Trickle Research

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

Earnings Update – 2Q Fiscal 2018

08/16/18

12 - 24 month Price Target: *$8.50

Allocation: 5

Closing Stock Price at Initiation (Close 04/24/17): $1.90

Date of Allocation Upgrade from 4 to 5: 06/07/17

Closing Stock Price at Upgrade (Close 06/07/17): $1.44

Closing Stock Price @ 08/15/18: $4.11

Social Reality, Inc.

SRAX

(Stock Symbol – Nasdaq: SRAX)

Prepared By:
David L. Lavigne

Senior Analyst, Managing Partner
Trickle Research LLC
Dave@TrickleResearch.com

The 2QF18 earnings call was largely dominated by the news of the SRAXmd sale. We provided some color on that in some recent notes so we will try not to rehash that, but, to reiterate the main point, the SRAXmd sale is a considerable milestone for the company on a variety of levels. Certainly, one of the more important of those levels is the notion that they have proven they can build and monetize a vertical, so now the question becomes can they continue that trend with the existing verticals they are developing. Below is a brief overview of each of these verticals and some notes regarding their stage of development as we understand them.

SRAXshopper – This is basically the company's CPG (consumer packaged goods) platform, which they have operated for some time now. We believe this segment is responsible for much of the balance of 1HF18 revenues that were not associated with SRAXmd. We think this vertical has considerable room for growth, in part because the Company may now have more resources and more incentive to devote to the platform than perhaps they have had in the past. Actually, that view pertains to all of these verticals, an encompasses in part why the company believes, and we tend to agree with, that they will be able to develop these new verticals more quickly than SRAXmd. We are not suggesting that throwing more money at something necessarily makes it happen faster or at all, but it sure doesn't hurt. In any event, we think CPG is SRAX legacy knowledge base, and we think they are now better positioned to exploit their platform and expertise than they have ever been.

SRAXsocial – In the Company's parlance: *"SRAX Social is a social media marketing tool that enables agencies and brands to push consistent messages to many audiences across all social media channels. SRAX Social enables users to launch social media programs in one central location while our artificial intelligent engine automatically determines the best way to spend media dollars to get the best results for the brand".* SRAXsocial is developed and being used to generate revenues today, but we don't think it has historically been used as a revenue generator on its own. As we recall, they have generally used this to augment other portions of the business, and by the way, we think it will be integral in the development of BigToken. Here again, we tend to think that their ability to now focus and develop SRAXsocial as a profit center should create better comparable results.

SRAXauto - This is the Company's auto vertical. As they describe it, *SRAXauto's intelligent stack of tools enable auto manufacturers and dealers to target and reach buyers at dealerships, auto shows or at home on both, desktop and mobile through precision audience building that identifies and targets highly engaged auto intenders on the road to purchase. We are continuing to develop this roadmap.* They have been developing this vertical for some time now, and while as they note they continue to do so, the segment is operational and we believe is generating some revenues today. The company believes this vertical has similar potential to SRAXmd, and they expect the trajectory to be similar. As a rough guideline, we think that means something like revenues of $1 million in the first year of full deployment, $4 million in year 2, $8 million in year 3 and perhaps $12 -16 million in year 4. Again, that is a rough path, but we think it is in the ballpark. We think they are capable of achieving those types of metrics based on their success with SRAXmd and the fact that they now have a much better working capital posture to work from. Recognize, we are not modeling SRAXmd type margins, but we are modeling a trajectory for the business similar to what we just laid out.

SRAXfan - *SRAXfan tools enables brands and agency connect with fans at home, the stadium or r out-of-home at gathering locations, such as bars, restaurants, universities, during live sporting events or concerts. And we are also continuing to develop this roadmap.* We are modeling a similar trajectory for this vertical as we are SRAXauto. Incidentally, we think both are great areas to focus on. However, we think SRAXfan development is a bit behind SRAXauto, so our model assumes accelerating and meaningful SRAXfan contributions further into 2019 and more so 2020.

