Aleafia Health Inc. (Q2 2020 Earnings)

August 12, 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:

- Patrick Sullivan; Eight Capital; Associate
- Rahul Sarugaser; Raymond James Ltd.; MD and Equity Analyst of Healthcare, Biotechnology & Cannabis
- Bill Papanastasiou; Canaccord Genuity Corp.; Associate

PRESENTATION

Operator: Ladies and gentlemen, thank you for standing by, and welcome to the Aleafia Health Second Quarter 2020 Earnings Conference 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, Mr. Nicholas Bergamini, Head of Investor Relations. Thank you. Please go ahead, sir.

Nicholas Bergamini: Thank you. Joining me on the call today are Aleafia Health's CEO, Geoffrey Benic; and CFO, Benjamin Ferdinand. This morning, Aleafia Health filed on SEDAR its unaudited consolidated financial statements and notes thereto for the quarter ended June 30, 2020, and its associated management discussion and analysis. All comments to be made on this call today should be taken with reference to and are qualified in their entirety by those documents.

Please note that this call contains forward-looking statements or information reflects the company's current expectations, estimates, projections, assumptions and beliefs about future events and financial trends 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 statements speak 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 operations and performance. These measures are not recognized or defined under IFRS, and as a result, they may not be comparable to the data presented by other issuers.

Geoffrey, over to you.

Geoffrey Benic: Thank you, Nick, and thank you for joining us. Before Ben walks us through some financial highlights in greater detail, I'll speak to some of our operational milestones and strategy moving forward. This quarter, we saw 3 major regulatory breakthroughs, through the licensing of our 60 acre Port Perry outdoor cultivation expansion, our Paris extraction and packaging facility expansion and our Niagara Greenhouse facility. The last 2 of these are absolutely essential and present major near-term opportunities.

As we've discussed in our previous earnings calls, production capacity and the loss of third-party supply remained a significant challenge for us, which meant that the bulk of our revenue was generated from wholesale transactions. Wholesale has never been a part of our long-term strategy. Now with our production facilities all operationalized, we are seeing packaged cannabis products representing a much higher proportion of our cannabis sales. We expect this trend to continue.

Our medical cannabis sales increased 44% sequentially, driven by significant increase in our base of patients. Our sales have continued to increase with June and July being our best months to date. As a result, we do not believe this increase in medical sales is due to COVID-19 pantry loading.

We're excited about these results for a few reasons: A 44% sequential increase in medical cannabis is very significant given that you are attracting patients one at a time. The increase also demonstrates the strength of our business model. Third, we believe that we can generate more revenue on a per patient basis, a better product mix later this year and also through the continued growth of registered patients. To that point, we reported 13,285 patients at June 30. Today, that number has increased further to approximately 14,250 patients.

On the adult-use side, our revenues increased by 23%, again, with sales increasing late in the quarter and continuing in July. For example, in July, our CBD oils were a top 5 oil SKU on ocs.ca.

Through offering competitively priced high-quality extract products, we've seen a significant increase month-over-month in sales volumes in Ontario. Despite some price reductions on our Symbl products, our adult-use gross margins improved sequentially by 7 percentage points. We attribute this to the benefits of our Paris facility expansion which, beginning in June, has seen us able to produce and package oil products more efficiently and at a significantly higher velocity, using low-cost input material from our outdoor grow. As I said in Q1, Paris gives us greater breadth of formats, greater scale and automation and higher margins. It's gratifying to see this now being realized in recent weeks, and we expect Paris to have a meaningful impact on our sales.

Now the strong revenue growth in both markets was generated almost entirely by extract products, which we now have a strong supply of. We believe that the introduction of dried flower and Cannabis 2.0 products in the coming weeks will likewise have a materially positive impact on revenue.

Beginning with dried flower. Our Niagara Greenhouse facility will commence perpetual harvest in September. We will be introducing a number of unique new THC cultivars into the market in various formats. We also intend to have new pre-roll production lines operational at the Paris facility in concert with Niagara's first harvest. We are now growing several cultivars, which are not available anywhere else in the legal cannabis market, offering us a significant differentiator.

Moving to Cannabis 2.0. As we've said, we believe that offering a portfolio of differentiated new cannabis product formats is essential to our success. We've made significant strides in this regard. And like with dried flower, we expect to have new products coming to the market in the near term. We'll be introducing universal 510 vape cartridges into the medical and adult-use markets in Q3, Q4.

