Trickle Research

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

Q3F24 Earnings Update

Sow Good Inc.

(OTC: SOWG)

Report Date: 11/19/24

12- 24 month Price Target: *$8.00

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 Price Target Decrease (Closing Px: 11/18/24): $3.94

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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.

We knew the quarter was compromised by the shipping and product quality problems created by the summer heart wave, but we were surprised by the magnitude of the issue on revenues. Pointedly, we think they have done and perhaps continue to do, a poor job of communicating the breath of the issue (ie: “guidance”). To that end, we were a bit taken back by management’s comments on the call that they thought the events of the quarter were already baked into the stock price (pre-earnings announcement). Given that the quarter came in *significantly lower* than all of the estimates, which frankly we analysts were forced to take a guess at in the first place, it should not have surprised anyone that the stock would have another leg down when the numbers were reported.

While again, our hope was that the filing and the subsequent call might provide us with some clarity on the breadth of the issue, neither provided much additional visibility. That said, there were a few talking points worth exploring to try to piece some of this together.

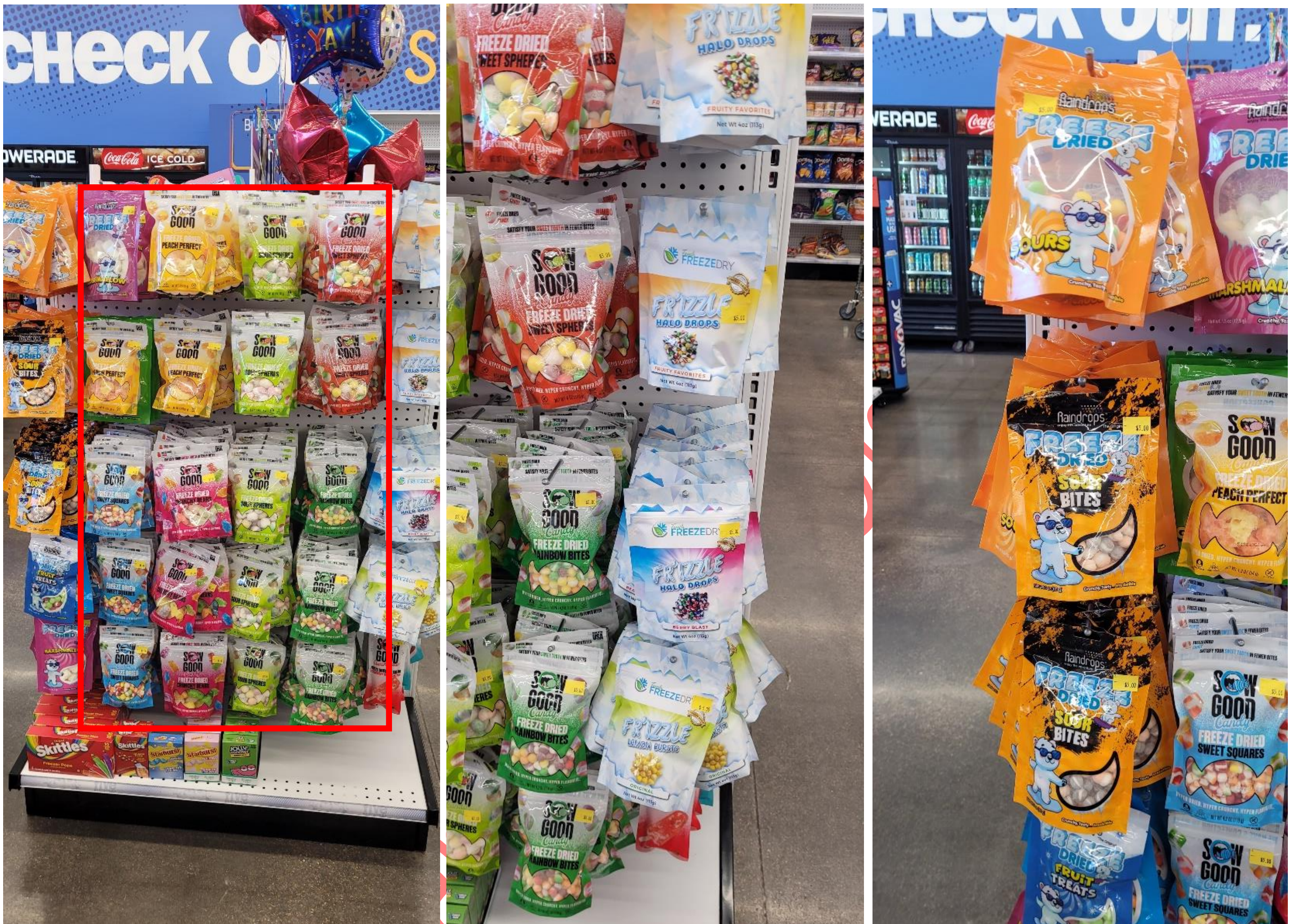
They noted that much of the shipping problem was related to certain SKUs and were also largely contained to some of their bigger accounts. Specifically, from the call transcript:

