Trickle Research

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

Earnings Update, Target and Allocation Increases

SideChannel

SideChannel, Inc.

(OTCQB: SDCH)

www.sidechannel.com

Report Date: 05/09/24

12- 24 month Price Target: *$.23

Allocation: **5

Closing Stock Price at Initiation (Closing Px: 10/09/23): $.045

Closing Stock Price at Allocation and Target Increase (Closing Px: 05/08/24): $.06

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

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

We initiated coverage of SideChannel in October 2023. The table below reflects the differences between our estimates and actual result for the first half ("1H") of fiscal 2024, which included the December 2023 quarter and the just released March 2024 calendar quarter. To edify, we have listed the differences between our estimates and the actual numbers In Table 1 below. We attempted to delineate the positive/negative differences by color (green denoting a more favorable outcome than we anticipated and red denoting a less favorable outcome than we anticipated). For instance, if a revenue line item is lower than we anticipated, it is reflected as red, on the other hand, if an expense line item came in lower than we anticipated it is green.

Table 1.

Income Statement	(Estimate) 12/31/23	(Actual) 12/31/23	Difference 12/31/23	(Estimate) 3/31/24	(Actual) 3/31/24	Difference 3/31/24	(Estimate) 1H Fiscal 2024	(Actual) 1H Fiscal 2024	Difference 1H Fiscal 2024
Revenues:	$ 1,871,879	$ 1,736,000	$ (135,878)	$ 1,862,183	$ 1,927,007	$ 64,824	$ 3,734,062	$ 3,663,007	$ (71,055)
Cost of revenues	$ 1,023,648	$ 891,000	$ (132,648)	$ 1,018,362	$ 1,059,007	$ 40,645	$ 2,042,009	$ 1,950,006	$ (92,003)
Gross profit	$ 848,231	$ 845,001	$ (3,230)	$ 843,821	$ 868,000	$ 24,179	$ 1,692,052	$ 1,713,001	$ 20,949
Operating expenses:			$ -				$ -		
General and administrative	$ 806,031	$ 709,000	$ (97,031)	$ 805,353	$ 849,000	$ 43,647	$ 1,611,384	$ 1,558,000	$ (53,384)
Selling and marketing	$ 237,258	$ 269,000	$ 31,742	$ 237,109	$ 156,000	$ (81,109)	$ 474,367	$ 425,000	$ (49,367)
Research and development	$ 150,000	$ 126,000	$ (24,000)	$ 130,000	$ 123,000	$ (7,000)	$ 280,000	$ 249,000	$ (31,000)
Acquisition costs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Goodwill impairment	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Other Operating Expenses:							$ -		
Total operating expenses	$ 1,193,290	$ 1,104,000	$ (89,290)	$ 1,172,462	$ 1,128,000	$ (44,462)	$ 2,365,752	$ 2,232,000	$ (133,752)
Operating income (loss)	$ (345,059)	$ (258,999)	$ 86,060	$ (328,640)	$ (260,000)	$ 68,641	$ (673,699)	$ (518,999)	$ 154,700
Other income:							$ -		
Other Income	$ -	$ 13,000	$ 13,000	$ -	$ 8,000	$ 8,000	$ -	$ 21,000	$ 21,000
Miscellaneous income	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Interest expense	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Total Other Income (Expense)	$ -	$ 13,000	$ 13,000	$ -	$ 8,000	$ 8,000	$ -	$ 21,000	$ 21,000
Net income (loss) Before Tax	$ (345,059)	$ (245,999)	$ 99,060	$ (328,640)	$ (252,000)	$ 76,641	$ (673,699)	$ (497,999)	$ 175,700
Income Tax Expense	$ -	$ -	$ -	$ -	$ 1,000	$ 1,000	$ -	$ 1,000	$ 1,000
Net Income	$ (345,059)	$ (245,999)	$ 99,060	$ (328,640)	$ (253,000)	$ 75,641	$ (673,699)	$ (498,999)	$ 174,700
Net income (loss) per common share – basic	$ (0.0016)	$ (0.0011)	$ 0.0005	$ (0.0015)	$ (0.0011)	$ 0.0003	$ (0.0031)	$ (0.0022)	$ 0.0008
Net income (loss) per common share – Diluted	$ (0.0016)	$ (0.0011)	$ 0.0005	$ (0.0015)	$ (0.0011)	$ 0.0003	$ (0.0031)	$ (0.0022)	$ 0.0008
Weighted average common shares outstanding – basic	212,765,780	221,645,310	8,879,530	223,765,780	222,773,052	(992,728)	223,765,780	222,773,052	$ (992,728)
Weighted average common shares outstanding – diluted	212,765,780	221,645,310	8,879,530	223,765,780	222,773,052	(992,728)	223,765,780	222,773,052	$ (992,728)

In general, as the table reflects, many of the numbers tracked relatively well, but there are a few items that we think are worth noting.

