Aleafia Health Inc.(Q4 2020 Earnings)

March 25, 2021

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:

- Rahul Sarugaser; Raymond James Ltd.; Research Division, MD and Equity Analyst of Healthcare, Biotechnology & Cannabis

PRESENTATION

Operator^ Good day. Welcome to Aleafia Health Fourth Quarter 2020 and Year-end Results Conference call. I would now like to turn the conference over to your host, Nick Bergamini, VP of Investor Relations. Please go ahead.

Nicholas Bergamini^ Thank you. Joining me on the call today are Aleafia Health CEO, Geoffrey Benic; and CFO, Benjamin Ferdinand. This morning, Aleafia Health filed on SEDAR its audited financial statements and notes there too for the year ended December 31, 2020, and its associated MD&A.

All comments to be made on this call today should be taken with reference to or are qualified in their entirety by those 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 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, perform 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 undue reliance on these forward-looking statements further. They speak only as of the date on which such statement is made.

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. Thanks everyone, for joining us today. It's exciting to see how far we've come over the last two years. 2019 saw us build out our three production facilities.

During 2020, we secured the licenses for these sites, while immediately shifting our focus to the development of differentiated cannabis products and brands. It's in the fourth quarter that we are just beginning to see the results from this groundwork we've laid over the last two years.

Putting things in perspective, our net cannabis revenue has increased from $600,000 in 2018 to $11 million in 2019 to $41 million in 2020. Capping this off is our strongest sales quarter-to-date with $14 million in net cannabis sales. This was driven by growth through all four channels of international medical, adult-use and domestic wholesale.

But what's most important is that 2020 saw us commence what is a major expansion of our product portfolio. As a result, we are beginning to see what will be a significant recalibration of our revenue away from domestic wholesale and towards the sale of packaged cannabis products.

I know Ben will discuss in greater detail, but I'll touch on the noncash accounting write-downs, which clearly impacted the net loss in the quarter. But it's important to note that these are accounting noncash, nonrecurring write-downs of tangible assets or goodwill.

These have no impact on our cash profitability, and they are not associated with the winding down of any facilities or other physical assets. It's something that many of our peers have also gone through and with that behind us, we are in a great position for continued growth. Removing these noncash items, we've realized our first annual positive adjusted EBITDA of $10 million on the year compared to a loss of $20 million in 2019.

With the licensing bottleneck removed, our team did an excellent job developing new products, including some highly differentiated formats. Since the launch of vapes, we've delivered a total of new 9 new product formats or significant line extensions.

Since October, we've released and launched a total of 31 new SKUs, many of which are sold in both the medical and adult-use markets. Given where we started six months ago, this is quite an achievement from our team and something that really speaks to their executional capabilities.

During Q4, we launched high potency CBD oil, 510 vape cartridges and cannabis-infused sublingual strips. Though sales of these products in the adult-use market only commenced in December, we are already beginning to see their impact, as we saw a 500% sequential increase in recreational sales over Q3, driven by these new formats.

In Q1 of this year, so far, our sublingual strips, Kin Slips, were our top-selling product format and CBD 50 was our top-selling individual product SKU. And recently, we launched THC Soft Chews, our first cannabis edible format. Of even greater importance, though, is our much more recent expansion of our dried flower portfolio.

This obviously remains the most important category in Canada by a wide margin. This month, we commenced shipments of several new dried flower SKUs, including pre-rolls from our outdoor cultivation harvest. Rounding up the product front is the imminent launch of our wellness line Noon & Night.

This is a highly differentiated brand that features formats that are familiar to consumers in non-cannabis form, but which often are not yet available to Canadian consumers. We received purchase orders for the first two formats under this brand, including omega-3 soft gels.

We're now at the point where we have an incredibly diverse product portfolio, but the consistent theme is that we focused on areas of key competitive advantages, whether that is through novel formats, quality or pricing.

On the international front, we've also made some significant headway. In December, we announced that our Niagara Greenhouse was deemed EU-GACP compliant. Why that's important is that means flower grown at our greenhouse is eligible to be exported to European Union and other international markets, with the caveat that it must be dried and shipped from an EU-GMP-certified facility.

