

REED'S, INC.  
Form 10-Q  
May 11, 2016

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2016

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 001-32501

**REED'S, INC.**

(Exact name of registrant as specified in its charter)

Delaware                      35-2177773  
(State of incorporation) (I.R.S. Employer Identification No.)

13000 South Spring St. Los Angeles, Ca. 90061

(Address of principal executive offices) (Zip Code)

(310) 217-9400

(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated filer  Accelerated filer   
Non-accelerated filer  Smaller reporting company

Indicate by check mark whether the issuer is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: There were a total of 13,184,331 shares of Common Stock outstanding as of May 9, 2016.



*Special Note Regarding Forward-Looking Statements*

*This Quarterly Report on Form 10-Q, including “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in Item 2 of Part I of this report include forward-looking statements. These statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance, or achievements expressed or implied by forward-looking statements.*

*In some cases, you can identify forward-looking statements by terminology such as “may,” “should,” “expects,” “plans,” “anticipates,” “believes,” “estimates,” “predicts,” “potential,” “proposed,” “intended,” or “continue” or the negative of these terms or other comparable terminology. You should read statements that contain these words carefully, because they discuss our expectations about our future operating results or our future financial condition or state other “forward-looking” information. There may be events in the future that we are not able to accurately predict or control. Before you invest in our securities, you should be aware that the occurrence of any of the events described in this Quarterly Report could substantially harm our business, results of operations and financial condition, and that upon the occurrence of any of these events, the trading price of our securities could decline and you could lose all or part of your investment. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, growth rates, levels of activity, performance or achievements. We are under no duty to update any of the forward-looking statements after the date of this Quarterly Report to conform these statements to actual results.*

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**Part I – FINANCIAL INFORMATION****Item 1. Financial Statements****REED'S, INC.****CONDENSED BALANCE SHEETS**

|  | March 31,<br>2016<br>(Unaudited) | December<br>31, 2015 |
|--|----------------------------------|----------------------|
| <b>ASSETS</b>  |                                  |                      |
| Current assets:  |                                  |                      |
| Cash   | \$648,000                        | \$1,816,000          |
| Trade accounts receivable, net of allowance for doubtful accounts and returns and discounts of \$263,000 and \$356,000, respectively | 2,675,000                        | 2,894,000            |
| Inventory, net of reserve for obsolescence of \$220,000 and \$290,000, respectively  | 8,186,000                        | 7,927,000            |
| Prepaid inventory  | 203,000                          | 47,000               |
| Prepaid and other current assets   | 456,000                          | 769,000              |
| <b>Total Current Assets</b>  | <b>12,168,000</b>                | <b>13,453,000</b>    |
| Property and equipment, net of accumulated depreciation of \$4,416,000 and \$4,216,000, respectively                                 | 5,788,000                        | 5,369,000            |
| Brand names  | 1,029,000                        | 1,029,000            |
| <b>Total assets</b>  | <b>\$18,985,000</b>              | <b>\$19,851,000</b>  |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIENCY)</b>   |                                  |                      |
| Current Liabilities:   |                                  |                      |
| Accounts payable   | \$7,721,000                      | \$7,458,000          |
| Accrued expenses   | 183,000                          | 168,000              |
| Line of credit   | 4,250,000                        | 4,443,000            |
| Current portion of long term financing obligations   | 167,000                          | 160,000              |
| Current portion of capital leases payable  | 151,000                          | 153,000              |
| Current portion of term loans  | 341,000                          | 341,000              |
| <b>Total current liabilities</b>   | <b>12,813,000</b>                | <b>12,723,000</b>    |
| Long term financing obligation, less current portion, net of discount of \$907,000 and \$953,000, respectively                       | 1,427,000                        | 1,443,000            |
| Capital leases payable, less current portion   | 536,000                          | 490,000              |
| Capital expansion loan   | 1,896,000                        | 1,542,000            |
| Term loan, less current portion, net of discount \$106,000 and \$132,000, respectively   | 2,894,000                        | 2,868,000            |
| <b>Total Liabilities</b>   | <b>19,566,000</b>                | <b>19,066,000</b>    |

Commitments and contingencies

Stockholders' equity (deficiency):

|  |                     |                     |
|--|---------------------|---------------------|
| Series A Convertible Preferred stock, \$10 par value, 500,000 shares authorized, 9,411 shares issued and outstanding                 | 94,000              | 94,000              |
| Common stock, \$.0001 par value, 19,500,000 shares authorized, 13,184,331 and 13,160,860 shares issued and outstanding, respectively | 1,000               | 1,000               |
| Additional paid in capital   | 27,613,000          | 27,399,000          |
| Accumulated deficit  | (28,289,000)        | (26,709,000)        |
| Total stockholders' equity (deficiency)  | (581,000)           | 785,000             |
| <b>Total liabilities and stockholders' equity (deficiency)</b>   | <b>\$18,985,000</b> | <b>\$19,851,000</b> |

The accompanying notes are an integral part of these condensed financial statements

**REED'S, INC.****CONDENSED STATEMENTS OF OPERATIONS****For the Three Months Ended March 31, 2016 and 2015****(Unaudited)**

|   | <b>Three months ended</b> |               |
|---|---------------------------|---------------|
|   | <b>March 31,</b>          |               |
|   | <b>2016</b>               | <b>2015</b>   |
| Sales   | \$ 10,004,000             | \$ 10,672,000 |
| Cost of goods sold  | 8,111,000                 | 7,413,000     |
| Gross profit  | 1,893,000                 | 3,259,000     |
| Operating expenses:   |                           |               |
| Delivery and handling expenses                                    | 849,000                   | 1,169,000     |
| Selling and marketing expense                                     | 1,041,000                 | 1,193,000     |
| General and administrative expense                                | 1,205,000                 | 914,000       |
| Total operating expenses  | 3,095,000                 | 3,276,000     |
| Loss from operations  | (1,202,000)               | (17,000 )     |
| Interest expense  | (378,000)                 | (254,000 )    |
| Net loss  | \$(1,580,000)             | \$(271,000 )  |
| Loss per share – basic and diluted                                | \$(0.12)                  | \$(0.02 )     |
| Weighted average number of shares outstanding – basic and diluted | 13,184,331                | 13,068,675    |

The accompanying notes are an integral part of these condensed financial statements



**REED'S, INC.****CONDENSED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY (DEFICIENCY)****For the Three Months Ended March 31, 2016****(Unaudited)**

|   | Common Stock |          | Series A<br>Preferred Stock |          | Additional<br>Paid-In<br>Capital | Accumulated<br>Deficit | Total<br>Stockholders'<br>Equity(Deficiency) |
|---|--------------|----------|-----------------------------|----------|----------------------------------|------------------------|--|
|   | Shares       | Amount   | Shares                      | Amount   |                                  |                        |  |
| Balance, January 1, 2015                                | 13,160,860   | \$ 1,000 | 9,411                       | \$94,000 | \$27,399,000                     | \$(26,709,000)         | \$ 785,000                                   |
| Common shares issued<br>upon exercise of warrants       | 16,260       |          |                             |          | 45,000                           |                        | 45,000                                       |
| Common shares issued<br>upon exercise of options        | 7,211        |          |                             |          | -                                |                        | -  |
| Fair value vesting of<br>options issued to<br>employees |              |          |                             |          | 169,000                          |                        | 169,000                                      |
| Net loss  |              |          |                             |          |                                  | (1,580,000 )           | (1,580,000 )                                 |
| Balance, March 31, 2016                                 | 13,184,331   | \$ 1,000 | 9,411                       | \$94,000 | \$27,613,000                     | \$(28,289,000)         | \$ (581,000 )                                |