> *We're seeing that in very specific items. So if we look at quarter-over-quarter performance on a SKU basis, we're seeing it really impact the crunchy worms, the sweet worms, the sour worms.* ***We were down 30% on the crunchy worms from Q2 to Q3*** *on Pfizer [ph] IRI, same thing with the sweet worm. So we're seeing the impact on those melted items. At the same time, we're seeing increases in our sweet bites, our sour spheres. So short-term impact on some of our top sellers that are more susceptible to heat, but from a sell-through data at the retail level, those items that aren't impacted by heat are continuing to do well.*

This is odd to us. Keep in mind, 3Q vs. 2Q was down 77%. Historically, as we have understood it, the Company’s best-selling SKUs have been their Rainbow Bites and their Sour Bites. These are Skittle based products, and looking around the space, these seem to be the most prevalent item from competitors as well. We believe that with many of their customers, initial onboarding typically involved two SKUs, and these were often the first two. Recall, in our initiating coverage we noted that some products are more difficult to dry, and some take longer than others. As it turns out these Skittle based products are easier and dry much quicklier that most, which probably explains why manufacturers, especially small “mom and po ps” have focused on these. With that in mind, ostensibly, the heat problem was largely related to these more difficult SKUs, (apparently the “worm” varieties), and those were down *30%* sequentially. If the lesser selling SKUs were only down 30% how could the quarter possibly be down 77%? That is perplexing.

We have a Five Below near us that we like to check the channel. We recognize that visiting one location does not constitute a vigorous channel check, but its better than nothing. Below are three photos of the freeze-dried selection at this particular store. There are a few things of particular note here from our perspective.

