Summary of SOCIAL REALITY, INC.

Form 10-K for SOCIAL REALITY, INC.

16-Mar-2016

Annual Report

ITEM 7.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

The following discussion of our financial condition and results of operations for 2015 and 2014 and should be read in conjunction with the consolidated financial statements and the notes to those statements that are included elsewhere in this report. Our discussion includes forward-looking statements based upon current expectations that involve risks and uncertainties, such as our plans, objectives, expectations and intentions. Actual results and the timing of events could differ materially from those anticipated in these forward-looking statements as a result of a number of factors, including those set forth under Cautionary Statement Regarding Forward Looking Information, Item
1. Business and Item 1A. Risk Factors in this report. We use words such as "anticipate," "estimate," "plan," "project," "continuing," "ongoing," "expect," "believe," "intend," "may," "will," "should," "could," and similar expressions to identify forward-looking statements.

Overview

We are an Internet advertising and platform technology company that provides tools to automate the digital advertising market. We have built technologies and leveraged partner technologies that service social media and the real-time bidding (RTB) markets. Our focus is to provide technology tools that enable both publishers and advertisers to maximize their digital advertising initiatives. We derive our revenues from:

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sales of digital advertising campaigns to advertising agencies and brands;

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sales of media inventory through RTB exchanges;

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sale and licensing of our SRAX Social platform and related media; and,

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creation of custom platforms for buying media on SRAX for large brands.

The core elements of our business are:

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Social Reality Ad Exchange or "SRAX" - Real Time Bidding sell side and buy side representation is our technology which assists publishers in delivering their media inventory to the real time bidding, or RTB, exchanges. The SRAX platform integrates multiple market-leading demand sources including OpenX, Pubmatic and AppNexus. We also build custom platforms that allow our agency partners to launch and manage their own RTB campaigns by enabling them to directly place advertising orders on the platform dashboard and view and analyze results as they occur;

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SRAX MD is our ad targeting and data platform for healthcare brands, agencies and medical content publishers. Healthcare and pharmaceutical publishers utilize the platform for yield optimization, audience extension campaigns and re-targeting of their healthcare professional audience. Agencies and brands purchase targeted digital and mobile ad campaigns;

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SRAX Social, is a social media and loyalty platform that allows brands to launch and manage their social media initiatives. Our team works with customers to identify their needs and then helps them in the creation, deployment and management of their social media presence; and

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SRAX APP, a recently launched new product, which is a platform that allows publishers and content owners to launch native mobile applications through our SRAX platform.

We offer our customers a number of pricing options including cost-per-thousand-impression ("CPM"), whereby our customers pay based on the number of times the target audience is exposed to the advertisement, and cost-per-engagement ("CPE"), whereby payment is triggered only when an individual takes a specific activity.

During the second quarter of 2015 we launched the SRAX App, a free platform that provides online publishers an opportunity to distribute their content via a branded mobile application that updates automatically as they publish new content to their website. The platform also allows publishers the opportunity to bring in influencer feeds from Facebook, Instagram, YouTube and Twitter that are relevant to their content. In 2015 we also completed the technology needed to both operate the buy side of our SRAX platform and the buy side of SRAX MD, and launched our SRAX APP which we expect to begin contributing to our revenues in a meaningful basis during the second half of 2016. Lastly, in 2015 we also combined our GroupAd, SRAX DI and Five Delta offerings and rebranded these offerings as SRAX Social. During 2016 we expect to continue to enhance all of our technology offerings of SRAX, SRAX Social, SRAX MD and SRAX APP. We are now in the marketing and monetization phases of these technologies and our efforts are focused on the continued growth of our sales and marketing efforts of these platforms.

Results of operations

2015 as compared to 2014

Selected Consolidated Financial Data

	Year Ended December 31, 2015	2014	change
Revenues	$ 30,294,165	$ 5,120,343	492 %
Cost of revenue	14,407,363	2,971,948	385 %
Gross margin percentage	52.4%	45.5%	6.9 %
Operating expenses	14,834,766	6,066,611	145 %
Operating income (loss)	1,052,036	(3,738,216)	128 %
Interest (expense)	(3,775,945)	(673,347)	461 %
Net (loss)	$ (2,723,909)	$ (4,411,563)	(38)%

Revenue

Increases in our revenues in 2015 from 2014 are due to growth in both the sell-side products, and buy-side products, as well as reporting operations for Steel Media for a full 12 month period.

