Aleafia Health, Inc. (Q4 2019 Earnings)

March 18, 2020

Corporate Speakers:

- Nicholas Bergamini; Aleafia Health Inc.; VP of IR
- Geoffrey Benic; Aleafia Health Inc.; CEO
- Michael Verbora; Aleafia Health Inc.; Chief Medical Officer
- Benjamin Ferdinand; Aleafia Health Inc.; CFO & Corporate Secretary

Participants:

- Graeme Kreindler; Eight Capital; Principal

PRESENTATION

Operator: Ladies and gentlemen, thank you for standing by. Welcome to Aleafia Health Fourth Quarter and 2019 Year-end Earnings Call. (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. Joining me on the call today are Aleafia Health's CEO, Geoffrey Benic; CFO, Benjamin Ferdinand; and Chief Medical Officer, Dr. Michael Verbora.

This morning, Aleafia Health filed on SEDAR its audited consolidated financial statements announced thereto for the year ended December 31, 2019, which have been prepared in accordance with International Financial Reporting Standards. The associated Management Discussion and Analysis as well as the company's annual information form for December 31, 2019, fiscal year-end. 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 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 operation, 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 undue reliance on the 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 statements 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 the call over to CEO, Geoffrey Benic. Geoff, over to you.

Geoffrey Benic: Thank you, Nick. Thank you to our stakeholders for being with us today.

In the period of economic uncertainty for the cannabis industry and globally, Aleafia Health continues to progress through disciplined, sustainable growth. This has been a transformative year for Aleafia Health. Before I identify some of these highlights, I'd like to first address the ongoing COVID-19 pandemic.

Risk factors relate to the impact of COVID-19 on our business and operations have been addressed in our annual information form filed on SEDAR. We've taken decisive action to ensure the safety and security of our patients. Since yesterday, all appointments in our national network of cannibal and GrowWise Health clinics have been moved to telemedicine. As we announced in October 2018, we have made significant investments to build the capabilities to scale our business through telemedicine. Today, those investments are more important than ever. As a result, we believe that we are in a position to not miss a single appointment.

In addition, the safety and security of our patients means also ensuring our patients receive access to uninterrupted medical care. Our Chief Medical Officer, Dr. Michael Verbora, joins us today. As a physician who also practiced in our clinic as assistant professor at the McMaster University School of Medicine, he will position to provide some insight on this.

Michael Verbora: Thank you, Geoff. As Geoff alluded to, we began implementing countrywide telemedicine capabilities in 2018. At the time, the move to telemedicine was a business decision to allow our patients and physicians greater choice in how they access or practice medicine while simultaneously reducing barriers to care for patients. Today, we can appreciate from a health and safety perspective, these investments are of even greater importance.

Earlier this week, we implemented a nationwide plan across our clinic network. We are proactively contacting every patient in advance of their appointments and providing them with instructions on how to complete their medical visits remotely. Despite the turbulent health environment, we are ensuring all of our patients are seen and their care remains uninterrupted. It is important to appreciate that as a health and wellness company, the responsibility we take as an organization is twofold: one, we must ensure the safety of our patients and staff; and two, we must always ensure that access to medicine continues uninterrupted for our patients.

Furthermore, given the global concern regarding COVID, we have begun offering medical expertise via our telemedicine network to connect any patients across Canada to a medical professional to discuss concerns regarding the virus and appropriate screening measures. Many failed to recognize that the patient population of medical cannabis users consist of complex patients, such as children with epilepsy or autism, where the risks to their health without access to cannabinoid therapy can have grave consequences. It's abundantly clear throughout our organization and instilled in our culture that the health of our patients is and will always be a top priority.

Geoffrey Benic: Thank you, Dr. Verbora. We really appreciate you joining us today. Our entire team's focus on ensuring our patient care continues. And I'm very proud of how we've handled this responsibility. We are a relatively young cannabis company. In fiscal 2018, our Canada sales were $600,000. But even from those humble beginnings, we did have the vision, which has been very clear from day 1: to be the leader in cannabis health and wellness. That vision remains true today.

