Trickle Research

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

Q2-F17 Earnings Update

Date: 08/18/17

12- 24 month Price Target: **$1.60**

Allocation: **5**

Closing Stock Price Prior to Initiation on 03/24/17: **$.58**

Current Stock Price (as of Close 08/17/17): **$.69**

Barfresh Food Group, Inc.

barfresh

(Stock Symbol - Other OTC: BRFH)
www.barfresh.com

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Barfresh reported 2Q F17 results a few days ago and they were as they typically are, a mix of good and bad. Actually, "bad" may be overstating it a bit, "not as good as we had hoped" is probably more appropriate.

The Company reported revenue of $629,000 which represented a 12% increase over 2Q F16. We think it is fair to say that most people following the stock were looking for much better YoY performance than 12%. We know we were, and the Company *intimated* that it was as well. In fact, we were looking for revenues of just over $2 million, so we weren't even in the same zip code. On the other hand, it is easy for us to put our finger on the bulk of the variance between our model and actual results, because that variance is centered on what has been both an ongoing expectation and a lingering question with respect to Barfresh's business; "when are they going to sign a national account"? In short, after seeing evidence of testing at both Subway and Sonic locations, and assuming that an adopter might want to launch at the start of the seasonally best part of the year, we modeled some national account traction in 2Q. Obviously, we got ahead of ourselves, which has been easy to do in this story. To be sure, the frustration regarding the lack of adoption by national accounts is unmistakable amongst both legacy shareholders and (in our view) the Company itself.

As we said, much of the revenue "miss" (relative to our model) was related to our assumptions about a national account. When we remove that assumption from our model we end up *reasonably* close to actual results. However, as we asked (and they addressed) on the call, we also think there was some attrition amongst some existing customers, and we tend to believe that may be the result of the Company steering the business towards a "higher quality" customer base. In other words, the modest 12% YoY growth was the result of measurable traction from some of the new accounts they have introduced along the way (Ellis Island, the Denver Zoo, Hoover Dam et al.) in the face of declines in the legacy customer base. While we are not sure losing customers should be spun as a positive event, small "mom and pop" stores selling Barfresh smoothies isn't going to make this deal work, so the notion of focusing on larger/scalable customers has merit.

Beyond the revenues, once we adjusted out our national account assumptions, the remaining expense line items tracked in-line (actually a bit lower) than our estimates. The Company has discussed its efforts to tighten up the business through a variety of means including realigning and refocusing sales (an issue that touches on the higher quality customer/attrition scenario we discussed above) and we think they are seeing positive results from those efforts. For instance, operating expense were down about 11% YoY, and that included some one-time charges related to bolstering the delivery infrastructure. More specifically, personnel costs were *down nearly 35% YoY*. They have clearly sharpened the pencil. That said, scaling the customer base is the missing cog, as well the street's focus (and metric of success) for Barfresh, and we get that, but we think the efforts to reduce overhead are important.

To reiterate, when it comes to Barfresh, all eyes are on scaling the customer base and we submit, the visibility to that end is not great, especially when it comes to the national account hurdle. We have no doubt, the Company is doing absolutely everything it can do to tip over one or more of these customers, which may be one of the problems with the story. That is, given the choice, we might feel better if there *actually was* something else the Company could do to move the needle on a large customer. They have suggested there is not, and we tend to think that is true. Again, that may or may not be the best place to be. Landing a large national account is beginning to feel like the flip of a coin, or a bet on red or black, which frankly, is becoming more unnerving as each day (without a national account) ticks by. However, as we have opined along the way, we do not believe that large national accounts are the only path to success for Barfresh. They may be the *quickest* path to success, but they are not the *only* path to success.

The Company spent some time on the call addressing their new school lunch initiatives. In short, they have been able to get their product into a large (40,000 student) school district in Florida, and they suggested they are in various stages of perhaps winning additional districts across the country. Moreover, we know they continue to make headway into universities, military bases, hospitals and others as well as into specialty venues like zoos, tourist attractions and others. With respect to the school lunch initiative, some simple math is worth reviewing:

If 40,000 students each consumed two Barfresh smoothies each week, adjusting for the school year and a few holidays, that would amount to over 3 million smoothies annually. We estimate that number would approximate the annual sales from a 430-store national account. The Company notes there are 55 million students in U.S. public primary and secondary schools. Again, according to our rough math, capturing 10% of this market with each student consuming one smoothie per week would be the equivalent of signing something around *20 national accounts*. This is in our view, a considerable opportunity for Barfresh. Moreover, it may also prove stickier than a national account and will provide a nice counterweight to the current seasonality problem. Further, as we covered in the past research, the specialty venue space the Company is gaining traction in as well, has afforded a product like Dippin' Dots a $250 million revenue base. We think this vertical remains topical to Barfresh. We reiterate, *we do not believe that large national accounts are the only path to success for Barfresh*. *They may be the quickest path to success, but they are not the only path to success.*

Looking ahead, the Company provided some metrics regarding 3Q specifically, and they noted that they expect the second half of F2017 to be "exponentially higher" both YoY and sequentially. They also note that they are currently in a test with a large QSR that is slated for a 45-day trial (which commenced over the past few days) and they have been told by the QSR that they will have a decision immediately following the test. At least we will get an answer and know where they stand.