This is a format that is widely sought after among both our medical patients and adult-use consumers. Secondly, we expect to have cannabis-infused sublingual strips in market soon after, using the award-winning brand and formulations of the category market leaders in California, Kin Slips. Kin Slips' carefully crafted blends of cannabinoids, terpenes and all-natural ingredients provides consumers with a discrete consistent experience in a 10- to 15-minute onset. This format is available nowhere else in Canada.

Coming after Kin Slips, we plan to introduce additional formats, likely led by confectionery edibles, soft chews and lozenges, produced in-house at the Paris facility. During Q2, we also completed planting of our 2020 outdoor cannabis crop across 66 acres at our Port Perry facility. The crop is progressing very well, and we expect to commence a staggered harvest in October. During the quarter, we completed the construction of 5 additional drying buildings along with in-ground irrigation and nutrient feeding, which served us very well during the heat wave in July. We're very delighted with our 2019 results, but we see a lot of advantages this year from the additional infrastructure.

Finally, I'll touch on COVID-19. While this has caused some delays in the order of hardware from third parties, by and large, we've been fortunate to not experience any significantly negative events due to COVID-19 thus far. We closed all of our physical clinic locations in March and have recently begun a gradual phase reopening of some clinics where permitted by provincial and local rules. COVID-19 also led us to accelerate the implementation of our contactless, direct-to-door AssureHome Delivery for medical cannabis. We recently commenced offering same-day delivery for patients who order products by noon on any business day. It's available throughout the entire GTA and surrounding communities, and we hope to launch in other major markets.

Thank you. I'll now pass the call on to our CFO, Benjamin Ferdinand.

Benjamin Ferdinand: Thank you, Geoffrey. One of the most important areas of improvement we saw during our second quarter was with respect to our balance sheet. Between our operations, our settlement with Aphria and our bought deal financing, we've seen our cash and marketable securities increase to $57 million at quarter end.

Given the prevailing global economic uncertainty, our cash position provides us with ample security and flexibility. Near term, it's allowed us to accelerate our plans to bring new formats and products to market much faster than we otherwise would have been able to. Additionally, we expect this to improve as we have completed all large capital projects.

This quarter also showcases good progress as we transition to a sales mix that will ultimately be dominated by packaged consumer products in the medical and adult-use markets. With the Paris facility producing oil-based products at large scale in June, we instituted a strategic price reduction in the adult-use market that has seen a significant and near-term increase in sales volume.

Despite this price reduction, which lowered our average net selling price per gram, our gross margins improved. This was due to significantly lowering in our cost of goods sold per gram, coupled with low out or -- low-cost outdoor input materials and high margin, large-scale production capabilities at Paris. That's evidence of our core competitive advantage relative to our peers and the [financial] business model in action.

We instituted a similar decrease in price in oil products in the medical market in Q1 2020, and now see the strategy positively impacting through Q2, with a 44% increase in revenue compared to Q1 2020 and a 94% increase in medical revenue year-over-year. This demonstrates the value of our model.

The price sensitivity of consumers is abundantly clear, which only reinforces our belief in our low-cost, high-margin production ecosystem across our 3 facilities.

We generated positive adjusted EBITDA of $3 million, the third consecutive quarter of positive adjusted EBITDA. This compares to Q1, which had a positive adjusted EBITDA of $6.4 million, and Q2 2019, which had an adjusted EBITDA loss of $4.5 million.

Our net loss improved to $4 million in Q2 compared to a loss of $6.2 million in Q1. This was partially offset by a $3.2 million write-down on saleable inventory to net realizable value to reflect current prices in the market. It's important to note that our inventory consists almost entirely of shelf-stable, saleable cannabis extract. We saw a modest increase in SG&A expenses as we operationalized 3 new facilities during the reporting period and also due to onetime legal and consulting expenses related to our bought deal financing, annual general meeting and our settlement with Aphria.

Lastly, we announced that we had applied for an inspection made to secure EU-GMP certification for our Paris facility. Also important to note is that the construction of our 60%-owned joint venture distribution center in Germany has recently been completed, and we expect our joint venture with the Acnos Pharma company to soon be authorized to import and sell cannabis in Germany. This means that our joint venture would be able to commence operations and begin generating revenue in Europe, even while we wait for EU-GMP certification of the Paris facility.

