Aleafia Health, Inc. (Q1 2020 Earnings)

May 13, 2020

Corporate Speakers:

- Nicholas Bergamini; Aleafia Health Inc.; VP of IR & Public Affairs
- Geoffrey Benic; Aleafia Health Inc.; CEO
- Benjamin Ferdinand; Aleafia Health Inc.; CFO & Corporate Secretary

Participants:

- Graeme Kreindler; Eight Capital; Principal
- Vivien Azer; Cowen and Company, LLC; MD & Senior Research Analyst
- Rahul Sarugaser; Raymond James Ltd.; MD and Equity Analyst of Healthcare, Biotechnology & Cannabis

PRESENTATION

Operator: Ladies and gentlemen, thank you for standing by. Welcome to the Aleafia Health First Quarter Results call. (Operator Instructions)

Please be advised that today's conference may be recorded. (Operator Instructions)

I would now like to hand the conference over to your speaker today, Nicholas Bergamini, Head of Investor Relations. Please go ahead.

Nicholas Bergamini: Thank you. Thank you for joining us on the call today. Joining me is our CEO, Geoffrey Benic, and CFO, Benjamin Ferdinand.

This morning, Aleafia Health filed on SEDAR's unaudited consolidated financial statements, and notes thereto for the quarter ended March 31, 2020, which have been prepared in accordance with IFRS standards. The associated management discussion and analysis as well.

All comments to be made on this call today should be taken with reference to and are qualified in their entirety by these documents. Please note that this call contains forward-looking statements or information and reflects the company's current expectations, estimates, projections, assumptions and beliefs about future events and financial trends that may -- that they believe may affect the company's financial condition, results of operations, business strategy and financial needs.

By their nature, forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements or other future events to be materially different from any future events, performance, or achievements expressed or implied by such forward-looking statements. Given these risks and uncertainties, shareholders and prospective purchasers of the company's securities should not place any undue reliance on these forward-looking statements.

Further, any forward-looking statement speaks only as of the date on which such statement is made, and except as required by applicable law, the company undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made.

This call also contains non-IFRS financial performance measures, which the company believes provides users with relevant information regarding operational performance. These measures are not recognized or defined under IFRS, and as a result, they may not be comparable to the data presented by competitors.

I'll now hand it over to CEO, Geoffrey Benic. Geoff, over to you.

Geoffrey Benic: Thank you, Nick. And on behalf of Aleafia Health team, I'd like to thank our stakeholders for joining us today. Before we begin, I'd like to recognize 3 Board members who are departing Aleafia at e end of this week. Our Chairman, Julian Fantino and Directors Raf Souccar and Bill Stewart. All three have played a significant role in Aleafia from the earliest days, and I'd like to thank them for their contributions.

Julian has often said that when the business began, it was without a telephone and an office. But what resonates with me about the story is that the days with no office and telephone was only 3 years ago. We've come a long way since then. So thank you to Julian, Raf and Bill.

And joining our Board are 2 outstanding new directors, Glenn Washer and Rhonda Lawson, each brings unique executive and board level experience in the pharmaceutical, healthcare and insurance industries, which will be invaluable to us in our future growth. This was, for many reasons, a breakthrough quarter for Aleafia Health. I'd like to look back in time to put things in perspective.

In Q1 2018, we generated $83,000 in revenue. In Q1 2019, revenue was $1.5 million. And in Q1 2020, that number has further exponentially increased to $14.6 million. While this is just a starting point for us, it's an -- it's exciting to see this dynamic growth in our young company. This was our fifth consecutive quarter of record revenue and our second consecutive quarter of positive adjusted EBITDA and our first quarter of positive cash flow from operations.

And yesterday's news really begins a new chapter for our business. Over the last 18 months, we've been simultaneously building out 3 unique production facilities. In the last 2 months, we received the necessary licenses for all of them. Our team has done a great job in removing the license roadblocks. Now it's all about execution. This quarter really speaks to the power of our low-cost cultivation advantage.

