call in late November, the Company didn't provide any changes to either backlog or revenue guidance. Its hard to believe that they didn't have some sense of the impending "misses". We are not sure what's worse, them knowing it and not providing some new guidance at that point, or them simply not knowing it. Neither is particularly good. More specifically, given that we were doing much of our due diligence through some of the periods referenced here, which included discussions with management, we feel a bit like we were thrown under the bus. We'll get over that, and it will only happen once.

The past few months are hard to describe as anything but disappointing, which includes some additional dilution as a result of their inability to even approach their anticipated cashflow breakeven by year end. Unfortunately, that period also encompassed our initiation of the stock, and we have been well "behind the 8-ball" ever since. For those of us largely judged by the success of our last pick, that's not a place we like to be. On the other hand, we continue to view the business favorably, which we think includes potentially marked opportunities in various markets. Further, while we are also frustrated with management's poor guidance, general inability to manage reasonable expectations and apparent willingness to brush over the shortfalls, that doesn't change the fact that they *have also* done several things right to get to this point. If the "backlog" does in fact begin to rollout according the (revised) plan, we are confident those results should speak to higher intrinsic values for the shares, especially from recently compressed prices. Conversely, as we addressed, we no longer view the "backlog" as a definitive proxy of future performance, which is not positive for visibility or by extension, the stock in general. Perhaps management will reassess their approach to that definition and can at some point win back the street's confidence in their ability to properly define that metric.

In summary, we're not pleased with where this has gone, but we also think the 65% decline in the stock from our initiation price is probably overdone. All things considered, we have recast the model to reflect a more modest monetization of the backlog, and we have applied some additional risk discounts to reflect what looks to us like more challenging visibility. Further, we have assumed some additional dilution since our model reflects future working capital deficits without it. We think added dilution is a likely scenario. We have also (more modestly) recast some of our assumptions about business currently not in the backlog, but to be honest, that is more of a defensive move because if they execute on some of the opportunities they addressed on the call, they really should exceed those expectations in that regard.

As a result of the above, we are establishing a new (lower) 12-24 month price target of $3.15 representing a reduction of 50% from our original $6.25 target. To reiterate, that conclusion is based on lower and extended backlog and new business rollouts, as well as more aggressive discount rates to reflect decreased visibility and greater dilution risk. On the other hand, given the recent compression in the stock we are also raising our allocation from 4 to 5 reflecting the disparity from the current stock price and our new target. As usual, we will reassess each as more data points become available.

