

REED'S, INC.
Form 10-K
April 24, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2016

Commission File Number 000-32501

REED'S, INC.

(Exact name of registrant as specified in its charter)

Delaware	35-2177773
State or other jurisdiction of incorporation or organization	I.R.S. Employer Identification Number

13000 South Spring Street	
Los Angeles, California	90061
Address of principal executive offices	Zip Code

(310) 217-9400

Registrant's telephone number, including area code

Securities registered pursuant to Section 12(b) of the Act:

Title of Class	Name of each exchange where registered
Common Stock, \$.0001 par value per share	NYSE MKT

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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 definition of "large accelerated filer," "accelerated filer" and "small reporting company" in Rule 12b-2 of the Exchange Act.

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

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates (excluding voting shares held by officers and directors) as of June 30, 2016 was \$28,320,000.

13,982,230 common shares, \$.001 par value, were outstanding on December 31, 2016.

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CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS AND INFORMATION

This Annual Report on Form 10-K (“Annual Report”), the other reports, statements, and information that we have previously filed or that we may subsequently file with the Securities and Exchange Commission (“SEC”) and public announcements that we have previously made or may subsequently make include, may include, incorporate by reference or may incorporate by reference certain statements that may be deemed to be forward-looking statements. The forward-looking statements included or incorporated by reference in this Annual Report and those reports, statements, information and announcements address activities, events or developments that Reed’s, Inc. (hereinafter referred to as “we,” “us,” “our” or “Reed’s”) expects or anticipates will or may occur in the future. Any statements in this document about expectations, beliefs, plans, objectives, assumptions or future events or performance are not historical facts and are forward-looking statements. These statements are often, but not always, made through the use of words or phrases such as “may,” “should,” “could,” “predict,” “potential,” “believe,” “will likely result,” “expect,” “will continue,” “a,” “seek,” “estimate,” “intend,” “plan,” “projection,” “would” and “outlook” and similar expressions. Accordingly, these statements involve estimates, assumptions and uncertainties, which could cause actual results to differ materially from those expressed in them. Any forward-looking statements are qualified in their entirety by reference to the factors discussed throughout this document. All forward-looking statements concerning economic conditions, rates of growth, rates of income or values as may be included in this document are based on information available to us on the dates noted, and we assume no obligation to update any such forward-looking statements.

The risk factors referred to in this Annual Report could cause actual results or outcomes to differ materially from those expressed in any forward-looking statements made by us, and you should not place undue reliance on any such forward-looking statements. Any forward-looking statement speaks only as of the date on which it is made and we do not undertake any obligation to update any forward-looking statement or statements to reflect events or circumstances after the date on which such statement is made or to reflect the occurrence of unanticipated events. New factors emerge from time to time, and it is not possible for us to predict which will arise. In addition, we cannot assess the impact of each factor on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements.

Management cautions that these statements are qualified by their terms and/or important factors, many of which are outside of our control, involve a number of risks, uncertainties and other factors that could cause actual results and events to differ materially from the statements made, including, but not limited to, the following risk factors.

Our ability to generate sufficient cash flow to support capital expansion plans and general operating activities,

Decreased demand for our products resulting from changes in consumer preferences,

Competitive products and pricing pressures and our ability to gain or maintain its share of sales in the marketplace,

The introduction of new products,

Our being subject to a broad range of evolving federal, state and local laws and regulations including those regarding the labeling and safety of food products, establishing ingredient designations and standards of identity for certain foods, environmental protections, as well as worker health and safety. Changes in these laws and regulations could have a material effect on the way in which we produce and market our products and could result in increased costs,

Changes in the cost and availability of raw materials and the ability to maintain our supply arrangements and relationships and procure timely and/or adequate production of all or any of our products,

Our ability to penetrate new markets and maintain or expand existing markets,

Maintaining existing relationships and expanding the distributor network of our products,

The marketing efforts of distributors of our products, most of whom also distribute products that are competitive with our products,

Decisions by distributors, grocery chains, specialty chain stores, club stores and other customers to discontinue carrying all or any of our products that they are carrying at any time,

The availability and cost of capital to finance our working capital needs and growth plans,

The effectiveness of our advertising, marketing and promotional programs,

Changes in product category consumption,

Economic and political changes,

Consumer acceptance of new products, including taste test comparisons,

Possible recalls of our products,

Our ability to make suitable arrangements for the co-packing of any of our products, and

Our ability to find alternative copacking and production facilities for our Kombucha and Private Label products if our Los Angeles production facility is damaged by a disaster.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance, or achievements.

PART I

Item 1. Business

Background

We develop, manufacture, market and sell natural non-alcoholic carbonated soft drinks, Kombucha, candies and ice creams. We currently manufacture, license, market and sell several unique product lines:

Reed's Ginger Brews,

Virgil's Root Beer, Cream Sodas, Dr. Better and Real Cola, including ZERO diet sodas,

Culture Club Kombucha,

China Colas,

Reed's Ginger candy and other products,

Sonoma Sparkler and other juice based products.

We also have a private label business.

We sell our products throughout the US and in select international markets. We started in specialty gourmet and natural food stores and have moved more into mainstream over time. We estimate that our products are sold in well over 22,000 natural, conventional, drug, club and mass merchandise accounts in the US, with approximately 10,000 of those being mainstream supermarkets. We sell our products through a network of natural, gourmet and beer distributors and direct to certain large national retailers.

We produce and co-pack our beverage products in part at our facility in Los Angeles, California, known as the Brewery and at contracted co-packing facilities in Pennsylvania and Indiana. These co-pack facilities typically service the eastern half of the United States and nationally for certain products that we do not produce at The Brewery.

Key elements of our business strategy include:

increase our relationship with and sales to the approximately 15,000 supermarkets that carry our products in natural and mainstream and capture more of the 30,000 supermarkets nationwide,

expand our distribution network by adding regional direct store delivery (DSD's) and additional direct accounts,

stimulate consumer demand and awareness for our existing brands and products through promotions and advertising,

develop additional product flavors under our brands (brand extensions) and other new products, including specialty packaging and alternative uses for our products,

develop and produce private-label products for select customers,

lower our cost of sales for our products by gaining economies of scale in our purchasing, and

optimize the size and focus of our sales force to manage our relationships with distributors and retail outlets.

