Aleafia Health, Inc. (Q3 Results)
November 12, 2019

Corporate Speakers:

- Nicholas Bergamini; Aleafia Health Inc.; Head of IR
- Geoffrey Benic; Aleafia Health Inc.; CEO
- Benjamin Ferdinand; Aleafia Health Inc.; CFO

Participants:

- Greg McLeish; Mackie Research Capital Corporation; Analyst
- Unidentified Participant;;

PRESENTATION

Operator^ Good day, ladies and gentlemen, and welcome to the Aleafia Health third Quarter results conference call.

(Operator Instructions)

I would now like to turn the call over to Nicholas Bergamini, Head of Investor Relations. You may begin.

Nicholas Bergamini^ Thank you, and thank you for joining us for Aleafia Health's 2019 Third Quarter Results Call. Joining me is CEO, Geoffrey Benic; and CFO, Benjamin Ferdinand.

This morning, Aleafia Health filed its third quarter 2019 financial statements and associated management discussion and analysis on SEDAR. Please note that this call contains forward-looking statements and reflects the company's current expectations.

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. Geoffrey and Benjamin will now deliver remarks.

Geoffrey, over to you.

Geoffrey Benic^ Thank you, Nick, and thank you to our stakeholders for being with us today. Aleafia Health third quarter, by a wide margin, turned out to be the best quarter in the history of our young company. As we demonstrate substantial improvements in every single key operating metric. This marks the second consecutive quarter, reaching both major increases in revenue and major decreases in expense.

I believe we're unique amongst our peers in that regard. My most important mandate as a CEO when I joined this very new company in the summer of 2018, was to meet the right hires at the senior management level and give them the authority to execute their individual responsibilities. The executional focus of this team is clearly apparent. At this time last year, the sum of our business was a 7,000-square-foot indoor growing operation and our Canabo Medical Clinics. We've come a long way since then.

But the objective, as articulated by our board Chair, Joan Santino, has been very clear from day one, to be the global leaders in Canada's health and wellness. We believe that responsible sustainable growth today means avoiding the mistakes we've seen across the industry as operational facilities are closed, and incomplete facilities are mothballed and both frontline staff and senior management officials are gone.

To continue scaling, our Canada's ecosystem globally, we continue to lean on our second mover advantage. Case and point, our outdoor cannabis facility in rightsized greenhouse, which features the most modern growing automation technology.

Last year, cannabis companies' valuations were tied to the square footage of their cultivation facilities. This created a perverse intent to build or buy the largest cultivation facility possible. The consequences of these actions are just beginning to be felt in the industry. We decided to pursue a different route, focusing on ultra-low-cost cultivation and high margin production.

Last year, we made a bet on outdoor cultivation. Despite major roadblocks and uncertainties surrounding licensing time, we completed our successful inaugural 2019 outdoor grow harvest, yielding 10,300 kilograms of dry flower at an all-in cost of $0.10 per gram to harvest.

Our current plan is to extract the entire harvest and use it for our high-margin oil-based products. Our present cannabinoid content, which represents the true underlying value of the harvest was only slightly below the cannabinoid content of cannabis growing in our small batch indoor growing facilities.

We can now say that Aleafia Health is among the lowest producers in the Canadian cannabis industry. Next year, we will benefit from a much earlier growing season, and increased automation and economies of scale as we expand our outdoor cultivation facility to 3.7 million square feet or 86 acres from the present 26 acres today.

We continue to remain extremely focused on our core business, growing, producing, selling and exporting high-margin cannabis health and wellness products. Relative to our other LPs, we are able to sell a higher proportion of our oil-based products versus dry flowers relative to our total sales.

As a result, we realized an average revenue per gram in medical sales of $15.11 per gram equivalent sold. This represents among the highest in Canada, and again, this is coupled with our low-cost production. Our team's primary focus has been and will continue to be repeating these successes on a larger scale.

As such, we are building out our sales team in key markets for recreational and both Canadian and international medical sales. From a production standpoint, we made a substantial progress over recent months. We are adding additional extraction machinery at our operational Paris facility in order to ensure adequate extraction capacity to process the 2019 outdoor harvest.

Our Paris facility handles all extraction, packaging, order fulfillment for our medical add-on use and international sales. Likewise, the Phase 2 expansion, interior and exterior Paris facility is 100% complete and is entirely dedicated to the extraction production packaging distribution of finished cannabis products. The new Paris facility will be able to extract [1,115 thousand] -- 1,115 kilograms of dry flower equivalent annually.

