

January 26th, 2022

Dear Shareholders,

We currently intend to release our 2021 audited financials in February. However, in an effort to communicate timely with you, please find attached our unaudited Q4 2021 and full-year 2021 financials, along with the following letter from your Chairman.

Steady-State FCF of PharmChem

It appears now that 2020 was an outlier year for PharmChem. COVID lockdowns may have driven customers to short-term use of our PharmChek product while social distancing measures were in effect. Customers may also have been pulling forward their patch purchases into 2020, increasing their inventory levels during uncertain times. Whatever the cause, sales in 2021 decreased by 6.7% over 2020. We note that 2021 sales are 12.3% higher than those in 2019. We believe this to be secularly growing business over time, although it's our job to prove that.

PharmChem incurred multiple one-time expenses which, while they certainly cost shareholders cash in 2021, will be non-recurring. The change in control that took place in August cost significant legal and severance expenses. We also spent legal fees on our Tender Offer, although we are very pleased with the outcome. Our best estimate of all in costs is ~\$340,000, split between Q3 and Q4 earnings reports. We also spent ~\$73,000 in what we consider to be "recurring growth capex" of salesforce compensation, although of course it is accounted for as SG&A per GAAP, which can be increased or decreased based on the ROIC it generates going forward.

These together mean that our GAAP stated earnings partially understate the in-place, steady-state free cash flow generation of this business for 2021, which we roughly estimate at \$2.07mm, or approximately \$0.39 per share.

The Capital Requirements of PharmChem

Our new Board has been in place for approximately 3 ½ months. Operational management of this company continues to be very efficient. Our central contribution has been our focus on capital allocation. Total capital deployed in this business is quite small, less than \$1,000 of PP&E and less than \$100,000 of inventory.

That leaves us with the question of what to do with cash generated by this business. We have analyzed vertical integration through purchase or construction of either a screening laboratory or patch manufacturing. These two possibilities appear to be too capital intensive to justify a speculative buildout. We had an active open-market buyback program, but found little volume in the stock at acceptable prices. Instead, we completed a Dutch Tender Offer in November. Between all share buybacks through the year, we reduced fully diluted shares outstanding by ~24% to approximately 5.3mm.

We currently intend to maintain ~\$2mm, or one full year of operating expenses, in cash on the balance sheet. We reserve the right to change this at any time if attractive capital allocation opportunities arise.

Our Salesforce

Hiring a new, dedicated salesforce could be a high ROIC use of cash, although we need quantitative results to back this hunch. Based on industry reports, drugs of abuse screening generates approximately \$2.6B of revenue in North America, and is growing >\$150mm per year. PharmChem's revenue is approximately 0.25% of this market. The vast majority of revenue nationally is collected by a urine testing duopoly, Quest Diagnostics and LabCorp. Their operations are tucked into other segments that make their margins difficult to parse; but we do know contribution FCF margin for additional PharmChek patches sold is attractive. We have no idea whether we can be 0.3% or 3% of the total revenue of this large market. But we are confident our product is superior in many ways (convenience of multi-week use, absence of unsanitary urine handling, higher fidelity) and we are excited to compete for a larger piece of the pie.

Previously all sales were handled by our now-CEO Kerri Wagner while she simultaneously managed the business as President. We began hiring a salesforce in Q4 2021 to assist her, which generated de minimis sales over 3 months' time, neither confirming nor negating our thesis. It's been slower going than we originally expected. Our customer base of municipal and government buyers has a long sales cycle. We don't expect to have enough data for 9-12 months to determine whether the increased SG&A investment of around \$400,000 per year from this salesforce exceeds the gross margin dollars (and incremental FCF) it generates. We are heartened by several larger possible customers circling orders, but it is the salesforce's job to convert these.