First, the Company generated gross margin of 46.7% versus our estimate of 45.3% which resulted in gross dollar margin nearly $21,000 higher than our estimate despite revenues that were $71,000 *lower than our estimate*. Further, the Company reflected Opex of $133,752 less than we anticipated, which contributed to a net loss that was nearly $176,000 lower than our projection.

From another perspective, **Table 2** reflects 1HF 23 results vs. 1H F24:

Table 2.

	6 Months Ended Mar. 31, 2023	Months Ended Mar. 31, 2024	Difference
Income Statement			
Revenues	$ 3,163,000	$ 3,663,000	$ 500,000
Cost of revenues	1,561,000	1,950,000	$ 389,000
Gross profit	1,602,000	1,713,000	$ 111,000
Operating expenses			
General and administrative	2,020,000	1,558,000	$ (462,000)
Selling and marketing	744,000	425,000	$ (319,000)
Research and development	303,000	249,000	$ (54,000)
Total operating expenses	3,067,000	2,232,000	$ (835,000)
Operating income (loss)	(1,465,000)	(519,000)	$ 946,000
Other income, net	7,000	21,000	$ 14,000
Net income (loss) before income tax expense	(1,458,000)	(498,000)	$ 960,000
Income tax expense		1,000	$ 1,000
Net income (loss) after income tax expense	$ (1,458,000)	$ (499,000)	$ 959,000
Net income (loss) per common share - basic	$ (0.01)	$ 0.00	
Net income (loss) per common share - diluted	$ (0.01)	$ 0.00	
Weighted average common shares outstanding - basic	148,830,224	218,653,945	
Weighted average common shares outstanding - diluted	148,830,224	218,653,945	

As we highlighted in **Table 2**, for the first half of fiscal 2024 (ended March 31, 2024) revenues improved by $500,000 or just under 16%. However, while growing revenues they also reduced corresponding Capex by $835,000 and by extension they reduced the operating loss by nearly $1 million ($946,000). That brings us to a point we alluded to in the initiating coverage, and to which management provided some pointed and definitive narrative around on the earnings call.

As we have suggested in several of our updates on some of the microcap names we cover, attracting equity capital for small unprofitable public companies has been particularly difficult since the start of the pandemic, and from our perspective remains acute. That scenario (small unprofitable public companies that rely on the equity markets to finance losses into the foreseeable future), provides some extraordinary risks for investors in terms of the limited visibility around the ultimate dilution required for the Company to reach positive cash flow and stop the dilution madness. To that end, that issue, along with one other we will address below, were among our major concerns when we were preparing and ultimately publishing our initiating coverage. One of the reasons we were willing to set this particular risk aside, (the concern that they may need to continue to access onerous equity financings to fund burn) was management's confidence that they could get to cash flow breakeven at much lower levels of revenue than historical operating results might suggest. Frankly, while we modeled improving results in that regard (relative to fiscal 2023) they did a much better job of that than we anticipated, which led to positive net cash contributions for 2QF24. This is a highly positive milestone, and in our view, it measurably improves the risk profile of the Company. Again, judging from management's comments on the call, getting to positive cash flow has been *the* priority, and they achieved that more quickly than ostensibly everyone one else including us, believed they could. This is a very constructive data point.

Aside from their resolute efforts to manage expenses, the Company also covered several positive notions regarding revenues. First, this is not an issue they covered on the call, but it is a cornerstone of our initiating thesis, so it bears repeating. SideChannel is in the cybersecurity business and unfortunately cybersecurity is becoming more topical *by the day*. Moreover, the Company's focus is on small to midmarket customers that are perhaps collectively some of the most vulnerable enterprises and, unlike some of their larger counterparts that have more resources to weather a cyber-attack, breaches at small and/or middle market enterprises can be and quite often are, catastrophic. In that regard, we think the Company has demonstrated the viability of their vCISO services and related pieces by both adding and retaining customers. According to a recent report from DataHorizzon Research (Cybersecurity Market Size, Share & Industry Forecast 2032 datahorizzonresearch.com) the cybersecurity market is set to grow at annual growth rates of 8.6% from 2022 levels of $180 billion eclipsing $400 billion by 2032. In short, from an industry perspective, we (continue to) believe the wind is at SideChannel's back.

