

Truett-Hurst, Inc.
Form 10-Q
November 20, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the Quarterly Period Ended September 30, 2018

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from _____ to _____

Commission File Number: 001-35973

TRUETT-HURST, INC.

(Exact name of registrant as specified in its charter)

| | |
|---|--|
| DELAWARE (State or other jurisdiction of incorporation or organization) | 46-1561499 (I.R.S. employer identification number) |
|---|--|

| | |
|---|---------------------|
| 125 Foss Creek Circle, Healdsburg, California (Address of principal executive offices) | 95448 (zip code) |
|---|---------------------|

(707) 431-4423

(Registrant's telephone number, including area code)

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 every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for

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such shorter period that the Registrant was required to submit such files). Yes No

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company” and “emerging growth company” in Rule 12b-2 of the Exchange Act.:

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant 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.

| | |
|---|------------------------------|
| Class A | Number of Shares Outstanding |
| Common stock, \$0.001 par value per share | 4,595,750 |

| | |
|---|------------------------------|
| Class B | Number of Shares Outstanding |
| Common stock, \$0.001 par value per share | 6 |

TRUETT-HURST, INC. AND SUBSIDIARY

FORM 10-Q

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

TRUETT-HURST, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share data)

| | September 30, | June 30, |
|---|------------------|----------|
| | 2018 | 2018 |
| | (unaudited) | |
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 5,554 | \$278 |
| Accounts receivable | 918 | — |
| Inventories | 6,162 | 5,826 |
| Bulk wine deposits | 68 | — |
| Other current assets | 170 | 251 |
| Current assets of discontinued operations | 692 | 18,396 |
| Total current assets | 13,564 | 24,751 |
| Property and equipment | 6,233 | 6,320 |
| Intangible assets, net | 29 | 38 |
| Other assets, net | 77 | 73 |
| Total assets | \$ 19,903 | \$31,182 |
| Liabilities and Equity | | |
| Current liabilities: | | |
| Lines of credit | \$ - | \$8,058 |
| Accounts payable | 692 | 409 |
| Accrued expenses | 1,552 | 237 |
| Current maturities of capital lease obligation | 11 | 11 |
| Current maturities of long term debt | - | 3,235 |
| Liabilities of discontinued operations | 363 | 3,740 |
| Total current liabilities | 2,618 | 15,690 |
| Capital lease obligation, net of current maturities | 48 | 52 |
| Total liabilities | 2,666 | 15,742 |
| Commitments and contingencies (Note 6) | | |
| Equity: | | |
| Shareholders' equity: | | |
| Preferred stock, par value of \$0.001 per share, 5,000,000 shares authorized, | | |
| none issued and outstanding at September 30, 2018 and June 30, 2018 | — | — |
| Class A common stock, par value of \$0.001 per share, 15,000,000 | 4 | 4 |
| authorized, 4,595,750 and 4,535,750 issued and outstanding at September 30, | | |

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2018 and June 30, 2018 respectively

Class B common stock, par value of \$0.001 per share, 1,000 authorized,

| 6 issued and outstanding at September 30, 2018 and June 30, 2018 | — | — |
|--|-----------|-----------|
| Additional paid-in capital | 16,695 | 16,527 |
| Accumulated deficit | (5,323) | (6,299) |
| Total Truett-Hurst, Inc. shareholders' equity | 11,376 | 10,232 |
| Noncontrolling interest | 5,861 | 5,208 |
| Total equity | 17,237 | 15,440 |
| Total liabilities and equity | \$ 19,903 | \$ 31,182 |

See accompanying notes to condensed consolidated financial statements.

TRUETT-HURST, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except share data)

(unaudited)

| | Three Months Ended | |
|--|--------------------|-----------|
| | September 30, | |
| | 2018 | 2017 |
| Sales | \$1,598 | \$1,411 |
| Less excise tax | (1) | (2) |
| Net sales | 1,597 | 1,409 |
| Cost of sales | 501 | 675 |
| Gross profit | 1,096 | 734 |
| Operating expenses: | | |
| Sales and marketing | 493 | 678 |
| General and administrative | 1,304 | 790 |
| Gain on disposal of assets | — | (22) |
| Impairment of other assets | 46 | - |
| Total operating expenses | 1,843 | 1,446 |
| Loss from operations | (747) | (712) |
| Other income (expense): | | |
| Interest expense, net | (68) | (110) |
| (Loss) gain on fair value of interest rate swap | (14) | 2 |
| Gain on insurance settlement, net | 469 | — |
| Other expense | (1) | (8) |
| Total other income (expense) | 386 | (116) |
| Loss before income tax expense | (361) | (828) |
| Income tax expense | - | - |
| Loss from continuing operations | (361) | (828) |
| Income from discontinued operations, net of tax | 1,990 | 535 |
| Net income (loss) attributable to Truett-Hurst, Inc. and H.D.D. LLC | 1,629 | (293) |
| Net income (loss) attributable to noncontrolling interest: H.D.D. LLC | 653 | (117) |
| Net income (loss) attributable to Truett-Hurst, Inc. | \$976 | \$(176) |
| Net (loss) income per share, basic and diluted: | | |
| Continuing operations | \$(0.08) | \$(0.19) |
| Discontinued operations | \$0.44 | \$0.12 |
| Attributable to noncontrolling interest | \$0.14 | \$(0.03) |
| Attributable to Truett-Hurst, Inc. | \$0.22 | \$(0.04) |
| Weighted average shares used in computing net (loss) income per share: | | |
| Basic weighted average shares | 4,555,967 | 4,437,998 |
| Diluted weighted average shares | 4,555,967 | 4,437,998 |

See accompanying notes to condensed consolidated financial statements.

TRUETT-HURST, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(unaudited)

| | Three Months Ended September 30, | |
|--|--|----------|
| | 2018 | 2017 |
| Cash flows from operating activities: | | |
| Loss from continuing operations | \$(361) | \$(828) |
| Income from discontinued operations, net of tax | 1,990 | 535 |
| Net income (loss) | 1,629 | (293) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Depreciation and amortization | 224 | 213 |
| Stock-based compensation | 50 | 62 |
| Executive termination benefits | 118 | — |
| Loss (gain) on fair value of interest rate swap | 14 | (2) |
| Gain on sale of assets | — | (22) |
| Gain on insurance settlement | (612) | — |
| Impairment of intangibles | 46 | — |
| Changes in operating assets and liabilities, net | | |
| Accounts receivable | (449) | (70) |
| Inventories | (193) | (5,242) |
| Bulk wine deposits | (68) | — |
| Other current assets | 67 | (355) |
| Accounts payable | 283 | 1,650 |
| Accrued expenses | 1,314 | 104 |
| Net cash provided by (used in) operating activities | 2,423 | (3,955) |
| Cash flows from investing activities: | | |
| Acquisition of property and equipment | (89) | (535) |
| Acquisition of intangible and other assets | (3) | (6) |
| Proceeds from sale of assets | — | 22 |
| Net cash used in investing activities | (92) | (519) |
| Cash flows from financing activities: | | |
| Net (payments on) proceeds from lines of credit | (8,058) | 325 |
| Proceeds from long term debt | — | 327 |
| Payments on long term debt | (3,235) | (137) |
| Payments on capital lease obligation | (4) | (3) |
| Net cash (used in) provided by financing activities | (11,297) | 512 |
| Discontinued Operations | | |
| Net cash provided by operating activities | 14,242 | 3,205 |
| Net cash provided by discontinued operations | 14,242 | 3,205 |
| Net change in cash and cash equivalents | 5,276 | (757) |

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| | | |
|---|---------|-------|
| Cash and cash equivalents at beginning of period | 278 | 783 |
| Cash and cash equivalents at end of period | \$5,554 | \$26 |
| Supplemental disclosure of cash flow information: | | |
| Cash paid for interest | \$103 | \$110 |
| Cash paid for income taxes | — | \$— |

See accompanying notes to condensed consolidated financial statements.