The accompanying notes are an integral part of these condensed financial statements

**REED'S, INC.****CONDENSED STATEMENTS OF CASH FLOWS****For the Three Months Ended March 31, 2016 and 2015****(Unaudited)**

|   | <b>Three Months Ended</b> |              |
|---|---------------------------|--------------|
|   | <b>March 31,</b>          |              |
|   | <b>2016</b>               | <b>2015</b>  |
| Cash flows from operating activities:                                       |                           |              |
| Net loss  | \$(1,580,000)             | \$(271,000 ) |
| Adjustments to reconcile net loss to net cash used in operating activities: |                           |              |
| Depreciation and amortization   | 261,000                   | 213,000      |
| Fair value of stock options issued to employees                             | 169,000                   | 212,000      |
| (Decrease) increase in allowance for doubtful accounts                      | (93,000)                  | 1,000        |
| Changes in assets and liabilities:  |                           |              |
| Accounts receivable   | 313,000                   | (479,000 )   |
| Inventory   | (259,000 )                | (2,054,000)  |
| Prepaid Inventory   | (156,000 )                | 474,000      |
| Prepaid expenses and other current assets                                   | 312,000                   | 168,000      |
| Accounts payable  | 263,000                   | 1,267,000    |
| Accrued expenses  | 15,000                    | 11,000       |
| Net cash used in operating activities                                       | (755,000 )                | (458,000 )   |
| Cash flows from investing activities:                                       |                           |              |
| Purchase of property and equipment  | (186,000 )                | (351,000 )   |
| Net cash used in investing activities                                       | (186,000 )                | (351,000 )   |
| Cash flows from financing activities:                                       |                           |              |
| Proceeds from warrant exercises   | 45,000                    | 31,000       |
| Principal repayments on long term financing obligation                      | (37,000)                  | (31,000 )    |
| Principal repayments on capital lease obligation                            | (42,000 )                 | (33,000 )    |
| Net draw down (repayment) on line of credit                                 | (193,000 )                | 1,104,000    |
| Net cash (used in) provided by financing activities                         | (227,000 )                | 1,071,000    |
| Net increase (decrease) in cash   | (1,168,000)               | 262,000      |
| Cash at beginning of period   | 1,816,000                 | 959,000      |
| Cash at end of period   | \$648,000                 | \$1,221,000  |
| Supplemental disclosures of cash flow information:                          |                           |              |
| Cash paid during the period for:  |                           |              |
| Interest  | \$364,000                 | \$201,000    |
| Non Cash Investing and Financing Activities                                 |                           |              |
| Property and equipment acquired through capital expansion loan              | \$354,000                 | \$311,000    |
| Property and equipment acquired through capitalized leases                  | 86,000                    | 250,000      |

The accompanying notes are an integral part of these condensed financial statements

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**REED'S, INC.**

**NOTES TO CONDENSED FINANCIAL STATEMENTS**

**Three Months Ended March 31, 2016 and 2015 (Unaudited)**

**1. Basis of Presentation and Liquidity**

The accompanying interim condensed financial statements are unaudited, but in the opinion of management of Reed's, Inc. (the "Company"), contain all adjustments, which include normal recurring adjustments necessary to present fairly the financial position at March 31, 2016 and the results of operations and cash flows for the three months ended March 31, 2016 and 2015. The balance sheet as of December 31, 2015 is derived from the Company's audited financial statements.

Certain information and footnote disclosures normally included in financial statements that have been prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission, although management of the Company believes that the disclosures contained in these condensed financial statements are adequate to make the information presented herein not misleading. For further information, refer to the financial statements and the notes thereto included in the Company's Annual Report on Form 10-K, as filed with the Securities and Exchange Commission on March 23, 2016.

The results of operations for the three months ended March 31, 2016 are not necessarily indicative of the results of operations to be expected for the full fiscal year ending December 31, 2016.

**Liquidity**

As of March 31, 2016, we had a stockholders deficit of \$581,000 and working capital deficit of \$645,000 compared to stockholders equity of \$785,000 and working capital of \$730,000 at December 31, 2015.

We believe that the Company currently has the necessary working capital to support existing operations until the revolver becomes due in December of this year. Consistent with past refinancing practices regarding the Line of Credit, the Company believes that we will be successful in renewing the Line of Credit for another time frame similar to the past for a two year time frame. There are no assurances that this refinancing will be completed. Our primary

capital source will be positive cash flow from operations. If our sales goals do not materialize as planned, we believe that the Company can reduce its operating costs and can be managed to maintain positive cash flow from operations. Historically, we have financed our operations primarily through private sales of common stock, preferred stock, convertible debt, a line of credit from a financial institution and cash generated from operations.

We may not generate sufficient revenues from product sales in the future to achieve profitable operations. If we are not able to achieve profitable operations at some point in the future, we eventually may have insufficient working capital to maintain our operations as we presently intend to conduct them or to fund our expansion and marketing and product development plans. In addition, our losses may increase in the future as we expand our manufacturing capabilities and fund our marketing plans and product development. These losses, among other things, have had and may continue to have an adverse effect on our working capital, total assets and stockholders' equity. If we are unable to achieve profitability, the market value of our common stock would decline and there would be a material adverse effect on our financial condition.

If we suffer losses from operations, our working capital may be insufficient to support our ability to expand our business operations as rapidly as we would deem necessary at any time, unless we are able to obtain additional financing. There can be no assurance that we will be able to obtain such financing on acceptable terms, or at all. If adequate funds are not available or are not available on acceptable terms, we may not be able to pursue our business objectives and would be required to reduce our level of operations, including reducing infrastructure, promotions, personnel and other operating expenses. These events could adversely affect our business, results of operations and financial condition. If adequate funds are not available or if they are not available on acceptable terms, our ability to fund the growth of our operations, take advantage of opportunities, develop products or services or otherwise respond to competitive pressures could be significantly limited.

## **2. Significant Accounting Policies**

### **Income (Loss) per Common Share**

Basic earnings (loss) per share is computed by dividing the net income (loss) applicable to common stock holders by the weighted average number of shares of common stock outstanding during the year. Diluted earnings per share is computed by dividing the net income applicable to common stock holders by the weighted average number of common shares outstanding plus the number of additional common shares that would have been outstanding if all dilutive potential common shares had been issued, using the treasury stock method. Potential common shares are excluded from the computation when their effect is antidilutive.

The Company had potentially dilutive securities that consisted of:

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|                          | March 31,<br>2016 | March 31,<br>2015 |
|--------------------------|-------------------|-------------------|
| Warrants                 | 325,000           | 267,271           |
| Series A Preferred Stock | 37,644            | 37,644            |
| Options                  | 965,000           | 1,013,333         |
| Total                    | 1,327,644         | 1,318,248         |

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## Use of estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Those estimates and assumptions include estimates for reserves of uncollectible accounts, inventory obsolescence, depreciable lives of property and equipment, analysis of impairments of recorded intangibles, accruals for potential liabilities and assumptions made in valuing stock instruments issued for services.

