Trickle Research

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

Initiating Research Coverage

Report Date: 05/22/2017

12 - 24 month Price Target: $7.50

Allocation: 4

Closing Stock Price at Initiation (Close 04/24/17): $1.90

Closing Stock Price at Update (Close 05/22/17): $1.59

Social Reality, Inc.

SRAX

(Stock Symbol – Nasdaq: SRAX)

www.srax.com

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We just initiated coverage of SRAX about three weeks ago, and frankly, we should have probably waited to put the stock out until after this quarter was announced. We chose not to do that largely because we didn't feel like the numbers from this quarter were particularly relevant to the longer-term thesis, and we still don't. That said, we will go over a few items from the quarter that may be relevant to the big picture.

First, we knew the period would be a bit of a "throw-away" quarter. However, we missed badly on several key line items, so it was admittedly uglier than we anticipated. Interestingly, SRAX wasn't the only player in the industry that apparently had a tough quarter. Some of the smaller public players in the space also posted difficult revenue comps for Q1-17 vs. Q1-16: Rocket Fuel (FUEL), Maxpoint (MXPT) and Rubicon Project (RUBI) reflected YoY revenue declines of -9%, -5.4% and -33% respectively. That might give us some pause regarding the industry in general except one of the larger publicly traded industry leaders; Criteo S.A. (CRTO) posted a revenue increase of nearly **+29%**, so we don't think this is about the industry slowing down.

In addition to being the seasonally weakest quarter, management was preoccupied with the financing (or refinancing) of the Victory Park debt and associated put(s) that resulted from that event. We think that likely added to G&A on at least a couple of fronts. Further, as management discussed on the earnings call, the quarter was also saddled by the remnants of some additions to the sales department that commenced last year. Unfortunately, that addition coincided with the "subtraction" of the large (albeit low margin) legacy customer we discussed in the initiating coverage, and the result was a very tough second half of 2016, which spilled into the first half of 2017. In short, we think the quarter was a "perfect storm" in terms of working capital and finances, revenues, expenses and operations. That storm, by the way, exacted a heavy toll on SRAX's share price, which we think should be viewed opportunistically by those new to the story. That notion (the severe compression in the stock as a result of some of their challenges) was/is a significant driver in our coverage decision. That said, we think they may have most of the dark clouds behind them and they should be able to reflect better year-over-year, and likely better sequential results through the balance of 2017.

Second, management took a new/interesting approach on the call that we found insightful. They intend to highlight a particular portion of the business on each subsequent call in an effort to allow shareholders and the street to better understand some of these segments. We think that is a positive step. We tend to view this story as a bit complex in terms of being able to understand what the Company does and how it generates revenues, so we think this should be helpful in that regard. This call they covered SRAX MD, and again, we found that portion of the presentation enlightening. Specifically, SRAX MD is a clear bright spot in the story, and we think validates our notion that SRAX's plan to add niche verticals to their product platform could prove fortuitous. Recognize, they have been building SRAX MD for over 4 years now, so this has been a significant and deep initiative. It appears that SRAX MD is accelerating considerably, and much of that is driven by its marked value proposition relative to legacy advertising approaches available to pharmaceutical and device companies trying to introduce new therapies/products. For example, they noted on the call that SRAX MD is experiencing *3X higher engagement rates* than traditional approaches. That means SRAX can charge premium CPM rates which in turn include the highest margins of any segment in the Company. We believe that SRAX has the potential to ultimately (not presently but ultimately) generate revenues commensurate with the Company's entire 2016 revenues from all segments combined and at margins that are likely 3x+ better than much of the traditional search/display business. In the context of the extraordinary margins, it's not hard to understand why we believe the stock might represent a considerable value from current levels. **In our opinion, the SRAX MD portion of the business (including the database of 500,000+ healthcare professionals) may be worth more than the current market cap of the stock and if that is not true today, we think it certainly could be shortly.**

In addition to SRAX MD, other new(er) initiatives are making up much of the additional growth in the business. For example, their new sell side initiatives are gaining marked traction amongst publishers. They indicate that in the most recent quarter they doubled the number of publishers using SRAX Reach.

In case it is not clear, we think that while the Company has experienced some marked challenges over what is now about the past year, they have also been building some considerable momentum in the "growth" initiatives they have been developing for some time now. Over the past six or nine months, the bad news has overshadowed the good news (and **there has** been good news), but we may be coming to an inflection where that situation may flip. We think their new lines of business should drive revenues but also margins, which again, should go a long way towards turning the numbers and the narrative. That brings us to a final point.

Despite the 2H-16 carnage that spilled into Q1 2017, management remains resolute in their guidance of revenues between $45-$50 million and EBITDA between $2-$5 million. Notice, our model does not reflect that level of business nor does it reflect that level of operating results. We are confident that in order for SRAX to achieve the levels in-line with their guidance, especially at the high end of the guidance, newer growth initiatives like SRAX MD, SRAX Reach and SRAX Social, are going to have to contribute measurably more to the business than we are modeling. Put another way, we think the guidance tells us that management is expecting great things from these (higher margin) initiatives. If they meet their guidance, that will almost certainly mean that these new segments are making increasingly larger contributions. If *that is true*, we think the stock should garner better earnings multiples going forward, which would result in much higher valuations for the SRAX shares.

