Trickle Research

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

Earnings Update – 3Q Fiscal 2017

11/17/2017

12 - 24 month Price Target: $7.50

Allocation: 5

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

Date of Allocation Upgrade from 4 to 5: 06/07/17

Closing Stock Price at Update (Close 06/07/17): $1.44

Closing Stock Price @ 11/16/17: $3.29

Social Reality, Inc.

SRAX

(Stock Symbol – Nasdaq: SRAX)

Prepared By:
David L. Lavigne

Senior Analyst, Managing Partner
Trickle Research LLC
Dave@TrickleResearch.com

We just provided a SRAX update around our recent site visit, so we will try to be brief here. First, we were unable to get on the earnings call because we were (unfortunately) on another earnings call at the same time. However, we have been over the transcript and we have a few short observations.

First, we missed the numbers miserably (again). Quite honestly, while it is obvious to those who read our updates on SRAX, we like this story and we have great confidence in management and its team as well as in their vision and their aggregate accomplishments to this point (bumps along the way notwithstanding), management's recent propensity to botch guidance (like not in the same zip code) is problematic. Frankly, it's surprising to me that it didn't come up on the call, so maybe no one except me, and the other analyst, noticed. I know he noticed because apparently, he missed the numbers worse than I did so I am most certain he noticed. I understand missing guidance on occasion, but missing it by large amounts on an ongoing basis begins to seriously undermine the term "guidance". We submit, there is nothing easy about forecasting numbers in small companies, thus, sometimes not providing guidance at all is a far better approach than providing guidance that ends up…misguided. With that said, we continue to believe there are things afoot at SRAX that speak to better valuations.

While much of the Company's prepared remarks on the call related to their new BIG platform, they did cover the financial highlights. As we said, we were not enamored with the numbers (mostly in the context of their guidance and the egg on our face) but here are some of the more salient points. Revenues were $5.6 million which was $1.9 million below our estimate and slightly lower *than the prior quarter*. Operating income came in at <$560,00> versus our estimate of $365,000, which was again largely the result of the revenue miss. That operating loss *was however, 57% lower* than the comparable 2016 period when revenues were nearly *72% higher*. Those metrics provide a stark contrast for just how aggressively they have worked to cull unprofitable business, tighten the screws on expenses and focus on higher margin endeavors. Specifically, gross margins for the quarter were 55.8% compared to 26.7% in Q3-F16, and were roughly equal to the prior quarter.

They also covered some capital issues, largely the financing they completed following the end of the quarter. Here is the discussion relative to that item.

> *We ended the quarter with $216,000 in cash on hand and in October we entered into definitive securities purchase agreement with existing investors to the sale of approximately $5.2 million of 12.5% secured convertible debentures due in April 2020.*
>
> *We also issued 863,365 Series A warrants to purchase Class A common stock, these are the five-year term, they're also part of this financing transaction. Debentures will be secured pari passu with the investors' prior debentures issued in the company's April 2017 offering. The debentures and warrants are initially convertible and exercisable at $3 per share and is subject to anti-dilution protection.*
>
> *Net proceeds from this financing were applied to our working capital. While we issued additional shares and warrants in this transaction by October 31, 2017, 1.1 million warrants had separately been retired or expired and this negates some of the recent overall dilutive effect. The cumulative outcome here as we now currently have 8.7 million common shares outstanding and we have 3.7 million warrants outstanding.*

According to our math the aggregate convertible debt is convertible into another 2.4 million shares of common. We have made those adjustments to our model, but recognize, that amounts to additional dilution of about 50% (new warrants considered) versus the share count of 8 million that existed when we first initiated our coverage. On the other hand, as we have noted along the way, we knew when we initiated the coverage that added dilution was imminent and the stock had at that point sold off considerably and presumably in part because of the recognition of potential dilution. Put another way, this dilution should not be a surprise to anyone, other than perhaps its magnitude. To be quite honest, we think the resulting dilution, while not insignificant, could have been much worse considering the current convertible debt is pegged at $3 (assuming no anti-dilution ratchets) and we believe some of that was cast when the stock was trading below that threshold. Again, we are not enamored with the dilution, but we did know it was coming…and it could have been worse.

