Q1F24 Earnings Update

Sow Good Inc.

(OTC: SOWG)

Report Date: 05/17/24

12- 24 month Price Target: $32.00

Allocation: 6

Closing Stock Price at Initiation (Closing Px: 07/17/23): $3.75

Closing Stock Price at Allocation & Price Target Increase (Closing Px: 08/16/23): $5.00

Closing Stock Price at Allocation & Price Target Increase (Closing Px: 11/14/23): $9.00

Closing Stock Price at Price Target Increase (Closing Px: 03/25/24): $10.19

Closing Stock Price at This Update (Closing Px: 05/17/24): $16.96

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

For Q1F14 (ended 03/31/24) Sow Good reported revenues of $11.4 million versus $199,000 for Q1F23 (ended 03/31/23). Obviously, those comps are breathtaking. Those results compared to our estimate of $9.8 million. On the other hand, the Company reported basic and diluted eps of $.08 and $.06, versus our estimates of $.25 and $.18, and net income of $510,588 vs. $1,485,219 respectively. The earnings results missed our estimates (especially given the higher revenue numbers) via a handful of contributory items we will briefly address below as well as providing some color around where we see these headed in future periods.

Starting at the top, margins came in at 40.6% versus our estimate of 41.6% or about 100 basis points. The Company provided some high-level guidance around margins in the near term, suggesting they may end up in the "mid to high 30s". They did not provide much color around that thought, but we suspect the compression (relative to our prior estimate of 40% to 41%), is related to the ramp of capacity, which will apparently include some co-manufacturing arrangements. We submit, the co-manufacturing notion is not something we have modeled in the past, and we will address that further in this update, but since they suggested the approach as a solution to some of their near-term capacity issues, we have wondered how *those* arrangements might impact margins. Perhaps their guidance is part of the answer, but we think it may have more to do with the front-end loading of their continued efforts to add internal capacity. To that end, they noted that their 5^{th} dryer is now operational, and the 6^{th} is slated to go online in Q3. We fully expect them to continue adding dryers going forward.

In addition to the above margin discussion, they also touched on a few other issues that we may need to put a sharper pencil to in terms of future margins. For instance, they discussed escalating shipping costs, which we are hearing from some other names, so we are adding some impact for that, but they also addressed product mix which is something we have modeled (so we recognize its potential to put pressure on margins), but our assumptions therein have not led us to resulting compression in *our estimates*. Obviously, we may have to rethink product mix in terms of margins. To edify, in our initiating coverage, we noted that there is considerable variability in the drying times associated with different SKUs and that variability is stark. That is, as we understand it, some items can be dried in 4 hours, while others may take as much as 30 or 40 hours. One can certainly imagine how the latter might negatively impact COGS. However, to that end, we know that to this point, the most popular SKUs have been the quicker drying varieties, which by the way, they also suggested on the call are the SKUs that tend to get rolled out first at new onboarded customers (specifically on the call Dollar General). Further, we have always assumed that there is some nuance to other portions of the COGS for specific SKUs that would offset some of the drying times. For example, it turns out that some of the longer drying time items also end up with fewer pieces in a package. Roughly, a dried package of "gummy" products might end up with a small fraction of the number of resulting pieces vs. a skittle-like candy. Frankly, this has all accelerated a bit more quickly than we originally anticipated, so we did not bother delving into some of these iterations until now, but we have made some adjustments and may make more as/if we gather more visibility around product mix, which includes two additional items that came up on the call.

CEO Claudia Goldfarb noted that the Dollar General rollout includes *"a smaller, bag size…somewhere between 0.8 to 1.2 ounces"*. We do not know how that addition to product mix will impact margins, but our initial sense is that a smaller bag may include higher relative COGS than a bigger bag. We were actually a bit surprised to hear they might entertain that approach, on the other hand, keep in mind, Dollar General is probably worth making some exceptions for as Dollar General currently has over 19,000 stores primarily in the U.S. Further, Dollar General's parent Dollar Tree, Inc. (NASDAQ: DLTR), also owns nearly 16,000 Family Dollar stores. For reference, Walmart currently has approximately 4,700 domestic stores. Also, they noted that they currently have 14 SKUs and they expect *"to end the year somewhere in the 20 range"*, which apparently includes some plans around seasonal offerings. Here again, conceptually, more SKUs complicate the product mix, which may complicate the margin evaluations. We have made a few adjustments around all of these issues.