Operator, over to you.

QUESTIONS AND ANSWERS

Operator: (Operator Instructions) Our first question comes from Patrick Sullivan with Eight Capital.

Patrick Sullivan: I just wanted to ask, looking at the back half of 2020, can you provide a detail on how you expect your revenue mix to change? Like what's the inflection point for adult-use revenues starting to take increasing share from the wholesale portion?

Geoffrey Benic: So we're -- great question, Patrick. So we're really optimistic for Q4 for a number of reasons, is that we've never been in such a great position where we have all our assets finally online and producing. So as an example, we are now flowering in Grimsby. We are now -- the plants in Port Perry are looking great. And all our 2.0 formats are starting to come online. And I really view the business in 4 buckets: number one, domestic medical; number two, domestic adult-use; number three, international; and four, last but not least, wholesale, which will probably become less and less of our business.

So Q4 is setting up to be a great quarter for us because we finally have a self-sustained API input material. We're going to have several cultivars of cannabis flower that were growing in the greenhouse that are going to be unique high THC strains that are very, very successful in most markets globally, and which is going to open up some tremendous opportunities for us in adult-use and/or rec. Furthermore is, we continue to bring on more patients as well.

As you've seen, our numbers are increasing month-over-month. What we reported back in June to where we are today, we've seen an increase of patients. So we continue to build our 4 components to our business, but the 2 that we're most excited about is the adult-use and ultimately, the medical because of the 2.0 format and our own self-sustained cultivation coming online.

The one that I'm going to -- that I think is going to surprise a lot of folks is going to be our international market where we're seeing some great opportunities there. With our partnership with Acnos, as Ben mentioned, we're very close now to license in -- with Aleafia Germany. And that creates a whole bunch of opportunities. And we're starting to see a lot of demand and a lot of inquiries coming in from overseas, where we're positioned very, very well with some of our current relationships as well as some new ones that we're partnering up with. So net-net, we think fourth quarter is going to be a very strong quarter for us in the other 3 buckets outside of wholesale.

Patrick Sullivan: Okay. Great. And I guess, on to the home delivery service. So can you provide any insight regarding what percent of the patient base is taking advantage of that? And of any of the new patients you've seen sign up, have any of them indicated that it's basically specifically for that service?

Geoffrey Benic: Yes, that's another great question. So AssureHome Delivery is something that we're very, very excited about. So 25% of our medical patients today are using and are on the AssureHome Delivery platform. And that's grown from 20%, and it continues to grow. And that's really a function of really one thing, is our ability to service geography. So right now, we're servicing economically the geography in the Golden Horseshoe.

And if I consider the Golden Horseshoe, I would say that's kind of St. Catharines to Oshawa as far north as Barrie. And what's powerful above that service is that, you get your order in by noon, and it's delivered that evening. So we think that, that puts us in a really strong position of convenience to be able to offer our patient base, which if you look at the distribution of population across Canada, Ontario and the GTA bodes very, very well for that. So we see that those numbers increasing tremendously.

So I really want to let everyone know. And I love this feature about our business is that now you can self-refer yourself at 9:00 a.m. to one of our clinicians, doctors or nurse practitioners. By 10:00 a.m., you could be seen scripted -- heard and scripted, sorry; by 11:00 a.m., you are registered; by 12:00 p.m., you place your order; and by 9:00 that evening you get your delivery. So we're excited about that, and we're going to continue to leverage our supply chain logistics expertise to continue to grow that across Canada with other major cities coming online in short order.

Patrick Sullivan: Okay. Great. And then one final one before I give up my spot here. The 2.0 products, will they be sold under the Symbl brand? Or are you looking at extending the offering there? And I guess, what segments of the market are you targeting with those 2.0 products?

Geoffrey Benic: So we're going to target both the medical and adult-use, but because we're looking at a lot of formats that are -- can be used both in adult-use as well as medical. So initially, you'll see some Symbl brands, but we are looking at other brands that we're going to be bringing the 2.0 products under.

And ultimately, we're excited about our 2.0 strategy. And I think our shareholders will be very excited about our 2.0 strategy because we -- second mover advantage, we like to leverage our second mover advantage to look into the market and see where all the activity is going outside of just flower sales and vapes.