The above touches most of the negatives for the quarter, so here are some of the positives.

From 10,000 feet, they have clearly executed a bit of a purge of the business, and it appears they are now focused on driving higher margin pieces of business. That has/will obviously negatively impact comparative revenues through some of 2018, but, in our view, it's hard to argue with the approach. From that perspective, we expect their new (and/or more recent) initiatives to drive large pieces of the business. Those would include SRAXmd, SRAXreach, SRAXsocial, SRAXauto and SRAXfan. These are greenfield initiatives supported by considerable in-house IP and associated technology (the heavy lifting of which is done at the technology center in Mexicali that we covered in the site visit update). We are not sure the street fully appreciates the technology value of SRAX and seems to view it as more of a pure sales organization. That brings us to another point we have covered in detail, but again came up on the call and is worth rehashing; the value of SRAXmd.

As many of our readers are aware, we have made the argument for some time now that SRAXmd is worth more than the market cap of the stock and we continue to believe that. Below is the excerpt from the transcript addressing SRAXmd:

> *Okay. I am holding a copy of a lawsuit that you guys filed against – it doesn't matter the name of the company, but a company in I believe the state of Illinois that was filed in August. In it one of the exhibits, it's looks like you had an offer to buy SRAXmd last December, the name was [indiscernible] they look like a fairly large company for a – well, it looks like up to $45 million. You mentioned that the unit has done better year-after-year. So should we be thinking about that kind of a number in terms of value because that would be substantially in excess of your market cap today?*

We have looked over the lawsuit as well. Here's the basic detail. SRAX was set to sell SRAXmd at the end of 2016. The buyer appears to be (have been) a large pharmaceutical company. The purchase price for SRAX was to be an initial payment of $15 million, plus additional earnout bonuses based on SRAXmd's 2018 and 2019 EBITDA. The purchase price with maximum earnouts could have been up to $45 million.

With respect to the above, here are some thing to consider:

- The market cap of SRAX at the time of this writing is $29 million.
- The earnouts mentioned above entailed some math, but their basic terms were that if SRAXmd achieved EBITDA in excess of $8.7 million in 2018 SRAX would earn an additional $15 million and if SRAXmd achieved EBITDA in excess of $11.5 million in 2018 SRAX would earn an additional $15 million, for a total purchase price of $45 million.
- The sale fell apart because due to SRAX's financial issues (brought on in part by issues that are now the subject of this lawsuit) the stock declined and the SRAXmd buyer could not justify paying a price for a portion of a public company that was greater than the value of the entire business.

Of course, what everyone is wondering today, is, "is SRAXmd, one year later, still "worth" something from $15 million to $45 million"? First, we are comfortable suggesting that SRAXmd is worth more today than it was one year ago, whatever that price might have been. Further, we think this information provides some color on something the Company has never broken out in the filings, which is their own expectation for 2018 and 2019 for SRAXmd, at least in the context of this prior purchase/sale agreement. It looks to us that this time last year SRAX anticipated that SRAXmd was capable of producing $8.7 million in EBITDA in 2018. (Just to be clear, we don't believe the recent revenue misses are related to underperformance at SRAXmd).

Going through the math, if we assume 85% margins at SRAXmd (we think they are higher) and 15% SG&A (we will defend that number if people would like), then SRAX would need to achieve revenue of about $12.5 million to post $8.7 million of EBITDA. Further, they also must believe that they can increase 2019/2018 YoY EBITDA by 30%+ ($11.5 million vs. $8.7 million). So here is the point. What multiple of expected 2018 EBITDA should SRAXmd be worth if it is capable of growing that EBITDA by 30% the following year, and likely at least double digits for the next handful of years? If we embrace the 2018 EBITDA assumption of $8.7 million, then the entire current market cap of SRAX values SRAXmd at (at most) 3.3X, and that assumes the rest of the Company is worth ZERO. Criteo (symbol: CRTO) a digital advertiser (albeit a much larger one), which we referenced as a comp in the initial coverage, trades about 12X EBITDA. A 12X EBITDA multiple for SRAXmd would imply a price of just over $100 million, or 3.6X the current price of SRAX shares (just under $12 per share.)

