Earnings Update 2Q F2017

Report Date: 08/21/2017

12 - 24 month Price Target: $7.50

Allocation: 5

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

Closing Stock Price at Update (Close 08/21/17): $1.23

Social Reality, Inc.

(Stock Symbol – Nasdaq: SRAX)
www.srax.com

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We have been providing microcap research under various labels for the better part of three decades, and we must admit, we are not sure we have ever missed revenues quite this badly. Certainly, in instances where a coverage subject is just emerging into measurable revenues it's a bit more difficult, but for us to miss revenues this badly regarding a company that has a history of revenues and has provided guidance therein, is uncomfortable ground. What is interesting about these results is that despite the dramatic revenue miss, the operating results were surprisingly favorable. We think those results speak to the magnitude of our forecast miss, but more importantly perhaps, the direction of the company.

Reviewing the detail, revenues finished at just under \$6 million versus our estimate of \$11.8 million. Recall our estimates were slightly below the low end of the guidance. From that (nearly 2X) higher forecast, we were looking for gross margin of roughly \$5 million or 47.4% of revenues. Rather, the roughly \$6 million of revenues resulted in gross margin of \$3.3 million or *55.8% of revenues* versus 32.3% for the same quarter last year. The gross margin expansion was stark considering that they generated 12% more gross margin on only 65% as much revenue (in dollar terms). We believe that represents a record gross margin level for the Company, at least over the past 10 quarters or so. The next closest quarter was September 2015, which generated gross margins of 55.4%. From September 2015, the Company's gross margins declined every sequential quarter for the next four quarters, culminating in a low of 26.7% in September 2016. Incidentally, at the time of the prior record margin quarter, (September 2015) SRAX had a market cap of approximately \$53 million. *That September 2015 market capitalization was over 5X the current market cap of SRAX*. We will revisit that in a moment.

As we have covered in some of the research, 2015 was largely about the acquisition and integration of Steel Media, while the second half of 2016 and the first half of 2017 have been about unwinding it. We think it is safe to say that the transaction did not live up to expectations, and that the negative net results were perhaps magnified by the size and the form of the financing that was done to complete it. The Company has suggested that 2Q 2017 should include the last remnants of that situation, although they have indicated that they intend to try to complete the green shoe from the financing that was done to "fix" the original Steel Media financing. We expect them to try to complete that \$3 million raise, which will likely involve some additional non-operating items.

The above said, we knew they were "winding down" the large Steel account that overall, drove revenues higher and margins lower. Part of our revenue miss was related to our lack of understanding of the magnitude of that endeavor as it appears that it no longer contributes *at all*. More importantly, it looks to us as though (and *we think* the Company concurred with on the call) SRAX used this situation to reassess all of its business, perhaps weeding out other lower quality revenue and presumably the expenses that supported them. It looks like they "pushed the reset button", and are clearly prioritizing profit over revenue growth. They are not the first company we have covered to pursue that sort of change, but we must note, that approach is generally far easier said than done. However, in this instance, the marked revenue expansion and ultimately the improved operating performance that went with it is encouraging. We recognize, one quarter does not constitute a trend, but again, the net results were encouraging.

The Company has guided to revenues of \$36 million and adjusted EBITDA of \$2 million to \$5 million. The revenue number essentially implies them achieving the same revenue level for the second half of the year that was implied by the prior revenue guidance of \$42 million+. Keep in mind, they missed the prior guidance, which doesn't provide a high level of comfort with respect to the new guidance. They reiterated adjusted EBITDA of \$2 million to \$5 million. Recognize, the *adjusted* EBITDA number in this case is an elusive (which explains the large variance in the guidance) and not particularly helpful metric from a standard EBITDA perspective because it is dominated by the "adjustments". We have attempted to rationalize that into our model a bit better. We have recast our model with the new guidance in mind but also with the caveat that guidance has been difficult. We are forecasting adjusted EBITDA of around $1.9 million.

