

# KEYSTONE'S

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

NOVEMBER 2016

Independent Equity Advisors

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Discovery Portfolio	Initial Coverage: Singing Machine Company Inc.
	Price: \$0.41
	Symbol: (SMDM: OTCQX)
	Near Term: ▲ SPEC BUY
	Long Term: ▲ SPEC BUY

### Summary

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. Representative customers include Amazon, BJ's Wholesale, Costco, Sam's Club, Target, Toys R Us, and Wal-Mart.

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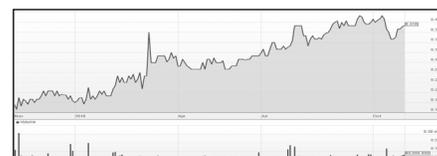


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**Singing Machine Company Inc. (SMDM: OTCQX)****Recommendation: SPEC BUY****Discovery Portfolio**

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**COMPANY DESCRIPTION**

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**A WELL TUNED TURNAROUND STORY**

A decade ago, the largest manufacturer of home karaoke machines in North America was being crowded out of retail store shelves by newer, cooler products such as portable DVD machines, MP3 players, digital picture frames and GPS tracking devices. Simultaneously, the karaoke industry was reeling from piracy lawsuits from record labels, who claimed hardware manufacturers were infringing on their copyrighted music. Video games such as "Guitar Hero" and "Rock Band" surged in popularity, making karaoke seem dated.

In 2008, the Singing Machine lost \$3 million and the former management exited. Its 100,000 square-foot warehouse in Ontario, California, was crowded with overstock and the 50-person staff was battered by layoffs. The company's end seemed a fait accompli.

But today, Singing Machine is singing a much happier tune. Last year, the company reported net sales of \$48.9 million for the March 31, 2016 fiscal year end period — an increase of 24% over 2015 of \$39.3 million. Gross profits increased by \$3.6 million to \$11.9 million, with a profit margin of 24.4% (up from 3.3% the year before). Inventory, a critical figure for a seasonal consumer electronics company, decreased by 50% to \$3.7 million. Overall, the company reported net income of \$1.7 million — a big jump from \$0.2 million the year before.

Singing Machine offers the industry's widest line of at-home karaoke entertainment products, which allows consumers to find a machine that suits their needs and skill level. The company's relatively large number of product SKU's also allows Singing Machine to position a product at \$10 increments from the low end machine at \$49 to the \$250 range. With this type of product breadth in its target segment, the company is able to boast a North American market share in the range of 60% but perhaps more importantly be a retail shelf space king with positioning in almost 90% of

**TABLE 1: MARKET DATA**

Symbol	SMDM
Yield	-
Market Capitalization	\$15.3 M
Shares Outstanding (basic)	38,181,635
Shares Outstanding (diluted)	38,597,862
Average Daily Trading Volume	21,244

**TABLE 2: QUARTERLY FINANCIAL DATA**

	Q1 2017	Q1 2017	Change
Revenues	\$4,859,392	\$3,466,874	40%
Operating Income	-\$571,841	-\$738,620	23%
Net Income	-\$437,073	-\$494,926	12%
EPS	-\$0.01	-\$0.01	0%
Total Debt	\$3,404,154	\$4,058,676	-16%
Shareholder's Equity	\$5,232,224	\$3,433,039	52%

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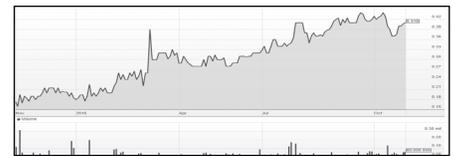
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Operating Income	\$1,937,152	\$568,612	241%
Adjusted Net Income	\$1,703,390	\$170,158	901%
Adjusted EPS	\$0.04	\$0	901%

**TABLE 4: FINANCIAL RATIOS**

	Trailing Twelve Months
Price-to-Earnings	8.69
EV-to-EBITDA	7.71
Debt-to-EBITDA	0.83
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EBITDA Margin	0.04

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the categories. It also allows for exclusive products at major retailers such as Wal-Mart, Costco and Target.

**SEASONAL AND QUARTERLY RESULTS**

Historically, Singing Machine's operations have been seasonal, with the highest net sales occurring in the second and third fiscal 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.

**INVESTMENT HIGHLIGHTS**

- 3 consecutive years of revenue growth from \$31.4 million in 2014 to \$48.86 million in 2015.
- Valuation: SMDM trades at 8.6 times earnings over its last 12 month and 7.45 times 2016e earnings despite 20% expected growth.
- New Product Launch in 2017 holds potential for new market growth.