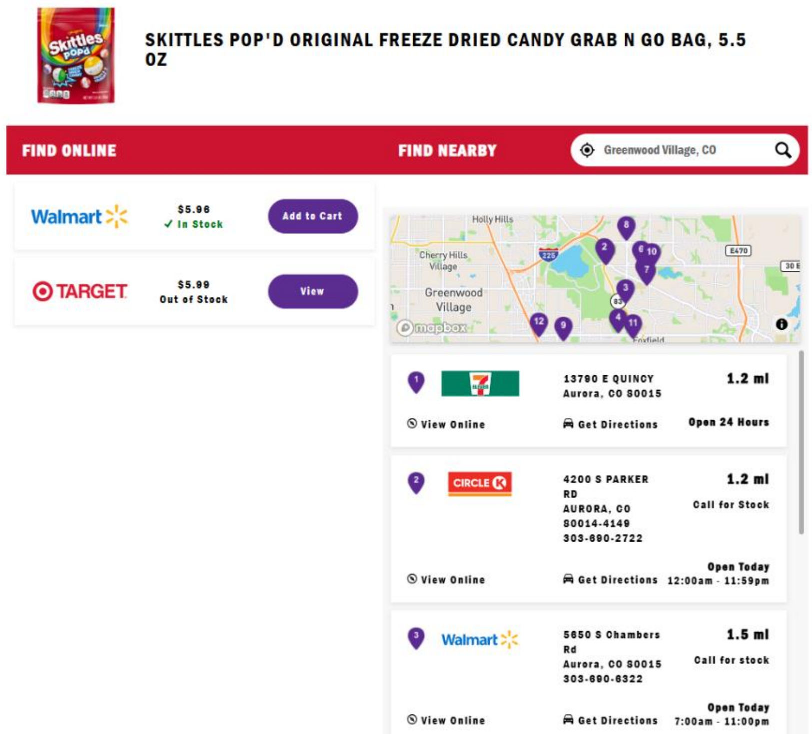
First, as we have outlined in the red box of the photo on the left, most of the section is dominated by Sow Good product. If our count is accurate, there are 7 SKUs here, which also coincides with our model assumption of Sow Good SKUs at Five Below. Notice, while there are two additional competitors on the shelf, Sow Good dominates the display. In terms of the competitors, we have been aware of the one on the right of the display, which is a Utah based company called “Family Freeze Dry”. The product on the left of the display branded “Raindrops”, and is apparently manufactured in China, which is mildly interesting. As the photo reflects, the display has a considerable amount of Sow Good product on it, which raises a number of questions from what is being pulled from the shelves (there are no worm products on the display that we can see) to sell through velocity (the shelf is full of product). That makes us believe that they likely did in fact pull the worm products from this location, although when we asked the store clerk about that, she had no idea what we were talking about.



On the call, the Company referenced, *"the entry of some of the world's largest CPG companies into the space we helped create underscores the legitimacy and the consumer demand for freeze-dried candy as an everyday indulgence"*. We believe they were speaking to Mar's beginning to market Skittles Pop'd, which is their version of freeze-dried Skittles. We have a handful of observations around this.

First, this was probably inevitable given the rapid growth of Sow Good and perhaps the category in general. While the Company has painted this as "validation" of the category, which we agree with, it is unclear to us if that validation is good or bad for Sow Good? We think it is certainly bad for the multitude of small "Mom & Pop" players selling these at farmers markets, online etc. We think that may be particularly problematic for those advertising their freeze-dried product with the name "Skittles" in the packaging. That was surprising to us from the beginning (and it is something Sow Good has gone to great lengths to avoid), but we suspect Mars will put a stop to that now that hey are in the market with a product.

Second, the Company is quick to reference its "innovative and differentiated products… bringing fresh experiences to consumers". To reiterate, we think Skittles are one of the easier or at least quicker products to freeze dry, which probably explains why Mars is jumping into the space with *their* Skittle product. Further, if this launch is successful, we would expect them to potentially follow up with Starbursts, since that is their brand as well. Clearly their entre into the market will impact players in the space and Sow Good will be no exception. The graphic here from a "Where to Buy" search result reflects that Mars is clearly in some of the large retailers where we expected Sow Good to be launching. The Company also addressed that on the call: *"...In regards to **Circle K and Target**, I don't have good answers for you on those. There are large CPG competitors that are entering the landscape. And our conversations have been that they may want to be the only freeze-dried product on-shelf at certain retailers. And the position that we're taking is we have the best product, the best assortment, the best pricing. And if you choose to go in a different direction with some exclusivities or whatever relationships you're going to, we're just going to pick up other shelves elsewhere because across the board, what we're hearing from retailers, is what their customers want is this broad assortment of freeze-dried candy".*



We think it is pretty clear what happened to some of their launches into some of the retailers they/we were anticipating. In short, it is not surprising that large CPG's have entered the space, but we are surprised at how quickly they did it. However, this issue has always been one of the *elephants in the room* in terms of Sow Good's prospects. For us, the question was, is freeze dried going to become a new category, or is it going to continue to be novelty with limited market breadth? By extension, which if those would be better for Sow Good, that is, to be a smaller but more innovative player in a large market, or large market leader in a small market. The answer to that with respect to Sow Good is still unclear to us, but again, it is a question we knew they would confront sooner or later. *That* turned out to be sooner, so here we are.

