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## REED'S, INC. (NYSE: REED)

# FIRST PROFITABLE YEAR

**RATING: ACCUMULATE**

**Recent Price:** \$4.44

### Market Data

Market Capitalization (mn)	\$57.9
Shares Outstanding (mn)	13.0
Float (mn)	8.5
Ave. 3-mo Volume ('000)	72.9
Ave. 3-mo Value ('000)	\$403.7
52-week high/low	\$8.98/4.26
Exchange	NYSE

### Balance Sheet Data

Shareholders' Equity (mn)	\$3.4
Price / Book Value (x)	15.3
Net Debt/(cash) (mn)	\$6.5
Gross debt (mn)	\$7.6
Net debt/equity (%)	191
Gross debt/equity (%)	223

### Consensus Data

	2014	2015
(FYE 12/31)		
EPS (US\$)	0.02	0.10

### INVESTMENT HIGHLIGHT SUMMARY

- Reed's, Inc. (REED) is a beverage company capitalizing on (perceived) healthier/natural products trend. Its sales have grown by a stellar 22% CAGR in 2010-13. Moreover, in 1Q14 (weather-impacted quarter), REED managed to still grow top line by 10% YoY, a healthy clip compared to other consumer/retail companies.
- REED has found great initial success of kombucha product (Reed's Culture Club - 14% of sales in 1Q14) launched in 3Q12. Kombucha segment is one of the fastest growing segments in functional beverage category. Furthermore, management claims that, with its Reed's Culture Club, REED has become #2 national producer of kombucha.
- 2014 would be the first profitable year (at net profit level), based on management guidance. \$1 - 1.5 mn EBITDA guidance implies \$ 200,000 - 300,000 net profit.
- Given stellar sales growth and progression toward net profit, I would put REED on the investing radar screen. Accumulate rating is assigned, subject to the company delivering financial target as it guides. A major risk factor is that setback on sales growth/margin in the foreseeable future would cause high share price volatility.

**INVESTMENT HIGHLIGHT**

**Capitalizing on (perceived) healthier/natural products trend**

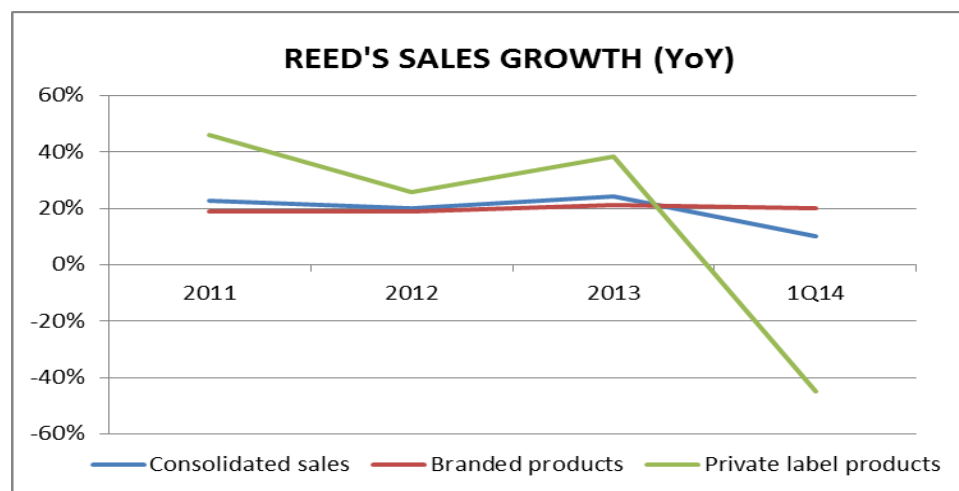
Reed's, Inc. (REED) has grown its top line by 22% CAGR in 2010-13, reflecting great product sales momentum. Importantly, this reflects that the company is capitalizing on (perceived) healthier/natural products trends consumers crave for these days. REED produces and sells GMO (genetically modified organisms) free carbonated soft drinks and non-carbonated kombucha (much more recently), using premium all natural ingredients.