Our Q4 2019 was again a significant step forward on the path to profitability. We have now reported our first quarterly positive adjusted EBITDA. While most LPs report substantial sequential decline, our cannabis net revenue has increased 27% quarter-over-quarter, led by medical cannabis sales and wholesale. Year-over-year, cannabis revenue has increased 1,748%. And perhaps most importantly, we can report 80% gross margin on Canada's net revenue. 80% gross margin is, to our knowledge, among the best in the cannabis industry.

We are a growth company in what has been a growth industry. However, it's very clear for all of us to see that times have changed. The most capital increases -- the cost of capital increases every day and balance sheet risk hangs like a cloud over the sector. Like many analysts, we knew this wake-up call could arrive for this industry, but we did not wait for it. Rather, we took decisive action over a year ago to ensure we could weather the storm when it arrived.

It was almost exactly a year ago today that we closed the acquisition of Emblem. Since that time, we have instituted a culture of disciplined growth, reducing overhead and focusing on core revenue-generating operations. In Q4 2019, our SG&A expenses were $4.3 million, a decline of 11% over the previous quarter. I'm excited with how far we've come, but we aren't resting our hands. We have a long way to go.

And to do that, we will continue to lean on Aleafia Health's second mover advantage. This means avoiding the mistakes made by some of our peers. In 2018, cannabis companies' valuations were tied to the square footage of the cultivation facility. This created a reverse incentive to build or buy the largest cultivation facilities possible. The consequences of this action are just being felt in the industry today. Since the onset, facility licensing has been a significant development for our business.

Obviously, we have some important news arrive over the weekend, receiving the cultivation license for our Niagara facility. To say it's long time coming would be an understatement, but we have been prepared for this day for months. Despite the size and scale of our outdoor cultivation, the Niagara facility remains incredibly important for us for 3 reasons. First, it will serve as the base of our operations for our outdoor cultivation with clones growing in Niagara and then transported to the outdoor site.

This significantly reduces risk and lead times relative to planting seeds. Niagara will also play a role following the outdoor harvest in the fall. Second, it gives us much needed source of input material for dried flower products. We do not have enough capacity at our indoor facilities to replace the loss of expected supply from third parties, specifically for the outlet use market.

We have not been able to obtain products from third parties that meet our needs. Lastly, we have heard a lot about facilities being rightsized, in other words, closed down, but the Niagara facility was built rightsized. From the get go, at a modest 160,000 square feet, this is appropriate for our uses today.

So now we finally have the licensing bottleneck opening and only 2 outstanding amendments for our expanded Paris production facility and our expanded Port Perry outdoor grow facility. While there can be no certainty on when the license amendments will be secured, we feel confident that both will arrive during the next quarter.

During the reporting period, we completed our inaugural outdoor cultivation harvest. Our very conservative estimates at the time indicated that we yielded approximately 10,300 kilograms. Since then, we have completed a drying-and-curing process and the official tally is [12,747 thousand] (sic) [12,747] kilos of dried flower.

We sold 1,122 kilograms of outdoor flower in Q4 2019. In this Q1 2020 to date, we have sold an additional approximate 4,000 kilos and will continue -- and continue to consider additional transactions. Looking forward, the cultivation infrastructure for Port Perry Phase II outdoor cultivation expansion to 86 acres is complete. The application is submitted, and we're looking forward to planting in the spring.

The fourth quarter was significant also for our Paris facility. This is by far the crown jewel of our production ecosystem and our most important facility. It's where all of our finished products are produced, packaged and shipped. We have now completed the Phase 2 expansion of Paris, which will exponentially increase our ability to produce, sell value-added cannabis product. The facility has been purpose-built to meet EU-GMP certification requirement. Senior members of our team have spent their entire careers in EU-GMP production and their expertise will be essential as we look to gain market access to the EU.

Looking forward, we have recently hired a medical cannabis sales veteran to help grow our core business. We continue to believe that medical cannabis, both in Canada and abroad, remain an incredibly attractive market, which many have ignored. Our medical sales have increased significantly in the last month as we see some of these changes paying dividends.

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

Benjamin Ferdinand: Thank you, Geoff. Now we will look to our financial results for 2019. As Geoff alluded to, it was a year of significant consistent growth for Aleafia Health. This was our fourth consecutive quarter of reporting of record revenue. Q4 2019 was a great quarter for us as we achieved our first quarter of positive adjusted EBITDA, a significant milestone.