**FINANCIAL OVERVIEW****Recent Performance:**

- Net sales for the first quarter of fiscal 2017 increased by 40% from \$3.5 million to \$4.9 million compared to the same period from last year. The increase in net sales is attributable to an increase in sales to one major retailer for a new holiday program.
- EBITDA for the period improved by approximately \$0.2 million compared to the same period last year.
- As a result, the company reported a decrease of \$167,000 in loss from operations to \$571,000 compared to a loss from operations of approximately \$739,000 in the same period in the prior year.
- The first quarter is the company's weakest reporting period due to seasonal factors.
- Net sales for the fiscal year 2016 increased by 24% to \$48.9 million. The increase in net sales is attributable to an increase in sales to Singing Machine's major retailers caused by successful marketing campaigns and increased consumer demand. The increase is also attributable to an expansion in international sales to the United Kingdom and other new territories. E-commerce sales through the company's online platforms continue to grow, accounting for 18% of the increase.
- Product returns reduced to historical low of 5.5% of gross sales.
- Net income for fiscal 2016 was \$1.7 million compared to \$0.2 million

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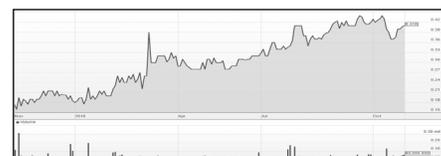
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for the 2015 fiscal year end and earnings per share for the fiscal year end was \$0.044.

**Financial Position:**

The company's balance sheet consists of total debt of \$1.92 million and cash of \$444,515.

**KEY AREAS OF GROWTH****Karaoke Culture:**

Singing Machine is benefiting from a cultural resurgence of karaoke, which is popping up everywhere from "The Late Late Show with James Corden's" celebrity-driven Carpool Karaoke segments to the USA Network's "Mr. Robot" cyberspace-thriller series. The popularity of music/song related TV reality shows such as American Idol and The Voice have every child in North America wishing to be the next Taylor Swift or John Meyer – what better way to start than at 8 or 10 years old on a big, flashy karaoke machine – in this case from the Singing Machine. The company's sales growth over the last 3 years mirrors the growth in popularity of Karaoke and singing in general across North America.

**Digital Download Machines:**

Recently, the company collaborated with a music content service provider (TSX listed Stingray Digital Group) allowing Singing Machine to offer karaoke downloads and streaming subscription services. This collaboration provides the company with a distribution platform for digital music sales and subscriptions and music sales to customers. Its music distribution system enables download or stream selections from content library – currently in the range of 12,000 songs. The company offers karaoke music through its Singing Machine Karaoke Download Store, Community, and iPhone/iPad Application.

The Digital Downloads could potentially be a game changer for the Singing Machine as the business would add high margin download revenue to its mix – revenue that could be less seasonal and highly accretive to earnings.

**Rough Breakdown of the Karaoke Licensing Agreement**

1. 33.3% Singing Machine.
2. 33.3% Stingray Digital.
3. 33.3% Artist (singer/songwriter).

**Current Download Revenues Small, but Growing in Potential**

Singing Machine sold roughly 1.4 million karaoke machines in fiscal 2016, of which, only 40,000 were digital download machines. The company estimates that of these 40,000 customers 60-65% registered to download songs and of those who downloaded songs, the average spend has been

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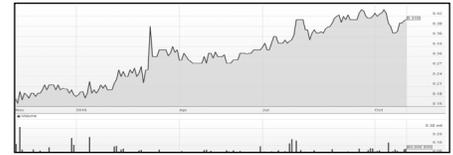
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in the range of \$27-\$30 with \$9-\$10 of that going directly to Singing Machine. The margin on downloaded songs is basically 100%.

As Singing Machine moves forward into fiscal 2017, the push is to put as many digital downloading machines into the market. Management expects in the current fiscal year (2017) the company will sell well over 200,000 digital downloading machines. If a significant percentage of the customers then purchase songs through the Download Store (50-60%) and the average purchase remains in the \$30 range annually, Singing Machine has the potential to add \$1.0 million, or \$0.025 per share, in annual profit. At this stage, we view that type of revenue as very speculative near term given the unproven nature of the download store and the company's app, the small sample size of data, and the competition. However, if the model is ultimately reasonably successful, the potential for a new very significant profit stream longer term is there. We view it as a bit of a lottery ticket at this stage. Without this potential boost, the stock still appears relatively undervalued.

**New Product Launches:**

In September 2016, the company announced two significant new product launches:

**1) SMC Kids Line**

SMC Kids will be an entirely new line of toy products with a central theme of music, entertainment and learning. The Kids Line offers colourful, appealing sing-along toys for kids aged 3-9 and will provide fun, affordable, easy-to-use singing products designed to teach children about the joy of singing. This is a previously unaddressed market for Singing Machine.

Management believes the SMC Kids line represents a huge area of potential growth for the company. The Kids Line should open up new distribution possibilities to a significant new number of retail customers that the company is not already doing business with. The line allows the company to cross sell to multiple departments within the retailers where Singing Machine is already doing business. The sing-along toy category is currently dominated by licensed products, such as Frozen™ and Doc McStuffins™. The Singing Machine Kids Line will be unaffiliated. This could allow for broader appeal to all age groups, effectively widening the target demographic. Management plans to add value to its retail partners to provide a lasting brand that won't go out of style at the speed of the latest Disney trend. The company believes customers will feel confident in purchasing a toy with staying power.

The Singing Machine Kids Line will launch with 6 new products for Spring 2017 release and will target suggested retail prices below \$49.