Cost of revenue

Cost of revenue consists of certain labor costs, payments to website publishers and others that are directly related to a revenue-generating event and project and application design costs. During 2015 we have continued to benefit from an increase in our gross margins as a result of the decrease in our cost of revenue. Cost of revenue as a percent of revenue decreased to 47.6% for 2015 as compared to 54.5% for 2014. This decrease is due to the mix of higher-margin products. Approximately 99% of cost of revenue for 2015 was attributable to payments to website publishers and other media providers as compared to 95% for 2014. The balance was attributable to labor costs and project and application design costs. As we continue to grow the revenue from our buy-side and sell-side product offerings, we expect that our blended gross margins will remain in the range of 40% to 50% in 2016.

Operating expense

Our operating expenses are comprised of salaries, commissions, marketing and general overhead expenses. Overall, our operating expense increased 145% for 2015 from 2014. Included in the overall increase is an increase of approximately 104% in our operating expenses which is attributable to operating expenses of Steel Media for a 12 months versus two months in 2014. Our other historic operating expenses have increased as we have increased our technical team, our sales team and our marketing efforts in support of the growth of our company.

Interest income (expense)

Interest expense in 2015 represents costs associated with the note issued to Mr. Steel as partial consideration for the purchase of Steel Media together with the notes issued under the Financing Agreement described elsewhere in this report. The expense also includes amortization of debt costs and the accretion of contingent consideration and the put liability associated with the Steel Media acquisition. While we satisfied the note to Mr. Steel in October 2015, we expect our interest expense will continue to increase during 2016 from 2015 as a result of increased borrowings under the Financing Agreement.

Quarterly results of operations data

The following table set forth our unaudited quarterly statements of operations data for the three months ended December 31, 2015 and 2014. We have prepared the quarterly data on a consistent basis with the audited consolidated financial statements included in this report. In the opinion of management, the unaudited quarterly financial information reflects all necessary adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of this data. This information should be read in conjunction with the audited consolidated financial statements and related notes included elsewhere in this report. The results of historical periods are not necessarily indicative of the results of operations for a full year or any future period.

	Three Months Ended December 31,	
	2015	2014
	(unaudited)	(unaudited)
Revenues	$ 8,121,070	$ 3,626,588
Cost of revenue	3,710,301	1,725,612
Gross profit	4,410,769	1,900,976
Operating expense	3,920,278	3,152,255
Income (loss) from operations	490,491	(1,251,279)
Interest (expense)	(916,990)	(674,612)
Net (loss)	$ (426,499)	$ (1,925,891)
Net loss per share, basic and diluted	$ (0.02)	$ (0.08)
Weighted average shares outstanding	27,346,804	24,672,299

Non-GAAP financial measures

We use Adjusted net (loss) to measure our overall results because we believe it better reflects our net results by excluding the impact of non-cash equity based compensation. We use Adjusted EBITDA to measure our operations by excluding interest and certain additional non-cash expenses. We believe the presentation of Adjusted net (loss) and Adjusted EBITDA enhances our investors' overall understanding of the financial performance of our business.

You should not consider Adjusted net (loss) and Adjusted EBITDA as an alternative to net income (loss), determined in accordance with GAAP, as an indicator of operating performance. A directly comparable GAAP measure to Adjusted net (loss) and Adjusted EBITDA is net (loss). The following is a reconciliation of net (loss) to Adjusted net (loss) and Adjusted EBITDA for the periods presented:

(unaudited, in thousands)	For the Three Months Ended December 31, 2015	2014	For the Years Ended December 31, 2015	2014
Net income (loss)	$ (427)	$ (1,926)	$ (2,724)	$ (4,412)
plus:				
Equity based compensation	373	1,127	1,475	1,858
Adjusted net income (loss)	$ (54)	$ (799)	$ (1,249)	(2,554)
Interest expense	917	675	3,776	673
Depreciation of property, plant and equipment	207	5	411	15
Adjusted EBITDA	$ 1,070	$ (119)	$ 2,938	$ (1,866)

