Q3F24 Earnings Update

Alliance Entertainment Holding Corporation

(Nasdaq: AENT)

Report Date: 05/10/24

12- 24 month Price Target: $4.25

Allocation: 4

Closing Stock Price at Initiation (Closing Px: 05/06/24): $2.00

Closing Stock Price at This Update (Closing Px: 05/09/24): $2.75

Prepared By:
David L. Lavigne
Senior Analyst, Managing Partner
Trickle Research

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

We just initiated the Alliance coverage a few days ago, so this will be brief. We recognize that begs the questions why we didn't just wait until the announcement of the quarter to put out the initiation, and there are few reasons for that, but primarily, the results of the quarter were not likely to change our general thesis regarding the Company's prospects and they didn't. That said, here are a few items of note from the release and subsequent call.

Revenues were lower than our estimates. The Company reported revenues of $211.2 million versus our estimate of $237.6 million, or about 11% lower than we anticipated. As we noted in the initiating coverage, one of the challenges we have here is trying to determine what the "normalized" business looks like. Recall, in the initiation we covered some of the good and the bad in terms of the impact the pandemic had on the business and trying to extrapolate that out of the past numbers to arrive at the remaining portions that we think are replicative is a challenge. For instance, the Company noted on the call that the comp quarter (Q2F23) still had some remnant sell-through of product from the supply chain issues, which led to higher sales but lower margins. That is the sort of noise we are trying to work through the model. Specifically, the segment reporting relative to our estimates provided additional support to the Company's notion. That is, about 70% of our revenue miss was in the gaming segment, which is where that "remnant sell through" was concentrated. **Table 1** below reflects the differences in our (segment) estimates vs. the actual results:

Table 1.			
	03/31/24 Actual	**03/31/24 Est.**	**03/31/24 Diff**
Gaming	$ 42,905	$ 61,131	$ (18,226)
Vinyl	$ 77,778	$ 68,250	$ 9,528
DVD/Blu-Ray/Ultra HD	$ 45,176	$ 47,235	$ (2,059)
CD	$ 25,365	$ 35,175	$ (9,810)
Collectibles/Toys/Consumer Products	$ 8,505	$ 9,975	$ (1,470)
Freight	$ 3,819	$ 5,691	$ (1,872)
Exclusive Distribution Fees	$ 3,701	$ 3,672	$ 29
Digital Delivery	$ 3,959	$ 6,500	$ (2,541)
	$ 211,208	$ 237,629	$ (26,421.10)
			-11%

As the table above reflects, we are still learning here in terms of getting our arms around the "normalized" business, but looking over the table, outside of the anomaly of the leftover gaming product in 2QF23, the results tell us quite a lot about what we already suspected and articulated in the initiating coverage. First, expect continued lumpiness around things like release dates of new high-profile product (Taylor Swift, Usher, Record Store Day etc.) and perhaps more systemically, we expect vinyl and gaming (setting aside this quarter's comp anomaly) to continue to grow, and we expect DVD and especially CD's to continue to face headwinds. We discussed that in the initiation in terms of some of the forward assumptions we built into the model for both specific segment challenges as well as the impact of a softer economic environment overall.

Actually, to the second point, we asked a question on the call regarding the state of the consumer, but they apparently did not understand what we were asking. That is probably our fault because we asked the question through the webcast portal as opposed to audibly so we could not redirect the question. In short, in terms of our attempts to model the impact that the macro environment might have on the business, we are curious what they are seeing in terms of signs that might suggest that consumer spending is slowing. That question was prompted by the following line from the quarterly filing regarding the lower revenue comp to the prior year: "*Along with other retailers and distributors in the United States, we are not immune to the macroeconomic headwinds caused by high interest rates and consumer discretion prompted by reduced buying power*". To be clear, we believe consumers are becoming more cautious and we have modeled a slowing economic environment through F25. This requires close attention.

Setting aside the revenue miss, the Company reported a net loss of <$3.852> million versus our estimate of <3.417> million. Given the revenue miss the minimal difference in bottom line is in our view quite constructive. Succinctly, opex was $28.8 million, vs. our estimate of $28.3 million and that *included* $2. 8 million of (presumably) nonrecurring "transaction costs" we did not account for. We asked about that on the call as well and did not get an answer we completely understood. However, opex was well in line, and assuming the transaction costs are not recurring, opex was *quite* favorable. We actually think they may outperform some of our opex numbers going forward because they have noted some coming costs savings that we are not certain we have integrated properly.