Next, we think, given the changing landscape, the Company's mantra as an "innovator" may be the answer to their ultimate success. As we alluded to above, as far as we can tell, the Company has been an "innovator" in the sense that they seem to be providing more variety than much of their competition. Again, while could be wrong, it is not surprising to see Mars leveraging its own Skittles brand to provide a freeze-dried product (as opposed to letting everyone else do the same), and we can certainly see them doing the same with their other products where applicable (Starburst for instance). However, we are not sure we see them going outside of those existing brands. In that event, Sow Good may continue to be able to differentiate itself by offering various and new SKU's. We think that may be more important for some customers than others, most notably specialty retailers like Five Below, as well as customers like Cracker Barrel which also tends to stock more unique and even "throwback" food items. To that end, they referenced on the call, *"domestically, we're intensifying our footprint expansion across **regional grocers**, convenience stores, travel hubs and **non-traditional retail outlets".*** To their strategy, we think there is a sizable market of retailers in that category that Sow Good has not reached, so we believe there continues to be opportunity there.

The Company continues to add capacity noting on the call that they, *"now have six freeze dryers operating at our Union Bower facility. And at Rock Quarry, we received our seventh freeze drier along with our two candy making machines. Freeze driers 8 through 12 are set to arrive within the next eight weeks with our automated packaging machine arriving in 8 to 12 weeks"*. Frankly, as we alluded to above, we think they have likely lost some of the large retailers they anticipated having, which likely led to the procuring of several new machines that may provide more capacity than they need in the intermediate term. We also think that scenario may explain why they are talking about potentially providing private label services to applicable customers. If we recall correctly, this is an issue they dealt with early on and decided against because they wanted to commit (at the time) limited manufacturing capabilities fully towards building the Sow Good brand. We do not have any insights as to how likely it is that they can revisit those potential opportunities, but we suspect they may need that type of business to keep 12 machines busy. In our view, a private label arrangement would be a welcome development.

The call also elaborated on some constructive data points (and introduced some others) that we think are worth reiterating. Briefly, they addressed entering some new international markets (the Middle East and Europe) in 2025. They reiterated plans to bring in new candy machines providing some vertical integration that should enhance their innovation strategy and includes new "rock candy" and other non-freeze-dried form factors, as well as some unique flavors. Further, it sounds as though they are going to get more aggressive with some marketing initiatives that include efforts in current quarter. While some of that may sound aggressive, we would remind readers that when we first visited the Company prior to our initiation, they were just entering the freeze-dried candy business and were essentially "pre-revenue" in segment. Management has demonstrated an ability to develop and commercialize new products quickly.

Looking ahead, Sow Good has definitely encountered some headwinds, that appear to have started with the shipping/heat issue, but frankly may have been boiling under the surface regardless. For instance, we do not think Mar's decision to start freeze drying their own Skittles had anything to do with heat waves. As we said, we think everyone following the story anticipated more competition, it was just a matter of when and by whom. It looked as though they would be able to establish a presence in a large swatch of the big box footprint before that competition could mobilize and have to displace them, however, Mars entrance into the market certainly complicates the game for Sow Good.

Unfortunately, as we believe we noted in our last update, we do not feel like the Company has communicated the breadth of the shipping issue and has largely left the street guessing. To that end, we were a bit taken back by this comment on the call, *"Now I understand, I looked at the stock this morning. I thought you guys had already priced in the third quarter issues"*. With all due respect, the quarter was 77% lower than the prior quarter and came in well below (especially) our and other analysts' estimates *despite those estimates all being pared back after the news of the shipping issue on the 2QF24 call*. Clearly, the quarter ended up worse than the bad it was anticipated to be so it should not surprise anyone that the stock has traded even lower. Further, they provided little guidance around Q4F24 either, so the street is still in our view left guessing. That is certainly how we feel.