Our gross margin on cannabis revenue was 85%, which is, we believe, the best among the best in the industry. While many of our peers operate expensive oversized greenhouses, we used our second mover advantage to accelerate our growth through outdoor cultivation. We look forward to building on the 13,000 kilograms produced on 13 acres in 2019. But that's only one side of the coin.

Our goal has always been to couple low-cost cultivation with high-margin value-added production at large scale. We've only seen the tip of the iceberg in our potential in that regard. But we've turned the corner with the license of our Paris Phase II expansion, which is by far our most important facility.

The expanded Paris facility is a state of the art and purpose-built to meet EU GMP standards. Senior members of our team have spent their entire careers in EU GMP production. And their expertise will be essential as we look forward to gain market access to the EU. Our application for inspection has already been submitted to German regulatory authorities.

On the more near term horizon, Paris allows us to rapidly scale up the extraction production and packaging of our existing product portfolio, while bringing new products to the market. To put things in perspective, our incredible team may do with only 2,500 square feet of processing, packaging, extraction area in the legacy Paris building to 20,000 square feet in the expanded building. This means greater breadth of formats, greater scale and automation and ultimately, bigger margins as we leverage all of these new advantages.

Paris was also the milestone we need to hit. To give us a clear path to launching Cannabis 2.0 products. We agree with certain analysts' commentary that offering a portfolio of differentiated new cannabis product formats will be essential to our success. Over the course of the second half of 2020, we'll be introducing a series of new formats, including sublingual strips, vapes, candies and additional derivative formats.

Our goal is to have some of these in market in Q3 and others in Q4. We expect to have a clear picture in the coming weeks and if there will be any supply chain disruptions due to COVID-19, which might delay the delivery of certain machinery and hardware. And we look forward to providing our full product rollout plan in very short order.

Finally, I'll touch on a couple of projects that our team is particularly proud of. Our newly launched medical cannabis Direct-to-Door service and our transition to 100% virtual clinic consultation. AssureHome Delivery has been long in the works, but following the needs of our patients in these unprecedented times, we launched early.

AssureHome Delivery is now available in nearly the entire greater Toronto area, home to 9 million people, and we will begin servicing the final communities next week. With the investments we made over the last 2 years in virtual clinic services, we have been able to quickly transition to completing 100% of our physician-led patient consultations remotely following this temporary voluntary closure of our physical clinic locations.

Now our patients can see a physician in the morning order medical cannabis and then have it delivered to their home that same day. I'll now pass it over to our CFO, Benjamin Ferdinand.

Benjamin Ferdinand: Thanks, Geoff. It's good speaking to you all, this morning. This quarter really demonstrates our differentiated health and wellness strategy in action as our team executes. Our ecosystem strategy has high barriers to entry and provides a defendable long-term competitive advantage relative to our peers. We are razor focused on having one of the highest margins in the business, the right cost controls, disciplined capital allocation and relentless execution.

This quarter demonstrated our strategy in action. In Q1, we saw the continued trend of 5 quarters of record revenue growth, the second consecutive quarter of positive adjusted EBITDA, and the first quarter of positive cash flow from operations. All significant milestones for us. Much of the attention will be on revenue growth, but equally important to us is our focus on cost discipline. Again, we've seen operational expenses and SG&A remain tightly controlled while we scale revenue and demonstrate the operational leverage in our business model.

Our team believes that we must continue to do more with less. Now we will look to the income statement. We're very pleased to see solid top line growth. Our Q1 revenue was $14.6 million. The key driver of that was that cannabis revenue increased by 183% over the previous quarter and over 2,400% over the prior year's quarter. Our Q1 adjusted EBITDA was $6.4 million or a very strong 44% adjusted EBITDA margin. The net loss for accounting purposes was $6.2 million compared to $9.8 million loss in the previous quarter.

However, this was largely due to noncash items, including depreciation and amortization and a $6.2 million noncash expense based on fair value of inventory sold in the period. For those not as familiar with IFRS, this is not an inventory write-down. This recognizes the fact that there was an increase in value to the cannabis crop while the crop is still growing, then balances out as an expense when the corresponding portion of the crop is sold.

