Trickle Research

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

1QF24 Earnings Update

Sonoma Pharmaceuticals, Inc.

(NASDAQ: SNOA)

Report Date: 08/24/23

12- 24 month Price Target: $3.00

Allocation: 4

Closing Stock Price at Initiation (Closing Px: 05/11/23): $1.03

Closing Stock Price at This Update (Closing Px: 08/23/23): $.86

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

We recently Initiated coverage of Sonoma ((May 2023) and they attended our Spring 2023 Rocky Mountain Microcap Conference. On August 10, 2023 Sonoma reported their Q1F24 results (ended June 30, 2023). Here are some highlights vis-à-vis our estimates.

For Q1F24, Sonoma reported revenues of \$3.427 million and a net loss of <\$1.42 million>. Those compared to our estimates of revenues of \$3.38 million and a net loss of <\$570,000> respectively. Obviously, our revenue estimates were in line, while our earnings estimates were less so. Here is some color in that regard.

Off the top, gross margin finished at 35% versus our estimate of 36%. In our initiating coverage, we note that margins vary by (international) region, wherein more advanced nations generally tend to deliver slightly better margins, so the geographic/product mix can impact blended margins in one period to the next.

Moving down the statement, operating expenses came in at \$2.44 million versus our estimate of \$1.8 million for a difference of \$640,000. Specifically, R&D for the quarter was \$325,000 versus our estimate of roughly \$7,000, representing about half of our miss, and SG&A was \$2.12 million versus our estimate of \$1.8 million reflecting the balance of the miss. We discussed operating expenses in the initiating coverage:

> *As we mentioned the restructuring has been in process for some time now and has included a marked reduction in SG&A to reduce burn and align expenses with available resources. Those efforts are reflected in their declining operating expenses over the past several quarters.*
>
> *We think they have wrung much of the excess out of the business, and while there could be a few additional remnants of the restructuring left to be reflected, our modeling/expectation is that current expense run rates may be close to the bottom range of those expenses going forward. While we applaud their efforts to reduce expenses, we also recognize that growing the product and distributor bases to accelerate growth will also require resources. We have cast our models to reflect those notions.*

In conjunction with the above, our estimate for Q1F24 was roughly equal to the level reflected in Q4F23, so from that perspective Q1F24 was a bit elevated. However, we believe the quarter was also impacted by seasonal charges (F23 auditing/accounting charges, costs of public listings, etc.), some of which they do not accrue. We will take note of that seasonality going forward, but to reiterate something from above, while we appreciate their efforts to drive down expenses, we also recognize that growing the business requires appropriate resources. As a result, SG&A may provide some continued volatility, but we think that will remain within a reasonable range.

Secondly, differences (actual results versus our estimates) in the R&D line item is an issue we raised with management in some of our original due diligence and we think is an issue they have had to address with others as well. That is, historically, the Company has reflected nominal levels of R&D, which is extraordinary for a company with "pharmaceuticals" in its name, but there are a few reasons for that. First, recognize, while the Company manufactures dozens of different products that they sell across the globe, the major ingredient in these products is largely the same: their proprietary shelf stable hypochlorous acid (HOCl). Predominantly, their products only differ in terms of labels, names and uses driven largely by their distribution partners in various countries and regions. As a result, they do not spend measurable resources

("R&D") creating new formularies. However, while their products are largely similar, they do provide them for different uses (wound care, foot care, eye care, surface disinfection etc.), and each time they do, they submit that iteration to local healthcare agencies along with supporting studies applicable to the specific use for certification. For instance, in the U.S. that amounts to an FDA 510K certification, while in Europe that include a CE Mark. These clinical studies and resulting submissions can be costly, and they take time to prepare. In some instances, their distribution partners have paid for some of these studies/submissions and in others, the Company pays for them. In the case of the latter, they sometimes record some of those associated expenses in R&D, while the balance ends up in COGS or in SG&A. As we understand it, they may be more inclined to start classifying more of these costs into R&D rather than elsewhere, so we will be cognizant of that. More importantly, we would point out that if we see higher R&D expenses hit the operating statements, it means that we will likely see more products certified in new jurisdictions in the coming quarters. As we have noted in the initiating coverage, more products in more jurisdictions are a major growth factor in the story.

Looking ahead, we believe the numbers will continue to improve as they add products, distributors and territories around the world, and perhaps as (or more) importantly, as they continue to evangelize the multiple effective uses of HOCl and continue to build awareness and adoption of the product. We will expand on that.

We believe stabilized HOCl has a multitude of important uses including killing pathogens (including deadly viruses, bacteria and funguses) healing wounds, reducing inflammation, reducing pain and itch, disinfecting surfaces, medical devices etc. and a host of others. Further, unlike most legacy products aimed at these problems, it is natural, non-toxic and non-caustic to skin, eyes and mouth. We believe there are multitudes of uses for HOCl that could (should) replace many legacy products/processes. That said, we would add a personal angle to that view.