The cannabis Canada health and wellness ecosystem we built continues to separate from our peers. Today, prospective patients can visit a physician at our medical cannabis clinics, take proprietary education courses through our fully edge academy and purchase emblematic medical cannabis products through an integrated experience.

This ecosystem creates loyalty amongst patients, and ultimately has led to a major increase in medical cannabis sales while most of our peers see their corresponding revenue segment or decline.

Our clinic expertise and education platform, along with products continue to be a major value-add for our international partners. For instance, our educational platform, Fully Edge Academy, is now available and being used by prescribing physicians in Australia, where our medical cannabis products are already in market.

Over the last six months, investors have clearly demonstrated their lack of confidence in the cannabis industry. Some of these sector-wide hurdles can be attributed to a slow rollout of retail stores and other regulatory challenges. But clearly, investors are rightly demanding a clear path to profitability, executional excellence and a focus on disciplined, sustained growth. With continued revenue growth and prudent allocation of capital, we're on the right track.

I'll now pass it over to our CFO, Benjamin Ferdinand.

Benjamin Ferdinand^ Thank you, Geoffrey, and good morning. Aleafia Health continues to demonstrate that our business model has very high barriers to entry and provide us with the lowest cost structure in the industry with one of the highest margins in the space. We are focused on owning the medical health and wellness cannabis space globally.

Disciplined, [true] allocation of capital remains a core focus of our management team across all divisions, and that is now clearly represented today. Examples of our model in action is our new outdoor cultivation with a cash cost only $0.08 per gram, while being able to have high-margin medical products sold for an average of over $15 per gram. That is a recipe for a very high-margin business.

I'd like to highlight some of the key metrics Geoffrey spoke to at a high level. As we said in previous earnings calls, earlier this year, we experienced a large number of expenses directly related to the Emblem acquisition, which have now been fully worked through in previous quarters. Total expenses declined quarter-over-quarter by 30%.

If we compare third quarter 2019 to first quarter 2019, total expenses have declined 59%. This expense discipline has occurred at the same time as we have vastly expanded our production facilities and scaled our business.

From an industry sales perspective, we agree with recent analyst commentary that company is relying on LP to LP wholesale sales -- sales are particularly vulnerable to declining prices and demand. For us, our focus is very different. We sell high-margin cannabis health and wellness products directly to patients. This quarter, packaged consumer products sold in the medical and recreational markets represented 94% of our net cannabis revenue. This distinguishes ourselves from our peers.

To continue this trend, we believe firmly in owning the patient experience. From a medical market perspective, LPs generally offer similar products in comparable prices. We, on the other hand, offer not only high-quality medical grade products, but also access to physician specialists and our medical clinics and our fully edge academy education platform.

Our active registered emblem medical patients increased 48% quarter-over-quarter to over 10,000 patients. A core focus of our business will be to continue this trend. Our Canabo Medical Clinics and GrowWise Health centers see approximately 3,400 unique patients per month, positioning us for further growth. The unit economics of our products remain very strong. This will keep margins very high compared to other LPs, who are now experiencing significant price and margin compression.

Quarter-over-quarter, gross profit before fair value adjustments increased 265%. However, we believe, from a production standpoint, we have significantly more upside. First and foremost, in the input material from our outdoor grill, which is cash cost of only $0.08 program to harvest from indoor will greatly reduce our cost per -- cost per gram and cost of goods sold in the future and create a great environment for high margins. This (inaudible) of production is a fraction of some of our peers.

In addition, we continue to benefit from economies of scale as we increased our sales footprint just as we saw in this quarter.

Next, I'll turn to our balance sheet. Our balance sheet is very, very strong and we're in a great position today. As at September 30, 2019, we had over $51 million in cash, along with an additional $6 million in marketable securities for a total of $57 million in cash and marketable securities. We also had $83 million in working capital. We're in a very, very strong liquidity position and allow us for a room to invest.

As we've said, our operating costs have declined by 2/3 over the course of 2019. During that time, we have undertaken major capital projects than (inaudible) Greenhouse, the Phase 2 expansion of the Paris facility and the outdoor growth facility, all of which are now substantially complete. We believe this puts us in an excellent position as we progress towards becoming cash flow positive.

Geoff, over to you.

Geoffrey Benic^ Thank you, Benjamin. In closing, obviously, we are pleased to have made a major step forward in all core areas of our business. However, we believe there remains a lot of room to grow, and our now veteran management teams remains as motivated as ever to continue on this trajectory. Never ever have I ever posed so confident in our business. And let's not forget that the best is yet to come.

Operator, over to you.