Next, I'll turn to our balance sheet. On Monday, we announced a bought deal offering that upon closing, will add an additional $13 million to our cash position. We said that in Q4, we would prioritize non-dilutive financing, but we had a great opportunity to raise capital in a very difficult global economic environment. So we took advantage of the opportunity. We view this moderately sized capital raise as very prudent. It provides us with substantial security during the time of global economic uncertainty, along with the ability to take advantage of growth opportunities should they arrive, or else.

With regards to cash flow, we generated our first quarter of positive cash flow from operations. This is a major milestone for our firm and the cannabis industry. Cash flow used in investing activities was $7.9 million, which was entirely due to the acquisition of property, plant and equipment. This included the payment of construction holdbacks for already completed work at the Paris facility and Niagara facility. The company also further invested in additional infrastructure at the Port Perry facility to manage the 2020 outdoor cultivation harvest, along with the purchase of planting and harvesting equipment.

Investments were also made in new production machinery, primarily for our new Cannabis 2.0 product formats. With regards to capital expenditures going forward, the figure will be lower in Q2 compared to Q1. Our remaining capital expenditures for the year will be focused on machinery and equipment for outdoor harvest and 2.0 products.

Next, we'll look at Cannabis segments. Our medical cannabis revenue declined by 21%, but this was due to a decline in international sales that are included in our medical cannabis revenue segment. With regards to Canadian Medical cannabis sales, they remain flat quarter-over-quarter.

As we previously guided in our Q4 earnings, we had some substantial supply challenges that led to inventory shortages for top-selling medical SKUs at the beginning of the year. I'm happy to report that since March, these SKUs are all back in stock, and we have strong inventory of medical cannabis products. The result was our best ever medical cannabis sales month in March, followed by an even stronger April and another new record.

On another positive note in the medical space, our active registered patients increased to 11,000 quarter's end and surpassed 12,000 just yesterday. This is an increase of over 1,000 patients in just 6 weeks, a strong validation of our business model from our patients in challenging times. Our adult-use revenue increased, although not at the same pace as our overall cannabis sales growth. Part of this was due to us ramping up inventory for adult-use, and we are now in the process of building out adult-use inventory.

We will soon be launching one of the most competitively priced, high-quality, high-value CBD oils available in Canada through our adult-use distribution network. However, with very low-cost outdoor cannabis at input material, our margins on these products should remain strong. Operator, over to you.

QUESTIONS AND ANSWERS

Operator: (Operator Instructions)

Our first question comes from the line of Graeme Kreindler with Eight Capital.

Graeme Kreindler: I just wanted to start off with respect to either on a top line or a kilogram basis. Would you be able to provide what the split was there in the segments in terms of medical, adult-use and wholesale?

Nicholas Bergamini: Yes. When you look at kilograms sold, the total kilograms sold for this quarter was approximately 5,000 kilograms sold with the split of substantial portion being wholesale followed next by medical and adult-use. We can follow-up with the specific details.

Graeme Kreindler: Okay. So with respect to thinking through the remainder of 2020, how do you expect relative to what the split was like in this quarter. How do you expect that -- would you expect that a larger proportion becomes adult-use? And what -- if we were to look sort of towards the end of the year, where would you envision the largest segment being at that point?

Nicholas Bergamini: Yes. We don't provide specific guidance, but what we can say is when we think about our medical division, it continues to ramp up. As we have inventory. And as we highlighted, our patient growth remains strong, and we balance our medical and adult-use segments with our wholesale business.

And as you've seen with our execution last year on outdoor and as we expect to have this year, we will have a large opportunity to have significant amount of product from outdoor, and we will be opportunistically looking to the key thing being -- putting those sales revenues through our medical, international and adult-use, but there will be an opportunity for us to sell wholesale based on discussions that we're having and what we're seeing in the market. So I don't have a specific split, but we will do what we can to maximize the revenue profit potential for our shareholders.

Graeme Kreindler: Okay. And then to follow-up with respect to the outdoor facility, what sorts of strains or what sort of even here, can you provide -- products you're going to be looking to plant there? Are those going to be strains that are heavier on the CBD side?

As you mentioned that product launch earlier on the call, are you looking for something that's higher potency THC side to supplement into the adult-use market, there? What are you guys doing there from a demand planning perspective to make sure that you have the optimal range of biomass?