And we have a strategic partner that does that for us. Since that time, we have sent batches to Germany for stability, quality and cannabinoid testing, and they were all deemed to meet EU-GMP standards.

We're now in the final stages of beginning exports to the EU, with securing the customary import and export permits. Similarly, we received an export permit earlier this week for our greenhouse flower to be exported to the U.K. Obviously, the international channels are filled with red tape and take time, but most of the heavy lifting is done, and we're excited to commence our first exports to new countries in Europe in the near future.

We also completed our largest international shipment ever to Australia in Q4. We may start to see more regularity in orders from our customers there as we immediately received a larger purchase order in January and are just waiting for the export permits now.

Lastly, I will touch on our agreement with Unifor, Canada's largest private sector union, which has 315,000 members. For American shareholders, Unifor would be the equivalent of the UAW in the U.S.

The purpose of this agreement is to gain insurance covered for medical cannabis for union members and their immediate family members. Unifor has shown great leadership in advancing this cause, which is fundamentally about patient access to medicine.

We now have one of the Canada's largest employers signed on to the program, with their employees and family members soon becoming eligible to spend $500 per year per person on medical cannabis through their insurance plans.

We are working on and hope to have many more large employers sign as we build out this program. The Unifor opportunity truly plays in the strengths of our medical cannabis ecosystem, from products to physician consultation and scheduled home delivery.

The team has worked incredibly hard to launch it with our first employer, and as we demonstrated its potential, this is another area that will truly differentiate us from our peers. Ben, over to you.

Benjamin Ferdinand^ Thanks, Geoff. This was both a very strong year and Q4 for Aleafia. Q4 was a strong quarter, not just from a revenue growth perspective, but also through a significant improvement in adjusted gross margins through all sales channels. But first, as Geoff said, it's important to note that the substantial net loss is largely due to noncash onetime accounting expenses. Primarily, this was due to the write-down of goodwill associated with the acquisition of Emblem Corp.

We announced this all-share acquisition in December 2018, and it closed in March 2019. In that time, between announcement and close of the transaction, the share prices of both companies nearly doubled, but from a relative perspective, the acquisition was unchanged. The increase in Emblem share price during that time resulted in a large accounting noncash goodwill asset on our balance sheet, which we have now written down.

Q4 gave us the first indications of what we expect will be a significant recalibration of our sales mix in 2021 from domestic wholesale towards more valuable and sustainable adult-use medical and international channels. Medical cannabis sales increased 42% sequentially in Q4 2020 versus Q3 2020.

New product formats, as Geoff talked about, have had an accretive effect on sales as we had hoped. As we introduce more formats to medical patients, we are really starting to see Emblem Cannabis become more of an e-commerce marketplace and a one-stop shop for medical cannabis.

Also, a lot of this growth is occurring in the Greater Toronto Area, where our AssureHome Delivery, same-day service is available. We intend to strategically push our competitive advantage in the GTA for both medical and recreational. Medical cannabis adjusted gross margin improved to 48% from 26% in the prior quarter.

This was largely due to the ongoing optimizations and scale from operating in the expanded Paris facility, which only commenced in May of last year. As we've previously said, the Canadian adult-use market was going to increasingly be a focus for us as we've gained the ability to expand our product portfolio.

Adult-use cannabis sales increased 500% sequentially in Q4. Prior to this quarter, our adult-use sales were almost entirely from extract products. Our adult-use portfolio has really begun to broaden and through the product launches only occurring late in the fourth quarter, they are already having a very positive impact.

With respect to domestic wholesale, obviously, we have benefited from strong outdoor cultivation harvest, which contributed -- which generated $10 million in sales from the segment.

Given our focus on adult-use, medical and international, we primarily have our greenhouse dried flower allocated to adult-use international sales. It's likely that we will see quarterly domestic wholesale revenue decline in the first quarter of 2021 relative to Q4 2020.

Lastly, our focus on sustainable growth has led to revenue increasing by a much higher margin than our operating expenses. We are really just scratching the surface our revenue-generating potential of our production facilities that have been fully operational now for several months.

Again, we reported positive adjusted EBITDA of [$4.3 million] for the quarter and positive adjusted EBITDA of $9 million for the year, which is a significant achievement for us and one which we hope to build on for this year. Operator, back to you.