Liquidity and capital resources

Liquidity is the ability of a company to generate sufficient cash to satisfy its needs for cash. As of December 31, 2015 we had approximately $1,100,000 in cash and cash equivalents and a deficit in working capital of $8,102,330, as compared to cash and cash equivalents of approximately $1,843,000 and a deficit in working capital of $4,396,240 at December 31, 2014. Our current assets increased 43% at December 31, 2015 as compared to December 31, 2014 which is primarily attributable to an increase in our accounts receivable as a result in the revenue growth. Our current liabilities increased 61% at December 31, 2015 as compared to December 31, 2014 which is the result of several factors, including the increase in our accounts payable and accrued expenses associated with our growth, as well as increased borrowings under the Financing Agreement, and reclassifications of contingent consideration, which represents the earn outs Mr. Steel may receive, and a put liability related to the warrant issued in connection with the Financing Agreement into current liabilities as a result of the due dates of these possible obligations. These increases were offset by a decline of $2.5 million in notes payable related party representing the payment of the note to Mr. Steel during the fourth quarter of 2015. In addition, during January 2016 we paid Mr. Steel $4 million of the contingent consideration representing his first year earn out payment.

Our principal sources of operating capital have historically been equity and debt financing. During 2014 we raised additional capital of approximately $5,049,000 in net proceeds through the sale of our equity securities. Subsequent to December 31, 2015 we have raised an additional $500,000 through the sale of our equity securities. During the fourth quarter of 2014 we entered into the Financing Agreement with Victory Park Management, LLC, as administrative agent and collateral agent for the lenders which is described below. In May 2015 we entered into the First Amendment to Financing Agreement with Victory Park Management, LLC, as administrative agent and collateral agent for the lenders. Under the terms of the amendment, the leverage ratio, senior leverage ratio, fixed charge coverage ratio and interest coverage ratio under the Financing Agreement were all modified, and the minimum current ratio was reduced. The amendment also modified our obligations with respect to the delivery of certain reports, certain representations by us as well as clarifying other additional terms by which the loan is administered.

The Financing Agreement provides for borrowings of up to $20 million. As of March 1, 2016 we have drawn a total of $14 million under the Financial Agreement, of which $9 million was used in connection with the initial acquisition of Steel Media in 2014, an additional $1.4 million was used in the payment of the Steel Note at its maturity in October 2015 and $1.6 million was used for the cash portion of the first year earnout payment to Mr. Steel in January 2016. The balance of the funds we have drawn under the Financing Agreement have been used for working capital. During 2015 we also made payments to VPC against the draws aggregating $1.9 million.

We do not have any commitments for capital expenditures. The terms of the Financing Agreement requires us to allocate a significant portion of our expected future cash flow to satisfying obligations under that agreements. Under the terms of the Financing Agreement, we are obligated to make:

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monthly interest payments, inclusive of payment-in-kind, or PIK interest, of approximately $140,000,

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quarterly amortization payments of 2.5% of principal in year one of the loan, resulting in principal payments of approximately $225,000 per quarter in the first year of the loan, increasing to 5% of principal in year two of the loan and further increasing to 10% of principal in year three of the loan;

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quarterly mandatory prepayments on the loan, in an amount calculated as 50% of excess cash flow as defined in the Financing Agreement, of EBITDA less amortization and interest payments, plus associated prepayment penalties;

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payments of proceeds from asset sales, proceeds of debt or equity financings, certain extraordinary receipts (including tax refunds and indemnification payments received in connection with any acquisition), and the proceeds of any taking or destruction of collateral; and

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other selected cash outlays, such as late charges, yield maintenance premiums, costs and expenses

In August 2015, Victory Park Management, LLC as agent for the lenders waived the excess cash flow payment for the quarter ended June 30, 2015.

