Trickle Research

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

Fiscal 2024 Earnings Update & Price Target Upgrade

Alliance Entertainment Holding Corporation

(Nasdaq: AENT)

Report Date: 09/20/24

12- 24 month Price Target: *$5.25

Allocation: 4

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

Closing Stock Price at This Target Update (Closing Px: 09/19/24): $2.04

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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.

For fiscal 2024 (ended 06/30/24) Alliance reported revenues of $1.100 billion, Net Income of $4.60 million and fully diluted EPS of $.09. Those results compare to our estimates for revenues of $1.100 billion, Net Income of $3.97 million and fully diluted EPS of $.08.

While the aggregate numbers compared favorably to our estimates, there were some elements within the numbers that we missed, and we think require elaboration. First, we projected better operating margins than they achieved, but those differences were related largely to our projected product mix. Recognize, the Company's respective margins across different segments vary considerably from mid-teens for some to mid-single digits for others. Succinctly, for 4QF24, the Company actually did a bit better in some of the lower margin and perhaps wanning segments (CD's and DVD's) and sold a bit less in some of the emerging segments (gaming and vinyls). Perhaps the biggest contributor to the margin miss was actually their digital delivery segment, which commands the highest margins of the group. We submit, and as we noted in the initiating coverage, the product mix remains a moving target, but we believe we will be able to continue to tighten up the numbers as new data points emerge. That said, we think the major points of our original thesis remain intact, and in our view, speak to better intrinsic valuations going forward.

First, our thesis centers on the view that the Company will continue to focus on the higher margin portions of the product mix, which at least for the foreseeable future, will likely result in relativly benign revenue growth, but with higher (more profitable) margins. As we alluded to above, our basic assumption going forward is that some of the Company's segments are poised for continued growth, while others may see limited, or even negative growth going forward. Further, that scenario favors the segments with higher margins. We submit, that is not how Q4F24 turned out, but again, we are still trying to understand the likely "normalized" product mix and associated growth going forward. Frankly, we are beginning to think that "reports of the death of CD's and DVD's may be greatly exaggerated" (Mark Twain …sort of). We would add, the Company's release around the earnings noted that *"...Direct-to-Consumer (DTC) sales contributed 36% of gross revenue in fiscal year 2024, up from 31% in the prior year"*, which we think speaks to some of the unanticipated strength in these segments, which may prove more sustainable than we are modeling. That would be a pleasant surprise, but for now, we will continue with the assumption that some segments will do marginally better than others. We would add, the Company suggested both in the body of the earnings call, as well as in response to some of the Q&A, that *their* expectations for the near term are for nominal top line growth with expanding margins and associated profitability. More specifically, again in line with some of the call discussion, we are modeling Adjusted EBITDA margins trending more towards the 4% - 5% range as opposed to the 2% range reflected for F2024.

Second, and as an extension of the above, notice that in support of our view that the Company is focused on driving more profitable segments, the Company's news releases over the past several months have largely included new partnerships/collaborations around their growing and higher margin segments. We expect that to continue and is a portion of our notion that margins are poised to expand. Further, those collaborations may also result in more robust revenue growth than we are currently assuming.

Third, the Company also alluded to their acquisitive history, and the potential for that to be a basis for future revenue expansion. We have no way of handicapping the potential for another acquisition, but we can certainly look to the past for some clues about the likelihood of that eventuality. Recognize, Alliance has been built around the identification and integration of strategic pieces that management has been able to effectively layer onto its robust distribution and fulfillment platform, as well as around its relationship with some of the largest retailers in the world. That combination has provided marked synergies for acquired assets, and in our view the likelihood of them adding others is high.

Fourth, while the Company continues to enhance the channels and opportunities for the existing product mix, they have also managed to improve efficiencies across the enterprise and drive down both overhead and unit costs. As we noted in prior updates, our site visit was an eye-opening experience and included a glimpse into several of these distribution/fulfillment initiatives. That includes some consolidation they have initiated, which should lead to further efficiency. We would add, while the product mix issue we discussed

above caused us to understate COGS for 4QF24, Operating Expenses for the quarter were nearly $1.5 million lower than our estimate ostensibly reflecting some of these efficiencies.

Fifth, the improving operating results continue to enhance and liquify the balance sheet. From the Fiscal 2024 earnings release:

- *Inventory levels were reduced to $97 million as of June 30, 2024, down from $147 million the prior year, as a result of effective inventory management.*
- *Revolver balance reduced by 45%, from $133 million to $73 million, significantly improving liquidity and reducing debt service costs.*

In our view, improving balance sheet liquidity is derisking the story, which on the face should lead to lower costs of capital and by extension better intrinsic discount assumptions and thus higher valuation conclusions.