Second, in addition to (and in conjunction with) their vCISO services, the Company is also in the midst of rolling out their proprietary security platform called Enclave. Recall, our initiating coverage assumed that the low hanging fruit for Enclave would be the upselling of their existing VCISO customer base. If we understood it correctly, it sounds like they are indeed experiencing some success in that regard. However, they also discussed several new potential Enclave customers that we believe could be transformative. These include a "large hotel chain" a "large manufacturing company" and, the Department of Defense ("DoD"). In short, reference customers of this nature would be major wins for SideChannel and would likely represent valuation catalysts. We are hopeful that they will be able to discuss these and perhaps others like them as they come to fruition. While we covered Enclave in the initiating coverage so we will not reiterate it here, we believe the potential for the platform is quite open-ended and provides considerable blue-sky for valuation potential *well beyond* our current targets. Succinctly, while we submit visibility remains challenging, we think Enclave is gaining traction more quickly than our assessments may reflect.

Further, they briefly alluded to a new "hardware agent" they have developed to enable the adoption of Enclave for companies with legacy assets that represent points of vulnerability in part because they were not designed to address cybersecurity threats. Those might include, for instance, machines on a *manufacturing floor* that are monitored by a network. We think the Company will continue to add functionality to Enclave that may enable them to accelerate adoption by, among other things, implementing hardened microsegmentation solutions around assets that again were not designed around that or other cybersecurity protocols.

Third, aside from the cashflow/dilution concern we alluded to above, one of the other major hurdles the Company faces is a batch of ratcheting warrants the Company issued in 2021. Again, we will not rehash the minutia of it here, but for reference, at the time of our initiation, there were 55.5 million warrants exercisable at $0.36 and with expiration dates between March 31, 2026 and April 16, 2026. However, the warrants also included a ratchet provision that reset the amount and exercise price in the event of an equity raise. Essentially, with the stock in the $.05 per share range, any equity raise the Company engaged (depending on its price) would have included a considerably diluted concession around these warrants. Ostensibly, that ratchet has driven much of management's focus on reaching a cash flow positive profile, as raising capital to fund burn would have had to include the warrants, which would have led to marked additional dilution.

That said, in late 2023, the Company was able to negotiate a swap, which involved warrant holders collectively receiving 7.3 million common shares and 17.4 million new warrants exercisable at $.18 or 50% of the exercise price of the old warrants, in exchange for the 55.5 million old ratcheting warrants. The Company was successful in converting 43.5 million or 78.4 % of those warrants. That leaves 12 million of the old warrants, which still carry enough leverage that we think an equity raise is unlikely. To reiterate, in our view, these ratcheting warrants have pressed management's focus on profitability, however, knowing management as we think we do, we do not believe they were inclined to engage an equity raise at these valuations in any case. Our point here, is that the overhang of these spiraling warrants carried marked potential dilution risk in the event that the Company was (is) unable to convert the warrants or eliminate the burn and avoid equity raises to fund it. While the remaining 12 million warrants remain problematic, they are more manageable than 55.5 million warrants. Moreover, if the Company can in fact continue to minimize burn in the context of available cash on hand (which they actually grew slightly in the recently reported quarter), they may ultimately run out the clock on these remaining warrants, which expire in less than two years. We think management is willing to do that, and their emergence into positive cash flow provides them with that option. While we think they will continue to try to resolve the remaining outstanding warrants, positive cash flow provides some leverage around the issue. Further, we tend to believe management may have some work arounds at their disposal as well if they choose to take that route. Our point here is that at the time of our initiation, the outstanding warrants in the context of their *historic* burn rate, poised a marked risk with no clear visibility for resolution outside of the prospect of substantially more dilution via a necessary equity raise that would trigger the resetting of the warrants. In our view, while the specter of that risk has not been completely eliminated, it has been markedly reduced.

To summarize, we think SideChannel has made marked progress on multiple fronts since our initiation roughly six months ago. Two of those wins, rightsizing the business to at or near positive cashflow and the restructuring of a large portion of the ratchet warrants were two significant risks to the story, that have been largely mitigated. Obviously, they need to maintain operations at or near that cash flow threshold, but they have clearly provided visibility towards the notion that they can in fact do that. Generally speaking, while still challenging, we think visibility is improving across the organization, and especially (again) with some particularly acute issues.