## Recent Accounting Pronouncements

There were recent accounting pronouncements issued by the FASB (including its Emerging Issues Task Force), the AICPA, and the Securities Exchange Commission (the "SEC"), such pronouncements are not believed by management to have a material impact on the Company's present or future financial statements.

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2014-09 (ASU 2014-09), Revenue from Contracts with Customers. ASU 2014-09 will eliminate transaction- and industry-specific revenue recognition guidance under current U.S. GAAP and replace it with a principle based approach for determining revenue recognition. On August 12, 2015, FASB delayed the required implementation to fiscal years ending after December 15, 2017 but now permitted organizations such as Reeds to adopt earlier. ASU 2014-09 will require that companies recognize revenue based on the value of transferred goods or services as they occur in the contract. The ASU also will require additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments and assets recognized from costs incurred to obtain or fulfill a contract. Entities can transition to the standard either retrospectively or as a cumulative-effect adjustment as of the date of adoption. Management has determined to adopt ASU 2014-09 in Fiscal 2017 and has not determined the effect of the standard on our ongoing financial reporting.

In February 2016, the FASB issued Accounting Standards Update (ASU) No. 2016-02, *Leases*. ASU 2016-02 requires a lessee to record a right of use asset and a corresponding lease liability on the balance sheet for all leases with terms longer than 12 months. ASU 2016-02 is effective for all interim and annual reporting periods beginning after December 15, 2018. Early adoption is permitted. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. The Company is in the process of evaluating the impact of ASU 2016-02 on the Company's financial statements and disclosures.

In August 2014, the FASB issued Accounting Standards Update No. 2014-15 (ASU 2014-15), Presentation of Financial Statements - Going Concern (Subtopic 205-10). ASU 2014-15 provides guidance as to management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. In connection with preparing financial statements for each annual and interim reporting period, an entity's management should evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued when applicable). Management's evaluation should be based on relevant conditions and events that are known and reasonably knowable at the date that the financial statements are issued (or at the date that the financial statements are available to be issued when applicable). Substantial doubt about an entity's ability to continue as a going concern exists when relevant conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date that the financial statements are issued (or available to be issued). ASU 2014-15 is effective for the annual period ending after December 15, 2016, and for annual periods and interim periods thereafter. Early application is permitted. The Company will adopt ASU 2014-15 on the Company's financial statement presentation and disclosures beginning in 2016.

Other recent accounting pronouncements issued by the FASB, including its Emerging Issues Task Force, the American Institute of Certified Public Accountants, and the Securities and Exchange Commission did not or are not believed by management to have a material impact on the Company's present or future consolidated financial statements.



## Concentrations

The Company's cash balances on deposit with banks are guaranteed by the Federal Deposit Insurance Corporation up to \$250,000. The Company may be exposed to risk for the amounts of funds held in one bank in excess of the insurance limit. In assessing the risk, the Company's policy is to maintain cash balances with high quality financial institutions. The Company had cash balances in excess of \$250,000 during the three months ended March 31, 2016.

During the three months ended March 31, 2016, the Company had two customers that accounted for 25% and 10% of gross sales. During the months ended March 31, 2015, the company had two customers that accounted for 30% and 15% of sales respectively. As of March 31, 2016, the Company had accounts receivable due from two customers who comprised 23% and 11% of its total accounts receivable and as of December 31, 2015 the Company had accounts receivable due from two customers who comprised 24% and 12% of its total accounts receivable.

During the three months ended March 31, 2016, the Company had one vendor which accounted for approximately 17% of all purchases, and in the three months ended March 31, 2015 one vendor who accounted for approximately 30% of all purchases. No other vendor accounted for more than 10% of all purchases in either period. As of March 31, 2016, the Company had two vendors which accounted for approximately 20% and 10% of total accounts payable and as of December 31, 2015, the Company had two vendors which accounted for approximately 31% and 11% of total accounts payable.

## Fair Value of Financial Instruments

The Company uses various inputs in determining the fair value of its investments and measures these assets on a recurring basis. Financial assets recorded at fair value in the balance sheets are categorized by the level of objectivity associated with the inputs used to measure their fair value. Authoritative guidance provided by the FASB defines the following levels directly related to the amount of subjectivity associated with the inputs to fair valuation of these financial assets:

Level 1—Quoted prices in active markets for identical assets or liabilities.

Level 2—Inputs, other than the quoted prices in active markets, that are observable either directly or indirectly.

Level 3—Unobservable inputs based on the Company's assumptions.

The Company had no such assets or liabilities recorded to be valued on the basis above at March 31, 2016 or December 31, 2015.

The carrying amounts of financial assets and liabilities, such as cash and cash equivalents, accounts receivable, short-term bank loans, accounts payable, notes payable and other payables, approximate their fair values because of the short maturity of these instruments. The carrying values of capital lease obligations and long-term financing obligations approximate their fair values due to the fact that the interest rates on these obligations are based on prevailing market interest rates.

### 3. Inventory

Inventory is valued at the lower of cost (first-in, first-out or market) and, net of reserves, is comprised of the following as of:

|                             | March 31,<br>2016 | December<br>31, 2015 |
|-----------------------------|-------------------|----------------------|
| Raw Materials and packaging | \$4,676,000       | 4,364,000            |
| Finished Goods              | 3,510,000         | 3,563,000            |
|                             | \$8,186,000       | 7,927,000            |

### 4. Property and Equipment

Property and equipment are comprised of the following as of:

|                                | March 31,<br>2016 | December<br>31, 2015 |
|--------------------------------|-------------------|----------------------|
| Land                           | \$1,107,000       | \$1,107,000          |
| Building                       | 1,875,000         | 1,875,000            |
| Vehicles                       | 500,000           | 500,000              |
| Machinery and equipment        | 3,794,000         | 3,800,000            |
| Equipment under capital leases | 944,000           | 857,000              |
| Office equipment               | 469,000           | 469,000              |
| Construction in Progress       | 1,515,000         | 977,000              |
|                                | 10,204,000        | 9,585,000            |
| Accumulated depreciation       | (4,416,000 )      | (4,216,000)          |
|                                | \$5,788,000       | \$5,369,000          |

Depreciation expense for the three months ended March 31, 2016 and 2015 was \$200,000 and \$191,000, respectively.

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## 5. Intangible Assets and Impairment Policy

Intangible assets are comprised of indefinite-lived brand names acquired and have been assigned an indefinite life as we currently anticipate that these brand names will contribute cash flows to the Company perpetually. These indefinite-lived intangible assets are not amortized, but are assessed for impairment annually and evaluated annually to determine whether the indefinite useful life is appropriate. As part of our impairment test, we first assess qualitative factors to determine whether it is more likely than not that the indefinite-lived intangible asset is impaired. If further testing is necessary, we compare the estimated fair value of our indefinite-lived intangible asset with its book value. If the carrying amount of the indefinite-lived intangible asset exceeds its fair value, as determined by its discounted cash flows, an impairment loss is recognized in an amount equal to that excess. For the years ended December 31, 2015 and 2014, the Company did not recognize any impairment charges for its indefinite-lived intangible assets.