Beyond the core business (the verticals above), there are a handful of other valuation catalysts that exist in the story and are worth noting. First, as part of the SRAXmd sale, the Company retained a portion of the acquirer's parent, which also includes a component tied to the potential disposition of SRAXmd. This transactional value of this piece looks to be $10 million, but, if SRAXmd continues to grow and prosper, this piece could presumably be worth considerably more at some point in the future. We were quite encouraged to learn that they actually retained a piece of SRAXmd, and we were surprised by the size of that retention. We think this could be a considerable "hidden asset" in the story going forward, but for our valuation purposes, we are limiting its value to the original $10 million transaction value.

The second valuation catalyst in the $9 million performance bonus tied to SRAXmd's gross profit through fiscal 2018. The Company seems confident that they will receive this. We are modeling about 1/3rd of that optimism. That is, we are assuming they will get another $3 million from this piece, and that is nothing more than a guess on our part. We do think that given the status of the metrics as described on the call, there is a likelihood that they will retain some portion of this payment.

The final valuation catalyst is BigToken. Our target assumptions provide no value for the BigToken piece. That by the way, is not because we think it is a dry hole, it is because as we have said al along, we have no idea how to value it at this stage. Further, since some portion of BigToken will be spun to existing shareholders and other portions presumably sold to investors to fund in the business, we are not even sure how much of BigToken SRAX will actually retain. That said, the Company provided some aggressive valuation metrics on the call that are telling. They indicate that 600,000 users would generate a $50 million revenue run rate. We would submit, if they are successful in achieving that type of adoption, the valuation impact to SRAX would likely be substantially…probably more than our entire target at this point. We will try to develop a better valuation framework around the BigToken asset as more information becomes available, but here again, we think this asset provides (another) open ended element to much higher potential future valuations.

Lastly, the SRAXmd transaction closed in Q3 so the financials for the quarter are going to be complex. They will include the sale proceeds and presumably some sort of taxation, but as the Company described on the call, the transaction included, escrowed funds, fees, bonuses, share repurchases and a variety of other nuances. We have not tried to model these nuances, but instead have reflected what we think the results may look like on a nonrecurring item basis. We don't see the point in trying to guess how GAAP and the associated accountants will deal with all of these issues. Rather, we took the resulting $21 million of net cash and worked from there. We will address the above "nuances" to the degree necessary after they file Q3. To translate, the Q3 filing will look **much different** than our model reflects, beginning with the SRAXmd sale proceeds.

To summarize, the SRAXmd sale is the most positive development the Company has reflected since we have been following the stock, and likely in its entire history. We have had a number of subscribers as us why (if that is the case) the stock has sold off after the announcement of the sale, and we have no good answer for that question. However, in spite of the stock's reaction, we are comfortable reiterating that, *the SRAXmd sale is the most positive development the Company has reflected since we have been following the stock, and likely in its entire history*. We submit, the Company now must prove that it can repeat its success with the new verticals, and we suppose that if the street believes that it cannot, then perhaps the stock's recent decline is appropriate. However, in our view, the fact that these verticals are well under way in terms of development, they now have a much more robust working capital posture to develop them and they have proven they can build and sell a successful vertical (SRAXmd) makes the success of the new verticals more likely than less. Quite simply, if we are correct about that, we are highly confident that our price targets will prove reasonable. In addition, as we noted, we think there are multiple additional catalysts in the story, that could make the stock worth more than the currently valuation on their own, not to mention collectively. For example, we think it is quite conceivable that their (effectively) 30% stake in SRAXmd could someday be worth more than the current $45 million market cap of the stock, yet our targets are assuming a 5 year terminal value of that asset of just the original $10 million transactional "cost" value. Again, we think the "unaccounted for" assets could prove telling to the ultimate valuation of the Company.

We reiterate our allocation of 5 for SRAX shares, and given the positive attributes from the SRAXmd sale, we are establishing a new 12-24 month price target of *$8.50 based on our new model assumptions surrounding the existing verticals, as well as some of the other component valuations addressed above. We will assess our allocations and targets as we learn more and perhaps validate some of our assessments regarding the continued progress of the new verticals.