We recognize there are still plenty of risk in the story. While they managed to raise the capital we addressed in the initiating coverage, we think working capital will continue to be a challenge until they are able to begin generating meaningful cash flow. While their guidance suggests that is where they are headed, company guidance, as we all know, is subject to both error and change. We see the path to that guidance, and we think it is based on reasonable potential outcomes, but again, there are certainly no guarantees that they will get there. On the other hand, the stock price certainly reflects the struggles here, so in our view current valuations do not reflect much of the blue sky implied in the guidance. Further, as we said, in order for them to hit guidance, we think it will take a marked contribution from some of their new/focus initiatives. Successfully hitting guidance will in our view validate these pieces of the business which we think would support much higher valuations.

We reiterate our 12-18 month price target of $7.50 as well as our allocation of 4. Given the continued compression in the stock even below our initiation price, we are inclined to raise the allocation. (If we liked it at $1.90, we must love it at under $1.60…right?) However, we also think the arbitrage remnants of the financings are continuing to impact the stock negatively and that may continue to weigh on the price until those wash out. We have no insights as to when that might be. On the other hand, we may be overstating the impact of the financings on the stock, and maybe the sellers are just shareholders who have become disenchanted or even concerned about the Company's prospects given the struggles they have endured. We understand that view as well, whatever the minutia, keeping the risk profile in mind, we think the stock is a compelling value from current levels for those who may be focused on the longer-term opportunity rather than on trying to ring the bell.

Projected Operating Model

Social Reality Inc. ("SRAX")						
Projected Operating Model						
By: Trickle Research LLC						
	(actual)	(est)	(est)	(est)	(est)	(est)
	03/31/17	06/30/17	09/30/17	12/31/17	Fiscal 2017	Fiscal 2018
Revenues	$ 5,326,163	$ 11,797,220	$ 11,746,640	$ 13,086,104	$ 41,956,127	$ 51,523,302
Cost of revenue	$ 3,279,120	$ 6,773,375	$ 6,744,334	$ 7,515,374	$ 24,312,203	$ 28,679,915
Gross profit	$ 2,047,043	$ 5,023,845	$ 5,002,306	$ 5,570,730	$ 17,643,924	$ 22,843,387
Operating expense:	$ -	$ -	$ -	$ -	$ -	$ -
General, selling and administrative expense	$ 4,409,807	$ 4,367,694	$ 3,862,130	$ 4,009,471	$ 16,649,103	$ 17,367,563
Impairment of goodwill	$ -	$ -	$ -	$ -	$ -	$ -
Restructirung and Other Operating expenses	$ 846,712	$ -	$ -	$ -	$ 846,712	$ -
Income (loss) from operations	$ (3,209,476)	$ 656,151	$ 1,140,175	$ 1,561,259	$ 148,109	$ 5,475,824
Other income (expense):	$ -	$ -	$ -	$ -	$ -	$ -
Write off of contingent consideration	$ -	$ -	$ -	$ -	$ -	$ -
Interest income (expense)	$ (133,306)	$ (174,893)	$ (265,018)	$ (244,408)	$ (817,625)	$ (356,135)
Amortization of Debt Issuance Costs	$ (578,140)	$ -	$ -	$ -	$ (578,140)	$ -
Accretion of Put Warrants	$ 1,894,563	$ -	$ -	$ -	$ 1,894,563	$ -
Other Income (expense)	$ -	$ -	$ -	$ -	$ -	$ -
Total Other income (expense)	$ 1,183,117	$ (174,893)	$ (265,018)	$ (244,408)	$ 498,798	$ (356,135)
Income (loss) before provision for income taxes	$ (2,026,359)	$ 481,258	$ 875,157	$ 1,316,851	$ 646,907	$ 5,119,689
Provision for income taxes	$ -	$ -	$ -	$ -	$ -	$ -
Net income (loss)	$ (2,026,359)	$ 481,258	$ 875,157	$ 1,316,851	$ 646,907	$ 5,119,689
Net loss per share, basic	$ (0.26)	$ 0.06	$ 0.11	$ 0.16	$ 0.08	$ 0.54
Net loss per share, basic and diluted	$ (0.26)	$ 0.06	$ 0.10	$ 0.14	$ 0.08	$ 0.46
Weighted average shares outstanding, basic	7,844,127	8,012,982	8,012,982	8,457,433	8,081,881	9,457,449
Weighted average shares outstanding, basic and diluted	7,844,127	8,309,283	8,605,584	9,346,336	8,526,332	11,013,028

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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 our performance purposes, 1 "investment unit" equals $250) and 10 representing 10 investment units or $2,500. Obviously, a rating of 10 would suggest that we 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 perhaps add another 5 of the names from our profiles). 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 hung up on the tradition of more typical 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.