**Stellar sales growth**

Division-wise, branded products (81% of sales) and private label products (19%) sales posted 20% CAGR and 36% CAGR, respectively, over the same period. In the branded products division, core brands (Reed's and Virgil's) grew close to the division's 20% CAGR, according to the management. Reed's Culture Club Kombucha, a new product launched in 3Q12, has achieved great initial success. In its first full year (2013), Reed's Culture Club Kombucha sales surged by 372% YoY, accounting for 10% of Reed's consolidated sales. Meanwhile, private label products sales have grown almost double the rate of branded products sales mainly because this business line was launched in 2009.

**Still grew in 1Q14 (weather impacted)**

In 1Q14 (weather impacted quarter for consumer/retail companies across the US), REED managed to still grow its consolidated sales by 10%, quite a feat in my opinion. Branded products sales rose by 19% YoY, while private label products sales dropped by 45% YoY due to the loss of a big customer. Management though is confident that private label products division will grow by 10-15% in 2014. As for branded products in 2014, management guides for 15-20% growth for core brands and 50-100% for Reed's Culture Club Kombucha. Net-net, 15-25% consolidated sales growth is management guidance for 2014.



**New product killer**

Worth highlighting, in my view, is the great initial success of Reed's Culture Club Kombucha (14% of consolidated sales). Kombucha (fermented tea, which is believed to have healing and cleansing characteristics) is one of the fastest growing segments in the functional beverage category, which includes coconut water, yogurt, and fresh juices. According to SPINS data provided by management, the refrigerated juices and functional beverages segment grew by 50% to \$600 mn in 2012. Kombucha comprises the overwhelming majority share of the segment.

**#2 national producer of kombucha**

Importantly, management claims that, with Reed's Culture Club Kombucha (eight flavors have been launched), the company is now the #2 national product of kombucha. This is an accomplishment achieved in a relatively short period of time given Reed's Culture Club Kombucha launch in 3Q12.

**2014 first profitable year**

Furthermore, 2014 would be the first profitable year (at net profit level), based on management guidance. As described above, REED's top line has grown fantastically, but it has never recorded net profit. In 2013, the company had net loss of \$1.5 mn. In 2014, management guides for \$1 - 1.5 mn EBITDA. My back-of-envelope calculation implies net profit of \$200,000-\$300,000. This is clearly an important milestone for the company mainly from the perspective of financing access (the company becomes more bankable, that could potentially reduce its interest cost as well).

As for valuation, REED is a company in its early stage of growth. The difficulty in valuing such a company is that simple PE, PB, or EV/EBITDA comparison against peers is not too useful. Management guides that when the company doubles its sales, gross margin should be in the low 40%-ish, vs currently 29-30% due to economies of scale. Operating leverage would kick in as well as opex/sales would get smaller.

I would put REED on the investing radar screen given stellar sales growth and progression toward net profit. Accumulate rating is assigned, subject to the company delivering financial target as it guides. A major risk factor worth noting is that setback on sales growth or margin in the foreseeable future would cause high share price volatility. Last, but not the least, investors should pay attention to the risk factors described in this report or REED's Form 10-K as it is in the early stage of growth period (not yet profitable until 2013).

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## Company Background

Reed's Original Ginger Brew was created in 1987 by Christopher J. Reed, the company founder and Chief Executive Officer, and was introduced to the market in Southern California stores in 1989. Throughout the 1990's, the company continued to develop and launch new Ginger Brew varieties.

In 1997, REED began licensing the products of China Cola and eventually acquired the rights to that product in 2000. In 1999, the company purchased the Virgil's Root Beer brand.

On December 12, 2006, the company completed the sale of 2,000,000 shares of its common stock at an offering price of \$4.00 per share in its initial public offering. Following the public offering, the company expanded sales and operations dramatically, initially using a direct store delivery strategy in Southern California, along with other regional independent direct store distributors (DSD). The company re-focused its sales strategy to eliminate company direct store delivery sales and to expand its sales to DSD's and natural food distributors on a national level. It also started selling directly to supermarket grocery stores, which has become a significant portion of its business today.