Lastly, we think some view Alliance as a "turn around" story, but we do not think that is the appropriate way to view the Company. While it is fair to say that fiscal 2024 definitely reflected a turnaround from fiscal 2023, in our view fiscal 2023 was an anomaly, that was largely driven by the reconciliation of the Company's pandemic related challenges. In contrast, we think Alliance should be evaluated from the perspective of two industry veterans and company founders (Chairman Bruce Ogilvie CEO/Director Jeff Walker), who have collectively built a bit of a moat around the presumably mature physical entertainment medium industry. In that regard, we are always tempted to view Alliance as a sort of "last men standing", in a declining industry. Frankly, even in that case, we would argue that current valuations do not reflect the value of the enterprise. However, the *real* opportunity here may well be in the overstatement of that "declining industry" outlook. For instance, as the Company noted in the earnings presentation:

- *The global vinyl records market size is estimated to grow by $790.55 million from 2024 to 2028, according to Technavio.*
- *The global brand licensing market is projected to grow from USD 274.9 billion in 2022 to USD 385.4 billion by 2027 at a CAGR of 4.1% from 2022 to 2027.*

In short, our belief is that management's experience and relationships in the industry coupled with its state-of-the-art distribution and fulfillment facility will allow them to continue to exploit opportunities in pockets of the industry that other competitors may not be able to address. Further, we continue to believe that those same attributes will likely lead to additional acquisitions that could broaden the moat.

To summarize, in our opinion, the results of Fiscal 2024 continue to validate our view that Alliance shares remain undervalued at current levels. Further, we think the continued derisking of the balance sheet further supports that view. As a caveat, our one concern here remains the macro environment and by extension the health of the consumer and their continued ability to spend on discretionary items. All things considered, we are establishing a new 12-24 month price target for Alliance shares of *$5.25 and we reiterate our allocation of 4. We would add, we are becoming more comfortable with *even higher* price targets, however we think our aforementioned macro concerns could provide some headwinds. We will reassess all of our conclusions here as new information emerges.

Projected Operating Model

Alliance Entertainment Holdings Corp.						
Projected Operating Model ('000's)						
By: Trickle Research						
	(Estimate)	(Estimate)	(Estimate)	(Estimate)	(Estimate)	(Estimate)
	09/30/24	**12/31/24**	**03/31/25**	**06/30/25**	**Fiscal 2025**	**Fiscal 2026**
Net Revenues	$ 222,417	$ 421,315	$ 209,898	$ 241,122	$ 1,094,752	$ 1,121,870
Cost of Revenues (excluding depreciation and amortization)	$ 194,536	$ 363,735	$ 183,090	$ 210,270	$ 951,632	$ 973,990
Operating Expenses:						
Distribution and Fulfillment Expense	$ 10,871	$ 15,227	$ 10,597	$ 11,281	$ 47,975	$ 48,569
Selling, General and Administrative Expense	$ 14,334	$ 14,632	$ 14,315	$ 14,362	$ 57,642	$ 57,683
Depreciation and Amortization	$ 1,411	$ 1,411	$ 1,411	$ 1,411	$ 5,644	$ 5,644
Transaction Costs	$ -	$ -	$ -	$ -	$ -	$ -
IC DISC Commissions	$ -	$ -	$ -	$ -	$ -	$ -
Restructuring Cost	$ -	$ -	$ -	$ -	$ -	$ -
Loss on Disposal of Fixed Assets	$ -	$ -	$ -	$ -	$ -	$ -
Total Operating Expenses	$ 26,616	$ 31,270	$ 26,323	$ 27,053	$ 111,261	$ 111,896
Operating (Loss) Income	$ 1,265	$ 26,310	$ 485	$ 3,798	$ 31,858	$ 35,984
Other Expenses:					$ -	$ -
Interest Expense, Net	$ 2,475	$ 3,394	$ 2,672	$ 2,775	$ 11,315	$ 11,513
Change in Fair Value of Warrants	$ -	$ -	$ -	$ -	$ -	$ -
Total Other Expenses	$ 2,475	$ 3,394	$ 2,672	$ 2,775	$ 11,315	$ 11,513
(Loss) Income Before Income Tax (Benefit) Expense	$ (1,210)	$ 22,916	$ (2,187)	$ 1,023	$ 20,543	$ 24,472
Income Tax (Benefit) Expense	$ (315)	$ 5,958	$ (569)	$ 266	$ 5,341	$ 6,363
Net (Loss) Income	$ (895)	$ 16,958	$ (1,618)	$ 757	$ 15,202	$ 18,109
Other Comprehensive Income:						
Foreign Currency Translation	$ -	$ -	$ -	$ -	$ -	$ -
Total Comprehensive (Loss) Income	$ (895)	$ 16,958	$ (1,618)	$ 757	$ 15,202	$ 18,109
Net (Loss) Income per Share - Basic	$ (0.02)	$ 0.33	$ (0.03)	$ 0.01	$ 0.30	$ 0.35
Net (Loss) Income per Share - Diluted	$ (0.02)	$ 0.33	$ (0.03)	$ 0.01	$ 0.30	$ 0.35
Shares Used in Computing Net Income per Share, Basic	50,973,622	50,994,228	51,015,040	51,036,060	51,004,738	51,089,670
Shares Used in Computing Net Income per Share, Diluted	50,973,622	50,994,228	51,015,040	51,036,060	51,004,738	51,089,670

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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.