QUESTIONS AND ANSWERS

Operator^ (Operator Instructions)

Our first question is coming from the line of Greg McLeish with MR.

Greg McLeish^ Congratulations on the quarter. Just a couple of questions. I think you indicated that you'd be extracting all of the outdoor grow and using it for your own products. Does that mean that you -- I mean, if you had excess oil, would you actually want to sell that to another license producers?

They could -- if they couldn't do it themselves? Or is this all -- do you think that all of the product that you're going to be extracting, be it necessary for your product development next year?

Benjamin Ferdinand^ Yes. Thanks, Greg. Benjamin. So our focus is on selling to the end consumer. And so when you think about our distribution and our priority, it's focused on selling to our medical patients, first and foremost. And we also have the recreation over-the-counter channel.

But as you know, we also have an international platform to be able to distribute our products to end users as well. And so our goal is really to take the outdoor harvest extracted into high-quality medical grade products and distribute to end consumers in Canada and globally.

Geoffrey Benic^ Greg, I'd like to add to that as well, is that oil, cannabis oil produced in Canada with our ecosystem is in very, very high demand globally. And we're exporting our entire ecosystem in our platform in many jurisdictions internationally. And it's in very, very high demand.

Greg McLeish^ Great. And just moving over to the cultivation assets. You're still awaiting the licensing of the Niagara Greenhouse. But you're also -- you do have a huge expansion going on next year with your outdoor growth. Does this mean that your CapEx is effectively complete and that we should see far lower CapEx going forward?

Benjamin Ferdinand^ Yes. It's Benjamin. Yes. So all of our facilities are substantially complete, and we have very little CapEx remaining.

Greg McLeish^ Great. And just could you maybe just discuss a bit about your strategy for retail products for cannabis 2.0, more aimed at the recreational market and not the medical market and sort of how you're progressing there?

Benjamin Ferdinand^ Yes. It's Benjamin. So one of the reasons why we had our outdoor low-cost cultivation was to prepare us for cannabis 2.0. And the way that we think about our model is focused on cash flow and being really diligent on our capital allocation. So we're not trying to build everything ourselves. We're working with partners to be able to get the best-in-class expertise and technology. So we have a number of partnerships that we'll be announcing in the near term.

Geoffrey Benic^ Yes. So I'd like to add to add specifically to cannabis 2.0 products, Greg. We'll be producing them when we received an amended license for our Paris Phase 2 expansion. There's a lot we're doing behind the scenes to ensure we are ready. We have licensed, as Ben mentioned, a lot of large international brands. We'll see coming out of California, including the formations productions, know-how and across a wide range of formats, and we're going to be a big player in cannabis 2.0 space.

Not to mention that with our retail partnership, with the (inaudible) private equity in one plant. You're going to start seeing a few more of those stores and a flagship one in the GTA, where we are going to have -- on the shelves in those flagship stores in these key markets in Ontario, and it's a big part of our strategy going forward.

Greg McLeish^ Great. And just one final question from me. Your G&A spend and sales and marketing and everything through the quarter was down a lot. I mean, is this a good run rate going forward? I mean, you guys -- I mean, this is a great trend going forward. But is it sort of sustainable? Or is there going to be some increase in spending going forward?

Benjamin Ferdinand^ Yes. It's Benjamin. So our focus is not wasting money and streamlining our operations. So it is a good level as it stands right now. But as you can imagine, as we ramp up sales growth, we'll have to invest. But as you know us and you've seen us -- we'll be investing very prudently and only a few.

Geoffrey Benic^ So the team is -- Greg, the team is intact. Very excited. And everyone loves come to work every day. And everyone is excited about executing and continue to becoming the lowest cost producer with the best products and the best outreach in our medically vertically integrated ecosystem here. And I can tell you the excitement in the office every day, it's just is unbelievable.

Greg McLeish^ And just what -- just sort of a hypothetical question. You're going to be doing 86 acres of outdoor next year. Are you having LPs come to you that are having trouble growing indoor, asking you to potentially grow outdoor for them to get biomass?

Benjamin Ferdinand^ Yes. It's Benjamin. I won't speak to specifics. But as Geoff's highlighted, are us being a leader in the outdoor space and low-cost grow is really changing the industry, and you're seeing a lot of these players in the space with overbuilt infrastructure and massive investments in indoor and whatnot realizing their errors of their ways.

And we are getting a number of calls. But we're focused on, as we said, delivering our products to the end consumer and making sure that experience makes sense. And we'll look at opportunities as they come up.

Operator^ Our next question coming from the line of William (inaudible) with Eight Capital.

