Aleafia Health Inc. (Q2 2021 Earnings)

August 12, 2021

Corporate Speakers:

- Nicholas Bergamini; Aleafia Health Inc.; Vice-President of IR & Communications
- Geoffrey Benic; Aleafia Health Inc.; CEO
- Matt Sale; Aleafia Health Inc.; CFO

Participants:

- Rahul Sarugaser; Raymond James Ltd.; MD and Equity Analyst of Healthcare, Biotechnology & Cannabis
- Pablo Zuanic; Cantor Fitzgerald & Co.; Research Analyst

PRESENTATION

Operator: Good day, and thank you for standing by. Welcome to the Aleafia Health Second Quarter 2021 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, Danny. Joining me on the call today are Aleafia Health's CEO, Geoffrey Benic; and CFO, Matt Sale.

This morning, Aleafia Health filed on SEDAR its financial statements and associated management discussion and analysis for the 3 and 6 months ended June 30, 2021. All comments to be made on this call today should be taken with reference to and are qualified in their entirety by those documents.

Today's call includes estimates and other forward-looking information from which our actual results could differ. Please review the cautionary language in today's press release regarding various factors, assumptions and risks that could cause our actual results to differ.

Furthermore, during this call, we will refer to certain non-IFRS financial measures, including adjusted EBITDA and adjusted gross margin. These measures do not have any standardized meaning under IFRS, and our approach to calculating these measures may differ from that of other issuers, and so these measures may not be directly comparable. Please see this quarter's MD&A for more information about these measures.

I will now pass the call over to our CEO, Geoffrey Benic.

Geoffrey Benic: Thank you, Nick. It's great speaking with my fellow shareholders today. We're very much appreciate you joining us. This quarter reinforces the disciplined and growth-oriented approach we've taken over the last year.

As we've said repeatedly on previous earnings calls, our focus over the last 12 months has been on scaling our production and bringing a strong portfolio of cannabis products to the medical, adult-use and international markets. And we believe these results demonstrate strong consumer and patient demand for our growing product and brand portfolio, starting with a 53% sequential increase in cannabis net revenue.

More importantly, we've realized a major shift in our sales mix, that has the benefit of providing us with more balanced, sustainable and ultimately, more valuable sources of revenue. In fiscal year 2020, the majority of our revenue was from bulk wholesale. That revenue mix has changed significantly this fiscal year with our 4 core pillars: medical, international, adult-use and wholesale contributing approximately evenly to our revenue base.

This result is better diversification of revenue, less seasonality and that allows us to react to market opportunities and achieve the highest possible net realizable margin. Q2 2021 saw us -- report record adult-use net revenue, increasing 87% sequentially and 270% over last year's quarter. This growth was achieved despite macro-industry challenges of significant retail store shutdowns and major delistings of product SKUs occurring in cannabis largest provincial market.

We agree with the assessment that COVID-19-related lockdowns have negatively impacted adult-use in-store sales, particularly in Ontario. This growth trajectory also occurred in medical as we realized record medical cannabis net revenue with 23% and 67% sequential and year-over-year increase, respectively.

This was driven by meaningful growth in both domestic and international medical sales. The gross margins and patient stickiness evident in medical, along with the absolute size and rapid growth rate of adult-use to make these channels both attractive. Bulk wholesale also increased 66% quarter-over-quarter as we continue to be opportunistic in utilizing this channel for sale of low-cost cannabis.

Together, this paints the picture of a substantially improved sales mix evenly distributed across 3 sales channels. The COVID-19-related headwinds have along with greater competition directly contributed to industry-wide price and margin compression. We are regularly seeing major Canadian LPs report lower and even negative gross margins on cannabis revenue. Matt will spend more time on this topic. But I think it's worth highlighting that we have again delivered what is to our knowledge among the strongest gross margin for Canadian LPs at 41% or 49% adjusted gross margin when subtracting noncash depreciation expenses.