QUESTIONS AND ANSWERS

Operator^ (Operator Instructions) Our first question comes from the line of Rahul Sarugaser with Raymond James.

Rahul Sarugaser^ And congratulations on the strong quarter. Indeed a testament to all the work that's been done at Aleafia. So I guess one of the first primary question I have, of course, is that the large portion of the cannabis sales have come from potentially wholesale, LP-to-LP.

How do you see that playing out going forward, given that this quarter, it was -- it represented the majority? And then how should we be thinking about that -- those -- that channel mix between medical, adult-use and LP-to_LP going forward?

Benjamin Ferdinand^ It's Ben. We don't give specific guidance, but as we've talked about, as our business continues to evolve, we continue to shift more of our emphasis and focus on to the business segments around medical, adult-use and international. So as we see 2021 being compared to 2020, we would envision more and more of our relative mix shifting over to shifting away from wholesale and more focused on the rec, medical and international.

Rahul Sarugaser^ Great. And so maybe focusing a little bit more on the adult-use market. Now given that Aleafia is really moving into the space, Geoff talked about some of these SKUs being well received. We know that, particularly Ontario, did about just a rationalization of this first quarter. How do you see that SKU rationalization impacting Aleafia?

Geoffrey Benic^ Rahul, thanks for being on the call. So we've had a lot of products that were in high demand by the OCS and are now entered in their program, and you're going to start seeing them. I think what a lot of the OCS really likes, they create a category or in the process of creating a category for specific for outdoor grow.

And we have a 12-pack format, 0.35 pre-roll, which we think is just going to be dynamite in the marketplace. It's -- you've got two extra pre-rolls basically for the same prices you're paying for 10 -- a 10-pack.

So we really think that's going to be a kind of a game changer for us. And ultimately, we just have a larger number of new listings and they really like our full portfolio, which is -- we're also seeing a number of new dried flowers and CBD wellness lines that are coming on. And the OCS has taken all of them.

Rahul Sarugaser^ Great. And if you indulge just one last quick question. Of course, Aleafia is quite unique in its partnership with Unifor. So how -- given that it's early days and there's a lot of potential there, how should we be thinking about penetration into Unifor's [300,000] or so members? And just also as a follow-on, how should we be thinking about future sign-ups of any additional unions going forward?

Geoffrey Benic^ So look, I'll answer that question. So first of all, when you look at the opportunity of Unifor, let's start with the 315,000 members and their family members, which we like to use about 2.5 to three incremental per household, which puts us in over 1 million folks that are -- that will be insured by Unifor.

So we have to go on to a collective bargain basis, but already some very, very large employers have approved medical cannabis coverage for their members, and we're just getting ready to start the program. So the opportunity is significant.

However, it's also very new. We expect it will take the time -- sorry, it will take time to ramp up. So we'd really need to get a full quarter of sales from the program before we can look further ahead, but it will take time. But it's a great opportunity and on that point as well.

As these collective bargain agreement has come up and there's literally dozens and dozens of them Rahul, under Unifor as well, CSCP Rail, CN Rail, Bell Canada, Air Canada, oil and gas sector, I can tell you that these opportunities for the sell-in is pretty easy, especially once we're going to kind of the template of being able to sell -- sorry, register, sell, deliver, bill and make it really seamless and make it easy. So I think it's going to be a really, really big hit.

Also on top of that, what people don't really understand about this opportunity, Rahul, is that we are collecting a tremendous amount of data here.

And the data that we're going to be collecting on a fully funded basis is really going to be able to allow us to start selling to other unions and other private employers or public employers. So what I mean by that is this, in the past, when you go and you start selling into some of these channels and potential clients, the first question they ask you is can you cost justify it, right?

Can you -- and no one's really had that data to be able to qualify and quantify the value of what you're doing for each one of these patients. So that data for us is going to be very integral in terms of being able to take that data and use it to sell-in and show other employers, other unions, the real value of medical cannabis as an opioid replacement therapy.

So we think that by us having that data, not only is going to help Aleafia, but we truly think it's going to help the industry. We think the medical cannabis is just skimming the iceberg right now. When people thought it was going away, it's just getting started.

Operator^ There are no further questions. Ladies and gentlemen, this concludes today's conference call. We thank you for your participation. You may now disconnect.