Additionally, under the terms of the Stock Purchase Agreement for the acquisition of Steel Media, we are potentially obligated to pay Mr. Steel up to two $4 million annual earn out payments based upon the satisfaction of certain targets generated by Steel Media operations for the periods ending October 31, 2015 and October 31, 2016. The adjusted EBITDA targets which must be met in order for Mr. Steel to earn these additional amounts are approximately $4.1 million for the 2015 period and approximately $4.9 million for the 2016 period. The EBITDA target for the first earnout period ended October 31, 2015 was achieved and in January 2016 we paid Mr. Steel $4 million, of which $1.6 million was paid in cash and the balance was paid through the issuance of shares of our Class A common stock in accordance with the terms of the Stock Purchase Agreement. If the 2016 earnout target is met, the cash payment we will need to make to Mr. Steel will reduce the funds which may be used for our debt service obligations and for working capital needs. Any failure on our part to make any earn out payment which may be due Mr. Steel could result in an event of default under the Financing Agreement.

The net effect of these required payments under the Financing Agreement and the Steel Note, while it remained outstanding, as well as the earn out payments to Mr. Steel, is anticipated to equal the majority of the cash flow generated from Steel Media's operations. Following the satisfaction of the Steel Note in October 2015, to the extent that we are able to increase the earnings attributable to Steel Media, we are paying down the notes issued under the Financing Agreement.

Other than cash generated from operations and the Financing Agreement, we do not have any external sources of liquidity. While the Financing Agreement provides that we can borrow up to $20 million in total, our ability to access any additional funds under it is at the discretion of the lender, and there can be no assurance the lender will agree to lend us any additional amounts. In the event of a default by us under the terms of the Financing Agreement, remedies for the lender range from notice and cure, to acceleration of both principal and interest. Our operations may not generate sufficient cash to enable us to service our debt. Upon an event of default under the Financing Agreement, if we were unable to cure the default within the prescribed periods, if at all, the lender could increase our interest rates or accelerate all amounts then due. If we were unable to repay these obligations, the lender could foreclose on our assets and collateral, in which case our ability to continue our business and operations as then conducted would be in jeopardy. If the lender should foreclose on our assets, it is likely you would lose your entire investment in our company.

If we are able to significantly increase our revenues and cash flows from operations, we should have sufficient internally generated working capital to satisfy these obligations and fund our ongoing business. If, however, we are not successful in these efforts and we are not able to access additional funding under the Financing Agreement, it is possible we will need to delay or scale back our growth plans.

Net Cash Provided (Used) in Operating Activities

Net cash provided by operating activities was $739,066 during 2015 compared to net cash used in operating activities of $2,481,551 for 2014. The period to period change was primarily attributable to a decrease in net loss (after adjusting for non-cash expenses) and increases in our accounts payable and other liabilities partially offset by increases in our accounts receivable and prepayments.

Net Cash Used in Investing Activities

We used $33,616 for the purchase of furniture and equipment during 2015, with $1,974,818 used during 2014, which included costs associated with the acquisition of Steel Media.

Net Cash (Used) Provided by Financing Activities

During 2015 net cash used in financing activities was $1,457,657 which represented the proceeds from draws under the Financing Agreement, net of costs and repayments including the satisfaction of the Steel Note. During 2014, we received $3,952,847 from the sale of our securities and paid costs of $16,291 associated with the sales. We received $1,227,601 in proceeds from the Financing Agreement and paid costs of $579,659.

Financing Agreement with Victory Park Management, LLC as agent for the lenders

On October 30, 2014, we entered into the Financing Agreement, which, as amended in May 2015, provides for borrowings of up to $20 million to be evidenced by notes issued thereunder, which are secured by a first priority, perfected security interest in substantially all of our assets, including those of our subsidiaries, and a pledge of 100% of the equity interests of each of our domestic subsidiaries pursuant to the terms of a Pledge and Security Agreement. At December 31, 2015 we had drawn $11.9 million under the Financing Agreement and have drawn an additional $2.1 million during the first quarter of 2016. During 2015 we made payments against the draws aggregating $1.9 million. The Financing Agreement contains covenants limiting, among other things, indebtedness, liens, transfers or sales of assets, distributions or dividends, and merger or consolidation activity. The notes issued pursuant to the Financing Agreement, bear interest at a rate per annum equal to the sum of:

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cash interest at a rate of 10% per annum, and

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payment-in-kind, or PIK, interest at a rate of 4% per annum for the period commencing on October 30, 2014 and extending through the last day of the calendar month during which our financial statements for December 31, 2014 were delivered. The PIK interest rate thereafter from time to time may be adjusted based on the ratio of our consolidated indebtedness to our earnings before interest, taxes, depreciation and amortization.