Nicholas Bergamini: So we've really taken a lot of lessons from our playbook last year in terms of outdoor in terms of strains. And as everyone knows, we had a really successful outdoor harvest in 2019, and we've taken a lot of that data to help us determine which strains we are going to plant this year. And obviously, one of the big in the format, the 2.0 formats, they're going to be rolling out in Q3, Q4.

So we're -- obviously, there'll be 3 kind of formats. There'll be high THC, a high CBD and obviously a balanced. And in terms of distribution right now, as Ben mentioned, we are looking at a number of wholesale opportunities as well as our medical channel.

So typically, with medical, the balance, then the CBD are strong contributors to that. And also with our 2.0 format, THC will play a big role in that as well. So in terms of the distribution, we -- again, to Ben's point, we don't give guidance, but I could tell you, it'll be a cross-section of all 3 strains.

Graeme Kreindler: Okay. And then my final question here. As Paris -- the Phase II there begins to ramp up, and you're going to launch some products into the second half of the year. Are you expecting any sort of initial margin headwind as you work through the first couple of batches of those products? And how might that differ from sort of the traditional margins you're seeing on your derivative products?

Nicholas Bergamini: Yes, that's a good question. I think because it will be -- we're going to be very focused on investing the resources in 2.0 to align with the revenue. So -- and as the ramp-up will be at a reasonable pace, we don't expect there to be significant margin decreases, thanks to 2.0. That said, there could be some, but our focus is we're going to have a balanced portfolio and we will have the goal of a good margin profile across all.

Operator: Our next question comes from the line of Vivien Azer with Cowen & Company.

Vivien Azer: In terms of the patient growth that you saw in the quarter, can you comment on how trends evolved subsequent to the quarter, to the extent that there is any kind of discernible impact positive or negative from COVID?

Nicholas Bergamini: Thanks, Vivien. For us, our -- this -- our business model has always been dynamic and prepared for scenarios like this. So our business model has physical clinics, but we've also been working on virtual clinics and virtual doctor consultations for 2 years now. So for us, as we recognize the impacts of COVID becoming more severe, we proactively did not allow any physical meetings with our doctors or coming into our clinic. So we switched within 24 hours to 100% virtual, and we did not miss a beat.

And as you highlighted, over past 6 weeks, our model has continued to demonstrate our ability to execute with over 4,000 patient visits and over 1,000 new patients that have come through. So our business model has executed very well and has played very well into the global market turbulence.

Geoffrey Benic: I'd like to add to that as well, Vivien. So our AssureHome Delivery is really a game changer. It's convenient and it's contactless. So I just want to walk you through our process, right? So a patient now can be seen, heard and scripted at 9:00 a.m., registered by 10 and have their delivery the same day.

And we think that, that's not only convenient but also contactless in this environment of unprecedented time with COVID. And ultimately, we think it's a game changer. And as we continue to build out our logistics capability, we're going to be able to offer this service 24/7. No matter what time of the day, what time of the night you will be being able to offer this service.

Vivien Azer: That's great. And then just to follow-up on that is a little bit in line with Graeme's question earlier. But given how successful you've been in transitioning to contactless patient engagement, relative to kind of your pre-COVID expectations entering the year, are you more constructive on the potential for the business mix to skew towards medical than you were pre COVID?

Geoffrey Benic: So we think that there's a tremendous amount of value and a tremendous amount of opportunity still in the medical channel. And we think that within the regulatory challenges of adult-use and the inconvenience -- sorry, the convenience that has truly still been an inconvenience in adult-use to the slow rollout and deployment of retail stores.

We truly believe that with assured or contactless convenient delivery, we see a tremendous amount of upside opportunity for us to continue to add a tremendous amount of patients that were either self-medicating through the adult-use channel through convenience. Now looking at assured and our logistics supply chain capabilities and not to mention all our formats, and our ability is to provide a great contactless convenience service, we see a tremendous opportunity in the medical channel on an ongoing basis.

Operator: Our next question comes from the line of Rahul Sarugaser with Raymond James.