Given that our sales growth has been driven by new product launches, it's a testament to our operations team that we've been able to protect margins even as we rapidly scale production and react nimbly to new opportunities. While we will always continue to innovate and do have some additional launches in the back half of 2021, Q2 saw a continued significant expansion in our product portfolio and brand road map. 13 net new SKUs were launched in multiple provincial markets during the quarter and in most cases, also to the medical patients.

Specifically, the launch of our brand, Divvy and our first larger format dried flower and pre-roll SKUs were our biggest revenue catalyst during the quarter. Along with vapes, these are the largest product categories in Canada, and we view it as essential to have a strong presence in them.

Our goal with Divvy is to build an iconic cannabis brand for high-volume regular cannabis users not willing to sacrifice on quality. Due to the successful launch, demand outpaced our projections, which did result in some supply challenges during the quarter. As we've realigned production and prioritize the cultivation of certain cultivars, we will be able to significantly increase supply for the most in-demand SKUs.

Moving to the medical channel. There were a few key items that drove growth in Q2. First, our dried flower was exported to German medical cannabis market, which was a long-awaited breakthrough for us. At the same time, we completed our largest shipments to Australia to date and have additional purchase orders for 2021. Scheduled same-day delivery, virtual consultations and our growing suite of medical cannabis products provide a unique ecosystem for Canadian patients. It's a completely differentiated value proposition for patients that does not exist elsewhere in the Canadian cannabis industry.

Domestically, we began registering our first patients unionized employees of the Ford Motor Company. So our exclusive agreement with Unifor Cannabis largest private sector union, the thesis underpinning in this relationship is that out-of-pocket costs remains the largest barrier for many potential cannabis patients. Through collective bargaining with some of the cannabis largest employers, Unifor is advocating for medical cannabis coverage in insurance plans. Since then, we've had 2 new employers together, representing roughly an additional 2,000 members, plus eligible family members sign up to part -- to be part of the Unifor program. We expect these new programs to take effect in September, and we will seek to grow penetration rates in Unifor's much broader 315,000 member base.

Lastly, I'll touch on our outdoor cultivation facility in Port Perry. When we completed our harvest last year, we communicated a series of improvements we would make in 2021 to build upon our 32,000 kilogram yield. Most importantly, that meant hitting the ground running with planting completed in June, over a month earlier than in 2020. The importance of this can't be overstated in a 5-month growing season.

I met the Port Perry facility regularly and very excited to commence the harvest in October. Matt, over to you.

Matt Sale: Thanks, Geoff. It's great to be speaking with our shareholders today. Since joining Aleafia 2 months ago, I've had the opportunity to actively participate in an exciting period for the company. The scale of our production assets, our diverse product portfolio and unique medical ecosystem model have situated us well for continued growth. As Geoff alluded to, this quarter was characterized by a more balanced sales mix that is a result of several months of focused product and brand development. We view this as the company maturing from a bulk wholesaler to a wellness-oriented CPG company.

I'll first unpack some key revenue metrics. Beginning with adult-use, the Ontario cannabis store ranked Divvy, the third most search brand online, ahead of many of the most well-established brands, driving a 545% sequential increase in dried flower sales and a 311% increase in pre-rolls.

Rounding out growth in adult-use was our newly launched Omega CBD soft gels, contributing to a 171% increase in capsule sales over the previous quarter. This really speaks to what we view as a still untapped market for over-the-counter wellness products. Adult-use revenue per gram increased slightly to $5.29 from $4.89 in Q1. This was due to continued strength in the sale of some of our higher-priced derivative formats, including Kin Slips and oils, and partially offset by growing sales of the value positioned Divvy pre-rolls. Adjusted gross margin for adult-use remained strong at 47%, a sequential decline from 56% in the previous quarter, also attributed to increased sales of pre-rolls.

Notably, we only commenced sales of higher-margin larger-format 14-gram pouches late in the quarter, and it certainly will be a key objective for us to continue growing sales in that important product subcategory. Revenue growth in medical was fairly evenly spread between all product categories and was more driven by increased average order size and increased units per order. Our medical ecosystem is completely unique in the Canadian cannabis industry, providing a defensible moat around our business.

