Trickle Research

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

Q2F24 Earnings Update

Sow Good Inc.

(OTC: SOWG)

Report Date: 08/16/24

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: 08/15/24): $13.21

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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 Q2F24 (ended 06/30/24) Sow Good reported revenues of $15.6 million versus $1.32 million for Q2F23 (ended 06/30/23). Once again, the comps are extraordinary, although we would add, Q2F23 was the first quarter to reflect meaningful candy sales, so forward comps will be less stark. In terms of our estimates, the $15.6 million compares to our estimate for revenue of $14.2 million, net income of $3.34 million vs. our estimate of $290, 000 and basic and diluted eps of $.35 and $.29, versus our estimates of $.04 and $.03 respectively. Again, it was clearly a very strong quarter, but it requires some color, especially in the context of our estimates.

First, the biggest contributor to the upside surprise in Net Income and resulting eps, was gross margin. We were looking for gross margin of 37.5% but actual gross margin came in at 57.6%. That difference, on top of 10% more revenue than we projected, created a gross profit of $9 million versus our estimate of $5.3 million. That drove most of the corresponding upside surprise in Net Income and eps. The setup to that surprise may be telling going forward. We will elaborate on that in points below.

Recall, in Q1F24, the Company reflected gross margins of 40.6%, which was in line with the prior quarter's gross margin of 40.2% but lower than the 46% margins reflected in 3QF23. Recognize, following the 1QF24 call, we lowered our gross margin expectations because the Company suggested gross margin "headwinds" for 2QF24. We are not sure what to make of that. That is, we are trying to understand if the margin "headwinds" comment was something the Company got wrong, or if it was simply an attempt to manage expectations. Frankly, we are not sure either of those is particularly constructive. We assume they had a good enough grasp of the business to project gross margin better than the "headwinds" guidance they provided, which suggests to us that the reason for the margin surprise had more to do with managing expectations. If that is going to be the Company's general guidance posture moving forward, we may need to read into that as we go. We will touch on that later, but further to the gross margin issue, on the 2QF24 call, they did note that moving to the new facility was delayed a bit, and as a result, they operated in the old facility at "110% of capacity", which created some efficiencies, and kicked some fixed cost associated with the new facility down the road. As a result, those costs are expected to (once again) cause some sequential margin "headwinds" in 3QF24. However, in the longer term, the new facility, among other things, should provide for margin efficiencies at expanded sales levels.

Moving down the Operating Statement, we estimated SG&A at $4.87 million for the quarter, whereas SowGood reported a much better $4.12 million. We were expecting higher Salaries and Benefits around hiring associated with the business expansion and we had also built in a layer of Professional Services costs around what we thought would be some items related to the secondary offering, which were less than we had anticipated. We are sharpening our pencil around those numbers going forward, but it has been a challenge givnethe stark increases in the level(s) of business.

In "Other Expenses" the Company reflected net Interest Expense of $596,000 and an additional loss on the Early Extinguishment of Debt of $696,502. Much of the interest expense was related to the amortization of debt discounts related to warrants issued in conjunction with debt. Those are largely non-cash charges, but they did represent a significant variance to our model. As an aside to that issue, we base our target assumptions on fully diluted numbers which we think adequately reflect the impact of those associated derivatives. GAAP can be a complex exercise sometimes.

To recap the numbers, the Company reflected another strong quarter both YoY and sequentially and earned a record $.29 per share on a fully diluted basis, yet the stock managed to sell off substantially following the release, trading down $7 or nearly 35%. To that end, we submit the call included some narrative that ostensibly led the decline.

Specifically, the Company noted that Q3F24 will be compromised because extreme temperatures caused them to suspend some shipments to customers after they discovered the heat was impacting their product quality.