Projected Operating Model

SG Blocks						
Projected Operating Model						
By: Trickle Research LLC						
	(Actual)	(Estimate)	(Estimate)	(Estimate)	(Estimate)	(Estimate)
	3/31/2019	6/30/2019	9/30/2019	12/31/2019	Fiscal 2019	Fiscal 2020
Revenue:						
Block sales	$ -	$ -	$ -	$ -	$ -	$ -
Construction services	$ 1,658,074	$ 1,656,000	$ 4,968,001	$ 6,832,081	$15,114,156	$ 50,142,964
Engineering Services	$ 77,050	$ 184,000	$ 552,000	$ 759,120	$ 1,572,170	$ 5,571,440
Total Revenue	**$ 1,735,124**	**$ 1,840,000**	**$ 5,520,001**	**$ 7,591,201**	**$16,686,326**	**$ 55,714,404**
Cost of revenue:						
Block sales	$ -	$ -	$ -	$ -	$ -	$ -
Construction services	$ 1,159,229	$ -	$ -	$ -	$ 1,159,229	$ -
Engineering Services	$ 31,790	$ -	$ -	$ -	$ 31,790	$ -
Cost of revenue	**$ 1,191,019**	**$ 1,685,200**	**$ 4,555,601**	**$ 6,171,137**	**$13,602,957**	**$ 44,457,235**
Gross profit	**$ 544,105**	**$ 154,800**	**$ 964,400**	**$ 1,420,064**	**$ 3,083,369**	**$ 11,257,169**
Operating expenses:					$ -	$ -
Payroll and related expenses	$ 638,550	$ 629,200	$ 702,800	$ 733,868	$ 2,704,418	$ 3,315,716
General and administrative expenses	$ 333,000	$ 536,800	$ 610,400	$ 651,824	$ 2,132,025	$ 3,114,288
Marketing and business development expense	$ 47,359	$ 67,351	$ 68,400	$ 105,200	$ 288,310	$ 678,179
Pre-project expenses	$ 15,931	$ -	$ -	$ -	$ 15,931	$ -
Other Operating Expenses	$ -	$ -	$ -	$ -	$ -	$ -
Total	**$ 1,034,840**	**$ 1,233,351**	**$ 1,381,600**	**$ 1,490,892**	**$ 5,140,683**	**$ 7,108,183**
Operating loss	**$ (490,735)**	**$ (1,078,551)**	**$ (417,200)**	**$ (70,828)**	**$ (2,057,314)**	**$ 4,148,986**
Other income (expense):						
Interest expense	$ -	$ -	$ -	$ -	$ -	$ -
Interest income	$ -	$ -	$ -	$ -	$ -	$ -
Other income	$ -	$ -	$ -	$ -	$ -	$ -
Loss on debt conversion	$ -	$ -	$ -	$ -	$ -	$ -
Change in fair value of financial instruments	$ -	$ -	$ -	$ -	$ -	$ -
Loss from equity affiliates	$ -	$ -	$ -	$ -	$ -	$ -
Total Other Income	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**
Loss before income taxes	**$ (490,735)**	**$ (1,078,551)**	**$ (417,200)**	**$ (70,828)**	**$ (2,057,314)**	**$ 4,148,986**
Income tax expense	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**
Net loss After Tax	**$ (490,735)**	**$ (1,078,551)**	**$ (417,200)**	**$ (70,828)**	**$ (2,057,314)**	**$ 4,148,986**
Less: Net loss attributable to non-controlling interests	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**
Net loss attributable to common stockholders of SG Blocks, Inc.	**$ (490,735)**	**$ (1,078,551)**	**$ (417,200)**	**$ (70,828)**	**$ (2,057,314)**	**$ 4,148,986**
Net loss per share attributable to SG Blocks, Inc. - basic and diluted:						
Basic	**$ (0.12)**	**$ (0.21)**	**$ (0.07)**	**$ (0.01)**	**$ (0.41)**	**$ 0.68**
Diluted	**$ (0.12)**	**$ (0.21)**	**$ (0.07)**	**$ (0.01)**	**$ (0.41)**	**$ 0.67**
Weighted average shares outstanding:						
Basic	**4,260,041**	**5,107,791**	**6,107,791**	**6,107,791**	**5,395,854**	**6,107,791**
Diluted	**4,260,041**	**5,120,372**	**6,131,809**	**6,142,207**	**5,413,607**	**6,163,786**

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Rating System Overview:

There are no letters in the rating system (Buy, Sell Hold), only numbers. The numbers range from 1 to 10, with 1 representing 1 "investment unit" (for my performance purposes, 1 "investment unit" equals $250) and 10 representing 10 investment units or $2,500. Obviously, a rating of 10 would suggest that I favor the stock (at respective/current levels) more than a stock with a rating of 1. As a guideline, here is a suggestion on how to use the allocation system.

Our belief at Trickle is that the best way to participate in the micro-cap/small cap space is by employing a diversified strategy. In simple terms, that means you are generally best off owning a number of issues rather than just two or three. To that point, our goal is to have at least 20 companies under coverage at any point in time, so let's use that as a guideline. Hypothetically, if you think you would like to commit $25,000 to buying micro-cap stocks, that would assume an investment of $1000 per stock (using the diversification approach we just mentioned, and the 20-stock coverage list we suggested and leaving some room to add to positions around allocation upgrades. We generally start initial coverage stocks with an allocation of 4. Thus, at $1000 invested per stock and a typical starting allocation of 4, your "investment unit" would be the same $250 we used in the example above. Thus, if we initiate a stock at a 4, you might consider putting $1000 into the position ($250 * 4). If we later raise the allocation to 6, you might consider adding two additional units or $500 to the position. If we then reduce the allocation from 6 to 4 you might consider selling whatever number of shares you purchased with 2 of the original 4 investment units. Again, this is just a suggestion as to how you might be able to use the allocation system to manage your portfolio.

For those attached to more traditional rating systems (Buy, Sell, Hold) we would submit the following guidelines.

A Trickle rating of 1 thru 3 would best correspond to a "Speculative Buy" although we would caution that a rating in that range should not assume that the stock is necessarily riskier than a stock with a higher rating. It may carry a lower rating because the stock is trading closer to a price target we are unwilling to raise at that point. This by the way applies to all of our ratings.

A Trickle rating of 4 thru 6 might best (although not perfectly) correspond to a standard "Buy" rating.

A Trickle rating of 7 thru 10 would best correspond to a "Strong Buy" however, ratings at the higher end of that range would indicate something that we deem as quite extraordinary..... an "Extreme Buy" if you will. You will not see a lot of these.