The Board of Directors

One genuine failure of the Chairman has been the complete inability to obtain reasonable debt financing for PharmChem, although this hasn't been for lack of effort. This company does not have real estate, manufacturing works, substantial receivables or inventory to borrow against: it is a gem of a business generating cash flow with little capital required. Lenders want hard assets as collateral; and without it request large equity grants, personal guarantees, nosebleed interest rates, or all three.

Your Board receives no cash salary, options, or compensation of any kind for its role at PharmChem. Our sole goal, the only way we make money here, is to increase the per-share value of this company for the shareholders. We are hopeful our sales efforts can show hard evidence of success in growing revenue in 2022. We look forward to our next report to you in April after Q1.

Tice Brown



Chairman of the Board

****Please read the Disclaimer on the Following Page.****

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 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 financial measures, including Return on Invested Capital (ROIC), free cash flow (FCF), steady-state free cash flow, 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

| | December 31, 2021 (unaudited) | December 31, 2020 |
|--|--|------------------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 2,217,270 | \$ 7,835,349 |
| Investments in marketable securities | - | 19,300 |
| Accounts receivable, net of allowance for doubtful accounts of \$15,000 in 2021 and 2020 | 676,883 | 650,492 |
| Inventories | 68,009 | 75,185 |
| Prepaid expenses and other current assets | 248,124 | 69,876 |
| Total current assets | 3,210,286 | 8,650,202 |
| Office equipment and leasehold improvements, net | 626 | 797 |
| Total assets | <u>\$ 3,210,912</u> | <u>\$ 8,650,999</u> |
| Liabilities and Stockholders' Equity | | |
| Current Liabilities: | | |
| Accounts payable | \$ 188,942 | \$ 189,381 |
| Loans payable | - | 125,455 |
| Accrued expenses and other liabilities | 280,134 | 763,640 |
| Deferred revenue | 87,772 | 62,706 |
| Total liabilities | 556,848 | 1,141,182 |
| Commitments and contingencies | | |
| Stockholders' equity: | | |
| Common stock, \$0.001 par value, 25,000,000 shares authorized, 5,103,273 issued and outstanding December 31, 2021, 5,852,593 issued and outstanding December 31, 2020 | 5,104 | 5,853 |
| Additional paid-in capital | 16,152,356 | 19,629,983 |
| Accumulated deficit | (13,503,396) | (12,126,019) |
| Total stockholders' equity | 2,654,064 | 7,509,817 |
| Total liabilities and stockholders' equity | <u>\$ 3,210,912</u> | <u>\$ 8,650,999</u> |

PHARMCHEM, INC.

STATEMENTS OF INCOME

Three and Twelve Months Ended December 31, 2021 and 2020

| | Three Months Ended December 31, 2021 (unaudited) | Three Months Ended December 31, 2020 (unaudited) | Twelve Months Ended December 31, 2021 (unaudited) | Twelve Months Ended December 31, 2020 |
|--|---|---|--|--|
| Sales, net | \$ 1,433,372 | \$ 1,553,802 | \$ 6,220,088 | \$ 6,667,633 |
| Cost of sales | 544,021 | 585,490 | 2,329,511 | 2,447,340 |
| Gross profit | 889,351 | 968,312 | 3,890,577 | 4,220,293 |
| Operating expenses: | | | | |
| Sales and marketing | 237,280 | 99,537 | 575,166 | 437,787 |
| General and administrative | 206,664 | 422,888 | 1,770,917 | 1,620,528 |
| Research and development | - | - | - | 21,745 |
| Total operating expenses | 443,944 | 522,425 | 2,346,083 | 2,080,060 |
| Income from operations | 445,407 | 445,887 | 1,544,494 | 2,140,233 |
| Other income (expense): | | | | |
| Dividend and interest income | 385 | 2,477 | 2,306 | 23,115 |
| Forgiveness of PPP loan | - | - | 125,455 | - |
| Other income (expense) | - | - | 900 | (290) |
| Total other income | 385 | 2,477 | 128,661 | 22,825 |
| Income before provision for income taxes | 445,792 | 448,364 | 1,673,155 | 2,163,058 |
| Provision for income taxes | (233,374) | 122,000 | 15,527 | 201,970 |
| Net income | \$ 679,166 | \$ 326,364 | \$ 1,657,628 | \$ 1,961,088 |
| Common shares outstanding | 5,103,273 | 5,852,593 | 5,103,273 | 5,852,593 |
| Diluted common shares outstanding | 5,343,273 | 6,988,319 | 5,343,273 | 6,988,319 |

PHARMCHEM, INC.

STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

Years ended December 31, 2021 and 2020
(unaudited)

| | <u>Common Stock</u> | <u>Additional Paid in Capital</u> | <u>Accumulated Deficit</u> | <u>Total</u> |
|------------------------------|-------------------------|---|--------------------------------|--------------------|
| Balance at December 31, 2019 | \$5,853 | \$19,629,983 | \$(13,501,848) | \$6,133,988 |
| Net Income | | | 1,961,088 | 1,961,088 |
| Dividends Paid | | | (585,259) | (585,259) |
| Balance at December 31, 2020 | \$5,853 | \$19,629,983 | \$(12,126,019) | \$7,509,817 |
| Net Income | | | 1,657,628 | 1,657,628 |
| Dividends Paid | | | (702,311) | (702,311) |
| Repurchase of Options | | | (2,282,619) | (2,282,619) |
| Repurchase of Common Stock | (749) | (3,477,627) | (50,075) | (3,528,451) |
| Balance at December 31, 2021 | <u>\$5,104</u> | <u>\$16,152,356</u> | <u>\$(13,506,396)</u> | <u>\$2,654,064</u> |

PHARMCHEM, INC.

STATEMENTS OF CASH FLOWS

Year Ended December 31, 2021 and 2020

| | December 31, 2021 (unaudited) | December 31, 2020 |
|--|--|------------------------------|
| Operating Activities | | |
| Net income | \$ 1,657,628 | \$ 1,961,088 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation | 170 | 2,708 |
| Forgiveness of loan | (125,455) | - |
| Provision for doubtful accounts | (3,415) | (1,225) |
| Net realized (gain) on investments in marketable securities | (700) | - |
| Net changes in operating assets and liabilities: | | |
| Accounts receivable | (22,976) | (10,049) |
| Bad debt recoveries | - | - |
| Inventories | 7,176 | (9,863) |
| Prepaid expenses and other current assets | (178,248) | 264 |
| Accounts payable | (438) | (8,551) |
| Accrued expenses and other liabilities | (483,505) | 220,139 |
| Deferred revenue | 25,065 | 18,864 |
| Total Adjustments | <u>(782,326)</u> | <u>212,287</u> |
| Net cash provided by operating activities | <u>875,302</u> | <u>2,173,375</u> |
| Investing Activities | | |
| Proceeds from sale of marketable securities | <u>20,000</u> | <u>-</u> |
| Net cash provided by (used in) investing activities | <u>20,000</u> | <u>-</u> |
| Financing Activities | | |
| Dividends paid | (702,311) | (585,259) |
| Repurchase of Options | (2,282,619) | - |
| Repurchase of Common Stock | (3,528,451) | - |
| Proceeds from loan | - | 125,455 |
| Net cash used in financing activities | <u>(6,513,381)</u> | <u>(459,804)</u> |
| Net (decrease)/increase in cash and equivalents | (5,618,079) | 1,713,571 |
| Cash and equivalents at beginning of year | <u>7,835,349</u> | <u>6,121,778</u> |
| Cash and equivalents at end of quarter | <u><u>\$ 2,217,270</u></u> | <u><u>\$ 7,835,349</u></u> |
| Supplemental Disclosure of Cash Flow Information | | |
| Cash paid during the year for federal and state income taxes | <u><u>\$ 277,160</u></u> | <u><u>\$ 161,343</u></u> |