We create consumer demand for our products by:

supporting in-store sampling programs of our products, and

generating free press through public relations, and

advertising in store publications, and

maintaining a company website (www.reedsinc.com), and

active social media campaigns on facebook.com, twitter.com and youtube.com, and

participating in large public events as sponsors, and

in the recent past deployed a national television commercial on cable television networks.

Our principal executive offices are located at 13000 South Spring Street, Los Angeles, California 90061. Our telephone number is (310) 217-9400. Our Internet address is (www.reedsinc.com). Information contained on our website or that is accessible through our website should not be considered to be part of this Annual Report.

Historical Development

Reed's Original Ginger Brew created in 1987 by Christopher J. Reed, our founder, former Chief Executive Officer, and current Chief Innovation Officer was introduced to the market in Southern California stores in 1989. By 1990, we began marketing our products through United Natural Foods Inc. (UNFI) and other natural food distributors and moved our production to a larger facility in Boulder, Colorado.

In 1991, we incorporated our business operations in the state of Florida under the name of Original Beverage Corporation and moved all production to a co-pack facility in Pennsylvania. Throughout the 1990's, we continued to develop and launch new Ginger Brew varieties. Reed's Ginger Brews reached broad placement in natural and gourmet foods stores nationwide through UNFI and other major specialty, natural/gourmet and mainstream food and beverage distributors.

In 1997, we began licensing the products of China Cola and eventually acquired the rights to that product in 2000. In 1999, we purchased the Virgil's Root Beer brand from the Crowley Beverage Company. In 2000, we moved into an 18,000-square foot warehouse property, the Brewery, in Los Angeles, California, to house our west coast production and warehouse facility. The Brewery also serves as our principal executive offices. In 2001, pursuant to a reincorporation merger, we changed our state of incorporation to Delaware and also changed our name to "Reed's, Inc."

On December 12, 2006, we completed the sale of 2,000,000 shares of our common stock at an offering price of \$4.00 per share in our initial public offering. The public offering resulted in gross proceeds of \$8,000,000. Following the public offering, we expanded sales and operations dramatically, initially using a direct store delivery strategy in Southern California, along with other regional independent direct store distributors (DSD). The relationships with DSD's were supported by our sales staff. In 2007 we raised a net of \$7,600,000 in a private placement. We re-focused our sales strategy to eliminate company direct store delivery sales and to expand sales to DSD's and natural food distributors on a national level. We also started selling directly to supermarket grocery stores, which has become a significant portion of our business today.

We continually introduce new products and line extensions, such as our California Juice Company products in 2009, Virgil's diet line of ZERO beverages introduced in 2010 and Dr. Better and Light 55 Calories Extra Ginger Brew in 2011. We commenced offering private label products in 2010 and in 2012 we launched our Culture Club Kombucha line that has been expanded as sales have grown. In 2015 we launched Stronger Ginger Brew that contains 50% more fresh ginger than our best-selling Reed's Extra Ginger Brew.

Industry Overview

We offer natural premium carbonated soft drinks (CSD), which are a growing segment of the estimated \$10 billion CSD market nationwide. Within natural food store markets, we are among the top-selling natural soft drinks. This market is steady and growing. We also sell in major grocery chains nationally. The trend in grocery stores is to expand offerings of natural products and we have the scale and capability to develop these direct customer relationships.

Our Products

We primarily manufacture and sell beverages and candies or other ginger related products. We make all of our products using premium all-natural ingredients and our beverage line is GMO free. Our primary brands are our Reed's ginger brew line, our Virgil's line of root beer and our Culture Club Kombucha. Our candy products that include Reed's Crystallized Ginger Candy and Reed's Chews represent a lesser portion of revenues. We have sold ginger ice cream in prior years.

Reed's Ginger Brews

Ginger ale is the oldest known soft drink. Before modern soft drink technology existed, non-alcoholic beverages were brewed at home directly from herbs, roots, spices, and fruits. These handcrafted brews were highly prized for their taste and their tonic, health-giving properties. Reed's Ginger Brews are a revival of this lost art of home brewing sodas. We make them with care and attention to wholesomeness and quality, using the finest fresh herbs, roots, spices, and fruits.

We believe that Reed's Ginger Brews are unique in their kettle-brewed origin among all mass-marketed soft drinks. Reed's Ginger Brews contain between 8 and 39 grams of fresh ginger in every 12-ounce bottle. We use pure cane sugar as the sweetener. Our products differ from commercial soft drinks in three particular characteristics: sweetening, carbonation and coloring for greater adult appeal. Instead of using injected-based carbonation, we produce our carbonation naturally, through slower, beer-oriented techniques. This process produces smaller, longer lasting bubbles that do not dissipate rapidly when the bottle is opened. We do not add coloring. The color of our products comes naturally from herbs, fruits, spices, roots and juices and our beverages are GMO free.

In addition, since Reed's Ginger Brews are pasteurized, they do not require or contain any preservatives. In contrast, modern commercial soft drinks generally are produced using natural and artificial flavor concentrates prepared by flavor laboratories, tap water, and highly refined sweeteners. Typically, manufacturers make a centrally processed concentrate that will lend itself to a wide variety of situations, waters and filling systems. The final product is generally cold-filled and requires preservatives for stability. Colors are added that are either natural, although highly processed, or artificial.

Our Reed's line contains the following products:

Reed's Original Ginger Brew was our first creation and is a Jamaican recipe for homemade ginger ale using 17 grams of fresh ginger root, lemon, lime, honey, raw cane sugar, pineapple, herbs and spices. Reed's Original Ginger Brew is 20% fruit juice.

Reed's Premium Ginger Brew is sweetened only with honey and pineapple juice. Reed's Premium Ginger Brew is 20% fruit juice and contains 17 grams of fresh ginger root.

Reed's Raspberry Ginger Brew is brewed from 17 grams of fresh ginger root, raspberry juice and lime. Reed's Raspberry Ginger Brew is 20% raspberry juice.