## 6. Notes Payable

### *Line of Credit*

On November 9, 2011, the Company entered into a Loan and Security Agreement with PMC Financial Services Group, LLC (PMC), which was amended and extended for two years on December 5, 2014, that provides a \$6,000,000 revolving line of credit. The Amended Agreement extends and amends the Revolving Loan and Term Loan (see discussion below) and adds a new Capital Expansion Loan (the "Capex Loan") (see discussion below). At March 31, 2016 and December 31, 2015, the aggregate amount outstanding under the line of credit was \$4,250,000 and \$4,443,000 respectively.

The revolving line of credit is based on 85% of accounts receivable and 60% of eligible inventory and is secured by substantially all of the Company's assets. The interest rate on the Revolving Loan was the prime rate plus .35% (9% at March 31, 2016). However, the interest rate has been adjusted as described below in term loans. The monthly management fee is .45% of the average monthly loan balance. As of March 31, 2016, the Company had a maximum borrowing availability of \$1,750,000 under the line of credit agreement.

The line of credit matures on December 5, 2016 and is subject to a 1% prepayment penalty for prepayment prior to the first anniversary of the effective date.

### *Term Loans*

The Company has the following term loans outstanding with PMC Financial Services Corporation;

|                    | March 31,<br>2016 | December<br>31, 2015 |
|--------------------|-------------------|----------------------|
| Term Loans         | \$3,000,000       | \$3,000,000          |
| Valuation discount | (106,000 )        | (132,000 )           |
| Long term portion  | \$2,894,000       | \$2,868,000          |

In connection with the Loan and Security Agreement with PMC, the Company entered into a Term Loan. The loan was \$750,000, and was secured by all of the unencumbered assets of the Company. Effective December 5, 2014 the Term Loan's outstanding principal balance was increased to \$1,500,000 and the annual interest rate was revised to prime plus 5.75% (currently 9%) subject to adjustment as described below.

Effective September 1, 2015 the Company entered into an additional Term Loan with a principal balance of \$1,500,000 at prime plus 11.60% (currently 14.85%) with PMC. As of March 31, 2016 and December 31, 2015, the aggregate amount under the Term Loans outstanding was \$3,000,000.

The interest rate on the line of credit and Term loans described above were modified on September 1, 2015 and are subject to adjustment as follows:

Under the new conditions, the rate charge will be calculated on a sliding scale based on the trailing 6 month EBITDA. If the EBITDA measuring point stays below \$1,000,000 where it is now, the rate will rise to 12% from the current rate of 9%. If EBITDA rises to \$1,500,000 then the rate will be reduced to 9%.

Notwithstanding the other borrowing terms above, if Excess Borrowing Availability under the \$6 million Revolving line of credit remains more than \$1,500,000 at all times during the preceding month (currently Reed's Borrowing Availability is zero) the Interest Rate shall remain unchanged for the asset based lending that includes the Revolving working capital loan, CAPEX capital improvement loan and Term Loan A. The six month Term Loan B rates will remain the same at 14.85%.

On November 9, 2015, the Company completed a restructuring of Term Loans with PMC. The aggregated amount of the principal for affected term loans is \$3,000,000. Under the new agreement, the maturity of both loans will be due in lump sum on April 1, 2017 under the same rates and conditions as before. In connection with the agreement, the Company granted PMC 125,000 warrants at an exercise price of \$4.50 per share with a term of five years and six months. The 125,000 warrants were valued at \$141,000 using the Black Scholes Merton option pricing model and

were recorded as a valuation discount. The following assumptions were made in valuing the 125,000 warrants; term of 5.5 years, volatility of 56.04%, expected dividends 0% and discount rate of 0.68%. The warrants value of \$141,000 is being amortized over the remaining 16 months of the term loans. During the three months ending March 31, 2016, \$26,000 of valuation discount was amortized resulting in an unamortized balance of \$106,000 at March 31, 2016.

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**Capital Expansion (“CAPEX”) Loan**

In connection with the loan and security agreement with PMC, the Company entered into a CAPEX loan in the aggregate outstanding amount not to exceed \$3,000,000. The CAPEX loan will finance new asset purchases for modernization and improvement of the beverage bottling equipment in the Los Angeles plant. Interest only on the CAPEX loan shall be paid from time to time until the end of each fiscal quarter, at which time the principal amounts of each outstanding CAPEX loan will be aggregated and repaid in 48 equal monthly installments of principal plus accrued but unpaid interest beginning July 31, 2016, or if earlier, the revolver maturity of December 2016. The interest rate on the CAPEX loan is the prime rate plus 5.75% (9.25% at March 31, 2016). At March 31, 2016 and December 31, 2015, the balance on the CAPEX loan balance was \$2,237,000 and \$1,883,000 respectively and as of March 31, 2016, the Company had future borrowing availability of \$908,000. On June 30, 2016, the loan funding will close and the Company will begin repayments in July, 2016.

In conjunction with this loan the Company has placed equipment with a cost of \$341,000 at a co-packing facility to enable the co-packer to manufacture our products. Should the Company be unable to secure access to the equipment in the event of failure of the co-packer, the amount will become due and payable by the Company immediately.

**7. Obligations under Capital Leases**

The Company leases equipment for its brewery operations with an aggregate value of \$944,000 under six non-cancelable capital leases. Most of the leases are personally guaranteed by the Company’s chief executive officer. Monthly payments range from \$341 to \$10,441 per month, including interest, at interest rates ranging from 6.51% to 17.31% per annum. At March 31, 2016, monthly payments under these leases aggregated \$16,000. The leases expire at various dates through 2020.

Future minimum lease payments under capital leases are as follows:

| <b>Years Ending December 31,</b>            |           |
|---|-----------|
| 2016  | \$168,000 |
| 2017  | 213,000   |
| 2018  | 217,000   |
| 2019  | 169,000   |
| 2020  | 49,000    |
| Total payments                              | 816,000   |
| Less: Amount representing interest          | (129,000) |
| Present value of net minimum lease payments | 687,000   |

|                       |           |
|-----------------------|-----------|
| Less: Current portion | (151,000) |
| Non-current portion   | \$536,000 |

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**8. Long-term Financing Obligation**

On June 15, 2009, the Company closed escrow on the sale of its two buildings and its brewery equipment and concurrently entered into a long-term lease agreement for the same property and equipment. In connection with the lease the Company has the option to repurchase the buildings and brewery equipment from 12 months after the commencement date to the end of the lease term at the greater of the fair market value or an agreed upon amount. Since the lease contains a buyback provision and other related terms, the Company determined it had continuing involvement that did not warrant the recognition of a sale; therefore, the transaction has been accounted for as a long-term financing. The proceeds from the sale, net of transaction costs, have been recorded as a financing obligation in the amount of \$3,056,000. Monthly payments under the financing agreement are recorded as interest expense and a reduction in the financing obligation at an implicit rate of 9.9%. The financing obligation was personally guaranteed up to a limit of \$150,000 by the principal shareholder and Chief Executive Officer, Christopher J. Reed.