To be sure, the past 12 months have been tumultuous for SRAX and its team. While the revenue miss is disconcerting, we understand some of its nuance, and in the end, we think the associated margin expansion mitigates and probably trumps it. With that said, when we initiated the coverage, we were well aware of the fact that the Company was in the midst of trying to fix the impact of an unfavorable transaction, and that the process would not be without its pain points. Further, at the time we initiated, we were not even sure they were going to get the financing done to keep all the balls in the air. Recall, part of our initial thesis was that the Company's problems were not lost on the street because the valuation of the company and its underlying shares have been sufficiently flogged as a result of these problems and the dilutive remedies required to fix them. Again, we knew all that and we still do. We chose to initiate in spite of these risks because we think the company has been oversold relative to the (productive) assets that *remain part of the story*. In our view, the margin improvements reflected in Q2, both gross margins and operating margins, support our view that the company possesses viable assets that can speak to much better valuations than the current and continued sell-off of the stock suggests. To reiterate, one quarter does not constitute a trend, but if they do in fact generate $24 million+ in revenues for the second half (in line with the new guidance), and they do that with margins in the "47% to 55%" range, we are confident our "oversold" comment will prove accurate. To circle back to a comment we made above, the current market cap of the stock is roughly 1/5th its market cap from 2 years ago when it posted its last 50%+ gross margin quarter.

Lastly, we need to edify a comment we made on the call that we are not sure was completely digested. We asked about some of the consolidation we have seen in the space, specifically a recent acquisition of publicly traded Rocket Fuel (FUEL). Here is our concern. For those who follow our research in totality, we recently had a public company called ID Watchdog, that was acquired by one of the big three credit reporting bureaus (Equifax) in a cash buyout at $.40 per share. We initiated the coverage at around $.14 about 6 months prior to the buyout, so on the face that seems like a good deal. However, we think Equifax underpaid for the company, even though at the time they offered a 70% premium to the public market price for the stock at the time of the acquisition. The lesson there is that sometimes, small public companies trade at valuations that may not accurately reflect their true value. Sometimes small stocks end up trading well below their value because of adverse events along the way (an underperforming acquisition in SRAX's case), that the street ultimately oversells. By the way, the "overselling" may be a function of frustration by legacy shareholders, a lack of visibility required to attract new shareholders, the ill-effects of poor financing options or some combination of all three.

We think these scenarios give potential acquirers opportunities to buy undervalued assets. (That may be especially true when tax nuances like potential carried losses are considered). Succinctly, sometimes these valuation discrepancies get large enough that acquirers can offer substantial premiums to the current market value of the stock *and still be paying far less than the fair value of the assets*. We belief that happened at ID Watchdog, and we believe it could happen here. Further, from the broader view, the Rocket Fuel acquisition tells us that the space may be consolidating. As we noted in prior SRAX research, we believe SRAX MD alone could potentially be sold for considerably more than the current market cap of the stock. We think the 2Q margin expansion (which essentially reflects the favorable margins in *performing portions of the business* like SRAX MD) speaks to that notion. We also think their attempts to add new additional vertical niches in automotive and sports are opportunistic given their demonstrated abilities at adding such verticals (ala SRAX MD). Further, as they addressed on the call, products like SRAX Social are designed to be data accumulators rather than direct revenue generators. Recall, we noted in the initial coverage, that the end game in SRAX might be a valuation determined by the massive amount of consumer data it collects along the way. We still believe in the validity of that concept, and we think that valuation would be considerably more than is currently reflected in the market cap.

We submit, this story is not without its risks and potential pitfalls. Liquidity issues remain, and in that regard, they suggested on the call that they will attempt to exercise the green shoe on the prior financing, which we believe translates into another 1 million+ share of ultimate dilution. Moreover, they still have not demonstrated an ability to consistently operate the business at a profit, which may speak to even further dilution (or other more draconian scenarios). With that said, we think most investors would rather pay less for a stock than more for it (all other things being equal). The trouble is, buying stocks when they are "cheap" can be difficult, because more often than not, when they are "cheap", they are "cheap" for a reason and those reasons are not always pretty. We recognize the challenges that remain, but we stand by our view that the Company holds some assets with considerable value, some of which was clearly validated through the 2Q numbers. We think the balance of the year will provide further validation of that view. *If we are correct* about that, we think we will also be correct about our assumptions that the stock is markedly oversold and in turn the risk return could prove extraordinary.