The company continually introduces new products and line extensions, such as its Virgil's diet line of ZERO beverages introduced in 2010 and Dr. Better and Light 55 Calories Extra Ginger Brew in 2011. It commenced

offering private label products in 2010 and has increased that business significantly in 2012 and 2013. In 2012, the company launched four flavors of its Culture Club Kombucha line that in 2013 was increased to eight flavors.

## Industry Overview

Within natural food store markets, REED is among the top-selling natural soft drinks. This market is steady and growing. REED also sells in major grocery chains nationally. The trend in grocery stores is to expand offerings of natural products and the company has the scale and capability to develop these direct customer relationships.

### REED Primary Markets

REED targets a niche in the estimated \$60 billion carbonated and non-carbonated soft drinks markets in the US, Canada and International markets. Its brands are generally regarded as premium and natural, with upscale packaging and are loosely defined as the artisanal (craft), premium bottled carbonated soft drink category.

The soft drink industry is highly fragmented and the craft soft drink category consists of such competitors as, Henry Weinhardts, Thomas Kemper, Boylans and Jones Soda, to name a few. Despite REED products having a relatively high price for an artisanal premium beverage product no mass media advertising and a relatively small but growing presence in the mainstream market compares to many of its competitors, the company believe that results to date demonstrate that Reed's Ginger Brew and Virgil's sodas are making strong inroads and market share gains against some of the larger brands in the market.

Kombucha is the largest growth segment of the functional beverage category of drinks and foods, including coconut water, yogurt and fresh juices. Among this broader category, the refrigerated juices and functional beverages segment grew by approximately \$200 million in 2012 to an estimated market of approximately \$600 million (50% growth), according to SPINS data. Kombucha comprises the overwhelming majority share of this explosive growth and comprises most of the segment.

The company primary and historical marketing and distribution source of its products has been natural foods and gourmet stores throughout the US. With the advent of large natural food store chains and specialty merchants, the natural food segment continues to grow each year, helping fuel the continued growth of its brands.

The company also sells its products to direct store delivery distributors (DSD) who specialized in distributing and selling its products directly to mainstream retail channels, natural foods, and specialty retail stores. The company local and national sales team has been able to place its products without having to pay significant slotting fees. The company also market its beverages to industrial cafeterias and to on premise bars and restaurants. The company intends to place its beverages in stadiums, sport arenas, concert halls, theatres, and other cultural centers.

## Competition

The beverage industry is highly competitive. The principal areas of competitions are pricing, packaging, development of new products and flavors and marketing campaigns. REED products compete with a wide range of drinks produced by a relatively large number of manufacturers. Most of these brands have enjoyed broad, well-established national recognition for years, through well-funded ad and other branding campaigns.

The kombucha market is dominated by one producer who sells their products nationally. The remainder of the producers is comprised of mostly fragmented regional or local companies. The company believes that Reed's is now the #2 national producer of kombucha, an accomplishment achieved in a relatively short period of time, by leveraging its existing distribution channels and customer relationships to expand its sales volume quickly. The company believes that its existing infrastructure creates a competitive advantage, including product design, manufacturing & production and a network of sales & distribution.

## Products

REED currently manufactures and sells 24 beverages, four candies and three ice creams. The company makes all of its products using premium all-natural ingredients and its beverage line is GMO free. Its primary brands are Reed's ginger brew line, Virgil's line of root beer and Culture Club kombucha. Its candy products that include Reed's Crystallized Ginger Candy and Reed's Chews represent a lesser portion of revenues, however, the products are popular and sales are expanding. The company also sells ginger ice cream.

Ginger ale is the oldest known soft drink. Before modern soft drink technology existed, non-alcoholic beverages were brewed at home directly from herbs, roots, spices, and fruits. These handcrafted brews were then aged like wine and highly prized for their taste and tonic, health-giving properties. Reed's Ginger Brews are a revival of this home brewing art and the company makes them with care and attention to wholesomeness and quality, using the finest fresh herbs, roots, spices, and fruits. Its expert brew masters brew each batch with fresh ginger. It uses pure cane sugar as a sweetener.