In connection with the financing obligation, the Company issued an aggregate of 400,000 warrants to purchase its common stock at \$1.20 per share for five years. The 400,000 warrants were valued at \$752,000 and reflected as a debt discount, using the Black Scholes Merton option pricing model. The following assumptions were utilized in valuing the 400,000 warrants: strike price of \$2.10 to \$2.25; term of 5 years; volatility of 91.36% to 110.9%; expected dividends 0%; and discount rate of 2.15% to 2.20%. The 400,000 warrants were recorded as valuation discount and are being amortized over 15 years, the term of the purchase option.

Effective October 1, 2014, the Company executed Amendment #1 to the Long-term Financing Obligation. In exchange for a release from the \$150,000 personal guarantee by the principal shareholder and Chief Executive Office, and a release of the brewery equipment which was collateral for the lease agreement, the Company issued 200,000 warrants to purchase its common stock for \$5.60 per share with a term of five years. The 200,000 warrants were valued at \$584,000 using the Black Scholes Merton option pricing model and were recorded as a valuation discount. The following assumptions were made in valuing the 200,000 warrants; term of 5 years, volatility of 59.53%, expected dividends 0% and discount rate of 1.25%. The warrants value of \$584,000 is being amortized over the remaining term of the purchase option. Amortization of valuation discount was \$28,000 and \$14,000 during the three months ended March 31, 2016 and 2015.

Long term financing obligation is comprised of the following as of:

|                      | March 31,<br>2016 | December<br>31, 2015 |
|----------------------|-------------------|----------------------|
| Financing obligation | \$2,501,000       | 2,538,000            |
| Valuation discount   | (907,000 )        | (935,000 )           |
|                      | 1,594,000         | 1,603,000            |
| Less current portion | (167,000 )        | (160,000 )           |

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Long term financing obligation \$1,427,000 1,443,000

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## 9. Stock Based Activity

### Stock Options

Stock options granted under our equity incentive plans generally vest over 3 years from the date of grant, at 33% per year or over 4 years at 25% per year and expire 5 years from the date of grant. The following table summarizes stock option activity for the three months ended March 31, 2016:

|                                | Shares    | Weighted-<br>Average<br>Exercise<br>Price | Weighted-<br>Average<br>Remaining<br>Contractual<br>Terms<br>(Years) | Aggregate<br>Intrinsic<br>Value |
|--------------------------------|-----------|---|--|---------------------------------|
| Outstanding at January 1, 2016 | 980,000   | \$ 4.51                                   |  |                                 |
| Granted                        | 0         |   |  |                                 |
| Exercised                      | (15,000 ) | \$ 2.43                                   |  |                                 |
| Forfeited or expired           | 0         |   |  |                                 |
| Outstanding at March 31, 2016  | 965,000   | \$ 4.21                                   |  | \$ 374,000                      |
| Exercisable at March 31, 2016  | 411,333   |   |  | \$ 354,000                      |

During the three months ended March 31, 2016, the Company did not grant any stock options to any employee or other party.

The aggregate intrinsic value was calculated as the difference between the closing market price, which was \$4.67, and the exercise price of the Company's stock options as of March 31, 2016. Stock-based compensation recognized on the Company's statement of operations for the three months ended March 31, 2016 and 2015 was \$169,000 and \$212,000, respectively. During the three months ended March 31, 2016, the Company issued 7,211 shares of the Company's common stock upon exercise of 15,000 stock options on a cashless basis.

### Stock Warrants

| Shares | Weighted-<br>Average | Weighted-<br>Average | Aggregate<br>Intrinsic |
|--------|----------------------|----------------------|------------------------|
|--------|----------------------|----------------------|------------------------|

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|                                |         | Exercise<br>Price | Remaining<br>Contractual<br>Terms<br>(Years) | Value     |
|--------------------------------|---------|-------------------|--|-----------|
| Outstanding at January 1, 2016 | 341,261 | \$ 3.74           |  |           |
| Granted                        |         |                   |  |           |
| Exercised                      | 16,260  | \$ 2.77           |  |           |
| Forfeited or expired           | 1       |                   |  |           |
| Outstanding at March 31, 2016  | 325,000 | \$ 5.18           |  | \$ 21,250 |
| Exercisable at March 31, 2016  | 200,000 | \$ 5.60           |  | \$ 0      |

The intrinsic value was calculated as the difference between the closing market price, which was \$4.67, and the exercise price of the Company's warrants common stock, as of March 31, 2016.

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## 10. Subsequent Events

On April 29, 2016 the Board of Directors approved an extension of the Line of Credit (see Note 6) with PMC Financial Services Group, LLC (PMC) to include prepaid inventory that normally would be excluded from the lending base. The Line of Credit maximum of \$6,000,000 and the rates remained unchanged.

In consideration, the Company will issue to PMC 10,000 warrants at a strike price of \$4.50 to be accounted for as a financing cost in the second quarter of 2016.

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## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

*The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our financial statements and the related notes appearing elsewhere in this report. This discussion and analysis may contain forward-looking statements based on assumptions about our future business.*

### Overview

The results for our first quarter of 2016 reflect the operations meeting demand, margins stabilizing and continued cost containment. We experienced decreasing resistance from long time loyal retailers in restocking our full line of beverage offerings. Our ginger products grew year over year and our flagship Virgils flavor, root beer, continued its growth. We believe that as all of our customers realize our commitment to keeping them in stock for our core beverages, that the retailers will begin repurchasing items as they have in the past.

We have included below detailed information on our products from a sales perspective with the associated cost of goods sold and production. The information is presented in the industry standard of eight ounce serving equivalents.

We continued work on upgrading our Los Angeles plant equipment in 2016 and on increasing its capacity. The Idle Plant costs decreased by \$395,000 over the same period last year even while we begin installation of the new equipment. The new plant will provide the Company capacity to expand volume without incurring time delays or cost increases and will continue the downward trend in freight costs.

Cost containment activity led to delivery expense returning to historic norms of 8.5% in the period as compared 11.0% in the same period in 2015. Further cost containment efforts led to a reductions in sales expenses of \$152,000 over the same period in the prior year, while G&A expenses increased by \$291,000 with the largest increase due to bad debt expense.

## Results of Operations

The following table sets forth key statistics for the three months ended March 31, 2016 and 2015, respectively.

|  | Three Months Ended |              | Pct.<br>Change |
|--|--------------------|--------------|----------------|
|  | March 31,<br>2016  | 2015         |                |
| Gross sales, net of discounts & returns *        | \$10,777,000       | \$11,351,000 | (5.0% )        |
| Less: Promotional and other allowances**         | 773,000            | 679,000      | 13.8%          |
| Net sales  | 10,004,000         | 10,672,000   | (6.3% )        |
| Cost of tangible goods sold                      | 7,838,000          | 6,745,000    |                |
| <i>As a percentage of:</i>                       |                    |              |                |
| <i>Gross sales</i>                               | 73                 | % 59         | %              |
| <i>Net sales</i>                                 | 78                 | % 63         | %              |
| Cost of goods sold – idle capacity               | 273,000            | 668,000      | (59.1% )       |
| <i>As a percentage of net sales</i>              | 3                  | % 6          | %              |
| Gross profit                                     | \$1,893,000        | 3,259,000    | (41.9% )       |
| Gross profit margin as a percentage of net sales | 18.9               | % 30.5       | %              |
| Expenses   |                    |              |                |
| Delivery and handling                            | \$849,000          | \$1,169,000  | (27.4%)        |
| Selling and marketing                            | 1,041,000          | 1,193,000    | (12.7%)        |
| General and administrative                       | 1,205,000          | 915,000      | 9.4%           |
| Total operating expenses                         | 3,095,000          | 3,277,000    | (5.5%)         |
| Income from operations                           | (\$1,202,000 )     | (\$18,000 )  |                |
| Interest Expense                                 | (378,000 )         | (254,000 )   |                |
| Net loss to stockholders                         | (\$1,580,000 )     | (\$272,000 ) |                |
| Shares outstanding                               | 13,184,000         | 13,068,000   |                |
| Net income (loss) per share                      | (\$0.12 )          | (\$0.02 )    |                |