(By the way, prevailing in the law suit might provide an additional windfall here, and while we are certainly not lawyers, it appears to us that SRAX may very well collect something from this. We won't hold our breath on the $35 million in damages, but we do think they may collect the $2 million+ they are actually owed).

Just to edify, for what it is worth, we are projecting SRAXmd revenues of about $13 million and EBITDA of about $9 million for fiscal 2018.

Lastly, we are not going to try to provide added color on their BIG platform. We have provided some of that prior and we will stand by those assertions for now, which are that it is a topical, cutting edge, exciting addition to the story, and is probably responsible for much of the stock's recent run. It could clearly change the entire company in a variety of positive ways. It is however, in our view, not essential to the assessment of higher valuations in line with our current targets.

We reiterate our allocation of 5 and our 12-24 month price target of $7.50. As usual, we will revisit both following additional data points.

Projected Operating Model

Social Reality Inc. ("SRAX")						
Projected Operating Model						
By: Trickle Research LLC						
	(actual)	(actual)	(actual)	(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**	**$ 5,554,182**	**$ 7,103,034**	**$ 23,963,067**	**$ 30,779,235**
Cost of revenue	$ 3,279,120	$ 2,644,208	$ 2,454,919	$ 3,133,781	$ 11,512,028	$ 12,861,931
Gross profit	**$ 2,047,043**	**$ 3,335,480**	**$ 3,099,263**	**$ 3,969,253**	**$ 12,451,038**	**$ 17,917,304**
Operating expense:	$ -	$ -	$ -	$ -	$ -	$ -
General, selling and administrative expense	$ 4,409,807	$ 3,344,445	$ 3,659,202	$ 3,896,334	$ 15,309,788	$ 14,845,716
Impairment of goodwill	$ -	$ -	$ -	$ -	$ -	$ -
Restructirung and Other Operating expenses	$ 846,712	$ -	$ -	$ -	$ 846,712	$ -
Income (loss) from operations	**$ (3,209,476)**	**$ (8,965)**	**$ (559,939)**	**$ 72,919**	**$ (3,705,461)**	**$ 3,071,588**
Other income (expense):	$ -	$ -	$ -	$ -	$ -	$ -
Write off of contingent consideration	$ -	$ -	$ -	$ -	$ -	$ -
Interest income (expense)	$ (133,306)	$ (197,267)	$ (338,010)	$ (253,831)	$ (922,414)	$ (390,726)
Amortization of Debt Issuance Costs	$ (578,140)	$ (187,568)	$ (281,352)	$ -	$ (1,047,060)	$ -
Accretion of Put Warrants	$ 1,894,563	$ 459,162	$ (2,895,027)	$ -	$ (541,302)	$ -
Other Income (expense)	$ -	$ (803,049)	$ -	$ -	$ (803,049)	$ -
Total Other income (expense)	**$ 1,183,117**	**$ (728,722)**	**$ (3,514,389)**	**$ (253,831)**	**$ (3,313,825)**	**$ (390,726)**
Income (loss) before provision for income taxes	**$ (2,026,359)**	**$ (737,687)**	**$ (4,074,328)**	**$ (180,912)**	**$ (7,019,286)**	**$ 2,680,863**
Provision for income taxes	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**
Net income (loss)	**$ (2,026,359)**	**$ (737,687)**	**$ (4,074,328)**	**$ (180,912)**	**$ (7,019,286)**	**$ 2,680,863**
Net loss per share, basic	**$ (0.26)**	**$ (0.09)**	**$ (0.50)**	**$ (0.02)**	**$ (0.85)**	**$ 0.25**
Net loss per share, basic and diluted	**$ (0.26)**	**$ (0.09)**	**$ (0.45)**	**$ (0.02)**	**$ (0.77)**	**$ 0.19**
Weighted average shares outstanding, basic	**7,844,127**	**8,025,017**	**8,115,790**	**8,871,070**	**8,214,001**	**10,570,448**
Weighted average shares outstanding, basic and diluted	**7,844,127**	**8,528,537**	**9,122,829**	**10,821,070**	**9,079,141**	**13,982,948**

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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.