To that end, we have no idea what we should be modeling here. It sounds as though Q4F24, much like Q3F24 is going to be challenging. That said, our approach is to go back and reassess some of the retail additions we were anticipating and essentially "start over", for lack of a better term. That is, we are going to start with the retailers we know and appear to be sticking and try to build around assumed traction amongst generally smaller more regional and or specialty retailers. That said, much like last quarter, visibility is poor, and unless the Company starts communicating more effectively (assuming they have any visibility of their own), visibility could be challenging for the foreseeable future. As a result, we have substantially crammed down our estimates, again around the customers they have specifically indicated they continue to work with, until we find some clarity regarding customer acquisition/retention. That said, we continue to view the Company as a leader and an innovator in a new category that appears to be maintaining traction. Granted some of that has manifested in the participation of large well-established players, but our view is that Sow Good will continue to carve out its share, which we think suggests the stock is largely oversold in here.

As a result of the above assessments, most notably the lack of visibility, we are establishing a new (much lower) 12- 24 month price target of *$8.00 based largely on new more subdued model assumptions. Further, given the stark reduction in the target, we would typically reduce our allocation but given the marked sell-off in the shares, that would be tantamount to closing the barn door after the horses have run free, so we will leave that where it is for now.

Projected Operating Model

Sow Good Inc.						
Projected Operating Model						
By: Trickle Research						
	(Actual)	(Actual)	(Actual)	(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	$ 3,554,157	$ 7,317,010	**$ 39,062,825**	**$ 39,581,700**
Cost of goods sold	$ 7,339,209	$ 6,640,917	$ 2,998,171	$ 5,017,850	**$ 21,996,147**	**$ 23,254,202**
Gross profit	$ 5,204,402	$ 9,007,129	$ 555,986	$ 2,299,160	**$ 17,066,677**	**$ 16,327,498**
General and administrative expenses:						
Salaries and benefits	$ 2,487,032	$ 2,123,572	$ 1,875,908	$ 2,102,436	$ 8,588,948	$ 8,976,993
Professional services	$ 467,826	$ 594,278	$ 320,289	$ 369,510	$ 1,751,903	$ 1,787,451
Other general and administrative expenses	$ 872,260	$ 1,399,244	$ 1,607,844	$ 1,409,755	$ 5,289,104	$ 5,793,725
Intangible Asset Impairments	$ -	$ -	$ -	$ -	$ -	$ -
Goodwill impairment	$ -	$ -	$ -	$ -	$ -	$ -
Total general and administrative expenses	$ 3,827,118	$ 4,117,094	$ 3,804,041	$ 3,881,701	**$ 15,629,954**	**$ 16,558,170**
Depreciation and amortization	$ 9,538	$ 4,939	$ 8,583	$ 8,720	$ 31,780	$ 36,299
Total operating expenses	$ 3,836,656	$ 4,122,033	$ 3,812,624	$ 3,890,421	**$ 15,661,735**	**$ 16,594,469**
Net operating loss	$ 1,367,746	$ 4,885,096	$ (3,256,639)	$ (1,591,261)	**$ 1,404,943**	**$ (266,971)**
Other income (expense):						
Interest Expense	$ (418,669)	$ (599,664)	$ (185,586)	$ (185,000)	$ (1,388,919)	$ (680,000)
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)	$ (185,586)	$ (185,000)	**$ (2,081,291)**	**$ (680,000)**
Net Income (Loss) Before Taxes	$ 949,077	$ 3,593,060	$ (3,442,225)	$ (1,776,261)	**$ (676,348)**	
Income Tax Expense	$ -	$ 3,593,060	$ (3,442,225)	$ (1,776,261)	**$ (1,625,426)**	
Net Income (Loss)	$ 949,077	$ 3,335,142	$ (3,379,910)	$ (1,776,261)	**$ (871,951)**	**$ (946,971)**
Weighted Average Number of Shares Outstanding, Basi	6,071,769	9,624,999	10,245,388	10,245,388	**9,046,886**	**10,245,388**
Weighted Average Number of Shares Outstanding, Dilu	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	$ (0.33)	$ (0.17)	**$ (0.10)**	**$ (0.09)**
Earnings Per Share, Diluted	$ 0.12	$ 0.29	$ (0.28)	$ (0.14)	**$ (0.08)**	**$ (0.08)**

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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.