TRUETT-HURST, INC. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands)

(Unaudited)

NOTE 1 – BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The unaudited interim condensed consolidated financial statements include the results of Truett-Hurst, Inc. (the “Company”) and its subsidiary H.D.D. LLC (the “LLC”). They have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) for interim financial information and with general instructions for quarterly reports filed on Form 10-Q and Article 8 of Regulation S-X. The Company consolidates the financial results of the LLC and records a noncontrolling interest representing the portion of equity ownership in the LLC that is not attributable to the Company.

The accompanying unaudited condensed consolidated financial statements do not include all of the information and footnotes required by GAAP for audited financial statements. The accompanying unaudited condensed consolidated financial statements were prepared on the same basis as the audited financial statements included in the Company’s Annual Report on Form 10-K for the fiscal year ended June 30, 2018, and, in the opinion of management, these financial statements include all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the results of the interim periods presented. The operating results for the interim period presented are not necessarily indicative of the results expected for the full fiscal year. These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements included in the Annual Report on Form 10-K for the fiscal year ended June 30, 2018 filed with the Securities and Exchange Commission (“SEC”) on October 15, 2018.

Quantities or results referred to as “to date” or “as of this date” mean as of or to September 30, 2018, unless otherwise specifically noted. References to “FY” or “fiscal year” refer to the fiscal year ending on June 30 the designated year.

Critical Accounting Policies and Estimates

Except as described below, and within the Recently Adopted Accounting Pronouncements discussion below, there have been no material changes to the critical accounting policies and estimates previously disclosed in the Company’s Annual Report on Form 10-K for the fiscal year ended June 30, 2018.

Revenue recognition:

Revenue is recognized once performance obligations under the terms of the Company’s contracts with its customers have been satisfied; this occurs at a point in time when control of the promised product or service is transferred to customers. Generally, all of the Company’s contracts with its customers have a single performance obligation and are short term in nature. Revenue is measured in an amount that reflects the consideration the Company expects to receive in exchange for those products or services. Revenue is recognized net of any taxes collected from customers, which are subsequently remitted to governmental authorities. The Company accounts for shipping and handling activities as

costs to fulfill its promise to transfer the associated products. Accordingly, the Company records amounts billed for shipping and handling costs as a component of net sales, and classifies such costs as a component of costs of sales. The Company's products are generally not sold with a right of return unless the product is spoiled or damaged. Historically, returns have not been material to the Company.

Wine club membership sales are made under contracts with customers, which specify the quantity and timing of future wine shipments. Customer credit cards are charged in advance of quarterly wine shipments in accordance with each contract. The Company transfers control and recognizes revenue for these contracts upon shipment of the wine to the customer.

TRUETT-HURST, INC. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands)

(Unaudited)

Tasting room and internet wine sales are paid for at the time of sale. The Company transfers control and recognizes revenue for this wine when the product is either received by the customer (on-site tasting room sales) or upon shipment to the customer (website/internet sales).

We hold various public and private events for customers and their wine club members. Upfront consideration received from the sale of tickets or under private event contracts for future events is recorded as deferred revenue. The balance of payments are due on the date of the event. The Company recognizes event revenue on the date the event is held.

Other revenue also includes tasting fees and retail sales, which are paid for and received or consumed at the time of sale. The Company transfers control and recognizes revenue at the time of sale.

Reclassifications

Certain prior period amounts in the condensed consolidated financial statements and notes thereto have been reclassified to conform to the current period presentation. See further discussion of reclassifications made within Note 2 – Discontinued Operations. Excluding the adjustment made to reflect the discontinued operations, any additional reclassifications had no material effects on the reported condensed consolidated results of continuing operations.

Recently Adopted Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (the “FASB”) issued ASU 2014-09: Revenue from Contracts with Customers (Topic 606), a comprehensive new revenue recognition model that requires a company to recognize revenue to depict the transfer of goods or services to a customer at an amount that reflects the consideration it expects to receive in exchange for those goods or services. In August 2015, FASB issued ASU 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date, which deferred the effective date of ASU 2014-09 to reporting periods beginning after December 15, 2017.

Effective July 1, 2018, we adopted the FASB amended guidance regarding the recognition of revenue from contracts with customers using the modified retrospective application method. The new revenue standard is required to be applied retrospectively to each prior reporting period presented or prospectively with the cumulative effect of initially applying the standard recognized at the date of initial application. The Company has evaluated the effect of the standard and concluded it will not be material to the Company’s financial reporting. Additionally, the Company has concluded that the application of the standard does not have a material effect that would require a retrospective adjustment. Our revenue consists primarily of the sale of wine through our Direct to Consumer (DTC) activities. Revenues consist of sales of products produced by us through our tasting rooms, wine clubs and our winery websites.

We have evaluated our business activities in an attempt to identify any other revenue generating activities under the disaggregation disclosure criteria outlined within the amended guidance and concluded that any other revenue generating activities are immaterial for separate disclosure.

In August 2016, the FASB issued ASU 2016-15, “Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments” (“ASU 2016-15”). ASU 2016-15 made eight targeted changes to how cash receipts and cash payments are presented and classified in the statement of cash flows. The Company adopted the provisions of ASU 2016-15 effective July 1, 2018, and the adoption of this standard had no impact the Company’s consolidated statement of cash flows.

In May 2017, the FASB issued ASU 2017-09, “Compensation - Stock Compensation (Topic 718): Scope of Modification Accounting” (“ASU 2017-09”). ASU 2017-09 clarifies when changes to the terms or conditions of a share-based payment award must be accounted for as a modification. Changes to the terms or conditions of a share-based payment award that do not impact the fair value of the award, vesting conditions, and the classification as an equity or liability instrument will not need to be assessed under modification accounting. The Company adopted the provisions of ASU 2017-09 effective July 1, 2018. The adoption of this standard did not impact the Company’s accounting for its stock-based compensation.

TRUETT-HURST, INC. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands)

(Unaudited)

Accounting Pronouncements Not Yet Adopted

In February 2016, the FASB issued ASU 2016-02, Leases (“ASU 2016-02”). This update requires that lessees recognize assets and liabilities on the balance sheet for the rights and obligations created by all leases with terms of more than 12 months. ASU 2016-02 also will require disclosures designed to give financial statement users information on the amount, timing, and uncertainty of cash flows arising from leases. These disclosures include both qualitative and quantitative information. The effective date for ASU 2016-02 is for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018 with earlier adoption permitted. The Company is still evaluating the impact of ASU 2016-02 on its consolidated financial position and results of operations.

In July 2017, the FASB issued ASU No. 2017-11, “Earnings Per Share (Topic 260); Distinguishing Liabilities from Equity (Topic 480); Derivatives and Hedging (Topic 815)”, which changes the classification analysis of certain equity-linked financial instruments with down round features. Under current U.S. GAAP, an equity-linked financial instrument with a down round feature that otherwise is not required to be classified as a liability under ASC 480 is evaluated under the ASC 815, Derivatives and Hedging, to determine whether it meets the definition of a derivative (and is therefore measured at fair value at each reporting period). Under ASU 2017-11, a down round feature no longer precludes equity classification when assessing whether the instrument is indexed to an entity’s own stock under ASC 815. Accordingly, these financial instruments are no longer measured at fair value at each reporting period. ASU 2017-11 also requires entities that calculate earnings per share to recognize the effect of the down round feature when it is triggered (at this time, the effect is treated as a dividend and as a reduction of income available to common stockholders in basic earnings per share). It is effective for annual and interim periods beginning after December 15, 2018. Early adoption is permitted. The Company is currently evaluating the impact of adopting this standard on the consolidated financial statements and disclosures.