If we achieve a reduction in the leverage ratio as described in the Financing Agreement, the PIK interest rate declines on a sliding scale from 4% to 2%. The notes issued under the Financing Agreement are scheduled to mature on October 30, 2017.

The Financing Agreement provides for our subsidiaries to join the Financing Agreement from time to time as borrowers and cross guarantors thereunder. Immediately after our acquisition of Steel Media on October 30, 2014, Steel Media executed a joinder agreement under which it became a borrower under the Financing Agreement. In addition, immediately after our acquisition of Five Delta on December 19, 2014, Five Delta executed a joinder agreement under which it became a borrower under the Financing Agreement.

Pursuant to the Financing Agreement, on October 30, 2014, we also issued to the lender a five-year warrant to purchase 2,900,000 shares of our Class A common stock at an exercise price of $1.00 per share, subject to adjustment, which we refer to as the Financing Warrant. The exercise price of the Financing Warrant is payable, at the option of the warrant holder, in cash or through a reduction in the principal outstanding under the notes issued under the terms of the Financing Agreement. The warrant holder may not, however, exercise the Financing Warrant for a number of shares of Class A common stock that would cause such holder to beneficially own shares of Class A common stock in excess of 4.99% of our outstanding shares of Class A common stock following such exercise. The number of shares issuable upon exercise of the Financing Warrant and the exercise price therefor are subject to adjustment in the event of stock splits, stock dividends, recapitalizations and similar corporate events. Pursuant to the Financing Warrant, the warrant holder has the right, at any time after the earlier of April 30, 2016 and the maturity date of the notes issued pursuant to the Financing Agreement, but prior to October 30, 2019, to exercise its put right under the terms of the Financing Warrant, pursuant to which the warrant holder may sell to us all or any portion of the Financing Warrant that has not been previously exercised. In connection with any exercise of this put right, the purchase price will be equal to an amount based upon the percentage of the Financing Warrant for which the put right is being exercised, multiplied by the lesser of 50% of the total of our consolidated revenue for the trailing 12-month period ending with our then-most recently completed fiscal quarter, or $1,500,000. As contemplated under the Financing Agreement, on October 30, 2014 we also entered into a Registration Rights Agreement with the holder of the Financing Warrant, pursuant to which we granted the holder certain "piggyback" rights to register the shares of our Class A common stock issuable upon exercise of the Financing Warrant. We registered the resale all of the shares underlying the Financing Warrant pursuant to a registration statement which was declared effective by the Securities and Exchange Commission on October 7, 2015.

As part of the arrangements under the Financing Agreement, Victory Park Management, LLC, Mr. Steel, and Social Reality and Steel Media also entered into a Subordination Agreement under which Mr. Steel has agreed, subject to the terms and conditions of the Subordination Agreement, to subordinate to the lenders and holders of notes issued under the Financing Agreement and the Financing Warrant certain obligations, liabilities, and indebtedness, including, without limitation, payments of earn out consideration owed to him as described later in this report under "Our Business - Acquisition of Steel Media."

Critical accounting policies

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amount of assets and liabilities, the disclosure of contingent assets and liabilities and the reported amounts of revenue and expenses during the reported periods. The more critical accounting estimates include estimates related to revenue recognition and accounts receivable allowances. We also have other key accounting policies, which involve the use of estimates, judgments and assumptions that are significant to understanding our results, which are described in Note 1 to our audited consolidated financial statements for 2015 appearing elsewhere in this report.

Recent accounting pronouncements

The recent accounting standards that have been issued or proposed by the FASB or other standards-setting bodies that do not require adoption until a future date are not expected to have a material impact on our financial statements upon adoption.

Off balance sheet arrangements

As of the date of this report, we do not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that are material to investors. The term "off-balance sheet arrangement" generally means any transaction, agreement or other contractual arrangement to which an entity unconsolidated with us is a party, under which we have any obligation arising under a guarantee contract, derivative instrument or variable interest or a retained or contingent interest in assets transferred to such entity or similar arrangement that serves as credit, liquidity or market risk support for such assets.

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