\* *Gross sales is used internally by management as an indicator of and to monitor operating performance, including sales performance of particular products, salesperson performance, product growth or declines and overall Company performance. The use of gross sales allows evaluation of sales performance before the effect of any promotional items, which can mask certain performance issues. We therefore believe that the presentation of gross sales provides a useful measure of our operating performance. Gross sales is not a measure that is recognized under GAAP and*

*should not be considered as an alternative to net sales, which is determined in accordance with GAAP, and should not be used alone as an indicator of operating performance in place of net sales. Additionally, gross sales may not be comparable to similarly titled measures used by other companies, as gross sales has been defined by our internal reporting practices. In addition, gross sales may not be realized in the form of cash receipts as promotional payments and allowances may be deducted from payments received from certain customers.*

*\*\* Although the expenditures described in this line item are determined in accordance with GAAP and meet GAAP requirements, the disclosure thereof does not conform with GAAP presentation requirements. Additionally, our definition of promotional and other allowances may not be comparable to similar items presented by other companies. Promotional and other allowances primarily include consideration given to the Company's distributors or retail customers including, but not limited to the following: (i) reimbursements given to the Company's distributors for agreed portions of their promotional spend with retailers, including slotting, shelf space allowances and other fees for both new and existing products; (ii) the Company's agreed share of fees given to distributors and/or directly to retailers for in-store marketing and promotional activities; (iii) the Company's agreed share of slotting, shelf space allowances and other fees given directly to retailers; (iv) incentives given to the Company's distributors and/or retailers for achieving or exceeding certain predetermined sales goals; and (v) discounted or free products. The presentation of promotional and other allowances facilitates an evaluation of their impact on the determination of net sales and the spending levels incurred or correlated with such sales. Promotional and other allowances constitute a material portion of our marketing activities. The Company's promotional allowance programs with its numerous distributors and/or retailers are executed through separate agreements in the ordinary course of business. These agreements generally provide for one or more of the arrangements described above and are of varying durations, ranging from one week to one year.*



*Three months ended March 31, 2016 Compared to Three months ended March 31, 2015***Metrics**

|   | <b>8 Ounce Volume</b> |             |               | <b>8 Ounce Gross Sales Revenue</b> |              |               |   |
|---|-----------------------|-------------|---------------|------------------------------------|--------------|---------------|---|
|   | <b>2016</b>           | <b>2015</b> | <b>Change</b> | <b>2016</b>                        | <b>2015</b>  | <b>Change</b> |   |
| <b>Gross Sales</b>                            |                       |             |               |                                    |              |               |   |
| Reeds Beverages                               | 489,688               | 464,932     | 5.3           | % \$5,457,510                      | \$5,170,413  | 5.6           | % |
| Virgils                                       | 281,791               | 318,337     | -11.5         | % 3,352,837                        | 3,773,642    | -11.2         | % |
| Kombucha                                      | 33,296                | 36,987      | -10.0         | % 796,429                          | 963,423      | -17.3         | % |
| All Other Reeds Beverages                     | 14,827                | 21,031      | -29.5         | % 199,898                          | 289,639      | -31.0         | % |
| Private Label                                 | 52,042                | 72,599      | -28.3         | % 546,444                          | 533,476      | 2.4           | % |
| Reeds Candy                                   |                       |             |               | 381,549                            | 548,434      | -30.4         | % |
| All Other Non-Beverages                       |                       |             |               | 44,076                             | 72,126       | -38.9         | % |
| <b>Total Gross Sales</b>                      | 871,643               | 913,887     | -4.6          | % \$10,778,744                     | \$11,351,152 | -5.0          | % |
| Sales Discounts Unallocated to Specific SKU's |                       |             | (774,358)     | (679,156 )                         | 14.0         | %             |   |
| <b>Net Sales</b>                              | 871,643               | 913,887     | -4.6          | % \$10,004,386                     | \$10,671,996 | -6.3          | % |
| <b>Gross Sales per 8 ounce</b>                |                       |             |               | \$12.37                            | \$12.42      | -0.4          | % |
| <b>Net Sales per 8 ounce</b>                  |                       |             |               | \$11.48                            | \$11.68      | -1.7          | % |
| <b>Cost of Goods Sold</b>                     |                       |             |               |                                    |              |               |   |
| Reeds Beverages                               | 489,688               | 464,932     | 5.3           | % \$3,617,098                      | \$3,371,984  | 7.3           | % |
| Virgils                                       | 281,791               | 318,337     | -11.5         | % 2,140,341                        | 2,082,252    | 2.8           | % |
| Kombucha                                      | 33,296                | 36,987      | -10.0         | % 432,218                          | 488,267      | -11.5         | % |
| All Other Reeds Beverages                     | 14,827                | 21,031      | -29.5         | % 138,397                          | 168,308      | -17.8         | % |
| Private Label                                 | 52,042                | 72,599      | -28.3         | % 414,226                          | 310,204      | 33.5          | % |
| Costs Unallocated to Specific SKU's           |                       |             |               | 705,211                            | (97,998 )    | 819.6         | % |
| Reeds Candy                                   |                       |             |               | 281,732                            | 341,023      | -17.4         | % |
| All Other Non-Beverages                       |                       |             |               | 108,575                            | 81,493       | 33.2          | % |
| <b>Cost of Goods Sold</b>                     | 871,643               | 913,887     | -4.6          | % \$7,837,800                      | \$6,745,534  | 16.2          | % |
| <b>Additional Cost of Goods Produced</b>      |                       |             |               |                                    |              |               |   |
| Idle Plant                                    |                       |             |               | 273,594                            | 667,822      | -59.0         | % |
| Cost of Goods produced and Sold               |                       |             |               | 8,111,394                          | 7,413,356    | 9.4           | % |
| <b>Cost of Goods Sold per 8 ounce</b>         |                       |             |               | \$8.99                             | \$7.38       | 21.8          | % |
| <b>Cost of Goods Produced Per 8 ounce</b>     |                       |             |               | \$9.31                             | \$8.11       | 14.7          | % |
| <b>Gross Margin including Idle Plant</b>      |                       |             |               | 18.9                               | % 30.5       | % -38.0       | % |

**Sales**

Gross sales decreased in 2016 to \$10,777,000 from \$11,351,000 in the same period in 2015. On an 8 ounce serving basis, net sales decreased \$0.05 per 8 ounce serving or 0.4% year over year. The main driver of the decrease was a 11.2% decrease in Virgils as retailers were slower than expected in replenishing their shelves with a the full line of Virgil's stock keeping units (SKUs).