Reed's Spiced Apple Brew uses 8 grams of fresh ginger root, the finest tart German apple juice and such apple pie spices as cinnamon, cloves and allspice. Reed's Spiced Apple Brew is 50% apple juice.

Reed's Cherry Ginger Brew is naturally brewed from 17 grams of fresh ginger root, cherry juice from concentrate and spices.

Reed's Light 55 Calories Extra Ginger Brew is a reduced calorie version of our top selling Reed's Extra Ginger Brew that was made possible by using Stevia. We use the same recipe of 26 grams of fresh ginger root, honey, pineapple, lemon and lime juices and exotic spices.

Reeds Extra Ginger Brew *is the same recipe as Original Ginger Brew, but has 26 grams of fresh ginger root for a stronger bite.*

Reeds Stronger Ginger Brew has 50% more ginger than the Extra Ginger Brew and has the highest ginger content of any of our beverage products.

Reed's Natural Energy Elixir is an energy drink infused with all natural ingredients designed to provide consumers with a healthy and natural boost to energy levels

Reed's Nausea Relief is based on our Ginger Brews with added B vitamins. Both ginger and B vitamins have been studied for their effectiveness in combating nausea.

Virgil's Root Beer

Virgil's is a premium craft root beer. We use all-natural ingredients, including filtered water, unbleached cane sugar, anise from Spain, licorice from France, bourbon vanilla from Madagascar, cinnamon from Sri Lanka, clove from Indonesia, wintergreen from China, sweet birch and molasses from the southern United States, nutmeg from Indonesia, pimento berry oil from Jamaica, balsam oil from Peru and cassia oil from China. We collect these ingredients worldwide and gather them together at the brewing and bottling facilities. We combine these ingredients under strict specifications and finally heat-pasteurize Virgil's Root Beer, to ensure quality. We sell Virgil's Root Beer in three packaging styles: 12-ounce bottles in a four-pack, a special swing-lid style pint bottle and a 5-liter self-tapping party keg. The Virgil's soda line is GMO free.

In addition to our Virgil's Root Beer, we also offer the following products under our Virgil's brand:

Virgil's Cream Soda,

Virgil's Orange Cream Soda,

Virgil's Black Cherry Cream Soda,

Virgil's Real Cola,

Virgil's Dr. Better,

Virgil's ZERO line, including Root Beer, Cream Soda, Real Cola, Dr. Better and Black Cherry Cream Soda. (Our ZERO line is naturally sweetened with Stevia), and

Reed's Culture Club Kombucha

We introduced our Culture Club Kombucha in 2012. Kombucha is a fermented tea that dates its origin back thousands of years. Among consumers, Kombucha is believed to have healing and cleansing characteristics. Sweetened tea is introduced to a "starter" culture and lightly fermented to produce an acetic drink. We make the finest Kombucha possible, using a combination of Oolong and Yerba Mate teas, spring water and a combination of ginger, organic juices and flavors. Initially, we produced four flavors, Goji Ginger, Hibiscus Ginger Grapefruit, Lemon Ginger Raspberry and Cranberry Ginger. We introduced four additional flavors in 2013, Pomegranate Ginger, Coconut Water Lime, Cabernet Grape, and Passion Mango Ginger.

Other Beverage Brands

We have other popular brands that currently have limited distribution, including China Cola, California Juice, Sonoma Sparkler and Flying Cauldron Butterscotch Beer. We are continually developing new brands and products.

Private Label Products

We design and manufacture drinks for private label customers in multiple facilities. We are experts in flavor development and in matching existing products in the market. We develop the recipe and may design the label and/or the bottle style. We do not private label any of our own branded product recipes.

Our private label products have been variations of any of our offerings. We develop the sources for glass and ingredients. We have a variety of packaging options, including swing-lid bottles, foil capsules and various label types. Our Los Angeles facility is certified as SQF level 2 compliant.

New Product Development

We are always working on ideas and products to continue expanding our Reed's Ginger Brews, Virgil's product line, Reed's Ginger Candy product lines and packaging styles. Current focus in our research is for reduced sugar offerings. Among the advantages of our self-operated Brewery are the flexibility to try innovative packaging and the capability to experiment with new product flavors at less cost to our operations or capital.

We have developed and are currently field testing an all-natural fountain offering. We expect the testing to be completed in 2017 and to begin distribution later in the year.

Our private label products require continual product development. We are able to be nimble and innovative, producing new products in a short amount of time.

Manufacture of Our Products

We produce our carbonated beverages in multiple facilities:

a facility in Los Angeles, California, known as The Brewery, at which we currently produce Kombucha, certain soda products and our private label products, and

two packing, or co-pack facilities in Pennsylvania and an additional co-packer in Indiana which supplies us with product we do not produce at The Brewery. The co-packer assembles our products and charges us a fee, generally by the case, for the products they produce.

We follow a “fill as needed” manufacturing model to the best of our ability and we have no significant backlog of orders. Substantially all of the raw materials used in the preparation, bottling and packaging of our products are purchased by us or by our contract packers in accordance with our specifications. Reed’s Crystallized Ginger is made to our specifications in Fiji. Reed’s Ginger Candy Chews are made and packed to our specifications in Indonesia.

Generally, we obtain the ingredients used in our products from domestic suppliers and each ingredient has several reliable suppliers. We have no major supply contracts with any of our suppliers. As a general policy, we pick ingredients in the development of our products that have multiple suppliers and are common ingredients. This provides a level of protection against a major supply constriction or calamity.

We believe that as we continue to grow, we will be able to keep up with increased production demands. The LA Brewery is nearing the completion of a major renovation that we believe will allow the Brewery to handle the entire West Coast business and to absorb significant increases in general sales. To the extent that any significant increase in business requires us to supplement or substitute our current co-packers, we are developing a pre-qualification for all prospective co-packers, so that there would not be a significant delay or interruption in fulfilling orders and delivery of our products. In addition, we do not believe that growth will result in any significant difficulty or delay in obtaining raw materials, ingredients or finished product that is repackaged at the Brewery.

Our Primary Markets

We target a niche in the estimated \$100 billion carbonated and non-carbonated soft drink markets in the US, Canada and International markets. Our brands are generally regarded as premium and natural, with upscale packaging and are loosely defined as the artisanal (craft), premium bottled carbonated soft drink category.