This quarter really demonstrated our differentiated health and wellness strategy and action as our team executes very, very well. Our strategy has high barriers to entry and provides defendable, long-term competitive advantage relative to our peers. On top of that, we are razor-focused on having one of the highest margins in the business, the right cost control, disciplined capital allocation and relentless execution.

Year-over-year, net revenue increased by 391%, led by increases in cannabis and clinic revenues. Our cost management discipline has been demonstrated as we have seen expenses decline sharply throughout the year. To put things into perspective, total expenses for the first 2 quarters of 2019 was $32 million compared to only $17 million in the second half of the year. We will continue to be vigilant on stamping out any unnecessary costs.

From a liquidity perspective, our balance sheet remains very strong as we reported $41 million in cash. Our cash burn continues to decline significantly as we drive towards profitability, and that should only improve as we increase sales and with major capital projects already completed.

Now we will look deeper into our product segments. Medical cannabis sales increased 19% over the previous quarter and medical cannabis gross margin was 68% compared to 40% -- 44% in the previous quarter. Patients have increasingly moved towards higher-margin products, including capsules and sprays relative to dried flower. We've also made significant improvements to production processes at the Paris facility to increase operational efficiency. All of this contributes to our higher-margin profile.

Having said that, we have continued to experience some supply challenges due to the loss of expected supply from third parties. Certain top-selling medical products were stuck between November and early February due to a lack of raw input material. The successful outdoor harvest helped rectify this, and we now have built medical inventory. Now that we finally have sufficient inventory, we have reallocated resources towards expanding our medical sales team. There is substantial room for growth in medical sales through both attracting new registered patients and increasing revenue per patient.

Bulk wholesale net revenue was $2.8 million in Q4 2019 and were sold at 97% gross margin. This demonstrates the power of successfully executing our low-cost, high-quality outdoor cultivation. We were the first to plant on a large-scale legal outdoor cannabis crop in Canadian history.

Our operations team performed fantastic work in navigating all of the challenges that were presented, and we are looking forward to doing this on our much larger scale this spring, utilizing 86 acres of cultivatable land or 3.7 million square feet. Lastly, adult-use revenue for the quarter was down, decreasing by 70%, largely due to lack of supply for recreational product. Fortunately, the challenges experienced were not permanent.

Our Niagara facility license that we just received not only creates a support system for executing on our outdoor crops, but also provides us with the ability to create high-quality strains for both the recreational and medical markets. Prudent allocation of capital remains our top priority. As sales increase, we do not expect to see a commensurate increase in overhead cost as we take advantage of our operational leverage and business model strength.

We expect that our $41 million in cash is more than sufficient to fund our operations for the next year. However, should additional capital be required for new growth initiatives, we will prioritize nondilutive financing methods. For example, we have 3 major facilities, all of which are unencumbered and have no debt. We have the option to monetize them through different arrangements, including credit facilities and sale leasebacks.

As we look to Q1 2020, our business model already has a large virtual presence, as Dr. Verbora mentioned, with telemedicine and shipping to home, so we're already well prepared to deal with the ongoing crisis. We will continue to service clients with the medical-first focus in this trying environment.

We believe that now is the time that investors and analysts will finally start to reward companies with high-margin, low-cost structures, high operational leverage and a clear path to cash flow and profitability. This will start to lead to a differentiation between competitors, and there will be clear winners and losers in this market.

Nick, over to you.

Nicholas Bergamini: Thank you, Ben. That concludes remarks. Operator, you may begin the question-and-answer session.

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 follow up on the comments with respect to the gross margin, very strong gross margins in the medical and wholesale channel. I was wondering if you could provide some color in terms of the gross margin on the adult-use side and how you expect that to trend in the coming quarters in addition to the scale-up of Niagara, whether that might see a bit of a headwind as you go through that process.

Geoffrey Benic: So Graeme, I'll let Ben answer that question. Ben, go ahead.