Our goal in medical is to make the ecosystem from e-commerce to medical consultation, to delivery and products, the one-stop shop for patients. We had some success in that regard with average revenue per patient increasing in the quarter. Adjusted gross margin on medical cannabis revenue was 41%, reflecting a lower net revenue per gram equivalent sold due to a higher volume sales strategy.

As previously discussed, we have moved to a virtual-only model for our medical clinic business, which is something that is more cost-effective and better for our patients. We continue to manage a national network of physical clinics. The transition has been positive with clinic revenue increasing 40% over the prior year's quarter. In connection with the sale of certain clinic assets, we realized the gain of $12.1 million in the quarter. Adjusted EBITDA loss was $3.3 million compared to $3 million in the previous quarter. SG&A increased only modestly over the previous quarter despite a significantly higher growth in revenue.

During the quarter, we established an at-the-market equity program that provides us with additional financial flexibility. The elimination of $25 million in debt earlier this year was also an important development that positions us well and enhances our access to capital. At quarter end, cash, cash equivalents and marketable securities was $70 million, providing us with financial capacity to continue to execute on our core growth initiatives.

Given the success of our brand launches, the demonstrated demand for our medical and adult-use products, we believe we are well positioned for continued growth across our 4 sales channels: medical, adult-use, bulk wholesale and international.

Operator, over to you.

QUESTIONS AND ANSWERS

Operator: (Operator Instructions) Your first question comes from the line of Rahul Sarugaser of Raymond James.

Rahul Sarugaser: I'd like to start with -- I guess maybe I'll start by saying congratulations on the strong margin profile that indeed is a leadership in the industry. So well done there. So I'd like to start on the medical cannabis and specifically, the Interfor contract. Geoff, you mentioned 2 new members with 2,000 patients.

Are you able to elaborate there in terms of who these members are? Any more details around 2,000 patients? And also, you've previously talked about in the last earnings call that Q3 was when we could expect to that Interfor -- the Interfor contracts start yielding revenue as you onboard patients. Could you also give us a sense of how that time line is going as well as when you expect these additional 2,000 patients to start hitting the income line?

Geoffrey Benic: Yes, Rahul, thank you, and thank you for joining us today, Rahul, always respect to your comments and questions. So I just want to start off by saying, the 2 new collective bargain agreements that have been barging in with cannabis, it's Martin Brower, which is supply chain for McDonald's Canada and Holland SMB, which is a farm equipment manufacturer.

So these 2 have been successfully bargained. And I could tell you, the one thing about Unifor is that they literally have hundreds and hundreds of collective bargaining agreements that are either going to be negotiated, are being negotiated or are in the process of being negotiated. So we continually are onboarding and working with all these collective bargain agreement companies that have successfully included cannabis.

And I can tell you, Jerry DS is a big advocate of medical cannabis. He believes in the benefits of it. And he's going to continue bargaining, and we continue working with their senior leadership team at Unifor, including all their bargaining agents and educating them in the net benefit of medical cannabis. And so we're excited about that. So really blue skies ahead.

So I want to also talk about in Q3. As everyone knows, our first big employer was in the auto sector. And unfortunately, the auto sector went through a period of time when their supply chain was disrupted with chips of all things. So a lot of these cars these days require a lot of chips to run them. And as a result of that, the supply chain shut down production. Production recently has started back up.

The supply chains are back in motion. And what's important about that role is that it gives us the opportunity to really get in front of all these members. So we get in front of them with pop-up clinics. We get in front of them in various other ways. And I got to tell you, they're embracing and really starting to leverage the net benefit of cannabis, a great education program with our Chief Medical Director, Dr. Michael Verbora, also with the help of Tricia Sims, our Chief Commercial Officer and her team. We're aggressively -- we think that it's a huge differentiator for us, especially with our medical ecosystem that we're going to continue to hit on that.

Rahul Sarugaser: And so just now returning to the cost side. We've seen a bit of an escalation in some of the OpEx costs. Maybe you can give us a little bit of color on that. And then how should we be thinking about that? How should we be thinking about that going forward?