The soft drink industry is highly fragmented and the craft soft drink category consists of such competitors as, Henry Weinhardts, Thomas Kemper, Hansen's, Izze, Boylan and Jones Soda, to name a few. These brands have the advantage of being seen widely in the national market and being commonly known for years through well-funded ad campaigns. Despite our products having a relatively high price for an artisanal premium beverage product, minimal mass media advertising and a relatively small but growing presence in the mainstream market compared to many of our competitors, we believe that results to date demonstrate that Reed's Ginger Brews and Virgil's sodas are making strong inroads and market share gains against some of the larger brands in the market.

Kombucha is the largest growth segment of the functional beverage category of drinks and foods, including coconut water, yogurt and fresh juices. Among this broader category, the refrigerated juices and functional beverages segment grew by approximately \$200 million in 2012 to an estimated market of approximately \$600 million (50% growth), according to SPINS data. We are preparing an exciting relaunch of these brands in 2017 and expect to gain back a significant amount of lost space. Kombucha comprises the overwhelming majority share of this explosive growth and comprises most of the segment. It is generally believed that the segment will continue to expand at a strong rate over the next few years. Other functional drinks in this category are also expanding sales at healthy rates, primarily coconut water and fresh pressed juices. Consumer awareness and demand for functional drinks is increasing and we feel that Kombucha and other cultured drinks will be in the forefront of this expanding market category.

We sell the majority of our products in the natural food store, mainstream supermarket chains and foodservice locations, primarily in the United States and, to a lesser degree, in Canada and Europe.

Natural Food Stores

Our primary and historical marketing and distribution source of our products has been natural food and gourmet stores throughout the US. These stores include Whole Foods Market, Trader Joe's, Sprouts, The Fresh Market, Earth Fare, and New Seasons, just to name a few. Our brands are also sold in gourmet restaurants and deli's nationwide. With the advent of large natural food store chains and specialty merchants, the natural foods segment continues to grow each year, helping fuel the continued growth of our brands.

Mainstream Supermarkets and Retailers

We also sell our products to direct store delivery distributors (DSD) who specialize in distributing and selling our products directly to mainstream retail channels, natural foods, and specialty retail stores. Our brands are further sold directly to some retailers who require that we sell directly to their distribution centers since they have developed their own logistics capabilities. Examples of chains that fall into the “direct” category are retailers such as, Costco, Trader Joe’s, some Whole Foods Market Regions and Kroger.

Supermarkets, particularly supermarket chains and prominent local/regional chains, often impose slotting fees in order to gain shelf presence within their stores. These fees can be structured to be paid one-time only or in installments. We utilize selective slotting in supermarket chains throughout the US and to a lesser degree, in Canada. However, our local and national sales team has been able to place our products without having to pay significant slotting fees. Slotting fees for new item placements on average have cost anywhere between \$10 to \$150 per store, per new item.

Food Service Placement

We also market our beverages to industrial cafeterias (corporate feeders), and to on premise bars and restaurants. As our business continues to mature, we intend to place our beverages in stadiums, sport arenas, concert halls, theatres, and other cultural centers as long-term marketing and pouring relationships are developed within this business segment.

International Sales

We have developed a limited market for our products in Canada, Europe and Asia. Sales outside of North America currently represent 3% of our total gross sales. Sales in Canada represent about 1.3% of our total sales. We believe that there are good opportunities for expansion of sales in Canada, Middle East, England and Australia and we are increasing our marketing focus on those markets. Other international sales become cost prohibitive, except in specialty sales circumstances, since our premium sodas are packed in glass, which involves substantial freight to move overseas. We are open to opportunities to export and to co-pack internationally and expand our brands into foreign markets, and we are holding preliminary discussions with trading companies and import/export companies for the distribution of our products throughout Asia, Europe, Australia and South America. We believe that these areas are a natural fit for Reed's ginger products, because of the importance of ginger in international markets, especially the Asian market where ginger is a significant part of diet and nutrition.

Distribution, Sales and Marketing

We currently have a national network of mainstream, natural and specialty food distributors in the United States and Canada. We sell directly to our distributors, who in turn sell to retail stores. We also use our own internal sales force and independent sales representatives to promote our products for our distributors and direct sales to our retail customers. One of the main goals of our sales and marketing efforts is to increase sales and grow our brands. Our sales force consists of senior sales representatives in five geographic regions across the country who are supported in their region by local Reeds sales staff. Generally, our sales managers are responsible for all activities related to the sales, distribution and marketing of our brands to our entire distributor and retail partner network in North America. We distribute our products primarily through several national natural foods distributors and an increasing number of regional mainstream DSD distributors. We have entered into agreements with some of our distributors that commit us to "termination fees" if we terminate our agreements early or without cause. These agreements call for our customer to have the right to distribute our products to a defined type of retailer within a defined geographic region. As is customary in the beverage industry, if we should terminate the agreement or not automatically renew the agreement, we would be obligated to make certain payments to our customers. We are in constant review of our distribution agreement with our partners across North America. We also offer our products and promotional merchandise directly to consumers via the Internet through our website, www.reedsgingerbrew.com.

Marketing to Distributors

We market to distributors using a number of marketing strategies, including direct solicitation, telemarketing, trade advertising and trade show exhibition. These distributors include natural food, gourmet food and mainstream distributors. Our distributors sell our products directly to natural food, gourmet food and mainstream supermarkets for sale to the public. We maintain direct contact with our distributor partners through our in-house sales managers. From time to time and in very limited markets, when use of our own sales force is not cost effective, we will utilize

independent sales brokers and outside representatives.

Marketing to Retail Stores

The primary focus of our sales efforts is supermarket sales. We have a small highly trained sales force that is directly contacting supermarket chains and setting up promotional calendars. In addition, we market to retail stores by utilizing trade shows, trade advertising, telemarketing, direct mail pieces and direct contact with the store. Our sales managers and representatives visit these retail stores to sell directly in many regions. Sales to retail stores are coordinated through our distribution network and our regional warehouses.