Lastly, the bright spot in the quarter was gross margin, which came in at 13.26% versus our estimate of 11.27%. Normalized gross margin is another one of those numbers we are trying to nail down, but these results have provided us with some good insights that we will work into our assessments. Namely, we need to revise our approach to gross margins because there are considerable differences in the *individual* gross margins across the segments. The good news is that in general, it appears the best margins are in the segments that are growing. To that end, management noted on the call that their expectation is for improving margins, which we expected, but not to the degree they are suggesting. Per the call, they spent some time talking about focusing on more profitable products. On the face, that might tell us to expect more challenging revenue comps but improving margin comps going forward. While there are certainly limits to the voracity of the statement, given the choice, it is generally better to get paid more for selling less.

To summarize, we were quite pleased with the results of the quarter. In the initiation, we fully suggested that finding the normalized pace of the business relative to the prior results would likely be a challenge for a few quarters, and it will likely be going forward because of the nature of their business. To translate, the revenue is not surprising, but it is telling on some levels so we have made appropriate adjustments. On the other hand, the margin results were in our view more positive than the revenue results were negative. We have made some revisions around that as well. On the whole, we are more optimistic about the story than we were prior to the earnings release. We reiterate our allocation of 4 and our 12-24 month price target of $4.25. We will revisit each as visibility dictates.

Projected Operating Model

Alliance Entertainment Holdings Corp.						
Projected Operating Model						
By: Trickle Research						
	(Actual)	(Actual)	(Actual)	(Estimate)	(Estimate)	(Estimate)
	09/30/23	**12/31/23**	**03/31/24**	**06/30/24**	**Fiscal 2024**	**Fiscal 2025**
Net Revenues	$ 226,755	$ 425,586	$ 211,209	$ 236,779	$ 1,100,329	$ 1,092,212
Cost of Revenues (excluding depreciation and amortization)	200,501	377,883	$ 183,196	$ 203,794	$ 965,373	$ 946,259
Operating Expenses:						
Distribution and Fulfillment Expense	11,714	15,144	$ 11,125	$ 11,685	$ 49,669	$ 49,919
Selling, General and Administrative Expense	14,439	15,116	$ 14,072	$ 14,555	$ 58,182	$ 58,438
Depreciation and Amortization	1,641	1,412	$ 1,402	$ 1,411	$ 5,866	$ 5,644
Transaction Costs			$ 2,086	$ -	$ 2,086	$ -
IC DISC Commissions			$ -	$ -	$ -	$ -
Restructuring Cost			$ 179	$ -	$ 179	$ -
Loss on Disposal of Fixed Assets	47		$ (51)	$ -	$ (4)	$ -
Total Operating Expenses	27,841	31,672	$ 28,813	$ 27,652	$ 115,978	$ 114,002
Operating (Loss) Income	(1,587)	16,031	$ (800)	$ 5,334	$ 18,978	$ 31,951
Other Expenses:					$ -	$ -
Interest Expense, Net	3,140	3,328	$ 3,052	$ 2,775	$ 12,295	$ 11,513
Change in Fair Value of Warrants			$ -	$ -	$ -	$ -
Total Other Expenses	3,140	3,328	$ 3,052	$ 2,775	$ 12,295	$ 11,513
(Loss) Income Before Income Tax (Benefit) Expense	(4,727)	12,703	$ (3,852)	$ 2,559	$ 6,683	$ 20,439
Income Tax (Benefit) Expense	(1,265)	3,789	$ (475)	$ 665	$ 2,714	$ 5,314
Net (Loss) Income	(3,462)	$ 8,914	$ (3,377)	$ 1,894	$ 3,969	$ 15,125
Other Comprehensive Income:						
Foreign Currency Translation			$ -	$ -	$ -	$ -
Total Comprehensive (Loss) Income	$ (3,462)	$ 8,914	$ (3,377)	$ 1,894	$ 3,969	$ 15,125
Net (Loss) Income per Share - Basic	$ (0.07)	$ 0.18	$ (0.07)	$ 0.04	$ 0.08	$ 0.30
Net (Loss) Income per Share - Diluted	$ (0.07)	$ 0.18	$ (0.07)	$ 0.04	$ 0.08	$ 0.30
Shares Used in Computing Net Income per Share, Basic	50,502,170	50,930,770	50,930,770	50,953,220	50,829,233	51,004,738
Shares Used in Computing Net Income per Share, Diluted	50,502,170	50,930,770	50,930,770	50,953,220	50,829,233	51,004,738

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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.