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They added to that scenario a notion we had not heard before, but apparently summer tends to be seasonally weaker for candy sales than other quarters. We accept those explanations, and we will account for that in our model going forward, and we recognize that this particular issue may be part of the learning curve and growing pains of a new/emerging business, but we have to admit, we do not think the Company did a good job of providing much color around the potential impact of the situation, which we think has led to much of the compression in the stock. Succinctly, despite efforts by others on the call to gather *some* intelligence around the impact of the event, the Company provided no guidance, which again, we think has added to the consternation. For our part, we have attempted to remodel Q3 around the narrative they provided, but frankly, we have no idea what that impact will be, or by extension how the quarter will pan out. That said, beyond the extraordinary results for the quarter, we thought the call narrative also included several additional *positive* items. Here are some of the more topical data points as we see them:

- The Company continues to roll out new large retail customers (Kroger, 7-Eleven, Circel-K and others) as well as introducing new SKU's in general, as well as additional SKU's in more establish customers like Five Below, Cracker Barrel and Big Lots.

- The Company provided some additional color around plans to develop seasonal/holiday SKU's, for instance, a freeze dried marshmallow product in holiday specific shapes.

- Sow good has placed orders and made deposits on 6 additional dryers, more than doubling 2QF24 in-house capacity from 5 dryers. They expect their 6th dryer to be installed by the end of Q3F24. We have modeled the addition of the 6 new dryers, but they did not provide much guidance on those additions, so *that* visibility is poor. On the other hand, given the contract manufacturing arrangements they have managed to forge, capacity may be a less acute issue than it was without those arrangements.

- The Company has done a good job sourcing raw materials, in fact, we believe that was part of what drove margins for the quarter, however, they intend to bring the manufacture of some of their raw material (candy) in house. We submit, that approach entails some risks, but we think it could add several advantages provided they can execute on the approach. We believe they have the expertise and the resources to do that.

- Management addressed this on the Q1F24 call, but expanded on it this time around as well. They are planning to introduce smaller packages, which we also think will include multiple advantages. While it is unclear to us how (if) that packaging will impact margins, but we think it has marked potential to increase awareness and customer breadth.

- In line with the smaller packaging, they also announced that they are automating some of their packaging operations. When we were first introduced to the Company, we felt like packaging (which was largely manual) might create some bottlenecks and perhaps impede growth/capacity. This may address some of those concerns.

Given the above bullet points, since our initiation we have fielded several questions about the competitive landscape the Company faces. In short, our argument has been that Sow Good was likely among the largest players in an (albeit) nascent category, and as such was likely one of the few players that could provide the scale to address large retailers. That said, success almost always attracts competition, and we suspect that is afoot here as well. However, we think each of the above bullet points should contribute to the Company's competitive moat. So, while we expect additional competition to emerge, we also think management has positioned itself to become a much more formidable force in the category. While we submit, we still believe there are risks associated with the potential of the category itself (Is freeze dried candy here to stay?), we believe Sow Good is well positioned to lead the way in the category.

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To summarize, the quarter was a blockbuster and while we understand some of the concerns about the shipping challenges around the heat wave and its impact on Q3F24, we think the street's (negative) reaction was markedly overblown. On the other hand, despite a larger float than when we initiated the coverage, the float remains relatively small, which is a recipe for volatility. That noted, we submit, the visibility around Q3F24 is problematic, and it may not get rectified until the Q3F24 numbers are released, which may create headwinds for the shares until that occurs. To that end, we have put our best foot forward in terms of trying to peg Q3 results, but we fully expect to miss the numbers. However, as the Company has suggested, we think Q4F24 should be another big quarter, and we remain constructive on the prospects for strong F2025 comps as well.

Lastly, we would reiterate that we do not think the Company communicated the setback well, and as such they probably could have minimized some of the damage with some additional objective guidance. Further, to revisit the point above, this may be the Company's way of setting up the "under promise /overperform" mantra that gets used too often. Unfortunately, absent some added color along the way, we may have to wait 90 days to see the impact.

The above noted, we reiterate our allocation of 6 and our 12-24 month price target of $32, which represents a multiple of 16X our F2025 fully diluted eps estimate. *If they can* approach something close to our estimates, we think our target may be understated.