Benjamin Ferdinand: Thanks, Graeme. So our margin profile for adult-use is about 40%, and that compares to medical at approximately 68% and our wholesale at around 97%. And to your point around Niagara, for us, what that's going to do is do 2 things. One is, as Geoff alluded to, it will be a support system to prepare for outdoor grow, and it will also allow us to create lower cost, high-quality flower and strains for medical and the recreational market, lower cost compared to the indoor. So we view this as a very big positive for us, which will allow us to create the product at scale and feed into our outdoor network.

Geoffrey Benic: Graeme, I just want to add as well, Graeme, that the -- first of all, we don't plant anything that we're not forecasting as selling and that includes our 4 million square feet that we're anticipating on our outdoor and our 160,000 that we think we'll get this year on our Dutch Hybrid modern greenhouse facility. We think that there's a void in the marketplace for high-THC flower in both medical and adult use, and we plan on using our greenhouse in Grimsby to meet that and exceed that void.

Graeme Kreindler: Okay. And to follow up on that, just trying to get an appreciation for the time frame in which that greenhouse can get ramped up. Is there a target date set right now for when you're expecting a first harvest?

Geoffrey Benic: So I'll answer that. So I could tell you, flowers or plants are going in as we speak. So the -- if I can connect the dot in our ecosystem, the first order of business for that greenhouse is to get our clones ready for outdoor harvest -- sorry, outdoor planting season, which we anticipate will be about May 2 or 4. we are going to have -- we are in the process of propagating and putting 100,000 plants in that facility and getting ready to be transplanted for our outdoor bill. Once that's complete, then we're going to continue going down the path of high-yielding, [high-THC, high-quality flower].

Graeme Kreindler: Okay. And then another question just to switch the topic here. Maybe if you can discuss, I guess, maybe over the past 14 days or so, what the purchasing behavior? Has it changed at all from any of your customers, whether that's on the medical side, the wholesale side or from the provincial control boards? We've seen a lot of headlines here about volumes picking up as customers are looking to stock up in light of the current environment. So any color you could provide on that and how you think that might trend over the next month or 2 would be helpful.

Benjamin Ferdinand: Yes. Thanks, Graeme. Look, the great thing about our business model is that it already has a large virtual presence in telemedicine going back to 2018.

And so we're already built for this virtual environment, shipping to home and medical first. So we stand at the ready to -- and we have been -- as Dr. Verbora has alluded to and Geoff alluded to, we have not missed any appointments and have continued to service the surge in the environment. And we continue to put our patients first and stand at the ready to make sure that they get their medicine. So we're continuing to execute, and our business model was built for these types of volumes.

Graeme Kreindler: Okay. And then my final question. With respect to the adjusted EBITDA figure in the quarter, if I recall correctly, I think there was about a $1.6 million add-back of onetime transaction-related costs. I was just wondering if you could provide a bit more detail what that pertained to.

Benjamin Ferdinand: Yes. So this pertained to a number of onetime transactions, also as we have explored various potential transactions which haven't been announced, but those are transaction costs that will subside but are related to business acquisitions and transactions that we're investing in, and that includes the banker, lawyer consulting fees.

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

Nicholas Bergamini: Thank you, everyone. Go ahead, Geoff.

Geoffrey Benic: No, I just really want to thank everyone that joined this call, from our analysts, obviously, to our shareholders and also to some of our patients and some of our customers.

This is an incredible time in our history as our history continues to evolve. One thing that we're proud about when we use a term in the industry right now is -- we use a term called cash barbecue. A lot of the LPs out there, unfortunately, have become cash barbecues. We pride ourselves to being very efficient, very effective, and most of all, we focus on execution.

And it's something that, I think, as a shareholder and as the leader of this organization, we pride ourselves on. And we will continue going down the path of representing our shareholders as best as we can. And I use the term as well that we throw nickels around like manhole covers in this business. And I truly, truly feel that way today is that we are looking out for our shareholders' best interest.

So we want to thank you for your questions. And on behalf of our Board of Directors, our management staff, we thank you for joining us today. Stay safe. Thank you. And I always say this and I want you to truly believe this that the best is yet to come. And that concludes our call today. And Nick, over to you.

Nicholas Bergamini: Thank you for joining us.

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