REED products differ from commercial soft drinks in three particular characteristics: sweetening, carbonation and coloring for greater adult appeal. Instead of using injected-based carbonation, the company produces its carbonation naturally, through slower, beer-oriented techniques. This process produces smaller, longer lasting bubbles that do not dissipate rapidly when the bottle is opened. REED does not add coloring. The color of its products comes naturally from herbs, fruits, spices, roots and juices and its beverages are GMO free. In addition, since Reed's Ginger brews are pasteurized, they do not require or contain any preservatives.

Virgil's Root Beer is a premium root beer. REED uses all-natural ingredients. It collects these all-natural ingredients worldwide and combines them under strict specifications and finally heat-pasteurize Virgil's Root Beer, to ensure quality.

Reed's Culture Club Kombucha was introduced in 2012. Kombucha is a fermented tea that dates its origin back thousands of years. Among consumers, kombucha is believed to have healing and cleansing characteristics. Sweetened tea is introduced to a "starter" culture and lightly fermented to produce an acetic drink. Initially, the company produces four flavors, Goji Ginger, Hibiscus Ginger Grapefruit, Lemon Ginger Raspberry and Cranberry. The company introduces four flavors in 2013.

The company has other popular brands that currently have limited distribution, including China Cola, Sonoma Sparkler and Flying Cauldron Butterscotch Beer. The company is continually developing new brands and products. The company also design and manufacture drinks for private label customers in its Los Angeles Brewery. Its private label products have been primarily sparkling juices, waters and teas.

### **Manufacturing of REED Products**

REED produces its carbonated beverages at two facilities, one is in Los Angeles, California, known as The Brewery and a packing facility in Pennsylvania which supplies products that is not produce at The Brewery. Generally, the company obtains the ingredients used in its products from domestic suppliers and each ingredient has several reliable suppliers. As a general policy, the company picks ingredients in the development of its products that have multiple suppliers and are common ingredients. This provides a level of protection against a major supply constriction or calamity.

The company believes that as it continues to grow, it will be able to keep up with increased production demands. The company believes that The Brewery has ample capacity to handle increased West Coast business. To the extent that any significant increase in business requires us to supplement or substitute its current co-packers, the company believes that there are readily available alternatives, so that there would not be a significant delay or interruptions in fulfilling orders and delivery of its products. In addition, the company does not believe that growth will result in any significant difficulty or delay in obtaining raw materials, ingredients or finished product that is repackaged at The Brewery.

## Summary/Conclusion

REED is a beverage company in its early growth phase (22% sales CAGR in 2010-13). Importantly, the company is capitalizing on (perceived) healthier/natural product trends consumers crave for these days. In 1Q14 (weather impacted quarter for consumer/retail companies across the US), REED still managed to grow its top line by a healthy 10% YoY. Worth highlighting, going forward, is the initial and continued success of Reed's Culture Club Kombucha (already 14% of sales in 1Q14). This product is in one of the fastest growing segments in the functional beverage category. Moreover, management claims that with this product, REED has become #2 national producer of kombucha, a feat achieved within a relatively short period of time (since the product launch in 3Q12). Furthermore, management is confident that 2014 would be the first profitable year (at net profit level), a major milestone for a company in its early growth phase. I would put REED on the investing radar screen, with Accumulate rating assigned. A major risk factor of note is that setback on sales growth/margin in the foreseeable future would cause high share price volatility. Last, but not least, investors should pay attention to the risk factors described in this report.

## Risk Factors

**The information below contains excerpts of some of the risk factors included in the Company's Form 10-K for its fiscal year ended Dec 31, 2013 that should be considered by investors. Investors should carefully consider the risk factors set out below and consider all other information contained herein and in the Company's SEC filings before making an investment decision. We assume no obligation to update or revise any such forward-looking statements to reflect events or circumstances that occur after such statements are made.**

**REED has had considerable change at top management level over last six months.**

On January 21, 2014, James Linesch submitted his resignation as Chief Financial Officer of the company, and such resignation become effective on January 30, 2014. On February 4, 2014, Thierry Foucaut resigned as Chief Operating Officer, effective immediately. On February 7, 2014, REED engaged David Williams to serve as its Interim Chief Financial Officer. Mr. Williams is a CPA and has extensive experience as a chief financial officer, controller, and auditor. However, on May 22, 2014, Mr. Williams and the company agreed to a mutual separation because they were not able to agree regarding the scope of Mr. Williams' duties as Interim CFO and his compensation moving forward. Subsequently, on May 27, 2014, REED engaged Lawrence Tomsic to serve as its Interim CFO. Mr. Tomsic is a CPA and has extensive experience as a CFO, controller, and auditor.