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Projected Operating Model

Sow Good Inc.						
Projected Operating Model						
By: Trickle Research						
	(Actual)	(Actual)	(Estimate)	(Estimate)	(Estimate)	(Estimate)
	3/31/2024	**6/30/2024**	**9/30/2024**	**12/31/2024**	**Fiscal 2024**	**Fiscal 2025**
Revenues	$ 12,543,611	$ 15,648,046	$ 8,838,578	$ 21,565,667	**$ 58,595,902**	**$ 113,623,995**
Cost of goods sold	$ 7,339,209	$ 6,640,917	$ 5,519,195	$ 12,435,232	**$ 31,934,553**	**$ 66,029,518**
Gross profit	$ 5,204,402	$ 9,007,129	$ 3,319,383	$ 9,130,435	**$ 26,661,349**	**$ 47,594,477**
General and administrative expenses:						
Salaries and benefits	$ 2,487,032	$ 2,123,572	$ 1,583,858	$ 2,856,567	$ 9,051,029	$ 14,162,400
Professional services	$ 467,826	$ 594,278	$ 415,157	$ 796,970	$ 2,274,231	$ 4,008,720
Other general and administrative expenses	$ 872,260	$ 1,399,244	$ 789,059	$ 911,871	$ 3,972,434	$ 4,744,467
Intangible Asset Impairments	$ -	$ -	$ -	$ -	$ -	$ -
Goodwill impairment	$ -	$ -	$ -	$ -	$ -	$ -
Total general and administrative expenses	$ 3,827,118	$ 4,117,094	$ 2,788,074	$ 4,565,407	**$ 15,297,693**	**$ 22,915,586**
Depreciation and amortization	$ 9,538	$ 4,939	$ 5,018	$ 5,098	$ 24,593	$ 21,222
Total operating expenses	$ 3,836,656	$ 4,122,033	$ 2,793,092	$ 4,570,506	**$ 15,322,287**	**$ 22,936,808**
Net operating loss	$ 1,367,746	$ 4,885,096	$ 526,291	$ 4,559,929	**$ 11,339,063**	**$ 24,657,669**
Other income (expense):						
Interest Expense	$ (418,669)	$ (599,664)	$ (41,880)	$ (31,880)	$ (1,092,093)	$ (27,520)
Other income	$ -	$ 4,130	$ -	$ -	$ 4,130	$ -
Gain on disposal of property and equipment	$ -	$ -	$ -	$ -	$ -	$ -
Gain on early extinguishment of debt	$ -	$ (696,502)	$ -	$ -	$ (696,502)	$ -
Gain on investment in Allied Esports Entertainment, Inc.	$ -	$ -	$ -	$ -	$ -	$ -
Total other income (expense)	$ (418,669)	$ (1,292,036)	$ (41,880)	$ (31,880)	**$ (1,784,465)**	**$ (27,520)**
Net Income (Loss) Before Taxes	$ 949,077	$ 3,593,060	$ 484,411	$ 4,528,049	**$ 9,554,598**	
Income Tax Expense	$ -	$ 3,593,060	$ 484,411	$ 4,528,049	**$ 8,605,520**	
Net Income (Loss)	$ 949,077	$ 3,335,142	$ 484,411	$ 4,528,049	**$ 9,296,680**	**$ 24,630,149**
Weighted Average Number of Shares Outstanding, Basic	6,071,769	9,624,999	10,245,388	10,245,388	**9,046,886**	**10,245,388**
Weighted Average Number of Shares Outstanding, Diluted	7,972,645	11,385,708	12,185,283	12,305,350	**10,962,246**	**12,418,925**
Earnings Per Share, Basic	$ 0.16	$ 0.35	$ 0.05	$ 0.44	**$ 1.03**	**$ 2.40**
Earnings Per Share, Diluted	$ 0.12	$ 0.29	$ 0.04	$ 0.37	**$ 0.85**	**$ 1.98**

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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.

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A Trickle rating of 4 thru 6 might best (although not perfectly) correspond to a standard "Buy" rating.

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