The accounting standards that have been issued by the FASB or other standards-setting bodies that do not require adoption until a future date are not expected to have a material impact on our financial statements upon adoption.

NOTE 2 - DISCONTINUED OPERATIONS

During the fourth quarter of fiscal year 2018, the Company determined to discontinue operations of our wholesale wine business (the “Wholesale Business”). The Company decided to sell all assets and liabilities directly related to those assets associated with the Wholesale Business due to the sustained losses incurred. Further, the Company determined that the discontinued operations represented a strategic shift that will have a major effect on the Company’s operations and financial results since it represented a complete exit from the wholesale business and, therefore, classified the disposal group as held for sale as of June 30, 2018. The Company received aggregate consideration of approximately \$18 million in cash and future royalty payments to acquire the Wholesale Business which consisted of the sale of certain assets, primarily inventory and related intangibles. Pursuant to the terms of the Purchase Agreement dated August 13, 2018, the Company also entered into a Royalty Payment Agreement and Transition Services Agreement.

A portion of the purchase price is based on Precept's sales of the Wholesale Business brands and is paid over time pursuant to a Royalty Payment Agreement. If Precept fails to sell sufficient amounts of such brands or the market for the Wholesale Business brands deteriorates, such royalty amounts may not be realized in full or at all.

Under the Transition Services Agreement, the Company is providing winemaking and other services to Precept over a nine-month period following the closing.

After the estimated transaction-related costs and expenses of approximately \$0.9 million, the Company used a portion of the remaining proceeds to pay off secured and unsecured debt of \$12 million. The Company also recorded a gain on sale of discontinued operations of approximately \$2.6 million.

TRUETT-HURST, INC. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands)

(Unaudited)

In accordance with ASC 205-20-45-1E, the results of discontinued operations were aggregated and separately presented in our consolidated statements of operations, net of income taxes. On August 13, 2018, pursuant to the terms of the Purchase Agreement of the same date, the LLC sold the Wholesale Business. The assets and liabilities of the discontinued operations are presented separately under the captions “Assets of discontinued operations” and “Liabilities of discontinued operations,” respectively, within the accompanying Consolidated Balance Sheets at June 30, 2018 and consist of the following:

Assets and Liabilities of Discontinued Operations

| | September 30, | June 30, |
|---|---------------|----------|
| | 2018 | 2018 |
| Carrying amounts of assets included in | | |
| discontinued operations | | |
| Accounts receivable | \$ 692 | \$3,031 |
| Inventories | - | 14,151 |
| Bulk wine deposits | - | 629 |
| Property, plant and equipment, net | - | 26 |
| Intangible assets, net | - | 219 |
| Other current assets, net | - | 340 |
| Total current assets | \$ 692 | \$18,396 |
| Carrying amounts of liabilities included in | | |
| discontinued operations | | |
| Accounts payable | \$ - | \$936 |
| Accrued expenses | - | 2,164 |
| Depletion allowance and accrual for sales returns | 363 | 640 |
| Total current liabilities | \$ 363 | \$3,740 |

Operating Results of Discontinued Operations

| | September |
|--|---------------|
| | September 30, |
| | 30, |
| | 2017 |
| | 2018 |

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| | | |
|---|----------|----------|
| Revenues | | |
| Total revenues less excise tax | \$ 2,058 | \$ 4,781 |
| Cost of sales | 1,754 | 3,468 |
| Operating costs and expenses | | |
| Selling, general and administrative expenses | 872 | 778 |
| Gain on sale of discontinued operations | 2,558 | — |
| Net gain attributable to Truett-Hurst, Inc. and | | |
| H.D.D. LLC from Discontinued Operations | 1,990 | 535 |
| Net gain attributable to noncontrolling interest: | | |
| H.D.D. LLC | 796 | 214 |
| Net gain attributable to Truett Hurst, Inc. | 1,194 | 321 |
| Net gain per share from discontinued | | |
| Operations: | | |
| Basic and Diluted | 0.44 | 0.12 |

TRUETT-HURST, INC. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands)

(Unaudited)

Cash Flow from Discontinued Operations

| | Three Months Ended | |
|--|--------------------|---------------|
| | September 30, | September 30, |
| | 2018 | 2017 |
| Net cash provided by operating activities | \$ 14,242 | \$ 3,205 |
| Net cash provided by discontinued operations | \$ 14,242 | \$ 3,205 |

As a part of this agreement the Company will maintain a continuing relationship with the purchaser as noted in the Royalty Payment Agreement (the "Royalty Payment Agreement") and the Transition Services Agreement (the "Transition Services Agreement").

NOTE 3 – INVENTORIES

Inventories comprise:

| | September | |
|------------------------------|----------------|----------|
| | 30, | June 30, |
| | 2018 | 2018 |
| | (in thousands) | |
| Grapes and bulk wine | \$ 1,706 | \$ 2,412 |
| Bottled wine | 4,452 | 3,315 |
| Bottling materials and other | 4 | 99 |
| Total inventories, net | \$ 6,162 | \$ 5,826 |

NOTE 4 – PROPERTY AND EQUIPMENT

Property and equipment, net comprise:

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| | September 30, | |
|---|----------------|---------|
| | 2018 | 2018 |
| | (in thousands) | |
| Land and land improvements | \$3,261 | \$3,260 |
| Building and improvements | 1,858 | 1,854 |
| Machinery and equipment | 3,519 | 3,437 |
| Vineyard development | 554 | 554 |
| Vineyard equipment | 53 | 53 |
| Furniture and fixtures | 438 | 391 |
| Leasehold improvements | 28 | 28 |
| Vehicles | 119 | 119 |
| | 9,830 | 9,696 |
| Less: accumulated depreciation and amortization | (3,597) | (3,376) |
| Total property and equipment, net | \$6,233 | \$6,320 |

Total depreciation and amortization expense for the three months ended September 30, 2018 and September 30, 2017 was \$0.2 million.

TRUETT-HURST, INC. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands)

(Unaudited)

NOTE 5 – BORROWINGS

In connection with the sale of the Wholesale Business on August 13, 2018, the Company paid off all obligations pursuant to its bank borrowings, and terminated its obligations thereunder. Our indebtedness in prior periods was comprised primarily of bank loans including lines of credit and long-term debt.

Lines of Credit

During the quarter the Company paid off all obligations pursuant to its lines of credit, and terminated its obligations thereunder. Balances outstanding under the lines of credit total \$8.1 million as of June 30, 2018.

Long Term Debt

Long term debt comprises:

| | | September 30, 2018 | June 30, 2018 |
|--------------------------|-----|--|---------------|
| | | (in thousands except payment information) | |
| Long term debt: | | | |
| Note 1 | (1) | \$ - | \$ 2,581 |
| Note 2 | (2) | - | - |
| Note 3 | (3) | - | 69 |
| Note 4 | (4) | - | 143 |
| Note 5 | (5) | - | 209 |
| Note 6 | (6) | - | 233 |
| Total notes payable | - | - | 3,235 |
| Less: current maturities | - | - | (3,235) |
| Total long term debt | | \$ - | \$ - |

⁽¹⁾Note payable to a bank, secured by a deed of trust on property, payable monthly with principal payments of \$11,270 plus interest, matures May 31, 2022, variable interest of 2.25% above LIBOR.

⁽²⁾Note payable to a bank, secured by equipment, payable monthly with principal and interest payments of \$6,535, matures November 1, 2018, at 3.75% interest.