**REED has a history of operating losses. If the company continues to incur operating losses, it eventually may have insufficient working capital to maintain or expand operation according to our business plan.**

As of March 31, 2014, the company had an accumulated deficit of \$22,204,000. For the three months ended March 31, 2014 and 2013 the company had incurred losses from operations of \$32,000 and \$239,000, respectively. As of December 31, 2013, the company had an accumulated deficit of \$21,984,000. For the years ended December 31, 2013 and 2012, the company incurred losses from operations of \$869,000 and \$(136,000), respectively.

**If REED is not able to retain the full-time services of Christopher J. Reed, it will be more difficult for the company to manage its operations and its operating performance could suffer.**

The company business is dependent, to a large extent, upon the services of Christopher J. Reed, its founder, President, Chief Executive Officer, Chairman of the Board and Chief Financial Officer. The company depends on Mr. Reed's creativity and leadership in running or supervising virtually all aspects of its day-to-day operation. The company does not have a written employment agreement with Mr. Reed. In addition, the company does not maintain key person life insurance on Mr. Reed. Therefore, in the event of the loss or unavailability of Mr. Reed to the company, there can be no assurance that the company would be able to locate in a timely manner or employ qualified personnel to replace him. The loss of the services of Mr. Reed or its failure to attract and retain other key personnel over time would jeopardize its ability to execute its business plan and could have a material adverse effect on its business, results of operations and financial condition.

**The Company may not be able develop successful new beverage products which are important to its growth.**



An important part of the company's strategy is to increase its sales through the development of new beverage products. The company cannot assure you that it will be able to continue to develop, market and distribute future beverage products that will enjoy market acceptance. The failure to continue to develop new beverage products that gain market acceptance could have an adverse impact on its growth and materially adversely affect our financial condition. The company may have higher obsolescent product expense if new products fail to perform as expected due to the need to write off excess inventory of the new products.

**The beverage business is highly competitive.**

The premium beverage and carbonated soft drink industries are highly competitive. Many of the company's competitors have substantially greater financial, marketing, personnel and other resources than the company does. Competitors in the soft drink industry include bottlers and distributors of nationally advertised and marketed products, as well as chain store and private soft drinks. The principal methods of competition include brand recognition, price and price promotion, retail space management, service to retail trade, new product introductions, packaging changes, distribution methods, and advertising. The company also competes for distributors, shelf space and customers primarily with other premium beverage companies. As additional competitors enter the field, its market share may fail to increase or may decrease.

**The loss of the company's largest customers would substantially reduce revenues.**

REED's customers are material to its success. If the company is unable to maintain good relationships with its existing customers, its business could suffer. Unilateral decisions could be taken by its distributors, and/or convenience chains, grocery chains, specialty chain store, club stores and other customers to discontinue carrying all or any of its products that they are carrying at any time, which could cause its business to suffer.

## Rating System

We rate companies based on the appreciation potential we believe their shares represent and the "riskiness" we perceive in our ratings.

### Explanation of Ratings

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<b>BUY</b>	The stock's total return is expected to exceed the total return of the relevant country Index average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, by more than 3 percentage point, over the next 12-18 months.
<b>HOLD</b>	The stock's total return is expected to be within +/- 3 percentage point of the total return of the relevant country Index or of the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis over the next 12-18 months.
<b>SELL</b>	The stock's total return is expected to be below the total return of the relevant country's equity indices and/or the total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, by more than 3 percentage point, over the next 12-18 months.
<b>ACCUMULATE OR REDUCE</b>	The analyst does not have adequate conviction about the stock's total return relative to the relevant country Index or the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months. Nonetheless, the analyst deems an investment action either accumulating or reducing to be a reasonable course of action

## Analyst Certification

I, Johannes Salim, CFA, hereby certify that the view expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the recommendations or views expressed in this research report.

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