Competition

The beverage industry is highly competitive. The principal areas of competition are pricing, packaging, development of new products and flavors and marketing campaigns. Our products compete with a wide range of drinks produced by a relatively large number of manufacturers. Most of these brands have enjoyed broad, well-established national recognition for years, through well-funded ad and other branding campaigns. In addition, the company's manufacturing these products generally have greater financial, marketing and distribution resources than we do. Important factors affecting our ability to compete successfully include taste and flavor of products, trade and consumer promotions, rapid and effective development of new, unique cutting edge products, attractive and different packaging, branded product advertising and pricing. We also compete for distributors who will concentrate on marketing our products over those of our competitors, provide stable and reliable distribution and secure adequate shelf space in retail outlets. Competitive pressures in the soft drink category could cause our products to be unable to gain or to lose market share or we could experience price erosion. We believe that our all natural innovative beverage recipes, packaging, use of premium ingredients and a trade secret brewing process provide us with a competitive advantage and that our commitments to the highest quality standards and brand innovation are keys to our success.

The Kombucha market is dominated by a few producers who sell their products nationally. The remainder of the producers is comprised of mostly fragmented regional or local companies. There are companies that gain market share in certain regions; however, most do not have the scale and capability to effectively sell and distribute on a national basis. We believe that Reed's Kombucha market share was achieved in a relatively short period of time, by leveraging our existing distribution channels and customer relationships to expand our sales volume quickly. We also have in-house production capabilities that can be scaled up as needed to make this a primary brand for Reed's. We believe that our existing infrastructure creates a competitive advantage, including product design, manufacturing & production and a network of sales & distribution.

Proprietary Rights

We own trademarks that we consider material to our business. Three of our material trademarks are registered trademarks in the U.S. Patent and Trademark Office: Reed's Original Ginger Brew All-Natural Jamaican Style Ginger Ale ®, Virgil's ®, and China Cola ®. Registrations for trademarks in the United States will last indefinitely as long as we continue to use and police the trademarks and renew filings with the applicable governmental offices. We have not been challenged in our right to use any of our material trademarks in the United States. We intend to obtain international registration of certain trademarks in foreign jurisdictions.

In addition, we consider our finished product and concentrate formulae, which are not the subject of any patents, to be trade secrets. Our brewing process is a trade secret. This process can be used to brew flavors of beverages other than ginger ale and ginger beer, such as root beer, cream soda, cola and other spice and fruit beverages. We have not sought any patents on our brewing processes because we would be required to disclose our brewing process in patent applications.

We generally use non-disclosure agreements with employees and distributors to protect our proprietary rights.

Government Regulation

The production, distribution and sale in the United States of many of our Company's products are subject to the Federal Food, Drug, and Cosmetic Act, the Federal Trade Commission Act, the Lanham Act, state consumer protection laws, federal, state and local workplace health and safety laws, various federal, state and local environmental protection laws and various other federal, state and local statutes and regulations applicable to the production, transportation, sale, safety, advertising, labeling and ingredients of such products. Outside the United States, the distribution and sale of our many products and related operations are also subject to numerous similar and other statutes and regulations.

A California law requires that a specific warning appear on any product that contains a component listed by the state as having been found to cause cancer or birth defects. The law exposes all food and beverage producers to the possibility of having to provide warnings on their products. This is because the law recognizes no generally applicable quantitative thresholds below which a warning is not required. Consequently, even trace amounts of listed components can expose affected products to the prospect of warning labels. Products containing listed substances that occur naturally or that are contributed to such products solely by a municipal water supply are generally exempt from the warning requirement. No Company beverages produced for sale in California are currently required to display warnings under this law. We are unable to predict whether a component found in a Company product might be added to the California list in the future, although the state has initiated a regulatory process in which caffeine will be evaluated for listing. Furthermore, we are also unable to predict when or whether the increasing sensitivity of detection methodology that may become applicable under this law and related regulations as they currently exist, or as they may be amended, might result in the detection of an infinitesimal quantity of a listed substance in a beverage of ours produced for sale in California.

Bottlers of our beverage products presently offer and use non-refillable, recyclable containers in the United States and various other markets around the world. Some of these bottlers also offer and use refillable containers, which are also recyclable. Legal requirements apply in various jurisdictions in the United States and overseas requiring that deposits or certain taxes or fees be charged for the sale, marketing and use of certain non-refillable beverage containers. The precise requirements imposed by these measures vary. Other types of beverage container-related deposit, recycling, tax and/or product stewardship statutes and regulations also apply in various jurisdictions in the United States and overseas. We anticipate that additional, similar legal requirements may be proposed or enacted in the future at local, state and federal levels, both in the United States and elsewhere.

All of our facilities and other operations in the United States are subject to various environmental protection statutes and regulations, including those relating to the use of water resources and the discharge of wastewater. Our policy is to comply with all such legal requirements. Compliance with these provisions has not had, and we do not expect such compliance to have, any material adverse effect on our capital expenditures, net income or competitive position.

Environmental Matters

Our primary cost environmental compliance activity is in recycling fees and redemption values. We are required to collect redemption values from our customers and remit those redemption values to the state, based upon the number of bottles of certain products sold in that state.

Employees

We have 62 full-time equivalent employees on our corporate staff down from 69 in the year ending December 31, 2015. The table below lists the departments. We employ additional people on a part-time basis as needed. We have never participated in a collective bargaining agreement. We believe that the relationship with our employees is good.

Department	Number of FTE's		
	2016	2015	Change
General Management	4.0	4.0	-
Administrative Support	9.2	11.1	(1.9)
Research & Development	5.5	4.0	1.5
Sales	16.0	17.4	(1.4)
Production & Warehouse	27.7	32.9	(5.2)
Total	62.4	69.4	(7.0)

Item 2. Property

We lease a facility of approximately 76,000 square feet, which serves as our principal executive offices, our West Coast Brewery and bottling plant and our Southern California warehouse facility. Approximately 30,000 square feet of the total space is leased under a long-term lease expiring in 2024. We also lease a warehouse of approximately 18,000 square feet under a lease expiring in October 2017, a warehouse of approximately 13,000 square feet under a lease expiring in November 2017, and a warehouse of 15,000 square feet on a month-to-month basis.