- ⁽³⁾Note payable to a bank, secured by equipment, payable monthly with principal and interest payments of \$7,783, matures March 15, 2019, at 3.75% interest.
- ⁽⁴⁾Note payable to a bank, secured by equipment, payable monthly with principal and interest payments of \$11,267, matures July 1, 2019, at 3.90% interest.
- ⁽⁵⁾Note payable to a bank, secured by equipment, payable monthly with principal and interest payments of \$8,729, matures July 1, 2020, at 3.95% interest.
- ⁽⁶⁾Note payable to a bank, secured by equipment, payable monthly with principal and interest payments of \$9,701, matures August 15, 2020, at 4.25% interest.

TRUETT-HURST, INC. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands)

(Unaudited)

Capital Lease

In June 2017, the Company entered into a \$0.07 million, 72-month capital lease related to wine production equipment. The future lease commitments are approximately \$0.02 million per year for fiscal years 2018 through 2023.

NOTE 6 – COMMITMENTS AND CONTINGENCIES

Leases

The Company leases space for wine production within a custom crush facility located in Santa Rosa, California. The initial lease term commenced April 15, 2017 and ended on June 15, 2018. The initial 14-month term has been renewed for an additional 12 month period as agreed to by both parties.

The Company leases approximately 2,500 square feet for administrative offices at 125 Foss Creek Circle, Healdsburg, California. In June 2016, the Company renewed the lease for an additional three years. The renewed lease term is November 1, 2016 through October 31, 2019. The Company also leases approximately 1,600 square feet for executive and administrative offices at 165 Foss Creek Circle, Healdsburg, California. The lease commenced on September 1, 2016 and ends on October 31, 2019.

Lease payments for these facilities were \$0.1 million and \$0.1 million for three months ended September 30, 2018 and September 30, 2017, respectively.

The future lease commitments as presented below include amounts for these two leases.

| Years ending June 30, (in thousands) | |
|---|--------------|
| 2019 (remaining nine months) | \$269 |
| 2020 | 31 |
| Total future rent payments | \$300 |

Supply Contracts

The Company enters into short and long-term contracts with third-parties and related party growers to supply a portion of its future grape requirements.

Future minimum grape purchase commitments are as:

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| Years Ending June 30, | Third-Party | Related Parties | Total |
|-----------------------|----------------|-----------------|---------|
| | (in thousands) | | |
| 2019 | \$ 1,822 | \$ 58 | \$1,880 |
| 2020 | 594 | 59 | 653 |
| 2021 | 157 | 60 | 217 |
| 2022 | 51 | 61 | 112 |
| 2023 | – | 62 | 62 |
| Total | \$ 2,624 | \$ 300 | \$2,924 |

TRUETT-HURST, INC. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands)

(Unaudited)

Production & Storage

The Company enters into various contracts with third-party service providers for grape crushing, wine storage and bottling. The costs are recorded in the period for which the service is provided. The actual costs related to custom crush services are based on volume. The Company's current contracts for custom crush services cover the 2018 harvest.

Litigation

From time to time, the Company may be subject to various litigation matters arising in the ordinary course of business. Other than discussed below, the Company is not aware of any current pending legal matters or claims, individually or in the aggregate, that are expected to have a material adverse impact on the Company's condensed consolidated financial position, results of operations, or cash flows.

The Company received a letter dated October 12, 2018 from a law firm representing one of our design firms alleging we had not paid the full value of the services provided during the last seven years for creative design and marketing services. The Company deems that it is likely that it will make a settlement payment in the range of \$300k to \$500k.

Exchange and Tax Receivable Agreement

The Company has an exchange agreement with the existing owners of the LLC, several of whom are directors and/or officers. Under the exchange agreement, each LLC member (and certain permitted transferees thereof) may (subject to the terms of the exchange agreement), exchange their LLC Units for shares of Class A common stock of the Company on a one-for-one basis, subject to customary conversion rate adjustments for stock splits, stock dividends and reclassifications, or for cash, at the Company's election.

In connection with the exchange agreement, the Company has entered into a tax receivable agreement ("TRA") with the LLC members. The TRA provides for the payment from time to time, as "corporate taxpayer," to holders of LLC Units of 90% of the amount of the benefits, if any, that the corporate taxpayer is deemed to realize as a result of (i) increases in tax basis resulting from the exchange of LLC Units and (ii) certain other tax benefits related to the Company entering into the agreement, including tax benefits attributable to payments under the agreement. These payment obligations are obligations of the corporate taxpayer and not of the LLC. The term of the TRA will continue until all such tax benefits have been utilized or expired, unless the corporate taxpayer exercises its right to terminate the TRA for an amount based on the agreed payments remaining to be made under the TRA or the corporate taxpayer breaches any of its material obligations under the TRA in which case all obligations will generally be accelerated and due as if the corporate taxpayer had exercised its right to terminate the TRA. In addition, the TRA provides that upon certain mergers, asset sales, or other forms of business combinations, substantial payment obligations to the Founders and Affiliates will accelerate.

Indemnification

From time to time the Company enters into certain types of contracts that contingently require it to indemnify various parties against claims from third-parties. Historically, the Company has not been required to make payments under these obligations, and no liabilities have been recorded at September 30, 2018 and June 30, 2018 for these obligations on the condensed consolidated balance sheets.

TRUETT-HURST, INC. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands)

(Unaudited)

NOTE 7 – STOCK-BASED COMPENSATION

Equity Incentive Plan

In 2012, the Board of Directors approved and adopted The 2012 Stock Incentive Plan (the “Plan”). The Plan allows for the granting of restricted stock units, restricted stock awards and stock options to employees, directors and non-employees. As of September 30, 2018, the 2012 Plan has 1.0 million shares reserved for issuance and a total of 0.3 million shares available to be issued.

A summary of the Company’s activity for restricted stock units is presented below:

| | Number | Weighted Avg Grant Date Fair Value of Shares per Share | Weighted Avg Contractual Term in Years |
|-----------------------------------|-----------|---|---|
| Outstanding at June 30, 2018 | 95,194 | \$ 1.86 | 0.52 |
| Granted | 83,475 | 1.49 | — |
| Exercised | (60,000) | (1.88) | — |
| Vested | 3,097 | 1.59 | — |
| Forfeited, cancelled or expired | — | — | — |
| Outstanding at September 30, 2018 | 121,766 | \$ 1.66 | 1.35 |

The restricted stock units vest predominantly over four years. The Company had an unrecognized expense at September 30, 2018 of approximately \$112,585 related to unvested restricted stock units which will be recognized over the remaining weighted average service periods of 0.7 years.

As of September 30, 2018 and June 30, 2018 the Company had no issued or outstanding restricted stock awards.

A summary of the Company’s activity for stock options is presented below:

Weighted Avg Weighted Avg Aggregate

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| | Number of Shares | Grant Date Fair Value per Share | Contractual Term in Years | Intrinsic Value (in thousands) |
|-----------------------------------|------------------------|---------------------------------------|---------------------------------|-----------------------------------|
| Outstanding at June 30, 2018 | 110,000 | \$ 1.09 | 8.18 | \$ (109) |
| Granted | — | — | — | — |
| Forfeited, cancelled or expired | — | — | — | — |
| Outstanding at September 30, 2018 | 110,000 | \$ 1.09 | 7.46 | \$ (82.1) |
| Options Vested | 100,000 | \$ 1.09 | 7.49 | \$ 74.94 |
| Options Non-Vested | 10,000 | \$ 1.12 | 7.21 | \$ 7.20 |
| Options Exercisable | 100,000 | \$ 1.09 | 7.49 | \$ 74.94 |

TRUETT-HURST, INC. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands)

(Unaudited)

Stock options vest predominantly over four years. As of September 30, 2018, unrecognized expense associated with unvested stock options totaled \$6,759. These expenses will be recognized over the remained weighted average service periods of 1.0 years.

