

# KEYSTONE'S

## U.S. Growth/Value Stock Research Service

Editor: Ryan Irvine, BBA (Finance)  
Senior Analyst: Aaron Dunn, CFA

Independent Equity Advisors

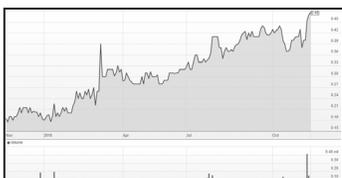
### The Singing Machine Company Inc.

**Current Price (November 18/2016): \$0.50**

**(SMDM:OTCQX)**

**RECOMMENDATION: SPEC BUY**

**U.S. MICRO-CAP HIGH GROWTH CONSUMER ELECTRONICS LEADER TRADING UNDER \$0.50 POSTS RECORD Q2, PE OF 8 DESPITE 20%+ ANNUAL GROWTH -MAINTAIN SPEC BUY**



Industry: Consumer Electronics  
Recommended: November 2016  
Recommendation Price: \$0.41  
Current Price: \$0.50  
Market Cap: \$18.33 million  
Shares Outstanding: 38,205,186  
Fully Diluted: 38,980,571

Discovery Portfolio

#### SELECTED QUARTERLY DATA

Income Statement	Q2 2016	Q2 2015
Revenues:	\$28,129,051	\$21,060,584
Earnings:	\$1,810,476	\$1,071,473
Earnings Per Share (EPS):	\$0.05	\$0.03
Fully Diluted EPS:	\$0.05	\$0.03

#### RATINGS

#### VALUE

P/E (2016 eEPS):	8.33
P/S (forward):	0.33
P/B:	2.77
Current Ratio:	1.21
D/E:	0.27

#### COMPANY DESCRIPTION

Founded in 1982 and based in Fort Lauderdale, Florida, Singing Machine® is engaged in the development, production, marketing and distribution of consumer karaoke audio equipment, accessories, music and audio consumer electronic products. The company contracts for the manufacturing of all its electronic equipment products with factories located in China. Singing Machine has grown into the North American leader in consumer karaoke products. The first to provide karaoke systems for home entertainment in the United States, the company sells its products world-wide through major mass merchandisers and on-line retailers. Products are sold throughout North America, Europe, Australia and South Africa. The company's customers include Amazon, BJ's Wholesale, Costco, Sam's Club, Target, Toys R Us, and Wal-Mart.

#### FINANCIAL HIGHLIGHTS & KEY AREAS OF GROWTH

##### Second Quarter Highlights:

- Q2 revenues increased 33% to \$28.1 million.
- Q2 earnings jumped 66% to \$1.81 million, or \$0.05 per share, compared to \$1.07 million, or \$0.03 per share, in the same period last year. Year-to-date earnings per share increased to \$0.04 per share.
- Net sales year-to-date increased by 34% to \$32.9 million.
- Net income before tax for the quarter increased to \$2.8 million compared to approximately \$1.9 million in the same period last year.
- Year-to-date net income before tax increased to approximately \$2.0 million compared to approximately \$0.9 million in the same period last year.

Singing Machine reported revenues increased 33% to \$28.1 million for the quarter-ended September 30, 2016, from \$21.1 million in the prior year. The increase in net sales is primarily (54%) due to an increase in sales to one major retailer for a Black Friday holiday program (\$3.8 million). Additionally, the growth (20% or \$1.4 mil-

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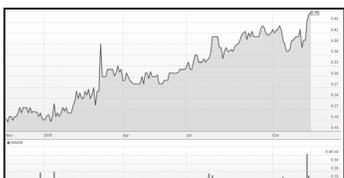
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lion) came from an increase in sales to a popular e-commerce retailer who anticipates strong demand for Singing Machine products for the holidays as well as timing factors with other retailers buying product early for the season. There was an increase of approximately \$474,000 in international sales with continued penetration in the United Kingdom market. The remaining increase of approximately \$1.37 million is due primarily to accelerated customer purchasing during the quarter ended September 30, 2016, compared to the quarter ended September 30, 2015.

Gross profit increased by approximately \$1.6 million to \$6.5 million, or 23.1% of net sales, compared to approximately \$4.9 million, or 23.3% of net sales, reported in the prior year. The mix of gross profit margins slightly lower (0.4% points) than regular margin due to a large portion of the sales going to one retailer for its Black Friday promotion. This is largely expected – large promo items are sold at a lower margin, but do not require any significant marketing expense on behalf of Singing Machine and the additional awareness and traffic generated by these items more than offsets the slightly reduced margin.