Item 3. Legal Proceedings

From time to time, we are a party to claims and legal proceedings arising in the ordinary course of business. Our management evaluates our exposure to these claims and proceedings individually and in the aggregate and provides for potential losses on such litigation if the amount of the loss is estimable and the loss is probable.

Item 4. Mine Safety Disclosures

Not applicable.

PART II**Item 5. Market for Common Equity and Related Stockholder Matters**

Our common stock is listed for trading on the NYSE MKT trading under the symbol “REED”. The following is a summary of the high and low bid prices of our common stock on the NYSE MKT Capital Markets for the periods presented:

	Sales Price	
	High	Low
Year Ending December 31, 2015		
First Quarter	\$7.00	\$5.32
Second Quarter	6.64	5.08
Third Quarter	6.39	4.44
Fourth Quarter	5.90	4.50
Year Ending December 31, 2016		
First Quarter	\$5.46	\$4.62
Second Quarter	4.85	2.37
Third Quarter	3.74	2.51
Fourth Quarter	4.25	3.86

As of December 31, 2016, there were approximately 4,500 stockholders of record of the common stock (including only non-objecting beneficial owners of record) and 13,982,230 outstanding shares of common stock.

Unregistered Sales of Equity Securities

During the fiscal year ended December 31, 2016, we issued the following equity securities that were unregistered under the Securities Act:

We issued 214 shares of common stock in exchange for Reeds Board of Director services. The value of the stock was based on the closing price of the stock on the issuance or agreed upon date. The total value of shares issued for services was \$900 the shares were issued pursuant to exemption from registration under Section 4(2) of the Securities Act.

Also during the fiscal year ended December 31, 2016, we issued the following equity securities that were registered under the Securities Act:

On June 2, 2016, pursuant to a Securities Purchase Agreement dated May 26, 2016 (“Purchase Agreement”) with institutional and accredited investors, Reed’s Inc., a Delaware corporation (“Reed’s” or the “Company”) closed a private financing transaction for the issuance and sale by Reed’s of 692,412 shares of common stock (“Shares”) and warrants to purchase 346,206 shares of common stock (“Warrants”), for gross proceeds to Reed’s of \$2,354,200. The Offering was made solely to accredited investors (as defined in Rule 501(a) under the Securities Act of 1933, as amended (the “Securities Act”)) in reliance upon the exemption from registration in Section 4(a)(2) of the Securities Act and Rule 506 of Regulation D.

The Company used the net proceeds from the offering for working capital and general corporate purposes.

The Warrants have an exercise price of \$4.25 per share and a term of 5 years. The exercise price of the Warrants is subject to customary adjustments in the event of stock dividends and splits, and the Warrants contain protective provisions in the event of fundamental transactions. In addition, holders of the Warrants shall be entitled to participate in distributions, dividends and subsequent rights offerings to the same extent that the holders would have participated therein if the holders had held the number of shares of common stock acquirable upon complete exercise of the Warrants. Except upon at least 61 days’ prior notice from a holder of a Warrant to the Company, the holder will not have the right to exercise any portion of the Warrant if the holder, together with its affiliates, would beneficially own in excess of 4.99% of the number of shares of the Company’s common stock (including securities convertible into common stock) outstanding immediately after the exercise.

The Company entered in to a registration rights agreement with the investors pursuant to which it filed a resale registration statement for the Shares and the common stock underlying the Warrants within 30 days of effective date.

Maxim Group LLC (“Maxim”) acted as the placement agent for the offering under a Placement Agent Agreement, dated May 26, 2016, between Maxim and Reed’s (the “Placement Agent Agreement”). Upon the closing of the offering, pursuant to the Placement Agent Agreement, Maxim received warrants to purchase up to 72,703 shares of common stock (“Placement Agent Warrants”). The Placement Agent Warrants have an exercise price of \$3.74 and are exercisable for a term of 5 years. The exercise price of the Placement Agent Warrants is subject to customary adjustments in the event of stock dividends and splits, and the Placement Agent Warrants contain protective provisions in the event of fundamental transactions.

Each of the Purchase Agreement and the Placement Agent Agreement contains customary representations, warranties and covenants of the parties thereto. The Company also agreed not to issue any shares of its common stock or rights to acquire shares of its common stock for a period of 90 days from the closing of the offering, subject to certain customary exemptions for issuances pursuant to the Company’s equity plans. In addition, the Company agreed not to enter into any variable rate transactions for a period of one year.

Dividend Policy

We have never declared or paid dividends on our common stock. We currently intend to retain future earnings, if any, for use in our business, and, therefore, we do not anticipate declaring or paying any dividends in the foreseeable future. Payments of future dividends, if any, will be at the discretion of our board of directors after taking into account various factors, including the terms of our credit facility and our financial condition, operating results, current and anticipated cash needs and plans for expansion.

We are obligated to pay a non-cumulative 5% dividend from lawfully available assets to the holders of our Series A preferred stock in additional shares of common stock at our discretion. In 2016 and 2015, we paid dividends on our Series A preferred stock in an aggregate of 1,504 and 751 shares of common stock in each such year, respectively and anticipate that we will be obligated to issue at least this many shares annually to the holders of the Series A preferred stock so long as such shares are issued and outstanding.

Securities Authorized for Issuance Under Equity Compensation Plans

2007 Stock Option Plan and 2015 Incentive and Non-statutory stock option plan

On October 8, 2007, our board of directors adopted the 2007 Stock Option Plan for 1,500,000 shares and the plan was approved by our stockholders on November 19, 2007. All of the shares granted under our 2007 Stock Option Plan have been issued. Forfeited options issued under the 2007 plan can be reissued prior to expiration of the plan. On April 6, 2015, our board of directors adopted the 2015 Incentive and Non-statutory Stock Option Plan for 500,000 shares and the plan was approved by our stockholders on December 30, 2015. Forfeited options issued under the 2015 plan cannot be reissued.

The plans permit the grant of options to our employees, directors and consultants. The options may constitute either “incentive stock options” within the meaning of Section 422 of the Internal Revenue Code or “non-qualified stock options”. The primary difference between “incentive stock options” and “non-qualified stock options” is that once an option is exercised, the stock received under an “incentive stock option” has the potential of being taxed at the more favorable long-term capital gains rate, while stock received by exercising a “non-qualified stock option” is taxed according to the ordinary income tax rate schedule.