The following table summarizes the Company's stock-based compensation included in the condensed consolidated statements of operations for the three months ended September 30, 2018 and September 30, 2017:

| | Three Months Ended September 30, (in thousands) | |
|--------------------------------|--|-------|
| | 2018 | 2017 |
| Sales and marketing | \$ — | \$ 5 |
| General and administrative | 50 | 57 |
| Total stock-based compensation | \$ 50 | \$ 62 |

On August 31, 2018, as part of the sale of the Wholesale Business, the Company terminated the Company's former Vice President of Sales. In connection with his termination, the Company entered into a separation agreement providing for a cash severance payment of \$0.05 million inclusive of payment for severance, annual bonus amounts owed and a portion of his COBRA premiums for continuation of health benefits. In addition, 60,000 of RSUs and 35,000 ISOs outstanding equity-based awards granted which were unvested on the date of his termination became fully vested and exercisable. The Company recorded \$0.05 million in general and administrative expense associated with the separation agreement as a severance expense and \$0.2 million in expense associated with the acceleration of stock options and restricted stock units.

NOTE 8 – FAIR VALUE OF FINANCIAL INSTRUMENTS

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The carrying amount reflected in the condensed consolidated balance sheets of financial assets and liabilities are all categorized as Level 1. They include cash and cash equivalents, accounts receivable, accounts payable and accrued expenses, which approximated their fair values due to the short-term nature of these financial assets and liabilities. The carrying amount of the Company's debt approximates its fair value based on prevailing interest rates and time to maturity.

In October 2012, the Company executed an interest rate swap obligation that was measured using observable inputs such as the LIBOR and ten-year Treasury interest rates, and therefore has been categorized as Level 2. This derivative

is not designated as a hedging instrument and has been recorded at fair value on the condensed consolidated balance sheets. Changes in the fair value of this instrument have been recognized in the condensed consolidated statements of operations in other expense. The maturity date of the swap is May 31, 2022. At June 30, 2018 the interest rate swap balance and derived Level 2 fair value equaled \$0.1 million. In connection with the sale of the Wholesale Business on August 13, 2018, the Company repaid all obligations pursuant to its outstanding interest rate swap, and terminated its obligations thereunder.

NOTE 9 – INCOME TAXES

For the three months ended September 30, 2018, due to the loss from continuing operations, the Company did not record an income tax expense and therefore had an effective tax rate of 0%. The Company has net operating loss (“NOL”) carryforwards available to offset fiscal year 2019 taxable income. The utilization of the NOL carryforwards may be subject to substantial annual limitations due to ownership change provisions under Section 382 of the Internal Revenue Code of 1986, as amended, and similar state provisions. The annual limitations may result in the expiration of NOLs before they can be utilized by the Company.

TRUETT-HURST, INC. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands)

(Unaudited)

The Company's effective tax rate is a function of:

- A rate benefit attributable to the fact that the LLC operates as a limited liability company which is not subject to federal or state income tax. Accordingly, a portion of the earnings are not subject to corporate level taxes.
 - Operating losses for the periods or utilization of net operating loss carryforwards.
 - Recording a full valuation allowance against net deferred tax assets as the Company has determined that it is more likely than not that the future tax benefits would not be realized. The Company did not record a deferred tax asset during the three months ended September 30, 2018.
- There were no unrecognized tax benefits at September 30, 2018 and the Company did not incur any income tax related interest expense or penalties related to uncertain tax positions.

NOTE 10 – SUBSEQUENT EVENTS

Certain of our inventory bottled during FY18 suffered damage from a faulty filtration system due to the mobile unit operator failing to take appropriate care during a bottling run. As a result, residual sugars began fermenting in the bottles resulting in damage. The Company filed a claim with its insurance carrier in August 2018, of which the coverage position and claim amount was accepted in October 2018. The Company accrued the amount of the insurance settlement of \$0.6 million and established an inventory reserve equal to \$0.1 million and recognized a gain on insurance settlement of \$0.5 million as of September 30, 2018. The corresponding insurance proceeds were received on October 26, 2018.

The Company has evaluated all subsequent event activity through the issue date of these consolidated financial statements and concluded that, other than the items discussed above, no additional subsequent events have occurred that would require recognition in the consolidated financial statements or disclosure in the notes to the condensed consolidated financial statements.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

FORWARD-LOOKING STATEMENTS

This Management's Discussion and Analysis of Financial Condition and Results of Operations and other parts of this Quarterly Report on Form 10-Q contain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). All statements, other than statements of historical fact, regarding strategy, future operations, financial position, prospects, plans, opportunities, and objectives constitute "forward-looking statements." The words "may," "will," "expect," "plan," "anticipate," "believe," "estimate," "potential," or "continue" and similar types of expressions identify such statements, although not all forward-looking statements contain these identifying words. These statements are based upon information that is currently available to the Company and or management's current expectations, speak only as of the date hereof, and are subject to risks and uncertainties. We expressly disclaim any obligation, except as required by federal securities laws, or undertaking to update or revise any forward-looking statements contained herein to reflect any change or expectations with regard thereto or to reflect any change in events, conditions, or circumstances on which any such forward-looking statement is based, in whole or in part. Our actual results may differ materially from the results discussed in or implied by such forward-looking statements. Important factors that could cause such differences include, but are not limited to, a reduction in the supply of grapes and bulk wine available; significant competition; any change in our relationships with retailers which could harm our business; we may not achieve or maintain profitability in the future; the loss of key employees; a reduction in our access to, or an increase in the cost of, the third-party services we use to produce its wine; credit facility restrictions on the Company's current and future operations; and failure to protect, or infringement of, trademarks and proprietary rights; these factors should not be construed as exhaustive and should be read in conjunction with the other cautionary statements that are included in this report. We undertake no obligation to publicly update or review any forward-looking statement, whether as a result of new information, future developments or otherwise. Risks that may affect our operating results include, but are not limited to, those discussed in the "Risk Factors" section of its Annual Report on Form 10-K for fiscal 2018 filed with the Securities Exchange Commission ("SEC") on October 15, 2018. Readers should carefully review the risk factors described in the Annual Report on Form 10-K for fiscal 2018 and in other documents that we file from time to time with the SEC.

The unaudited interim condensed consolidated financial statements include the results of the Company and its subsidiary, the LLC, and have been prepared in accordance with GAAP for interim financial information and with the general instructions for quarterly reports filed on Form 10-Q and Article 8 of Regulation S-X. The disclosures do not include all the information necessary for audited financial statements in accordance with GAAP. These unaudited interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes contained in the Annual Report on Form 10-K for the fiscal year ended June 30, 2018 filed with the SEC on October 15, 2018. In the opinion of the Company's management, all adjustments, which include normal recurring adjustments, considered necessary for a fair presentation have been included. All intercompany transactions and balances have been eliminated. Unless otherwise indicated, the notes to the unaudited condensed consolidated financial statements relate to the discussion of the Company's continuing operations. Our condensed consolidated financial statements reflect all of our accounts, including those of its controlled subsidiary and the portion of equity in a consolidated subsidiary that is not attributable to the Company, directly or indirectly, is presented as noncontrolling interests.

OVERVIEW OF BUSINESS

General

Truett-Hurst, Inc. ("Truett-Hurst", the "Company", or "THI") is a holding company formed in Delaware and its sole asset is a controlling interest in H.D.D. LLC ("LLC"). Unless the context suggests otherwise, references in this report to

“Truett-Hurst,” the “Company,” “we,” “us” and “our” refer to Truett-Hurst, Inc. and its consolidated subsidiary. Truett-Hurst consolidates the financial results of the LLC and records a noncontrolling interest for the economic interest in the LLC it does not own. Our amended and restated certificate of incorporation authorizes two classes of common stock, Class A common stock and Class B common stock.

