

July 27<sup>th</sup>, 2022

Dear Shareholders,

This has been a quarter of significant activity for our company, including a withdrawn debt issuance, a cancelled tender offer, and management reorganization. The long-term results of our decisions will have to speak for themselves, but shareholders deserve insight into our decision-making.

## Discretionary SG&A Expenses

Our Q2 2022 sales were slightly down vs. 2021 (down 2%). Without our ongoing salesforce efforts, revenue would have been down nearly 7% as we continue to decline off our COVID peak. Our expenses were much higher, including our continued efforts to grow revenue. This business on a standstill basis produces meaningful cashflow each month before growth spending. We are spending shareholder cash today to attempt to increase long-term FCF per share by growing sales and shrinking shares outstanding. We think it's helpful to disaggregate the standstill cash flow of this business from "elective" operating expenses we decide to undertake. Elective expenditures can be further divided into "capital structure reorganization," like buybacks and recapitalization legal costs, and "growth opex" buckets. Net elective expenditures totaled approximately \$400,000 for Q2 2022.

### *Capital Structure Reorganization*

Capital structure reorganization expenses were large this quarter, and are all the more frustrating because they did not result in any changes to our shares outstanding or capital structure. We aim to reduce shares outstanding at accretive prices when no attractive internal expenditures present themselves. Legal and advisory expenses were approximately \$200,000. While we would take advantage of low-priced shares or low-cost debt if we had the opportunity, current plans do not include further debt issuance or buyback. We will wait to see if new internal growth opex spending proves attractive. We think it will.

### *Growth Opex*

Ongoing growth opex is the spending we are doing to try to grow gross margin dollars beyond the current steady-state of this business. Today this includes compensation for our new CEO and three salespersons, totaling between \$500 - \$600k per year (~\$200k this quarter net of management reorganization efficiencies). This will increase our SG&A by around 25% on an annual basis. Our hurdle rate on opex expenditure is high, but with the strategic avenues our new CEO Matt Katz is exploring, we might expect to happily spend significantly more in this column going forward.

Our preliminary data on the salesforce is beginning to indicate that this is a productive use of shareholder capital, that the NPV of incremental gross margin dollars generated by additional sales exceeds all-in ongoing compensation costs. Q2 new customer sale revenue was twice Q1's. We are still gathering data, as the sales cycle is a slow one. Our sales force increased gross margin dollars in Q2 by nearly \$50,000, and we hope for this to ramp up such that it justifies the additional SG&A drag.

Matt is exploring several new "blue sky" verticals to apply our patch IP and sales force. One immediate target is employer/employee private use. Some of the longer-term targets may include direct-to-consumer or international market. Matt only began four weeks ago, so we will reserve judgment on the value of his additional compensation spend until we have more data.

### *Pro forma Operating Income without Growth and Buyback Spending*

If one pretends for a moment that we didn't spend the net \$400,000 in elective expenses this quarter, and didn't enjoy the additional sales from that spend, quarterly pro forma EBIT would have been ~\$560,000, or right at \$0.11 per share. We have approximately exhausted our NOL shield, and will pay taxes at a ~22% rate going forward barring any further developments.

These expenses were real – the shareholder's cash was spent! – and we will likely incur similar one-time and recurring expenses going forward both to try to grow and to try to reorganize the capital structure. We break this out in an effort to provide you, the shareholder, with the same data we use to make decisions.

### **Customer Disruption**

Our single largest customer has notified us that their funding will not permit any purchases in Q3 2022. This customer represents approximately 10% of our revenue. This is a federal customer, and our degree of customer concentration with them is a historical anomaly of this business. Excluding this customer, federal sales are now a small percentage of our ongoing business. We have no further information on whether they will continue purchases in October 2022 when their funding resumes. Our current growth initiative ambitions are such that we hope that this sales loss, whether it is short-lived or permanent, will not be a long-term impairment to the value of the company.

As we posted in detail on our Investor Relations page, our Annual Meeting will be held in Fort Worth, Texas, on August 31. We hope to see you there.

Thank you again for the trust you've put in us.

Tice Brown



Chairman of the Board

**\*\*Please read the Disclaimer Below.\*\***

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#### DISCLAIMER

This letter contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 and Section 27A of the Securities Act of 1933 ("Forward-looking Statements"), which are subject to the "safe harbor" created by these Sections. Forward-looking statements are statements about future financial results, future products or services and [www.pharmchem.com](http://www.pharmchem.com) other events that have not yet occurred. These forward-looking statements contain words such as, but not limited to, "expect", "anticipate", "estimate", "believe", "will", "may" or "might". Investors should be aware that actual results may differ materially from our expressed expectations because of risks and uncertainties about the future. We will not



necessarily update the information in this letter if any forward-looking statement later turns out to be inaccurate.

To supplement our unaudited condensed consolidated financial statements presented on a GAAP basis, we disclose certain non-GAAP and Pro Forma financial measures, including Return on Invested Capital (ROIC), free cash flow (FCF), steady-state free cash flow, pro forma EBIT, and steady-state free cash flow per share that exclude certain amounts, one-time expenses from corporate actions and new sales force employee compensation costs. These non-GAAP financial measures are not in accordance with generally accepted accounting principles in the United States and should not be considered in isolation from or as a replacement for the most directly comparable GAAP financial measures. Further, other companies may calculate these non-GAAP financial measures differently than we do, which may limit the usefulness of those measures for comparative purposes.