While the recasting of our model probably suggests revisiting our target we are going to stand pat on both that and the allocation for the time being. Obviously, we will communicate any changes therein as we evaluate new data points.

Projected Operating Model

Social Reality Inc. ("SRAX")						
Projected Operating Model						
By: Trickle Research LLC						
	(actual)	(actual)	(est)	(est)	(est)	(est)
	03/31/17	06/30/17	09/30/17	12/31/17	Fiscal 2017	Fiscal 2018
Revenues	**$ 5,326,163**	**$ 5,979,688**	**$ 7,429,685**	**$ 9,296,928**	**$ 28,032,463**	**$ 35,185,786**
Cost of revenue	$ 3,279,120	$ 2,644,208	$ 3,632,246	$ 4,643,720	$ 14,199,295	$ 17,138,346
Gross profit	**$ 2,047,043**	**$ 3,335,480**	**$ 3,797,439**	**$ 4,653,207**	**$ 13,833,169**	**$ 18,047,439**
Operating expense:	$ -	$ -	$ -	$ -	$ -	$ -
General, selling and administrative expense	$ 4,409,807	$ 3,344,445	$ 3,432,265	$ 3,637,662	$ 14,824,179	$ 15,330,436
Impairment of goodwill	$ -	$ -	$ -	$ -	$ -	$ -
Restructirung and Other Operating expenses	$ 846,712	$ -	$ -	$ -	$ 846,712	$ -
Income (loss) from operations	**$ (3,209,476)**	**$ (8,965)**	**$ 365,174**	**$ 1,015,545**	**$ (1,837,723)**	**$ 2,717,003**
Other income (expense):	$ -	$ -	$ -	$ -	$ -	$ -
Write off of contingent consideration	$ -	$ -	$ -	$ -	$ -	$ -
Interest income (expense)	$ (133,306)	$ (197,267)	$ (265,018)	$ (250,375)	$ (845,967)	$ (380,270)
Amortization of Debt Issuance Costs	$ (578,140)	$ (187,568)	$ -	$ -	$ (765,708)	$ -
Accretion of Put Warrants	$ 1,894,563	$ 459,162	$ -	$ -	$ 2,353,725	$ -
Other Income (expense)	$ -	$ (803,049)	$ -	$ -	$ (803,049)	$ -
Total Other income (expense)	**$ 1,183,117**	**$ (728,722)**	**$ (265,018)**	**$ (250,375)**	**$ (60,999)**	**$ (380,270)**
Income (loss) before provision for income taxes	**$ (2,026,359)**	**$ (737,687)**	**$ 100,155**	**$ 765,170**	**$ (1,898,721)**	**$ 2,336,733**
Provision for income taxes	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**
Net income (loss)	**$ (2,026,359)**	**$ (737,687)**	**$ 100,155**	**$ 765,170**	**$ (1,898,721)**	**$ 2,336,733**
Net loss per share, basic	**$ (0.26)**	**$ (0.09)**	**$ 0.01**	**$ 0.09**	**$ (0.23)**	**$ 0.25**
Net loss per share, basic and diluted	**$ (0.26)**	**$ (0.09)**	**$ 0.01**	**$ 0.08**	**$ (0.22)**	**$ 0.21**
Weighted average shares outstanding, basic	**7,844,127**	**8,025,017**	**8,025,017**	**8,469,468**	**8,090,907**	**9,469,484**
Weighted average shares outstanding, basic and diluted	**7,844,127**	**8,321,318**	**8,617,619**	**9,358,371**	**8,535,359**	**11,025,063**

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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.