We are strong believers in concentrates for the adult-use market. We truly believe, if you look at what's happened in California and/or Denver, and we're using them as kind of benchmarks in terms of trends, concentrates are a big growing part of that market segment, and we're going to be very, very strong players in concentrates.

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

Rahul Sarugaser: So just wanted to quickly start off on the revenue line. So we've seen a bit of a -- Geoff, you mentioned that there was not a major impact from COVID, but I would assume that patient flow into the clinics would have been attenuated. So maybe you can just give us a little more color on patient flow in the past quarter before we look forward? And how that has impacted the revenue?

Geoffrey Benic: Ben, do you want to take that?

Benjamin Ferdinand: Yes. Yes. Thanks. Thanks, Rahul, for joining. So we've actually seen significant growth on the medical side. And we -- and to Geoff's point, not necessarily COVID related. Our business model continues to demonstrate its value where our -- where we continue to see, although the foot traffic has been, to your point, somewhat muted, we've still been able to grow the significant patient base, have a lot of patients and new customers that have never ordered before continue to order, largely because of the quality of our products. Also Assure Delivery, which is a big selling point and differentiator. And as we said, June and July were a record quarter. So we continue to see a very, very strong trend.

Rahul Sarugaser: Then -- sorry, so just I'm having a little trouble reconciling the dip in revenue then. So could you maybe elaborate on that then, please?

Benjamin Ferdinand: Yes. So on the medical side, our revenue increased 44% quarter-over-quarter. And on the adult-use side, increased about 23%, where the dip came from total cannabis revenue with a decrease in the wholesale portion of the business.

Rahul Sarugaser: Got it. Okay. That -- I appreciate that. That was the piece I was missing. And so then coming -- moving to the gross margins. There's also been quite a significant change in the gross margin. Could you maybe give us a little bit more color on that as well, please?

Benjamin Ferdinand: Yes. So when you think about the margin into the 3 core segments on the …

(technical difficulty)

Operator: Ladies and gentlemen, please stand by. Your conference will resume momentarily.

Benjamin Ferdinand: Sorry about that, Rahul. Can you hear me?

Rahul Sarugaser: Yes, I was hoping it wasn't me. So...

Benjamin Ferdinand: Yes. Sorry about that.

Rahul Sarugaser: I think we lost you at 3 core segments.

Benjamin Ferdinand: Yes. So 3 core segments. So on the medical cannabis side, we had strong gross margins of 41%. This is lower than Q1, but this was a conscious effort to make sure that we were getting our price points at the right level, and we're seeing that really resonate with our revenue growth there.

On the adult cannabis use side, adult-use side, we're at 37% gross margins. That actually is an increase versus Q1. And again, a lot of the product right now is our oils, which we're actually able to leverage our low-cost outdoor grow and actually pass -- not only pass those savings on to our consumers, but also maintain and increase our margins. And then the wholesale margins declined to about 30%, and that is due to the mix. Last quarter in Q1, a large portion of that was -- it was all our outdoor grow, which has very, very strong margins given the very low cost base. And this quarter was a mix of extracts and whole so far.

Rahul Sarugaser: Okay. Great. That's really helpful. And so as we think forward, given sort of the quarter-to-quarter variation in margins, what should we be thinking about sort of as a blended traveling gross margin on an annual basis?

Benjamin Ferdinand: Yes. I mean we don't kind of give specific guidance, but you can use -- I think this quarter is a pretty good indication of how to think about it.

Rahul Sarugaser: Okay. Great. That's helpful. And then finally, my last question is, Geoff, you did speak about the international opportunity and your excitement around that, specifically in Germany. Could you provide a little more color in terms of your strategy with the German market? How you plan on penetrating, particularly given that there is sort of mounting competition from other incumbents in the space?

Geoffrey Benic: Sure, Rahul. So with our partnership with Acnos Pharma, and we're working on a couple of other significant partnerships there as well. I think one of the challenges that the -- specifically to the German market, the EU-GMP authorities are not easy to deal with in terms of getting oils and/or flower approved. And so as a result of that, it's -- some of the early entrants into that market have products in there that are subpar, if you will.

So as a second mover, we have the ability to bringing in greater products into greater quality products with higher THC, which is in very high demand there, much better quality. So ultimately, we truly believe that the quality of our product is going to be a big differentiator in that marketplace, even if it were to get crowded.