We believe that presenting Return on Invested Capital, free cash flow, steady-state free cash flow, and steady-state free cash flow per share, in addition to the corresponding GAAP financial measures, provides investors greater transparency to the information used by management for its operational decision-making and allows investors to see our results “through the eyes” of management. We further believe that providing this information assists our investors in understanding our operating performance and the methodology used by management to evaluate and measure such performance.

**PHARMCHEM, INC.**  
**BALANCE SHEETS**

	<b>June 30, 2022 (unaudited)</b>	<b>December 31, 2021 (audited)</b>
<b>Current Assets:</b>		
Cash	\$ 2,253,922	\$ 2,217,270
Securities	-	-
	2,253,922	2,217,270
Receivables:		
Trade	681,777	691,883
Other	241,200	241,200
Less: Allowance for Doubtful Accounts	(15,000)	(15,000)
Total Receivables, Net	907,977	918,083
Inventories	319,737	68,009
Prepays & Other	41,721	20,124
Deferred Tax Asset, Net	53,116	166,861
TOTAL CURRENT ASSETS	3,576,473	3,390,347
Equipment	17,818	17,818
L.H. Improvements	13,750	13,750
NetSuite Implementation	-	-
TOTAL	31,568	31,568
Less: Accumulated Depreciation/Amortization	(31,025)	(30,941)
Net Fixed Assets	543	627
TOTAL ASSETS	\$ 3,577,016	\$ 3,390,974
<b>Current Liabilities:</b>		
Accounts Payable	\$ 194,737	\$ 188,941
TOTAL CURRENT LIABILITIES	194,737	188,941
Accrued Expenses:		
Other Accrued Expenses	118,643	87,772
Accrued Income Taxes	-	-
Accrued Compensation	119,889	265,745
Dividend Payable	-	-
TOTAL ACCRUED LIABILITIES	238,532	353,517
TOTAL LIABILITIES	433,269	542,458
<b>Stockholders' Equity:</b>		
Common Stock	5,059	5,103
Additional Paid-In Capital	13,696,917	13,819,663
Accumulated Deficit	(10,558,229)	(10,976,250)
TOTAL EQUITY	3,143,747	2,848,516
TOTAL LIABILITIES & EQUITY	\$ 3,577,016	\$ 3,390,974
Shares Authorized	25,000,000	25,000,000
Shares Outstanding	5,058,995	5,103,273

**PHARMCHEM, INC.**  
**STATEMENTS OF INCOME**  
**(unaudited)**

	<b>Three Months Ended June 30,</b>		
	<b>2022</b>	<b>2021</b>	<b>% Inc(Dec)</b>
Sales, net	\$ 1,508,119	\$ 1,531,905	(1.6%)
Cost of sales	543,022	593,083	(8.4%)
Gross profit	965,097	938,822	2.8%
Operating Expenses:			
Sales and marketing	208,596	113,799	83.3%
General and administrative	559,060	382,971	46.0%
Total operating expenses	767,656	496,770	54.5%
Income from operations	197,441	442,052	(55.3%)
Other income (expense):			
Dividend and interest income	1,989	666	
Forgiveness of PPP loan	-	125,455	
Other income (expenses)	-	200	
Total other income	1,989	126,321	(98.4%)
Income before provision for income taxes	199,430	568,373	(64.9%)
Provision for income taxes			
Federal - current	9,878	99,995	
Federal - deferred	41,880	-	
	51,758	99,995	(48.2%)
Net income	147,672	468,378	(68.5%)
Earnings per share	\$ 0.029	\$ 0.080	
Diluted earnings per share	\$ 0.028	\$ 0.067	
Common shares outstanding	5,058,995	5,852,593	
Diluted common shares outstanding	5,298,995	6,992,593	

**PHARMCHEM, INC.**  
**STATEMENTS OF INCOME**  
**(unaudited)**

	<b>Six Months Ended June 30,</b>		
	<b>2022</b>	<b>2021</b>	<b>% Inc(Dec)</b>
Sales, net	\$ 3,048,447	\$ 3,173,375	(3.9%)
Cost of sales	1,105,164	1,193,313	(7.4%)
Gross profit	1,943,283	1,980,062	(1.9%)
Operating Expenses:			
Sales and marketing	487,071	218,565	122.8%
General and administrative	916,735	782,373	17.2%
Total operating expenses	1,403,806	1,000,938	40.2%
Income from operations	539,477	979,124	(44.9%)
Other income (expense):			
Dividend and interest income	2,230	1,368	
Forgiveness of PPP loan	-	125,455	
Other income (expenses)	(63)	200	
Total other income	2,167	127,023	(98.3%)
Income before provision for income taxes	541,644	1,106,147	(51.0%)
Provision for income taxes			
Federal - current	9,878	218,975	
Federal - deferred*	113,745	-	
	123,623	218,975	(43.5%)
Net income	418,021	887,172	(52.9%)
Earnings per share	\$ 0.083	\$ 0.152	
Diluted earnings per share	\$ 0.079	\$ 0.127	
Common shares outstanding	5,058,995	5,852,593	
Diluted common shares outstanding	5,298,995	6,992,593	

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The financial statements attached differ from the financial statements included in the proxy as a journal entry of \$41,880 was made in June to reduce the Deferred Tax Asset and increase the Federal Tax Expense, after the deadline for the proxy mailing had passed. A similar journal entry for \$71,865 was entered as of March 31, 2022. This totals \$113,745 of Federal Tax Expense related to the reduction of the Deferred Tax Asset account as of June 30, 2022.