In summary, we submit, the waiting for a national account has been frustrating and nerve wracking. Moreover, given what we know about specific national tests, by specific national chains, each day that rolls by *feels like* the chances of landing one of those accounts gets a little smaller. We are not suggesting that is fact, we are just suggesting the it *feels like* fact. On the other hand, as the Company also referenced on the call, the turn of a friendly card in terms of a national account could amount to an opening order of several million dollars, and we think it is safe to say would create a marked catalyst for the valuation of the Company and the price of its stock. A national account would likely be one of those rare overnight watershed events for the Company. We think that is worth hanging in here for especially given the traction the Company appears to be gaining in some of the other markets they are selling into today.

We are sticking with the notion that while risks remain, we think Barfresh is on the right path, and we continue to believe they will experience a marked expansion of the business in the coming quarters, including, ultimately, signing some national accounts. We have adjusted our model to reflect the addition of school lunch opportunities as we understand them, while reducing some nearer term assumptions regarding national accounts and essentially pushing those assumptions out further into the future. We admit the visibility remains poor, but the upside is also extraordinary.

We reiterate our allocation of 5 and our price target of $1.60. We may revisit each as more information regarding national accounts becomes available.

<u>**Projected Operating Model**</u>

Barfresh Food Group, Inc.						
Trickle Research LLC						
Projected Operating Model	(actual)	(actual)	(estimate)	(estimate)	(estimate)	(estimate)
	3/31/17	6/30/17	9/30/17	12/31/17	Fiscal 2017	Fiscal 2018
Revenue	**$ 312,170**	**$ 628,997**	**$ 1,214,891**	**$ 2,134,662**	**$ 4,290,721**	**$ 47,181,382**
Cost of revenue	**$ 181,649**	**$ 306,877**	**$ 631,743**	**$ 1,110,024**	**$ 2,230,294**	**$ 24,534,318**
Gross profit	**$ 130,521**	**$ 322,120**	**$ 583,148**	**$ 1,024,638**	**$ 2,060,427**	**$ 22,647,063**
Operating expenses:	$ -	$ -	$ -	$ -	$ -	$ -
General and administrative	$ 2,433,530	$ 2,403,293	$ 2,410,106	$ 2,571,066	$ 9,817,995	$ 16,362,319
Depreciation Amortization	$ 56,031	$ 76,570	$ 76,645	$ 89,145	$ 298,391	$ 381,580
Total operating expenses	$ 2,489,561	$ 2,479,863	$ 2,486,751	$ 2,660,211	$ 10,116,386	$ 16,743,899
Operating loss	**$ (2,359,040)**	**$ (2,157,743)**	**$ (1,903,603)**	**$ (1,635,573)**	**$ (8,055,959)**	**$ 5,903,164**
Other expenses:	$ -	$ -	$ -	$ -	$ -	$ -
Interest	$ -	$ -	$ -	$ -	$ -	$ -
Loss on Extinguishment of Debt	$ -	$ -	$ -	$ -	$ -	$ -
Pre Tax Net Income (Loss)	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**
Income Tax Expense	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**
Net (loss)	**$ (2,359,040)**	**$ (2,157,743)**	**$ (1,903,603)**	**$ (1,635,573)**	**$ (8,055,959)**	**$ 5,903,164**
Per share information - basic and fully diluted:	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**
Weighted average shares outstanding (Basic)	**117,251,662**	**117,732,465**	**118,332,365**	**118,332,365**	**117,912,214**	**118,332,365**
Weighted average shares outstanding (Diluted)	**125,974,340**	**127,562,542**	**129,088,861**	**130,441,188**	**128,266,733**	**141,779,956**
Net (loss) per share (Basic)	**$ (0.02)**	**$ (0.02)**	**$ (0.02)**	**$ (0.01)**	**$ (0.07)**	**$ 0.05**
Net (loss) per share (Diluted)	**$ (0.02)**	**$ (0.02)**	**$ (0.01)**	**$ (0.01)**	**$ (0.06)**	**$ 0.04**

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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 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.