Now I could tell you that a lot of these jurisdictions are starting to open up against -- sorry, of allowing cannabis for medical use. And we're seeing that in many new countries in intercontinental Europe that are inquiring and are in late stages of approval. So we think we're positioned very well by having our facility up and running beachhead there. And some great distribution partners and great distribution points that we think, like anything else, leveraging our second mover advantage, we really could be the come-from-behind kind of winner here.

Operator: Our next question comes from Bill Papanastasiou with Canaccord.

Bill Papanastasiou: Just had another question in regards to the international market. I was wondering if you could speak to any impacts COVID-19 has had on the German market? And how you see you guys transition to the headwinds or the tailwinds? Being experienced in Germany, my understanding is that there's a bit of speculation that there could be distribution delays from domestic growers and so forth. Hoping to get a bit more color on that.

Geoffrey Benic: Yes. So I'll give you an update on. So the German authorities have been expediting the process virtually with us. So I could tell you that a lot of the EU-GMP certification has really been virtual for us and continuous, so we haven't really seen any gap in that process. So that continues to move on and is on schedule. And hopefully, we'll be making some announcements in the near -- very near future here in regard to that.

In terms of -- you're right about some of the cultivation that -- and the setup of cultivation in Germany has really slowed and some of the big players that we're all aware of have changed their strategies and pivoted from reducing human resources, both in sales and also in infrastructure build-out. So we think that we're positioned well. Again, because we're going to be bringing on some great cultivars and oils.

And if you understand the process of EU-GMP certification in terms of the process of getting product into the market, proven shelf stability, and again, certification, it's a long process. It's not an easy process. And for you, if you're in market like some of the current LPs are, they have kind of a SKU base today, a flower base today. It's something that they don't want to -- or that they're not actually improving or changing on. So again, with second mover advantage, we're bringing in some -- we're going to bring some new innovative opportunities that we think are going to trailblaze in that market along with our relationships.

But again, the EU-GMP certification really is a discipline for other markets in Europe as well. So we're seeing Poland, we're seeing parts of Italy, and we're also seeing some other jurisdictions in Europe really starting to light up. The one thing about us is that, we got invites and we get a lot of calls because we're vertically integrated in medical cannabis. So when a country in the EU calls and says, "Hey, look, we're thinking about doing this", we're a natural fit because we have clinics, we have doctors, we have records management, we have scripting methodologies. And now soon, we're going to have product in market. So we get a lot of calls.

And we see that the U.S. is starting to really ramp up. And we're starting to see it become much more mature there. We truly believe the next frontier and possibly the biggest one is going to be Europe, intercontinental Europe, and then second to that is Africa. And I could tell you that we're positioned very well in both those markets.

Bill Papanastasiou: Okay. Great. And just one quick other question. I guess, shifting over to the rec market and the expectation of there being higher inventory holding in the back half of 2020. I was just wondering if you could talk a bit more about your potential product rollouts in the dried flower segment? There's been a common theme of launching a value-oriented product amongst the LPs. I was wondering whether the company has considered that and if you could provide more color on that as well?

Geoffrey Benic: Sure. So I like the value segment, but I also like the premium segment. So I'm first going to talk about the value segment. So I think we've been pretty clear to everyone is, in Port Perry, we're growing on about 12 to 15 acres of high-THC outdoor flower, which is just coming in very, very nicely. That's (inaudible). And in terms of taking that outdoor grow, and last year, I think we were in the $0.10 range.

I think this year at scale, we should be a lot less. We're going to take a lot of that high-THC product and put it into pre-rolls. And as I mentioned in my discussion is that, we're investing in pre-rolls, and we think that we're going to have a very strong value pre-roll brand that we're going to put into market that, I think, is going to be well received, both in price and in quality. And we're going to put in formats and size formats that I think are going to be very, very well received by the adult-use or rec user.

Now moving over to Grimsby. I could tell you that our greenhouse there and some of the cultivars that we were able to bring in with that new license are going to be top-performing cultivars. And these are cultivars that are big in California. We think we're going to get really great quality out of them. And we think that we're going to be pretty low cost in terms of cultivation there, just because of the design of the facility and the business processes that we're operating under there.

So we're excited about bringing those -- that flower into the market because you're absolutely right, the last thing we want to do was play in the middle shelf. The middle shelf is pretty crowded. And we think that we've been given a great opportunity with second mover advantage to bring in some of these new cultivars that, I think, are going to be very, very exciting, very exciting.

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