The plans are currently administered by the board of directors. The plan administrator has full and final authority to select the individuals to receive options and to grant such options as well as a wide degree of flexibility in determining the terms and conditions of options, including vesting provisions.

The exercise price of an option granted under the plan cannot be less than 100% of the fair market value per share of common stock on the date of the grant of the option. The exercise price of an incentive stock option granted to a person owning more than 10% of the total combined voting power of the common stock must be at least 110% of the fair market value per share of common stock on the date of the grant. Options may not be granted under the plan on or after the tenth anniversary of the adoption of the plan. Incentive stock options granted to a person owning more than 10% of the combined voting power of the common stock cannot be exercisable for more than five years.

When an option is exercised, the purchase price of the underlying stock will be paid in cash, except that the plan administrator may permit the exercise price to be paid in any combination of cash, shares of stock having a fair market value equal to the exercise price, or as otherwise determined by the plan administrator.

If an optionee ceases to be an employee, director, or consultant with us, other than by reason of death, disability or retirement, all vested options must be exercised within three months following such event. However, if an optionee's employment or consulting relationship with us terminates for cause, or if a director of ours is removed for cause, all unexercised options will terminate immediately. If an optionee ceases to be an employee or director of, or a consultant to us, by reason of death, disability, or retirement, all vested options may be exercised within one year following such event or such shorter period as is otherwise provided in the related agreement.

For the 2007 plan, when a stock award expires or is terminated before it is exercised, the shares set aside for that award are returned to the pool of shares available for future awards. For the 2015 plan, when a stock award expires or is terminated before it is exercised, the shares are canceled and cannot be reissued.

No option can be granted under the plan after ten years following the earlier of the date the plan was adopted by the board of directors or the date the plan was approved by our stockholders.

Equity Compensation Plan Information

The following table provides information, as of December 31, 2016, with respect to equity securities authorized for issuance under compensation plans:

Plan Category	Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights	Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (excluding securities reflected in Column (a))
	(a)	(b)	
Equity compensation plans approved by security holders	1,048,500	\$ 4.68	87,500
Equity compensation plans not approved by security holders	803,909	\$ 4.50	-
TOTAL	1,852,409	\$ 4.60	87,500

Item 6. Selected Financial Data

As a smaller reporting company, Reed's is not required to provide the information required by this Item 6.

Item 7. 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 Annual Report. This discussion and analysis may contain forward-looking statements based on assumptions about our future business. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors, including but not limited to those set forth under "Risk Factors" and elsewhere in this Annual Report.

Results of Operations

The following table sets forth key statistics for the years ended December 31, 2016 and 2015, respectively.

	Year Ended		Pct.	
	December 31, 2016	2015	Change	
Gross sales, net of discounts & returns (a)	\$46,198,000	\$49,713,000	-7	%
Less: Promotional and other allowances (b)	3,726,000	3,765,000	-1	%
Net sales	\$42,472,000	\$45,948,000	-8	%
Cost of tangible goods sold (c)	31,626,000	32,295,000	-2	%
As a percentage of:				
Gross sales	68	% 65		%
Net sales	74	% 70		%
Cost of goods sold – idle capacity (d)	1,864,000	2,048,000	-9	%
As a percentage of net sales	4	% 4		%
Gross profit	\$8,982,000	\$11,605,000	-23	%
Gross profit margin as a percentage of net sales	21	% 25		%

(a) 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 Generally Accepted Accounting Principles "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.

(b) 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.

(c) Cost of tangible goods sold consists of the costs of raw materials and packaging utilized in the manufacture of products, co-packing fees, repacking fees, in-bound freight charges, inventory adjustments, as well as certain internal transfer costs. Cost of tangible goods sold is used internally by management to measure the direct costs of goods sold, aside from unallocated plant costs. Cost of tangible goods sold is not a measure that is recognized under GAAP and should not be considered as an alternative to cost of goods sold, which is determined in accordance with GAAP, and should not be used alone as an indicator of operating performance in place of cost of goods sold.

(d) Cost of goods sold – idle capacity consists of direct production costs in excess of charges allocated to our finished goods in production. Plant costs include labor costs, production supplies, repairs and maintenance, and inventory write-off. 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 goods sold – idle capacity is not a measure that is recognized under GAAP and should not be considered as an alternative to cost of goods sold, which is determined in accordance with GAAP, and should not be used alone as an indicator of operating performance in place of cost of goods sold.

Year ended December 31, 2016 Compared to Year ended December 31, 2015

Gross Sales

Gross sales for all of Reeds products decreased 7% to \$46,198,000 for the year ended December 31, 2016 from \$49,713,000 in the prior year.

Sales Volume Eight Ounce Equivalents - Our total sales volume for all beverages decreased 5.0%. Reed's Ginger based beverages increased 0.5%, Reed's variety beverages led by Flying Cauldron was up 4.4% and net private label beverages were up 0.5%. Virgils decreased 10.4% and Reed's Kombucha decreased 54.3%.

Gross Sales Dollars Eight Ounce Equivalents - Our gross sales dollars for all beverages decreased 5.9%. Reed's Ginger based beverages increased 1.9%, Reed's variety beverages led by Flying Cauldron were up 4.1% and net private label beverages was up 3.6%. Virgils decreased 9.8% and Reed's Kombucha decreased 53.8%. On an eight-ounce serving size, gross sales were unchanged at \$12.16 per eight-ounce case.

Sales are down an average of 9% in all selling channels. All customers representing at least one percent of sales in 2015 were still customers in 2016. We believe that the decline in all channels was due to consumer preferences away from all sugar sodas including our natural based sugars. In response to the general consumer trend, the Company's research and development efforts have focused on all natural alternatives that have 12 calories per 12 ounce serving. We are in tests in the market place and expect to have these offerings available in the marketplace in the second half of this year.

Gross sales of items such as candy, ingredients, packaging and mail order are not included in the discussion above. These items as a group totaled \$1,684,000 in gross sales, a decrease of \$743,000 or 31% over 2015. The decrease in candy was \$597,000 and was the direct result of a California lawsuit that has required the Company to find reliable alternative suppliers.