We remain quite bullish on management, which frankly, in the context of the trajectory of the industry, is a cornerstone of our enthusiasm for the story. We continue to believe that for a small Company in a complex but high growth space, the Company includes considerable industry related talent starting with (but not limited to) CEO, Founder and Director Brian Haugli, who as we noted in the initiating coverage, is a known and highly regarded cybersecurity expert across the industry. That noted, they have also displayed an aptitude for managing the business processes as well. Given that we were introduced to the story via prior collaboration with CFO Ryan Polk, we are not overly surprised that they have been able to outperform our expectations in that regard.

To reiterate, since our initiation, we think SideChannel has made marked progress moving the needle on multiple fronts. These include reducing some potentially draconian risks associated with potential dilution, focusing on and markedly improving cash flow, advancing the sales pipeline for both the core vCISO business and Enclave, attracting some (potentially) watershed reference customers, improving albeit still challenging visibility, and others. Considering those improvements, in our initiating coverage we noted that our price targets were based on relatively high discount rates to our DCF based methodologies that we thought were appropriate given several of the risks we identified at the time and have revisited above. As a result, we are establishing a new (higher) 12-24 month price target of *$.23. Further, given the spread between that target and the current share price, we find the risk/reward potentially extraordinary, especially in the context of where we think the industry is headed and the potential for that tide to raise all boats (including SideChannel). As a result, we are increasing our allocation as well from 4 to **5. We will reassess each of these as new data points emerge.

Projected Operating Model

SideChannel, Inc.						
Projected operating Model						
Prepared By: Trickle Research						
	(Actual)	(Actual)	(Estimate)	(Estimate)	(Estimate)	(Estimate)
	12/31/2023	3/31/2024	6/30/2024	9/30/2024	Fiscal 2024	Fiscal 2025
Income Statement						
Revenues	$ 1,736,000	$ 1,927,007	$ 2,015,843	$ 2,149,503	$ 7,828,352	$11,467,867
Cost of revenues	$ 891,000	$ 1,059,007	$ 1,076,083	$ 1,149,329	$ 4,175,418	$ 6,084,943
Gross profit	**$ 845,001**	**$ 868,000**	**$ 939,760**	**$ 1,000,173**	**$ 3,652,934**	**$ 5,382,923**
Operating expenses						
General and administrative	$ 709,000	$ 849,000	$ 741,109	$ 750,465	$ 3,049,574	$ 3,202,751
Selling and marketing	$ 269,000	$ 156,000	$ 271,599	$ 281,509	$ 978,109	$ 1,210,468
Research and development	$ 126,000	$ 123,000	$ 135,000	$ 145,000	$ 529,000	$ 685,000
Acquisition costs	$ -	$ -	$ -	$ -	$ -	$ -
Goodwill impairment	$ -	$ -	$ -	$ -	$ -	$ -
Other Operating Expenses	$ -	$ -	$ -	$ -	$ -	$ -
Total operating expenses	**$ 1,104,000**	**$ 1,128,000**	**$ 1,147,708**	**$ 1,176,974**	**$ 4,556,683**	**$ 5,098,219**
Operating income (loss)	**$ (258,999)**	**$ (260,000)**	**$ (207,948)**	**$ (176,801)**	**$ (903,749)**	**$ 284,704**
Other income:						
Other Income	$ 13,000	$ 8,000	$ -	$ -	$ 21,000	$ -
Miscellaneous income	$ -	$ -	$ -	$ -	$ -	$ -
Interest expense	$ -	$ -	$ -	$ -	$ -	$ -
Total Other Income (Expense)	$ 13,000	$ 8,000	$ -	$ -	$ 21,000	$ -
Net income (loss) Before Tax	**$ (245,999)**	**$ (252,000)**	**$ (207,948)**	**$ (176,801)**	**$ (882,749)**	**$ 284,704**
Income Tax Expense	**$ -**	**$ 1,000**	**$ -**	**$ -**	**$ 1,000**	**$ 1,000**
Net Income	**$ (245,999)**	**$ (253,000)**	**$ (207,948)**	**$ (176,801)**	**$ (883,749)**	**$ 283,704**
Net income (loss) per common share – basic	**$ (0.00)**	**$ (0.00)**	**$ (0.00)**	**$ (0.00)**	**$ (0.00)**	**$ 0.00**
Net income (loss) per common share – Diluted	**$ (0.00)**	**$ (0.00)**	**$ (0.00)**	**$ (0.00)**	**$ (0.00)**	**$ 0.00**
Weighted average common shares outstanding – basic	**221,645,310**	**222,773,052**	**224,355,805**	**224,355,805**	**223,282,493**	**269,355,805**
Weighted average common shares outstanding – diluted	**221,645,310**	**222,773,052**	**224,355,805**	**224,355,805**	**223,282,493**	**269,928,722**

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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.