We have two classes of stock with shares outstanding: Class A common stock and Class B common stock. As of September 30, 2018, there were 4,595,750 shares of Class A common stock and 6 shares of Class B common stock outstanding. One share of Class B common stock is issued to each holder of LLC units which, on matters presented for shareholder vote, provides its owner one vote for each LLC unit held. The 6 shares of Class B common stock were associated with 2.73 million LLC units (the entire amount of LLC units held by parties other than the Company) and represents 40% of the voting power of the combined outstanding Class A and Class B common stock.

We maintain an exchange agreement with holders of LLC units, several of whom are directors and/or officers, under which each LLC member may exchange their LLC units for shares of Class A common stock on a one-to-one basis. Through ownership of Class A and Class B common stock, individuals who are officers and/or directors of the Company control 40% of the voting power of the combined outstanding Class A and Class B common stock.

We operate and control all the business and affairs and consolidates the financial results of the LLC. In addition, pursuant to the limited liability company agreement of the LLC, the Company has the right to determine when distributions will be made to the members of the LLC and the amount of distributions. If a distribution is authorized, such distribution will be made to the members of the LLC pro rata in accordance with the percentages of their respective limited liability company interests.

Quantities or results referred to as “to date” or “as of this date” mean as of or to September 30, 2018, unless otherwise specifically noted. References to “FY” or “fiscal year” refer to the fiscal year ending on June 30th of the designated year. For example, “FY18” and “fiscal year 2018” each refer to the fiscal year ended June 30, 2018. This Quarterly Report on Form 10-Q references certain trademarks and registered trademarks which may be trademarks or registered trademarks of their respective owners.

On August 13, 2018, we entered into an Asset Purchase Agreement (the “Purchase Agreement”) with Precept Brands LLC, a Washington limited liability company (“Precept”) pursuant to which the Company agreed to sell certain assets comprising its wholesale wine business (the “Wholesale Business”) to Precept. As a result, certain balances have been adjusted to reflect the results of this transaction. See Note 2, “Discontinued Operations”.

Following the sale of the Wholesale Business to Precept on August 13, 2018, we are now only operating our direct to consumer (“DTC”) business based at our estate property in Healdsburg, California as well as the sale of our three brands to national retailers. We produce luxury tier Pinot Noir, Chardonnay, Sauvignon Blanc, Zinfandel, Petite Sirah, and Syrah for our three brands: Truett Hurst, VML and Svengali. We maintain a wine club for Truett Hurst and VML and we provide a premier experience leveraging our creekside property, hospitality, customer service and award winning wine quality. We continue to be headquartered in Sonoma County, California and lease space for wine production within a custom crush facility located in Santa Rosa, California. The direct to consumer channel consists of sales of products produced by us through our tasting rooms, wine clubs and our winery websites.

We operate two tasting rooms and lease a winery where wine is produced from many varieties of grapes principally grown or purchased in Sonoma County’s Dry Creek Valley and Russian River Valley appellations. Established in 2007, Truett-Hurst was the first winery operation and brand that focuses on producing limited lots of super-premium wine from a range of varietals, including Zinfandel, Chardonnay, Sauvignon Blanc, Pinot Noir, Petite Sirah and other unique red blends from grapes sourced from local growers in the Dry Creek Valley. Established in 2011, VML was the second winery operation and brand that focuses on producing limited lots of super-premium and ultra-premium wines from grapes purchased from local growers in the Russian River Valley. The primary varietals include Pinot Noir, Chardonnay, Sauvignon Blanc, and Gewurztraminer. The Svengali brand was established most recently to focus entirely on a single Dry Creek Valley Syrah.

Strategic Objectives

We sell our wine into two primary categories: Super Ultra-Premium (\$25-49 per bottle retail price) and Luxury (\$50+ per bottle retail price). With our focus on the DTC business, we plan to focus on the following sales channels:

- Walk In Visitors: Dry Creek Valley is home to over 75 wineries and tasting rooms and draws from a large population base in and around the San Francisco Bay Area. These sales make up approximately 25% of our total sales and we work to convert these customers to longer term customers via our Wine Clubs.

•**Wine Club:** Truett Hurst and VML Wine Clubs have over 6,000 member from which we generate approximately 75% of our annual sales. Wine Club members can choose from a variety of membership options and can also customize their membership to include specific wines or shipping timing. The most common memberships ship four times per year.

•**E-Commerce:** With a database of over 20,000 customers we regularly develop offerings of special lots, one time buys and end of vintage opportunities.

•**Retail:** We currently sell the Truett Hurst brand directly to several retailers including Total Wine and More and sell the VML brand to a select group of retailers via a traditional three tier distribution.

RESULTS OF OPERATIONS

Factors Affecting Operating Results

Net sales are affected by advertising, discounts and promotions, merchandising and packaging, all of which have a significant impact on consumers' buying decisions. Continued growth of net sales and profits will depend, substantially, on the continued popularity of existing brands, the ability to effectively manage the sales channels, and the ability to maintain sufficient product supply to meet expected growth in demand.

Cost of sales includes wine-related inputs, such as grapes and semi-finished bulk wine, bottling materials, such as bottles, capsules, corks and labeling materials, labor and overhead expenses, including inbound and outbound freight, storage and barrel depreciation.

Discontinued Operations

During the fourth quarter ended June 30, 2018, we implemented a plan to sell off the Wholesale Business. On August 13, 2018, the Company entered into an Asset Purchase Agreement (the "Purchase Agreement") with Precept Brands LLC, a Washington limited liability company ("Precept"). Pursuant to the terms of the Purchase Agreement dated August 13, 2018 the Company received aggregate consideration of approximately \$18 million in cash and future royalty payments to acquire the Wholesale Business which consisted of sale of certain assets, primarily inventory and related intangibles. The Company also entered into a Royalty Payment Agreement and Transition Services Agreement.

As the result of this transaction, the financial results of the Wholesale Business are presented as "discontinued operations" on the Condensed Consolidated Statements of Operations for the three months ended September 30, 2018 and 2017. We have classified the assets and liabilities that are held for sale within the descriptions "assets of discontinued operations" and "liabilities of discontinued operations" within current and non-current assets and liabilities, on the condensed consolidated balance sheet as of September 30, 2018 and June 30, 2018. See Note 2 - Discontinued Operations in the notes to the condensed consolidated financial statements for more information.

Comparison of the three months ended September 30, 2018 and 2017

The following table compares the Company's financial results:

Three Months Ended September 30,
(in thousands, except percentages)

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Direct to
Consumer

Increase

| | 2018 | 2017 | (Decrease) | % Change | |
|----------------|---------|---------|------------|----------|---|
| Net Sales | \$1,597 | \$1,409 | \$188 | 13.3 | % |
| Cost of Sales | 501 | 675 | (174) | (25.8) | % |
| Gross Profit | \$1,096 | \$734 | \$362 | | |
| Gross Profit % | 68.6 % | 52.1 % | 16.5 | | % |

For the three months ended September 30, 2018, net sales increased \$0.2 million or 13%, as compared to the same period during the prior fiscal year, and consolidated gross profit margin increased from 52.1% to 68.6%. The increase in gross profit was primarily due to continued efforts to grow the channel through wine club and tasting room sales, as well as special offers presented via email to wine club members and others.

Sales and Marketing

Sales and marketing expenses consist primarily of personnel costs, advertising and other costs for marketing and promoting the Company's products.

Sales and marketing expenses consist of the following:

| | Three Months Ended September 30, (in thousands, except percentages) | | | |
|-------------------------|--|-------|------------|----------|
| | Increase | | | % |
| | 2018 | 2017 | (Decrease) | Change |
| Sales and marketing | \$493 | \$678 | \$ (185) | (27.3)% |
| Percentage of net sales | 30.9% | 48.1% | (17.2)% | |

Sales and marketing expenses decreased 27.3% for the three months ended September 30, 2018 compared to the same period last fiscal year. The decrease for the fiscal year 2018 is due to lower hosted wine club events and lower freight and shipping costs.