Promotional and other allowances

Promotions and allowances for beverage products decreased in dollars 1% to \$3,726,000 (8.1% of gross sales) for the year ended December 31, 2016 from \$3,765,000 (7.6% of gross sales) in the prior year.

The promotional discounts on eight-ounce equivalent increased 4.1% or \$0.04/case to \$1.02/case from \$0.98/case in 2015. This increase is primarily attributable to an increase in the promotional programs and discounts offered in the fourth quarter of 2016 over a lower sales volume.

Net Sales

Net sales of all items decreased 7.6% or \$3,476,000 to \$42,472,000 for the year ended December 31, 2016 from \$45,948,000 in the prior year.

For beverage products, net sales by 8oz case equivalents decreased in 2016 by 2.7% to \$11.60/case from \$11.92/case from the prior year.

Cost of Goods Sold

Cost of goods sold consists of the costs of raw materials and packaging utilized in the manufacture of products, co-packing fees, repacking fees, in-bound freight charges, inventory adjustments, as well as certain internal transfer costs. Cost of goods sold also consists of direct production costs in excess of charges allocated to our finished goods in production. Plant costs include labor costs, production supplies, and repairs and maintenance. 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.

Total cost of goods sold decreased to \$33,490,000 in the year ended December 31, 2016, a decrease of \$853,000 or 2.5% from 2015. The decrease was due to net volume decrease of 7.6% and increases in cost of production. Had total cost of goods decreased at a rate equal to the volume decrease of 7.6%, total cost of goods would have decreased a total of \$3,228,000. The company incurred an additional \$2,376,000 in the rate of cost of goods sold.

Specific production costs that comprised the additional \$2,376,000 or \$0.65 eight-ounce case was comprised of direct write off of inventories of \$705,000 or \$0.19/eight-ounce case, packaging cost increases of \$1,208,000 or \$0.33/eight-ounce case and ingredient cost increases of 842,000 or \$0.23/eight-ounce case. These increases were partially offset by labor productivity decreases of \$183,000 or \$0.05/eight-ounce case and a decrease in the reserve for obsolescence by \$175,000 over 2015 or \$0.05/eight-ounce case.¹⁷

Gross Profit

Our gross profit of \$8,982,000 in the year ended December 31, 2016 represents a decrease of \$2,623,000, or 22.6% from 2015. As a percentage of sales, our gross profit decreased to 21.1% in 2016 as compared to 25.3% in 2015. As noted above, the gross profit is the result of a decrease in net selling price of 4.1% and an increase cost of goods sold of 7.1%.

The Company has in place for the first quarter of 2017 cost cutting initiatives related to ingredient usage and package pricing that are on track to drive over 200 basis point improvement for the full year. In addition, the Company LA plant is scheduled for production in May that will enable the Company to realize an overdue savings of an additional 350 basis points on an annualized basis from that initiative. We believe that since these initiatives are under our control, the savings will be realized in 2017.

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 to \$3,902,000 in the year ended December 31, 2016 compared to \$5,100,000 in 2015. The \$1,198,000 (23%) decrease is due to lower volume but higher full truck quantities. Current rates of 9% are comparable to historic rates. The Company expects costs to decrease further when the L.A. Brewery upgrade is finalized.

Selling and marketing expenses

Selling and marketing expenses consist primarily of three categories; direct charges for staff compensation costs in sales labor, sales operations consisting of travel and entertainment, office rent and communications and sales support consisting primarily of brokers fees, advertising and consultants. Selling and marketing costs for 2016 were \$3,701,000 or a decrease of 24% when compared to \$4,867,000 in 2015.

The decrease of \$1,166,000 is the result of decreases in sales labor costs of \$461,000, sales operations of \$188,000 and sales support of \$517,000.

Our sales staff decreased to 16 full time equivalents (FTE's) employees at December 31, 2016, from 17 FTE's at December 31, 2015.

General and Administrative Expenses

General and administrative expenses consist primarily of three categories; direct charges for staff compensation costs in office and general management, General and administrative operations consisting of office rent, facility depreciation, utilities, General and administrative support in information, SEC filings, shareholder meetings, legal and audit and finally; miscellaneous expenses such as amortization of intangibles and bad debt expense. General and administrative costs for 2016 were \$4,208,000 or a decrease of 4% when compared to \$4,368,000 in 2015.

The total decrease of \$160,000 is due to a decrease in administrative wage related expenses of \$257,000, a decrease of administrative operations of \$154,000, an increase administrative support expenses of \$251,000. Impairment loss of \$224,000 driven by the China Cola brand impairment.

The General management and administrative staff decreased to 13 FTE's at December 31, 2016, from 15 at December 31, 2015.

Loss from Operations

Loss from operations was \$3,053,000 in the year ended December 31, 2016, as compared to loss from operations of \$2,730,000 in 2015 or an increase of \$323,000. The increase in the operating loss is due to the decline in sales that were not offset by similar reduction in cost of goods sold that resulted in a lower gross profit of \$2,623,000. The lower gross profit was mirrored by a similar decrease in expenses of \$2,300,000.

Interest Expense

Interest expense increased to \$1,724,000 in the year ended December 31, 2016, compared to interest expense of \$1,231,000 in the same period of 2015. During 2016 and 2015 the Company's losses incurred liquidity shortages that required a an infusion of capital. A total of \$3,000,000 was obtained that also changed the terms of the existing line of credit and CAPEX loan. As the plant approached completion, further borrowing was obtained to complete the plant. As a direct consequence of the term change and the additional borrowing, the Company's net interest charge increased.

Modified EBITDA

The Company defines modified EBITDA (a non-GAAP measurement) as net income (loss) before interest, taxes, depreciation and amortization, impairment charges, non-cash share-based compensation and warrant liability expenses. 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

	Year ended December 31,	
	2016	2015
	(unaudited)	(unaudited)
Net loss	\$(5,009,000)	\$(3,961,000)
Modified EBITDA adjustments:		
Depreciation and amortization	642,000	933,000
Interest expense	1,724,000	1,231,000
Reserve for replacement on fixed assets	260,000	-
Stock option and warrant compensation		