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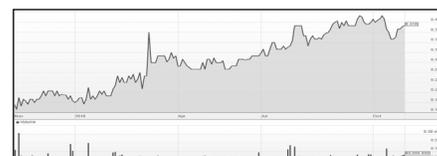
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**2) The Remix**

On September 15, 2016, Singing Machine announced the release of the Remix - a new opening price point HD download karaoke machine for Fall 2016. The Remix, available in white or black, joins the digital download line with a suggested retail price of \$79.99 which makes it the newest entry level price point option within the series. As part of the digital download line, the Remix will support all the same features as the rest of the line and include High-Def full motion karaoke video playback, Bluetooth® audio streaming, vocal recording, and access to the Karaoke Download Store App, hosted by Stingray Karaoke, a Premium Partner of Singing Machine.

**VALUATION**

On a trailing twelve-month basis, the company reported revenues of \$50.25 million and net income of \$1.75 million, or \$0.046 per share. 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%. If the company is able to grow earnings by 20% in fiscal 2017, it will end the fiscal year with \$0.055 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 \$0.66 per share or a 61% increase from the current trading range.

**CONCLUSION**

Singing Machine is not the sexiest story on the street, but this rather impressive little turnaround story has produced profits in 5-consecutive years, a record year of earnings in fiscal 2016 and began the first quarter of its fiscal 2017 with strong growth. For investors, the story is becoming quite sexy. In fiscal 2016 management drove improvements in all financial areas including sales growth, margin improvement, inventory reduction, and significant improvement in bottom line earnings. In addition, the company realized a historically low rate of product returns (5.5% of gross sales compared to historical average of 8.0% of gross sales), signaling that its end customers are happy with the new digital line of products.

As the business moves into fiscal 2017, the company enters the fiscal year with some of North American's best and most recognizable retailers carrying Singing Machine year-round, increasing international demand, a solid cash position, significantly improved balance sheet, and a product development strategy that will focus on driving more music sales to the company's various music revenue platforms (Download Store).

From a valuation perspective, Singing Machine appears attractive. On a trailing twelve-month basis, the company reported revenues of \$50.25

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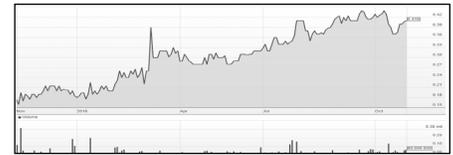
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As such, we are initiating coverage on the stock with a SPEC BUY and making the stock one of the initial purchases in our U.S. Growth Stock Discovery Portfolio. The stock is not without risks given the very competitive nature of the consumer electronics 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 two strongest seasonable quarters of its fiscal year (Q2 and Q3), the stock appears to offer good speculative value in its current range (\$0.39-\$0.47). We expect the company will end the current fiscal year with \$0.055 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 \$0.66 per share or a 60% increase from the current trading range.

**Please note: SMDM's shares are relatively illiquid. We advise placing initial limit orders in the \$0.40-\$0.47 range and stress patience.**

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**2008a; 2009e**

The term (a) refers to the actual results that a company has posted on its financial statements. The term (e) refers to analyst estimates of future results.

**Book value (BV)**

The total value of a company's assets, on its Balance Sheet, less any liabilities. Also referred to as Shareholder Equity. (The value of a company's assets, on its Balance Sheet, does not necessarily reflect the true value of assets).

**Cash Flow from Operations (CFO; Operating Cash Flow)**

The cash inflow that a company receives during a period, resulting from operating activities (does not include Cash Flow from Investing or Financing).

**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 (the ratio should be greater than 1).

**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 (a lower ratio indicates lower relative debt ratios).

**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.

**Fair Value**

The price at which an analyst believes a company's stock should be priced. Although this value is based on intelligent analysis, it in no way is a representation of what the company's share price will be trading at given any period of time. The analysis used to determine Fair Value is based on numerous assumptions and uncertainties. Fair Value should be used only as a general guide to investing and should not be depended upon.

**FCFE: Free cash flow to equity**

Cash flow from operations less working capital requirements, sustaining capital expenditures and scheduled debt repayments. FCFE consists of cash inflows that are available to the shareholders of the company.

**Net working capital surplus (deficiency)**

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 (as positive figure is a surplus, whereas a negative figure is a deficiency).

**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.

**P/CF: Price-to-cash flow ratio**

Calculated as a company's current share price divided by its 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.

**Tangible Book Value (TBV)**

The total value of a company's assets, on its Balance Sheet, less any liabilities and intangible assets such as goodwill. Also referred to as Shareholder Equity. (Also true asset values likely differ from Balance Sheet Values, Tangible Book Value is generally considered a more accurate representation of value).

**Times Interest Earned**

The multiple of Net Income (before interest and taxes) to interest payments during the period. This assesses a company's ability and margin of safety, with respect to meeting its interest obligations (a higher number is more attractive).

**Yield**

The investment return resulting from income distributions. Calculated as the annual or annualized interest or dividend distribution, divided by the cost of the original investment.

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

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