The amounts billed to customers for shipping and handling are recorded as sales and reported as the costs are incurred for shipping and handling as a sales and marketing expense. For the three months ended September 30, 2018 and September 30, 2017 shipping costs were \$0.2 million.

General and Administrative

General and administrative expenses include the costs associated with personnel, professional fees, insurance and other expenses related to administrative and compliance functions.

A comparative summary of general and administrative expenses is as follows:

| | Three Months Ended September 30, (in thousands except percentages) | | | |
|----------------------------|---|-------|------------|--------|
| | Increase | | | % |
| | 2018 | 2017 | (Decrease) | Change |
| General and administrative | \$1,304 | \$790 | \$ 514 | 65.1 % |
| Percentage of net sales | 81.7 % | 56.1% | 25.6 % | |

General and administrative expense for the three months ended September 30, 2018 increased compared to the same period in fiscal year 2018 both in terms of absolute dollars and measured as a percentage of net sales. The increase was primarily due to increases in personnel related costs and outside services and consulting expenses associated with compliance efforts associated with the Precept transaction.

On August 31, 2018, as part of the sale of the Wholesale Business, the Company terminated the Company's former Vice President of Sales. In connection with his termination, the Company entered into a separation agreement providing for a cash severance payment of \$0.05 million inclusive of payment for severance, annual bonus amounts owed and a portion of his COBRA premiums for continuation of health benefits. In addition, 60,000 RSUs and 35,000 ISOs outstanding equity-based awards granted which were unvested on the date of his termination became fully vested and exercisable. The Company recorded \$0.05 million in general and administrative expense associated with the separation agreement as a severance expense and \$0.2 million in expense associated with the acceleration of stock options and restricted stock units.

Interest Expense

Interest and loan fee amortization was \$0.1 million for both three months ended September 30, 2018 and 2017.

Income from discontinued operations, net of tax

| | September September 30, | September 30, |
|---|----------------------------|------------------|
| | 2018 | 2017 |
| Revenues less excise tax | \$ 2,058 | \$ 4,781 |
| Cost of sales | 1,754 | 3,468 |
| Gross Profit | 304 | 1,313 |
| Operating costs and expenses | 872 | 778 |
| Gain on sale of discontinued operations | 2,558 | — |
| Income from discontinued operations, net of tax | \$ 1,990 | \$ 535 |

During the three months ended September 30, 2018 and 2017, we recorded income from discontinued operations from the Wholesale Businesses of \$2.0 million and \$0.5 million respectively. The quarter over quarter variance of \$1.5 million was primarily related to the recognition of the gain on sale of discontinued operations of \$2.6 million offset by lower Wholesale Business gross profits resulting from lower business activities.

LIQUIDITY AND CAPITAL RESOURCES

General

The primary sources of available cash are from operations, bank borrowings and equity offerings. The primary cash needs are to fund working capital requirements (primarily inventory), capital expenditures for barrels and other equipment to facilitate production, repay indebtedness (interest and principal payments) and operating expenses. We are able to borrow against working capital assets (accounts receivable and inventory) through an asset based bank loan.

| | September 30, 2018 | June 30, 2018 | Increase (Decrease) | % |
|---------------------------|------------------------------------|---------------------|------------------------|--------|
| | (in thousands, except percentages) | | | |
| Working capital | \$10,946 | \$9,061 | \$ 1,885 | 20.8 % |
| Cash and cash equivalents | \$5,554 | \$278 | \$ 5,276 | 1898% |

The line of credit, which was refinanced on August 17, 2017, was a revolving line of credit with a maximum commitment of \$10.0 million which accrues interest at 2.25% above the LIBOR. The line of credit initially matured on July 31, 2018. We received an extension on the maturity to October 31, 2018.

All debt balances were paid off on August 13, 2018 with the proceeds received from the sale of Wholesale Business to Precept.

We believe that our cash position and net cash provided by operating activities in coming periods, will be adequate to finance working capital and operations needs for at least the next twelve months. We may, however, require additional liquidity as we continue to execute our business strategy. We anticipate that to the extent that we require additional liquidity, it will be funded through the incurrence of indebtedness, additional equity financings or a combination of these potential sources of liquidity, although no assurance can be given that such forms of capital will be available at all, or if available, on terms acceptable to us.

Cash Flows

| | Three Months Ended September 30, (in thousands) | | Increase (Decrease) |
|---|--|-----------|------------------------|
| | 2017 | 2017 | |
| Net cash provided by (used in) operating activities | \$2,423 | \$(3,955) | \$6,378 |
| Net cash used in investing activities | (92) | (519) | (427) |
| Net cash (used in) provided by financing activities | (11,297) | 512 | (11,809) |

Operating Activities

For the three months ended September 30, 2018, net cash used in operating activities was \$2.4 million which was an increase of \$6.4 million compared to the same period last fiscal year. The changes in cash flows provided by operating activities are attributable to lower cash used for inventory and higher accounts receivables.

Investing Activities

For the three months ended September 30, 2018, cash used in investing activities increased by \$0.4 million compared to the same period of last fiscal year due to less purchases of machinery and equipment.

Financing Activities

Financing activities, which consisted primarily of the extinguishment of the Company's existing borrowings from bank financing, utilized \$11.3 million for the three months ended September 30, 2018, an increase of \$11.8 million over the same period of the prior year.

Contractual Obligations and Commitments

Financing Agreements

Our indebtedness was comprised primarily of bank loans including lines of credit and long term debt. All associated balances were paid in full in during the first quarter of 2019.

Lines of Credit

All associated balances were paid in full in during the first quarter of 2019. See discussion under "Liquidity and Capital Resources" above.

Long Term Debt

Long term debt consisted of various notes payable to a bank secured by specific property and/or equipment. In connection with the sale of the Wholesale Business on August 13, 2018, the Company repaid all obligations pursuant to its bank borrowings, and terminated its obligations thereunder.

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Capital Lease

In June 2017, we entered into a 72-month capital lease related to wine production equipment. The future lease commitments are approximately \$0.02 million per year for fiscal years 2018 through 2023.

Concentration of Credit Risk and Off-Balance Sheet Arrangements

Our cash is held in highly rated credit institutions. Although we try to limit the amount of credit exposure with any one financial institution, we do in the normal course of business, maintain cash balances in excess of federally insured limits.

Accounts receivable consists primarily of trade receivables from customers. We review accounts receivable regularly and makes estimates for an allowance when there is doubt as to the collectability of individual balances. The accounts receivable credit risk is not concentrated within any one geographic area. We have national distribution agreements with multi-state distributors and these distributors make up a significant amount of the accounts receivable; however, we believe the accounts receivable credit risk is limited. We have not experienced any material charge offs.

Off-Balance Sheet Arrangements

We do not have off-balance sheet risks related to foreign exchange contracts, option contracts or other foreign hedging arrangements.

We enter into short and long-term contracts with third-parties and related party growers to supply a portion of its future grape and bulk wine inventory requirements. Future minimum grape and bulk wine inventory purchase commitments are as follows:

| Years ending June 30, | Related Parties | | Total |
|--------------------------------|-------------------------------|------|---------|
| | Third-Party (in thousands) | | |
| 2019 | \$1,822 | \$8 | \$1,880 |
| 2020 | 594 | 59 | 653 |
| 2021 | 157 | 60 | 217 |
| 2022 | 51 | 61 | 112 |
| 2023 | - | 62 | 62 |
| Total | \$2,624 | \$00 | \$2,924 |

Production & Storage

We enter into various contracts with third-party service providers for grape crushing, wine storage and bottling. The costs are recorded in the period for which the service is provided. The actual costs related to custom crush services are based on volume. Our current contracts for custom crush services cover the 2018 harvest.