As a result, the company reported income from operations increased 47% to \$2.8 million compared to income from operations of approximately \$1.9 million in the same period in the prior year. Net income for the quarter increased 66% to \$1.8 million, or \$0.05 per share, on a fully diluted basis compared to \$1.1 million, or \$0.03 per share, on a fully diluted basis over the same period last year. Net income for the first six months was \$1.4 million, or \$0.04 per share, compared to approximately \$0.6 million over the same period last year.

#### Digital Download Machines and Music Downloads

In the second quarter, the company stated they had a significantly higher number of Digital Download Machines in market than in the same period of last year. However, management did not provide any hard numbers. The company went on to state that the numbers are looking good in reference to visitors to the store, registrations,

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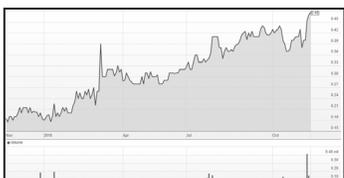
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transactions, and total dollars. The only metric that did not move up was the average revenue per paying user which fell from the \$30 range to the \$20 range. The company stated that the reason for the drop was that they have far more “new customers” that have yet to have the time to make any purchases. Management believes this number will move higher (\$30 range) as the users make purchases at Christmas and in the months following.

#### SEASONAL AND QUARTERLY RESULTS

Historically, Singing Machine's operations have been seasonal, with the highest net sales occurring in the second and third quarters (reflecting increased orders for systems and music merchandise during the Christmas holiday season) and to a lesser extent the first and fourth quarters of the fiscal year. Sales in the company's second and third fiscal quarters combined accounted for approximately 85% and 87% of net sales in fiscal 2016 and 2015, respectively. Singing Machine's results of operations may also fluctuate from quarter to quarter as a result of the amount and timing of orders placed and shipped to customers, as well as other factors. The fulfillment of orders can therefore significantly affect results of operations on a quarter-to-quarter basis.

#### VALUATION

On a trailing twelve-month basis, the company reported revenues of \$57.32 million and net income of \$2.93 million. Currently the company trades at a price-to-earnings multiple of 8.91 times despite the fact we see growth potential in the current year in the range of 20% - 30%. If the company is able to grow earnings by 25-30% in fiscal 2017, it will end the fiscal year with \$0.06 per share. Given a conservative multiple of 12 times this figure our fair value estimate over the next 12 months is in the range of \$0.72 per share or a 44% increase from the current trading range, despite the rise we have benefitted from following the company's record Q2 results.

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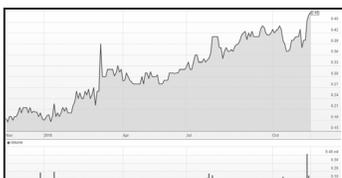
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#### CONCLUSION

As we expected, Singing Machine's second quarter was very strong by all financial measures. The company grew by 33% over last year, earnings by 66% and year-to-date earnings are now up 138%. Impressively, the quarter marked the tenth consecutive quarter of year-over-year growth in sales and earnings. The revenue increase in the quarter is the result of the company's expanded partnership with its retailers and e-tailers as well as a continued commitment to position the brand as a leader in home entertainment. Management believes that Singing Machine is now properly aligned to take advantage of the increase in home entertainment purchases by families across the world.

The company released two additional Digital Download karaoke machines this year – the Remix and the Fiesta - expanding its assortment to meet the need of consumer demands for new technology in the digital download segment. The jump in sales also reflects the early sell through trends this year, which its retail partners anticipate will continue during the key holiday rush. Encouragingly, the company is also seeing strong demand internationally, where management anticipates 100% increase in year-over-year growth.

Given the Black Friday orders and the fact a good deal of product was shipped direct import, there will be somewhat of a slide of revenues from the third quarter into the numbers just reported in Q2. Having said this, management still expects a busy upcoming quarter, but it will likely not eclipse the Q2 results.