We have used and witnessed the effectiveness of HOCl. We can personally attest, **this stuff works**. We have seen/experienced it relieve the pain and itch of bugs bites, reduce eczema, lessen the impact of nasal/ allergy symptoms, and heal wounds in a few weeks that were largely unresponsive to months of legacy wound care protocols. Again, we have personally witnessed HOCl address these things and others. From that perspective, we think there is broad application for Sonoma's products, and if they can continue to effectively drive even modest adoption amongst distributors, healthcare providers, and consumers, we believe they have a profound opportunity to grow the Company and its resulting valuation. We would add, while they are yet to reach profitability, we think there is a path to profitability that may not *require* additional capital. Clearly, that implies that our model proves relatively accurate, which we admit, it may or may not, but we think there is a potential path to that end or at least a path to limited additional dilution. We will continue to monitor that scenario.

Given our enthusiasm for the product(s), we are reiterating our 12-24 month price target as well as our allocation, further, barring negative news we are not aware of, we would be inclined to raise our allocation on weakness in the shares.

Projected Operating Model

Sonoma Pharmaceuticals, Inc.						
Projected Operating Model						
By Trickle Research						
	(actual)	(estimate)	(estimate)	(estimate)	(estimate)	(estimate)
	6/30/2023	9/30/2023	12/31/2023	3/31/2024	Fiscal 2024	Fiscal 2025
Revenues	$ 3,427,000	$ 3,708,549	$ 4,111,618	$ 4,577,408	$ 15,824,575	$ 20,521,664
Cost of revenues	$ 2,223,000	$ 2,379,449	$ 2,662,415	$ 2,999,624	$ 10,264,489	$ 12,916,491
Gross profit	**$ 1,204,000**	**$ 1,329,099**	**$ 1,449,203**	**$ 1,577,784**	**$ 5,560,086**	**$ 7,605,174**
Operating expenses						
Research and development	$ 325,000	$ 202,967	$ 203,289	$ 203,662	$ 934,918	$ 816,417
Selling, general and administrative	$ 2,119,000	$ 1,814,050	$ 1,856,282	$ 1,916,743	$ 7,706,075	$ 8,161,225
Total operating expenses	**$ 2,444,000**	**$ 2,017,017**	**$ 2,059,572**	**$ 2,120,405**	**$ 8,640,993**	**$ 8,977,642**
Loss from operations	**$ (1,240,000)**	**$ (687,917)**	**$ (610,369)**	**$ (542,621)**	**$ (3,080,907)**	**$ (1,372,469)**
Interest income (expense), net	$ -	$ 1,772	$ 1,444	$ 1,154	$ 4,370	$ 2,508
Forgiveness of PPP Loan	$ -	$ -	$ -	$ -	$ -	$ -
Other income (expense), net	$ (211,000)	$ -	$ -	$ -	$ (211,000)	$ -
Gain on sale of assets	$ -	$ -	$ -	$ -	$ -	$ -
Loss before income taxes	**$ (1,451,000)**	**$ (686,145)**	**$ (608,925)**	**$ (541,466)**	**$ (3,287,536)**	**$ (1,369,960)**
Income tax benefit (expense)	$ 33,000	$ -	$ -	$ -	$ 33,000	$ -
Income (Loss)Loss from continuing operations, net of tax	**$ (1,418,000)**	**$ (686,145)**	**$ (608,925)**	**$ (541,466)**	**$ (3,254,536)**	**$ (1,369,960)**
Income (Loss) from discontinued operations, net of tax	$ -	$ -	$ -	$ -	$ -	$ -
Net Income (Loss)	**$ (1,418,000)**	**$ (686,145)**	**$ (608,925)**	**$ (541,466)**	**$ (3,254,536)**	**$ (1,369,960)**
Net Income (Loss) per share: basic	**$ (0.29)**	**$ (0.14)**	**$ (0.12)**	**$ (0.11)**	**$ (0.65)**	**$ (0.27)**
Net Income (Loss) per share: diluted	**$ (0.29)**	**$ (0.14)**	**$ (0.12)**	**$ (0.11)**	**$ (0.65)**	**$ (0.27)**
Weighted-average number of shares: basic	**4,936,050**	**4,971,050**	**5,006,050**	**5,041,050**	**4,988,550**	**5,128,550**
Weighted-average number of shares: diluted	**4,936,050**	**4,971,050**	**5,006,050**	**5,041,050**	**4,988,550**	**5,128,550**
Foreign currency translation adjustments	$ 511,000	$ -	$ -	$ -	$ 511,000	$ -
Comprehensive Gain (Loss)	$ (907,000)	$ (686,145)	$ (608,925)	$ (541,466)	$ (2,743,536)	$ (1,369,960)

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Trickle Research co-sponsors two microcap conferences each year. Trickle Research encourages its coverage companies to present at those conferences and Trickle charges them a fee to do so. Companies are under no obligation to present at these conferences. Sonoma Pharmaceuticals has paid fees to present at Trickle co-sponsored conferences and we will encourage them to do so in the future.

Portions of this publication excerpted from company filings or other sources are noted in *italics* and referenced throughout the report.

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 "Hold" 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.