Matt Sale: Rahul, it's Matt here. Thanks for the question. What we saw in SG&A in Q2 was a modest uptick. When we look at the way we think about it relative to our revenue growth, which grew at a much higher rate. So we're comfortable directionally that we are starting to extract some operating leverage out of the business.

In terms of where those costs increased in Q2, they were targeted, I'd say, in 2 areas: one in our grow operations to fulfill higher production volumes; and two, in our sales and marketing group to facilitate the extensive amount of SKU listings and new product launches in the quarter. Going forward, as you know, we don't provide specific guidance. I'd say, we're comfortable with the level of SG&A in Q2, and think that, that's a good base rate for you to think about in the coming quarters.

Operator: Your next question comes from the line of Pablo Zuanic of Cantor Fitzgerald.

Pablo Zuanic: Can you comment in terms of the medical market in Canada? Outside of these agreements with the labor unions, what has to happen from a regulatory perspective for the medical market to start ramping up in Canada?

Geoffrey Benic: Thank you, Pablo, and thank you for joining us today. I always appreciate your questions. So we think that there's a health can review when health care legalized cannabis in 2018 under the Legalization Act of Cannabis. There's a formal review happening and it was a 3 review. We expect something to be issued somewhere around October. And what we think is going to happen is that medical cannabis and -- or cannabis-derived CBD products and formats that everyone is going to -- is already used to -- will go over the counter.

And we think that, that will be a tremendous catalyst for the industry, specifically for Aleafia because we're positioned really well with our new (inaudible) brands, which is our lead -- market-leading cannabis health and wellness brand. We have a whole bunch of formats in there that everyone is already used to in terms of topicals and sprays, et cetera, et cetera, that will be accessible over the counter. And we think accessibility is the key to driving health and wealth and medical cannabis in Canada.

Pablo Zuanic: That's great. And then just, I guess, it's a bit of a modeling question. But when we think about the outdoor crop, right, come October, you have more land planted. You have higher yields, it help potentially, it help us quantify that. And how much of that is already sold? Or is it going to be an issue that it just builds up a lot of inventory?

Matt Sale: Pablo, thanks for the question. It's Matt here. Nice to be speaking with here today. On the outdoor grow, I guess, 2 metrics I'd point you towards. One was, we have planned to those plants earlier in the growing season. And so on a yield per plant basis, we directionally feel it's well positioned to meet last year and perhaps exceed. As you know, there's a lot of variability that goes into growing, but that would be the first point.

The second one is the quantum or the number of acres planted. And so with our increased acreage, we've more than doubled the acreage assigned to our outdoor grow this year. And then the second part of your question in terms of how much we've sold. We have sizable purchase orders with some partners, which represent a good portion of that wholesale. We continue to look at maximizing margin such that we think about servicing all of our sales channels, so medical, adult-use international and wholesale and looking for the highest margin opportunity.

And so last year, we were able to sell it at 100% of our outdoor growth season that didn't -- I guess, the last comment I make is in terms of time frame. Much of that, we believe, will be ultimately sold in Q4, but some of that we would anticipate to go into the Q1, Q2 period of 2022.

Operator: And we have no further questions at this time. Presenters, you may continue with your closing remarks.

Geoffrey Benic: So I just wanted to conclude with a quarter where you've really seen a pivot in our business in terms of a much better mix of business getting away solely from the B2B and focusing on medical domestic, medical international, which is one that we're really excited about that we think is going to be a game changer for us come Q3 and Q4 as a huge differentiator in the marketplace.

For the first time in a long time, we're actually going to have first-mover advantage. And when you have first mover advantage, it's a tremendous opportunity for us. So we are really looking forward to that. Our Divvy brands continue to be selling very well in the recreational markets. Number one -- sorry, number three, search product in the OCS. And ultimately, we really feel we're heading in the right direction.

We thank all our shareholders for all their support. And we really look forward to Q3 and especially Q4. So thank you, everyone for joining us. We look forward for some really blue skies. Thank you.

Operator: That concludes conference call. Thank you for participating. You may now disconnect.