Net sales decreased in 2016 to \$10,004,000 from \$10,672,000 in the same period in 2015. On an 8 ounce serving basis, net sales decreased \$0.20 per 8 ounce serving or 1.7% year over year. The main driver of the decrease was a 13.7% increase in promotional costs combined with a lower sales volume. Candy sales continued to be negatively impacted by the California lawsuit regarding specific resourcing locations in the first quarter. Candy sales were down \$59,000 over the same period in 2015. A new supplier has been identified and sales of the affected lines will begin again in late second quarter.

## Cost of Goods Sold and Produced

Cost of tangible goods sold consists of the costs of raw materials utilized in the manufacture of products, co-packing fees, repacking fees, in-bound freight charges, inventory adjustments and internal transfer costs. Idle capacity consists of direct production costs of our Los Angeles plant in excess of charges allocated to our finished goods in production. Plant costs include labor costs, production supplies, repairs and maintenance, and depreciation. Our charges for labor and overhead allocated to our finished goods are determined on a market cost basis, which is lower than our actual costs incurred. Plant costs in excess of production allocations are expensed in the period incurred rather than added to the cost of finished goods produced.

Cost of goods *sold* increased in 2016 to \$7,838,000 from \$6,745,000 in the same period in 2015. On an 8 ounce serving basis, cost of goods *sold* increased \$1.61 per 8 ounce serving or 21.8% year over year. The main driver of an increase in costs unallocated to specific SKUs was comprised primarily of inventory adjustments.

Cost of goods *produced* increased in 2016 to \$8,111,000 from \$7,413,000 in the same period in 2015. On an 8 ounce serving basis, cost of goods *sold* increased \$1.20 per 8 ounce serving or 14.7% year over year. The main driver of the increase is the costs unallocated to specific SKUs in the cost of goods *sold* discussed earlier. The increase was partially offset by an improvement in LA Plant Idle Plant costs. Idle Plant costs decreased to \$273,000 from \$668,000 over the same period in 2015.

## Gross Margin

Gross margin declined to 18.9% from 30.5% as costs unallocated to specific SKU's in sales increased to \$774,000 from \$679,000 or \$95,000 on a lower volume base. In addition, costs unallocated to specific SKU's in production also increased to \$705,000 from (\$98,000) or \$803,000. These increases are primarily due to sales discounts and inventory adjustments respectively.

## Delivery and Handling Expenses

Delivery and handling expenses consist of delivery costs to customers and warehouse costs incurred for handling our finished goods after production. Delivery and handling costs decreased by 27.4% to \$849,000 in the three months ended March 31, 2016 compared to \$1,169,000 over the same period in 2015. The decrease is due to lower sales volume of 4.6% and a rate and utilization mix reduction of 22.5%. As percentage of net sales, the decrease to 8.5% for the first quarter of 2016 is comparable to historic rates.

### **Selling and Marketing Expenses**

Selling and marketing expenses consist primarily of direct charges for staff compensation costs, advertising, sales promotion, marketing and trade shows. Selling and marketing costs decreased \$152,000 overall to \$1,041,000 in the three months ended March 31, 2016 from \$1,193,000 in 2015. This decrease over last year is primarily due to reductions in public relations, advertising, promotions, professional fees and brokers fees. Employee compensation, travel and entertainment and trade show expenses were flat vs. same period in prior year.

### **General and Administrative Expenses**

General and administrative expenses consist primarily of the cost of executive, administrative, and finance personnel, as well as professional fees. General and administrative expenses increased \$291,000 to \$1,205,000 during the three months ended March 31, 2016 from \$915,000 in the same period of 2015. The increase was due to increases in bad debt expense of \$120,000, compensation related expenses of \$72,000 amortization of certain fees of \$40,000, increased filing fees of \$26,000 and upgrades to IT functions of \$17,000.

### **Loss from Operations**

The loss from operations was (\$1,202,000) in the three months ended March 31, 2016, as compared to a loss of \$(17,000) in the same period of 2015. The loss was comprised of decreases in sales volume of \$668,000, cost of goods sold increases of \$1,094,000 that were partially offset by lower idle plant costs of \$395,000 and lower expenses of \$180,000.

### **Interest Expense**

Interest expense and bank related charges increased \$124,000 to \$378,000 in the three months ended March 31, 2016, compared to expenses of \$254,000 in the same period of 2015. The increase is primarily due to increased borrowing on our revolving line of credit, an additional term loan and new capital expansion loan.

Recap of current quarterly interest and bank fees.

**Quarterly Interest**

|                           |           |       |
|---------------------------|-----------|-------|
| Working Capital           | \$151,772 | 15.4% |
| Capex                     | 49,134    | 9.4 % |
| Term Loan*                | 89,812    | 12.0% |
| Equipment Leases          | 16,317    | 10.6% |
| Equipment Sale Leaseback* | 62,331    | 9.9 % |
| Bank Fees                 | 8,364     |       |
|                           | \$377,730 | 12.2% |

\* Does not include amortized fees

**Modified EBITDA**

The Company defines modified EBITDA (a non-GAAP measurement) as net loss before interest, taxes, depreciation and amortization, and non-cash expense for securities. Other companies may calculate modified EBITDA differently. Management believes that the presentation of modified EBITDA provides a measure of performance that approximates cash flow before interest expense, and is meaningful to investors.

**MODIFIED EBITDA SCHEDULE**

|  | <b>Three Months Ended</b> |             |
|--|---------------------------|-------------|
|  | <b>March 31,</b>          |             |
|  | <b>2016</b>               | <b>2015</b> |
| Net loss                               | \$(1,580,000)             | \$(271,000) |
| Modified EBITDA adjustments:           |                           |             |
| Depreciation and amortization          | 261,000                   | 213,000     |
| Interest expense                       | 378,000                   | 200,000     |
| Stock option compensation              | 169,000                   | 212,000     |
| Total EBITDA adjustments               | 808,000                   | 625,000     |
| Modified EBITDA income from operations | \$(772,000)               | \$354,000   |

The \$1,126,000 decrease in modified EBITDA for the three months resulted from the increases in the EBITDA adjustments totaling \$183,000 for the quarter ended March 31, 2016 plus the \$1,309,000 increase in the net loss. The \$32,000 increase in Depreciation and amortization was due to the raised asset base, the increase in Interest expense was due to the increased loan balances and Stock option compensation decrease was due to no new options granted.

**Liquidity and Capital Resources**

As of March 31, 2016, we had a stockholders deficit of \$581,000 and working capital deficit of \$645,000 compared to stockholders equity of \$785,000 and working capital of \$730,000 at December 31, 2015.

Our cash and cash equivalents at March 31, 2016 decreased by \$1,168,000 to \$648,000 at March 31, 2016 compared to \$1,816,000 at December 31, 2015. Net cash used in operating activities of \$755,000 for the three months ended March 31, 2016. Investing activities included \$186,000 used to purchase machinery in the Los Angeles plant. A total

of \$227,000 in financing activities was used pay down leases and the line of credit.