Rahul Sarugaser: So my question is kind of philosophical. I -- given Aleafia's dominance in the medical channel, and of course, given the cost of goods and potential for dominance in the wholesale channel, my question really is around cannabis 2.0. We're seeing in the early days here that even some of the most well-developed producers are struggling with cost of goods.

And given that your strategy is primarily to work with external partners and external IP. How do you see this fitting in with your broader philosophy of being a medical-focused producer with real advantages in 2 of the 3 primary channels, and maintaining those margins in those channels as compared to what may be compressed margins in Cannabis 2.0 for yourself?

Geoffrey Benic: That's a great question, Rahul. So now that we have our Paris facility license, the clock has really begun ticking on bringing new products to the market. Our focus will be on health and wellness tailored formats, but we intend to bring these to both the medical and adult-use markets. So look, it's too early to give exact time lines.

But sometimes, we'll be looking to do over the next coming weeks. But for starters, we'll be focusing on vapes, sublingual strips and candies. But we expect there will be more -- but we're not ready to announce that yet. We've been prepared for months with equipment order formulations completed and have built a large -- built up large inventory cannabis extracts to be used in input material of new formats and immediate use in the new facility. Now it's time for execution.

And ultimately, in terms of our formulations, licensing agreements that we have, we truly save money and time. And a second mover advantage. We always talk about this rule, but we are really not reinventing the wheel. We are becoming asset-light, asset-smart in terms of execution and really looking at the first movers, picking up on some of the mistakes that they made.

And in terms of investment, in terms of time, and unfortunately, some of the regulatory hurdles that are unplanned for. And in this environment, I can tell you from experience is that it really depends on how fast you can pivot if you are a first mover. So being second mover, you get to learn from the mistakes. And ultimately, it translates into saving of time and money. When you have low input material like we do from outdoor grow, it really gives us a strong competitive advantage in market on the shelf.

So as an example, a 10 ml serving of chocolate for us, our biggest cost, unfortunately, now, will be packaging. And so in packaging, they're trying to solve for, not input material and format, I think that's a great problem to have. And some of the IP that through our relationships with our flying high brands that we're going to be rolling out, I think people will see how in market, we can be very, very competitive and maintain very, very strong margin.

Rahul Sarugaser: Great. Great. And then just as a quick follow-up. One thing we have been seeing is that wholesale markets, while they're somewhat still quite volatile, are starting to stabilize a bit. And represent some sort of buffer for some of the lowest cost producers, particularly as adult-use sales also are quite -- continue to be quite volatile. How do you see your customers shaping up in terms of wholesale? Are they primarily other LPs? Are they primarily extractors? And sort of how do you foresee the durability of your revenue in the wholesale channel?

Benjamin Ferdinand: So for our business model, it kind of goes back to basic economics, and we view as having a key strength as having the lowest cost. And what we're able to do there is we can leverage that as we work with our partners at scale and pricing. So we are very confident and -- in our business model, which provides us the flexibility to have -- to work with any of our partners, as we've already demonstrated with high-quality product, consistent product at scale so that our partners know exactly what they're going to get at a price that makes sense.

So as the wholesale market evolves, we view ourselves as very well-positioned in any way it goes to be able to partner with our partners in any way that works for them. And that could be extractors, it could be other licensed producers, it could be a lot of the players that want to get out of this space because their cost structures are just too high, and it's not sustainable. We stand with our cost structure ready to take market share and really provide a strong partner for those that want to work with us.

Geoffrey Benic: And Ben, I'd like to add to that as well, Rahul. This is a scale operation. So 86 acres is potentially over 100,000 kilograms based on our results of last year. So this is large scale. We're not growing 100-kilogram batches, we're talking about 100,000 kilogram scale, which is really attractive to someone that's running a scale business that will need scale product, the API, to be able to formulate, standardize and continue down the path of some of their formats.

Operator: This concludes today's question-and-answer session. I would now like to turn the call back to Geoff Benic for closing remarks.

Geoffrey Benic: Yes. Thank you, Operator. Thank you to everyone for joining us. We're excited about the future. And on behalf of the Aleafia Health team, wishing you all the best to you in your families. Thank you.

Operator: Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.