Projected Operating Model

Social Reality Inc. ("SRAX")						
Projected Operating Model						
By: Trickle Research LLC						
	(Actual)	(Actual)	**(estimate)	(estimate)	(estimate)	(estimate)
	03/31/18	06/30/18	09/30/18	12/31/18	Fiscal 2018	Fiscal 2019
Revenues	**$ 2,110,850**	**$ 4,697,351**	**$ 1,436,850**	**$ 1,716,900**	**$ 9,961,951**	**$ 7,923,660**
Cost of revenue	$ 818,105	$ 1,320,464	$ 750,098	$ 882,050	$ 3,770,717	$ 3,522,601
Gross profit	**$ 1,292,745**	**$ 3,376,887**	**$ 686,753**	**$ 834,850**	**$ 6,191,235**	**$ 4,401,059**
Operating expense:	$ -	$ -	$ -	$ -	$ -	$ -
General, selling and administrative expense	$ 4,130,258	$ 5,414,791	$ 3,102,422	$ 2,786,028	$ 15,433,499	$ 9,208,339
Impairment of goodwill	$ -	$ -	$ -	$ -	$ -	$ -
Restructirung and Other Operating expenses	$ -	$ -	$ -	$ -	$ -	$ -
Income (loss) from operations	**$(2,837,513)**	**$(2,037,904)**	**$(2,415,670)**	**$(1,951,178)**	**$ (9,242,264)**	**$(4,807,280)**
Other income (expense):	$ -	$ -	$ -	$ -	$ -	$ -
Write off of contingent consideration	$ -	$ -	$ -	$ -	$ -	$ -
Interest income (expense)	$ (434,785)	$ (486,758)	$ (78,625)	$ (78,625)	$ (1,078,793)	$ (314,500)
Amortization of Debt Issuance Costs	$ (332,658)	$ (472,589)	$ -	$ -	$ (805,247)	$ -
Accretion of Put Warrants	$ -	$ -	$ -	$ -	$ -	$ -
Other Income (expense)	$ (4,664)	$ (596)	$ -	$ -	$ (5,260)	$ -
Total Other income (expense)	**$ (772,107)**	**$ (959,943)**	**$ (78,625)**	**$ (78,625)**	**$ (1,889,300)**	**$ (314,500)**
Income (loss) before provision for income taxes	**$(3,609,620)**	**$(2,997,847)**	**$(2,494,295)**	**$(2,029,803)**	**$(11,131,564)**	**$(5,121,780)**
Provision for income taxes	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**
Net income (loss)	**$(3,609,620)**	**$(2,997,847)**	**$(2,494,295)**	**$(2,029,803)**	**$(11,131,564)**	**$(5,121,780)**
Net loss per share, basic	**$ (0.36)**	**$ (0.29)**	**$ (0.23)**	**$ (0.17)**	**$ (1.04)**	**$ (0.42)**
Net loss per share, basic and diluted	**$ (0.29)**	**$ (0.27)**	**$ (0.23)**	**$ (0.17)**	**$ (0.96)**	**$ (0.42)**
Weighted average shares outstanding, basic	**10,037,905**	**10,213,618**	**11,034,671**	**11,684,671**	**10,742,716**	**12,219,671**
Weighted average shares outstanding, basic and diluted	**12,522,905**	**11,034,671**	**11,034,671**	**11,684,671**	**11,569,230**	**12,219,671**

**** The above 3QF18 estimate does not include the impact of the SRAXmd sale**

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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 our performance purposes, 1 "investment unit" equals $250) and 10 representing 10 investment units or $2,500. Obviously, a rating of 10 would suggest that we 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 perhaps add another 5 of the names from our profiles). 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 hung up on the tradition of more typical rating systems (Buy, Sell, Hold) we would submit the following guidelines.
A Trickle rating of 1 thru 3 would best correspond to a "Speculative Buy" 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.