Leases

We lease space for wine production within a custom crush facility located in Santa Rosa, California. The lease, which relates to the 2017 harvest, commenced April 15, 2017 and initially terminated on June 15, 2018. The initial 14-month term has been renewed for an additional 12-month period as agreed to by both parties. The future lease commitments as presented below include amounts for this lease. In addition, pursuant to the terms of the lease and related winery facilities agreement, we are obligated to pay variable processing fees based on the tonnage of grapes crushed in the facility.

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We lease approximately 2,500 square feet for administrative offices at 125 Foss Creek Circle, Healdsburg, California. In June 2016, we renewed the lease for an additional three years. The renewed lease term is November 1, 2016 through October 31, 2019. We also lease approximately 1,600 square feet for executive and administrative offices at 165 Foss Creek Circle, Healdsburg, California. The lease commenced on September 1, 2016 and ends on October 31, 2019. The future lease commitments as presented below include amounts for these two leases.

Lease payments for these facilities were \$0.1 million and \$0.1 million for three months ended September 30, 2018 and September 30, 2017, respectively.

Future lease commitments are:

| Years ending June 30, (in thousands) | |
|---|-------|
| 2019 (remaining nine months) | \$269 |
| 2020 | 31 |
| Total future rent payments | \$300 |

Effects of Inflation and Changing Prices

The results of operations and financial condition have not been materially affected by inflation and changing prices; however, as agricultural commodities, grape and bulk wine prices experience certain levels of variability. We intend to pass along rising costs through increased selling prices, subject to normal competitive conditions. There can be no assurances, however, that we will be able to pass along rising costs through increased selling prices effectively. In addition, we continue to identify on-going cost savings initiatives.

Critical Accounting Policies and Estimates

Except as described within the Recently Adopted Accounting Pronouncements discussion above there have been no material changes to the critical accounting policies and estimates previously disclosed in the Annual Report on Form 10-K for the fiscal year ended June 30, 2018.

Accounting Pronouncements

See Note 1 of the condensed consolidated financial statements of this Quarterly Report on Form 10-Q for the summary of accounting pronouncements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company is a smaller reporting company as defined by Rule 12b-2 of the Exchange Act and is not required to provide the information required under this Item.

ITEM 4. CONTROLS AND PROCEDURES

Management's Report on Internal Controls over Financial Reporting

Under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, the Company's management has evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act of 1934, as of the end of the period covered by this report. Based upon that evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective and provide reasonable assurance, as of the end of the period covered by this report, that information required to be disclosed by the Company in its reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and were effective to provide reasonable assurance that such information is accumulated and communicated to our management, including our principal executive and financial officers, as appropriate, to allow timely discussions regarding required disclosure.

Changes to Internal Controls over Financial Reporting

There have been no changes in the Company's internal controls over financial reporting during the quarter ended September 30, 2018 that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

Limitations on the Effectiveness of Controls

A control system, no matter how well designed and operated, cannot provide absolute assurance due to its inherent limitations: it is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human or other failures. A control system also can be circumvented in various ways, including, without limitation, by collusion or improper management override. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of such limitations, disclosure controls and internal control over financial reporting cannot prevent or detect all misstatements, including, without limitation, unintentional errors or fraud. Because these inherent limitations are known features of the financial reporting process, it is possible to design and implement process safeguards to reduce such risk, however, such risk cannot be completely eliminated. As such, management, including the Chief Executive Officer and Chief Financial Officer, does not expect that the Company's disclosure controls or internal controls over financial reporting will prevent or detect all misstatements, including without limitation, unintentional errors and fraud.

PART II – OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The Company may be subject to various litigation matters arising in the ordinary course of business from time to time. Other than the matters discussed below, the Company is not aware of any current pending legal matters or claims, individually or in the aggregate, that are expected to have a material adverse impact on our consolidated financial position, results of operations, or cash flows.

The Company received a letter dated October 12, 2018 from a law firm representing one of our design firms alleging we had not paid the full value of the services provided during the last seven years for creative design and marketing services. The Company deems that it is likely that it will make a settlement payment in the range of \$300k to \$500k.

ITEM 1A. RISK FACTORS

There have been no material changes in information regarding our risk factors as described in Item 1A of our Form 10-K for the fiscal year ended June 30, 2018 as filed with the SEC on October 15, 2018.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not Applicable

ITEM 4. MINE SAFETY DISCLOSURES

Not Applicable

ITEM 5. OTHER INFORMATION

Not Applicable

ITEM 6. EXHIBITS.

Exhibit Number Description

- 3.1+ Amended and Restated Certificate of Incorporation of Truett-Hurst, Inc. (incorporated by reference to Exhibit 3.1 to the Annual Report on Form 10K/A submitted to the SEC on April 17, 2018 (File No.: 333-187164)).
- 3.2+ Bylaws of Truett-Hurst, Inc. (incorporated by reference to Exhibit 3.2 to the Annual Report on Form 10K/A submitted to the SEC on October 29, 2018 (File No.: 333-187164)).
- 3.3+ Third Amended and Restated Operating Agreement of H.D.D. LLC, dated as of June 19, 2013 (incorporated by reference to Exhibit 10.1 to the Report on Form 8-K submitted to the SEC on June 25, 2013 (File No.: 001-35973)).
- 4.1+ Class A common stock certificate (incorporated by reference to Exhibit 4.1 to the Registration Statement on Form S-1/A submitted to the SEC on April 11, 2013 (File No.: 333-187164)).
- 4.2+ Class B common stock certificate (incorporated by reference to Exhibit 4.2 to the Registration Statement on Form S-1/A submitted to the SEC on April 11, 2013 (File No.: 333-187164)).
- 10.1+ 2012 Stock Incentive Plan (incorporated by reference to Exhibit 10.14 to the Registration Statement on Form S-1 submitted to the SEC on March 11, 2013 (File No.: 333-187164)).
- 10.2+ Exchange Agreement, dated as of June 19, 2013, by and among Truett-Hurst, Inc. and the members of H.D.D. LLC from time to time party thereto (incorporated by reference to Exhibit 10.2 to the Report on Form 8-K submitted to the SEC on June 25, 2013 (File No.: 001-35973)).
- 10.3+ Tax Receivable Agreement, dated as of June 19, 2013, by and among Truett-Hurst, Inc., H.D.D. LLC and the members of H.D.D. LLC from time to time party thereto (incorporated by reference to Exhibit 10.3 to the Report on Form 8-K submitted to the SEC on June 25, 2013 (File No.: 001-35973)).
- 10.4+ Registration Rights Agreement, dated as of June 19, 2013, by and among Truett-Hurst, Inc. and the members of H.D.D. LLC from time to time party thereto (incorporated by reference to Exhibit 10.4 to the Report on Form 8-K submitted to the SEC on June 25, 2013 (File No.: 001-35973)).
- 31.1 Certification of the Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934
- 31.2 Certification of the Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934
- 32.1 Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

| | |
|---------|--|
| 32.2 | <u>Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002</u> |
| 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 |

⁽¹⁾+ Indicates documents previously filed with the Company's registration and prospectus filings with the SEC.

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, in the City of Healdsburg, State of California, on the 19th day of November 2018.

TRUETT-HURST, INC.

/s/ Paul E. Dolan
Paul E. Dolan, III
President and Chief Executive Officer
(Principal Executive Officer) November 19, 2018

/s/ Karen Weaver
Karen Weaver
Chief Financial Officer
(Principal Financial/Accounting Officer) November 19, 2018