Unidentified Participant^ Hey, it's (inaudible) today on from Graeme. And congrats on a pretty solid quarter. My first question, and apologies, I cut out over earlier, so I might have missed this. But I was wondering if you could give an update on licensing timelines for the Paris and Niagara facilities?

Geoffrey Benic^ So I'll speak to that. So our Paris facility. So let's start with the Niagara greenhouse. So the greenhouse construction is complete. And we can operate this facility within two weeks in securing our licensing. We have an ongoing dialogue with Health Canada, we remain optimistic that we are getting close to the -- to the licensing of that facility.

Our (inaudible) Phase 2, we're expecting our outdoor by -- our outdoor by 60 acres for next year. The construction of the new site is almost entirely complete, and we'll be submitting our licensing amendment application for (inaudible) package later this year. Our Paris Phase 2, and that's our Paris production facility 2, expansion is 100% complete. And we'll have an update on submitting our site evidence package very, very soon.

Unidentified Participant^ Okay, great. So I noticed that finished inventory was $5.6 million in the quarter. So it's -- let's just say that equates to about 1,000 to 1,400 kilograms, plus the over 10,000 kilograms from outdoor.

So just wondering how you guys are feeling about inventory levels between now and next year as you kind of wait for the next outdoor harvest? And just if there is any delays with Niagara? Like do you guys see wholesale as a potential alternative to kind of increase supply? So --

Benjamin Ferdinand^ I'll thank you for that question. It's Benjamin, we'll split into two components. On the -- your second point, we're not looking at wholesale as a supply. We're focused on having our own product, low-cost and being able to call the margin ourselves.

And on the first point, we feel very good about our inventory levels, as we talked about, a combination of our finished good inventory, our work in progress inventory that we're continuing to finish as well as we've already started the process and extract some of the outdoor grow as well. We feel very good about our inventory level.

Unidentified Participant^ Okay. Just kind of on the outdoor extraction. With you guys seeing potency, like just under normal levels. Do you think you'll extract all of that harvest? Or do you think you could sell a little bit into the market?

Benjamin Ferdinand^ When you say into the market, you mean LP to LP?

Unidentified Participant^ Yes. Or even directly into like the distributors.

Benjamin Ferdinand^ Got it. Yes, so the question is, would we sell some of it as flower or extract everything, correct?

Unidentified Participant^ Yes.

Benjamin Ferdinand^ Yes. I mean, so for us, that when you look at our core patient base, it actually is over 80% non flower. They're really focused on the extract. These are the baby boomers, people who are focused on really, health and wellness and taking how they treat their body very seriously. So for us, flower is a relatively small component. So for the most part, all of it will be extracted from outdoor and passed through to our expectations.

Geoffrey Benic^ I just want to make a note there as well. We have 3,400 patients coming through our clinic every month. We're converting those patients on to the Emblem platform. Now that we have sustained input material and reliable info material, our goal is to crystallize a sale with every single instating on a complete basis.

That is our goal. That is our sales initiatives. So with that said, not to mention the international experience opportunities that we've been speaking to, where our oil into platform are very high demand. We think that we're going to be in a great position to sell-through and not have to rely on wholesale.

Australia and Germany are two big opportunities for us. In Germany, we're in the process now of finalizing our agreement and licensing and getting our products. And you think that, that is going to be a great opportunity for us as well.

Unidentified Participant^ Perfect. And just one last question for me. Just kind of looking outside the rec market here, and looking into wholesale and the medical market. I noticed you guys had some wholesale revenue like LP to LP in the quarter.

I was just kind of wondering what your outlook is for that? Like are you guys seeing prices coming down significantly? And how do you expect that trend for you guys? And kind of the same thing for the medical market. How do you guys see that growing as retail continues to expand in adult use?

Benjamin Ferdinand^ Yes, that's a good question. I mean, our focus, as we've said, is focusing on selling into our medical help them on the ecosystem. So for us, as we published, our average revenue per gram is $15 per gram equivalent in the medical space. So that's the area that we're really laser-focused on. And I spend that we're seeing very strong prices.

Geoffrey Benic^ We've got a captive audience, as I mentioned. When you have 3,400 patients coming through our door monthly because we do have the cannabis. It presents a great opportunity for us to check continue selling in our brands.

So our brands are -- what's important to us and a big differentiator to us in getting our patients and some of our out-of-use consumers attached to our brands and the benefits of brands as we continue to grow the stickiness of our brands.

Operator^ That concludes the Aleafia Health third quarter results Conference Call. Thank you for listening. You may now disconnect.