The stock is not without risks given the very competitive nature of the consumer electronics segment, its exposure to consumer trends and the sensitivity of the company's sales to general economic conditions. Given the company's current sales momentum and heading into its second strong seasonal quarter (Q3), the stock continues to offer good speculative value, despite the greater than 20% jump following its strong Q2 results. We expect the company will end the current fiscal year with

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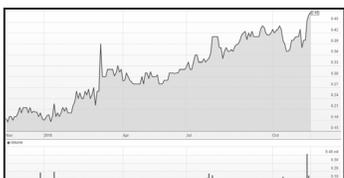
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\$0.06 in earnings per share. Given a conservative multiple of 12 times this figure, our fair value estimate over the next 12 months is in the range of \$0.72 per share or a 44% increase from the current trading range. As such, we are maintaining coverage on the stock with a SPEC BUY after making it one of the initial purchases in our U.S. Growth Stock Discovery Portfolio.

**Please note: SMDM's shares are relatively illiquid. We advise placing initial limit orders in the \$0.47- \$0.53 range and stress patience.**

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**BV (BV/Share): Book value (book value per share)**

Book value per common share calculated as total shareholder's equity less preferred equity, and divided by the number of common shares outstanding. Should the company decide to dissolve, the book value per common share indicates the dollar value remaining for common shareholders after all assets are liquidated and all creditors are paid.

**D/E: Debt-to-equity ratio**

A measure of a company's financial leverage calculated by dividing long term debt by shareholders equity. It indicates what proportion of equity and debt the company is using to finance its assets.

**Current ratio**

One of many ratios designed to evaluate short-term liquidity of a company. Calculated as current assets divided by current liabilities, this ratio gauges the level of cash resources relative to current liabilities as a measure of cash obligations.

**EBITDA**

Earnings before interest, taxes, depreciation, and amortization. EBITDA is calculated as revenue minus expenses (excluding tax, interest, depreciation, and amortization).

**EPS: Earnings per share**

A company's earnings available to common shareholders, also known as net income or net profit, divided by the number of shares outstanding.

**EV: Enterprise value**

Enterprise value is calculated as market capitalization less cash and equivalents, plus debt. Evaluation of EV relative to the company's trailing EBITDA is used in identifying potential takeover targets.

**FCF: Free cash flow**

Capital expenditures are subtracted from cash flow from operating activities to arrive at free cash flow, which intends to measure the cash available to a company after making all cash outlays necessary to maintain existing productive capacity (as measured by capital expenditures on a company's cash flow statement).

**Net working capital**

A measure of the company's ability to carry on its normal business comfortably and without financial stringency, to expand its operations without the need of new financing, and to meet emergencies and losses. Calculated by deducting current liabilities from the current assets.

**P/B: Price-to-book ratio**

Calculated as a stock's market value (current closing price) divided by its latest quarter's book value. While a lower P/B ratio could mean that the stock is undervalued, it could also serve as a sign of weak fundamentals, and as with most ratios, this varies a fair amount by industry.

**PEG ratio**

The price/earnings to growth, or PEG ratio is calculated as P/E ratio divided by a company's annual EPS growth. The PEG ratio is used to determine a stock's value while taking into account earnings growth.

**P/FCF: Price-to-free cash flow ratio**

Calculated as a company's current share price divided by its free cash flow per share (i.e., free cash flow divided by the number of company's shares outstanding) over the last four quarters (called "TTM," or "trailing 12 months" calculation). It is a measure of the market's expectations regarding a firm's future financial health.

**P/S: Price-to-sales ratio**

It is calculated as a stock's current market price divided by its sales (revenue) per share. When calculating this ratio, we use the company's revenue from its latest four quarters, or on a TTM basis.

**ROE: Return on equity**

A measure of a corporation's profitability, calculated as net income divided by shareholder's equity. ROE is often useful in comparing the profitability of a company to other firms in the same industry.

Featured companies in KeyStone's Small-Cap Stock Report are evaluated on a scale of 1 to 5 on each of the following criteria:

**Value:** 1 - poor investment value  
5 - excellent investment value

**Risk/Liquidity:** 1 - high exposure to liquidity concerns  
5 - low exposure to liquidity concerns

**Growth:** 1 - poor growth potential  
5 - excellent growth potential

**Overall:** 1 - poor fundamental characteristics  
5 - excellent fundamental characteristics

Disclosure					
Stock Holding				Other	
Companies	KeyStone	KeyStone Employees	Related Companies	Investment Banking Client	Related Company Business Relationship
The Singing Machine Company Inc.	YES	NO	NO	NO	NO