Moving down the Income Statement, the quarter included some expense items we did not anticipate in our last update. From the 10,000-foot view, OPEx was $3.7 million versus our estimate of $2.4 million. Beyond the impact of higher expenses related to higher revenues, here is a bit of the minutia inside of those numbers.

Salaries and Benefits were about $850,000 higher than we anticipated. We think most of that is related to the expansion and onboarding of people needed to support the growth of the business and we think that occurred companywide. As we noted, this is happening a bit faster than we anticipated, but we have made some adjustments around that acceleration. Succinctly, these *are* levels we modeled them getting to, just not this quickly. The question is, where do these “normalize” as a percentage of sales? Additionally, judging from other comments on the call, we will be adding some expenses to reflect what sounds like some new marketing and promotion layers, which we think will prove constructive since much of the progress to this point has been largely void of much promotion. That may be a bit hard to believe, but we believe it is largely accurate.

Professional Services were about 34% higher (roughly $120,000) than we projected, but the quarter included a capital raise that likely involved added accounting/legal expenses, as well as some preparation for the secondary and uplisting completed in early May (2024), which we did not anticipate at the last update. Q2F24 will probably include some of that as well. Other General and Administrative Expenses were higher by about $325,000, which was likely related to both the financing activities as well as the anticipated growth issues reflected above. More specifically, between the call and the filing, it looks like executive bonuses and directors’ stock grant/fees fell in the quarter, which appear to be 40%+ of the $1.3 million of overages as well. Netting it out, we think there was certainly a fair amount of the accelerated costs around the inflection of the business but some non-recurring others as well. Again, will continue to make changes to the model around emerging information, especially regarding the scaling of the business, but in general, there are mor moving parts being added which provide new challenges.

Beyond OPEx, we believe Interest Expenses of about $270,000 above our estimates were related the amortization of warrants issued along with prior debt. To that point, we tend to derive our valuations around fully diluted numbers that include the impact of warrants and options given particular pricing assumptions (the “Treasury Method”), as an alternative to trying to compute theses quarter-to-quarter GAAP non-cash iterations around the derivatives, which to be honest, we do not fully understand in the first place. That said, we think *our* approach leads to the same or very similar conclusions.

To summarize expenses, the quarter certainly contained some items we did not anticipate, but none that change our view of the overall trajectory here, which brings us back to the top of the Income Statement.

In general, the acceleration of Sow Good’s business is providing some complexity to the model and associated assessments. For instance, as we covered in the prior research, we have been quite comfortable building our revenue assumptions around available and planned (internal) capacity *in conjunction with* the announced customers and their associated storefronts. Obviously, the addition of capacity via (undetermined) co-manufacturing arrangement makes that more difficult, however, it does lead us to the (affirmative) conclusion that if we base revenues solely on the utilization of existing/planned internal capacity, we will likely end up understating the revenues. While understating revenues and earnings appears to be the normal course of business on Wall Street, we prefer to try to get it right as much as possible as difficult as that may be with small companies in general, but especially small companies like Sow Good that are rapidly accelerating their businesses.

Lastly, the Company has spent the past 10 months or so raising about $24 million through a handful of equity private placements as well as the recent secondary and associated uplisting. These proceeds have been used along the way to expand capacity and to otherwise grow the business, and the latter will be used to pay down some related party debt as well. The equity sales, along with continued profitability have markedly improved the Company's Balance Sheet and associated liquidity since the time of our initiation. Our new model reflects the aforementioned dilutive events.