Our Loan and Security Agreement with PMC Financial Services Group, LLC provides a \$6 million revolving line of credit and a \$1,500,000 term loan and a new \$3 million Capital Expansion loan. The revolving line of credit is based on 85% of eligible accounts receivable and 50% of eligible inventory. Effective December 5, 2014 the interest rate was revised to prime plus 5.75% which is currently 9% on all three loans. At March 31, 2016, the revolving line of credit balance was \$4,250,000 the term loan balance was \$3,000,000 and the Capital Expansion loan balance was \$2,237,000.

On April 25, 2016, PMC Financial Services Group, LLC modified the \$6 million revolving line of credit to include certain prepaid inventory in the definition of inventory. (See Note 10).

We believe that the Company currently has the necessary working capital to support existing operations until the revolver becomes due in December of this year. Consistent with past refinancing practices regarding the Line of Credit, the Company believes that we will be successful in renewing the Line of Credit for another time frame similar to the past for a two year time frame. There are no assurances that this refinancing will be completed. Our primary capital source will be positive cash flow from operations. If our sales goals do not materialize as planned, we believe that the Company can reduce its operating costs and can be managed to maintain positive cash flow from operations. Historically, we have financed our operations primarily through private sales of common stock, preferred stock, convertible debt, a line of credit from a financial institution and cash generated from operations.

We may not generate sufficient revenues from product sales in the future to achieve profitable operations. If we are not able to achieve profitable operations at some point in the future, we eventually may have insufficient working capital to maintain our operations as we presently intend to conduct them or to fund our expansion and marketing and product development plans. In addition, our losses may increase in the future as we expand our manufacturing capabilities and fund our marketing plans and product development. These losses, among other things, have had and may continue to have an adverse effect on our working capital, total assets and stockholders' equity. If we are unable to achieve profitability, the market value of our common stock would decline and there would be a material adverse effect on our financial condition.

If we suffer losses from operations, our working capital may be insufficient to support our ability to expand our business operations as rapidly as we would deem necessary at any time, unless we are able to obtain additional financing. There can be no assurance that we will be able to obtain such financing on acceptable terms, or at all. If adequate funds are not available or are not available on acceptable terms, we may not be able to pursue our business objectives and would be required to reduce our level of operations, including reducing infrastructure, promotions, personnel and other operating expenses. These events could adversely affect our business, results of operations and financial condition. If adequate funds are not available or if they are not available on acceptable terms, our ability to fund the growth of our operations, take advantage of opportunities, develop products or services or otherwise respond to competitive pressures could be significantly limited.





## Critical Accounting Policies and Estimates

Our financial statements are prepared in accordance with accounting principles generally accepted in the United States of America, or GAAP. GAAP requires us to make estimates and assumptions that affect the reported amounts in our financial statements including various allowances and reserves for accounts receivable and inventories, the estimated lives of long-lived assets and trademarks and trademark licenses, as well as claims and contingencies arising out of litigation or other transactions that occur in the normal course of business. The following summarize our most significant accounting and reporting policies and practices:

*Revenue Recognition.* Revenue is recognized on the sale of a product when the product is shipped, which is when the risk of loss transfers to our customers, and collection of the receivable is reasonably assured. A product is not shipped without an order from the customer and credit acceptance procedures performed. The allowance for returns is regularly reviewed and adjusted by management based on historical trends of returned items. Amounts paid by customers for shipping and handling costs are included in sales. The Company reimburses its wholesalers and retailers for promotional discounts, samples and certain advertising and promotional activities used in the promotion of the Company's products. The accounting treatment for the reimbursements for samples and discounts to wholesalers results in a reduction in the net revenue line item. Reimbursements to wholesalers and retailers for certain advertising activities are included in selling and marketing expenses.

*Long-Lived Assets.* Our management regularly reviews property, equipment and other long-lived assets, including identifiable amortizing intangibles, for possible impairment. This review occurs quarterly or more frequently if events or changes in circumstances indicate the carrying amount of the asset may not be recoverable. If there is indication of impairment of property and equipment or amortizable intangible assets, then management prepares an estimate of future cash flows (undiscounted and without interest charges) expected to result from the use of the asset and its eventual disposition. If these cash flows are less than the carrying amount of the asset, an impairment loss is recognized to write down the asset to its estimated fair value. The fair value is estimated at the present value of the future cash flows discounted at a rate commensurate with management's estimates of the business risks. Quarterly, or earlier, if there is indication of impairment of identified intangible assets not subject to amortization, management compares the estimated fair value with the carrying amount of the asset. An impairment loss is recognized to write down the intangible asset to its fair value if it is less than the carrying amount. Preparation of estimated expected future cash flows is inherently subjective and is based on management's best estimate of assumptions concerning expected future conditions. No impairments were identified during the three months ended March 31, 2016.

Management believes that the accounting estimate related to impairment of our long lived assets, including our trademark license and trademarks, is a "critical accounting estimate" because: (1) it is highly susceptible to change from period to period because it requires management to estimate fair value, which is based on assumptions about cash flows and discount rates; and (2) the impact that recognizing an impairment would have on the assets reported on our balance sheet, as well as net income, could be material. Management's assumptions about cash flows and discount rates require significant judgment because actual revenues and expenses have fluctuated in the past and we expect they will continue to do so.

**Recent Accounting Pronouncements**

See Note 2 of the financial statements for a discussion of recent accounting pronouncements.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

A smaller reporting company is not required to provide the information required by this Item.

**Item 4. Controls and Procedures.**

*Evaluation of Disclosure Controls and Procedures*

Under the supervision and with the participation of our management, including our Chief Executive Officer and our Interim Chief Financial Officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Securities and Exchange Act of 1934 Rules 13a-15(f). Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of March 31, 2016.

*Changes in Internal Control Over Financial Reporting*

There have been no changes in the Company's internal control over financial reporting during the three months ended March 31, 2016 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## **PART II – OTHER INFORMATION**

### **Item 1. Legal Proceedings**

We are subject to various legal proceedings from time to time in the ordinary course of business, none of which are required to be disclosed under this Item 1.

### **Item 1A. Risk Factors**

A smaller reporting company is not required to provide the information required by this Item.

### **Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None.

### **Item 3. Defaults Upon Senior Securities**

None.

### **Item 4. Mine Safety Disclosures**

Not applicable.

### **Item 5. Other Information**

**Item 6. Exhibits**

Exhibit No. Description

- 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.\*
- 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.\*
- 32.1 Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.\*
- 32.2 Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.\*

101.INS XBRL Instance Document\*

101.SCH XBRL Taxonomy Extension Schema Document\*

101.CAL XBRL Taxonomy Extension Calculation Linkbase Document\*

101.DEF XBRL Taxonomy Extension Definition Linkbase Document\*

101.LAB XBRL Taxonomy Extension Label Linkbase Document\*

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document\*

\*filed herewith

In accordance with SEC Release 33-8238, Exhibits 32.1 and 32.2 are being furnished and not filed.

Furnished herewith, XBRL (Extensive Business Reporting Language) information is furnished and not filed or a part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Reed's, Inc.  
(Registrant)

Date: May 11, 2016 */s/ Christopher J. Reed*  
Christopher J. Reed  
President and Chief Executive Officer  
(Principal Executive Officer)

Date: May 11, 2016 */s/ Daniel V. Miles*  
Daniel V. Miles  
Chief Financial Officer  
(Principal Financial Officer)