Sow Good's performance since our initiation has been extraordinary, and several catalysts along the way have improved the story as well as their underlying share price, which include the uplisting and ostensibly the improvement in the liquidity/trading of the shares in the public market *at much higher levels*. That is a favorable combination for shareholders. We remain quite constructive on Sow Good shares and for now, we reiterate our allocation of 6 and our 12-24 month price target of $32 per share. However, we would add, our new assessments point us to higher targets, but we will hold that card until we see a few more data points unfold.

Projected Operating Model

Sow Good Inc.						
Projected Operating Model						
By: Trickle Research						
	(Actual)	(Estimate)	(Estimate)	(Estimate)	(Estimate)	(Estimate)
	3/31/2024	6/30/2024	9/30/2024	12/31/2024	Fiscal 2024	Fiscal 2025
Revenues	$ 11,406,320	$ 14,189,030	$ 17,144,447	$ 22,401,067	**$ 65,140,864**	**$ 121,633,768**
Cost of goods sold	$ 6,776,882	$ 8,860,251	$ 10,705,742	$ 13,540,185	**$ 39,883,060**	**$ 73,520,769**
Gross profit	$ 4,629,438	$ 5,328,779	$ 6,438,704	$ 8,860,883	**$ 25,257,804**	**$ 48,112,999**
General and administrative expenses:						
Salaries and benefits	$ 2,350,557	$ 2,502,684	$ 2,857,334	$ 3,488,128	$ 11,198,703	$ 17,796,052
Professional services	$ 467,826	$ 985,781	$ 492,889	$ 598,021	$ 2,544,517	$ 3,032,675
Other general and administrative expenses	$ 872,260	$ 1,378,899	$ 899,057	$ 1,007,460	$ 4,157,676	$ 4,914,687
Intangible Asset Impairments	$ -	$ -	$ -	$ -	$ -	$ -
Goodwill impairment	$ -	$ -	$ -	$ -	$ -	$ -
Total general and administrative expenses	$ 3,690,643	$ 4,867,363	$ 4,249,280	$ 5,093,610	**$ 17,900,896**	**$ 25,743,415**
Depreciation and amortization	$ 9,538	$ 9,691	$ 9,846	$ 10,003	$ 39,077	$ 41,639
Total operating expenses	$ 3,700,181	$ 4,877,053	$ 4,259,125	$ 5,103,613	**$ 17,939,973**	**$ 25,785,054**
Net operating loss	$ 929,256	$ 451,726	$ 2,179,579	$ 3,757,269	**$ 7,317,830**	**$ 22,327,945**
Other income (expense):						
Interest Expense	$ (418,669)	$ (161,880)	$ (61,880)	$ (21,880)	$ (664,309)	$ (79,520)
Other income	$ -	$ -	$ -	$ -	$ -	$ -
Gain on disposal of property and equipment	$ -	$ -	$ -	$ -	$ -	$ -
Gain on early extinguishment of debt	$ -	$ -	$ -	$ -	$ -	$ -
Gain on investment in Allied Esports Entertainment, Inc.	$ -	$ -	$ -	$ -	$ -	$ -
Total other income (expense)	$ (418,669)	$ (161,880)	$ (61,880)	$ (21,880)	**$ (664,309)**	**$ (79,520)**
Net Income (Loss)	$ 510,587	$ 289,846	$ 2,117,699	$ 3,735,389	**$ 6,653,521**	**$ 22,248,425**
Weighted Average Number of Shares Outstanding, Basic	6,071,769	7,955,562	7,955,562	7,955,562	**7,484,614**	**7,955,562**
Weighted Average Number of Shares Outstanding, Diluted	7,972,645	9,088,943	9,716,777	10,053,116	**9,207,870**	**10,371,272**
Earnings Per Share, Basic	$ 0.08	$ 0.04	$ 0.27	$ 0.47	**$ 0.89**	**$ 2.80**
Earnings Per Share, Diluted	$ 0.06	$ 0.03	$ 0.22	$ 0.37	**$ 0.72**	**$ 2.15**

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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 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.