Aleafia Health Q3 2021 Earnings Call Transcript

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Company Participants

Nicholas Bergamini - VP, IR & Communications

Geoffrey Benic - CEO

Matt Sale - CFO

Conference Call Participants

Pablo Zuanic - Cantor Fitzgerald & Co.

Rahul Sarugaser - Raymond James

Venkata Velagapudi - Research Capital Corporation

Operator

Good day, and thank you for standing by. Welcome to the Aleafia Health Third Quarter 2021 Earnings Conference Call. [Operator Instructions].

I would now like to hand the conference over to your first speaker for today, Mr. Nicholas Bergamini, VP of Investor Relations. Please go ahead, sir.

Nicholas Bergamini

Thank you. Joining me on the call today are Aleafia Health CEO, Geoffrey Benic; and CFO, Matt Sale. This morning, Aleafia Health filed on SEDAR its financial statements and associated MD&A for the 3 and 9 months ended September 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 they 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, and it's great speaking with my fellow shareholders today. We very much appreciate you joining us.

Today's Remembrance Day in Canada, where we recognize the courage and sacrifice of our veterans, along with the men and women who today serve in the Canadian armed forces. I know we have many veterans as both investors and patients. So on behalf of Aleafia Health, I give you my sincere thanks.

This quarter reinforces the disciplined and growth-oriented approach we've taken over the last year. Similar to our momentum established over the previous 2 quarters, it features significant growth in adult-use cannabis sales as we continue full steam ahead in developing our wellness CPG business model. At the same time, we've also realized a reduction in SG&A expenses.

But first, I'd like to quickly touch on the noncash write-off of intangible and goodwill assets, which clearly resulted in the significant net loss for the quarter. It's really important to note that these are noncash, onetime impairments of nonphysical assets. These have absolutely no effect on our cash profitability. And like many of our peers, we have undertaken these impairments to adjust for current market conditions. Now with these items no longer on our balance sheet, it's cleared the deck for the strong growth moving forward.

I'd like to speak to some incredibly exciting results at our outdoor cultivation facility in Port Perry, Ontario. In 2019 and 2020, we demonstrated that we could generate significant yield. But as we've always said, the outdoor flower potency was about 80% as high as that of our indoor and our greenhouse. Our goal this year was to produce high THC, low-cost dried flower at scale for sale directly in the adult-use market with potencies meeting or exceeding greenhouse results.

I believe our third annual harvest, which we completed this week has achieved that goal. The average potency level for all THC flower harvested is 22% with some cultivars reaching into the high 20s. Together, we have 11,600 kilograms of dried flower above 20%, almost all of which will be directly allocated towards the adult-use market, specifically in pre-roll and milled formats. Apples-to-apples, this is over 20-fold increase in plus 20% THC dried flower harvest over last year. From our perspective, potency much more sold in total weight, is the best indicator for investors of the total revenue generating potential for the harvest.

Now to be clear, the figures I just mentioned do not include our CBD in balance trains, which are still in the process of being weighted and tested and which make up the majority of the total harvest. So the 11,600 kilos is just a fraction of the total weight harvested, and we look forward to reporting on the total amount later this year. The outdoor cultivation results are important because it quickly ramps up supply for our top-selling SKUs, which also leverage our low-cost cultivation advantage. As we said on previous earnings calls, these products are often sold out due to high demand. So these results will help alleviate the supply/demand imbalance.

Stepping back, exactly a year ago today on our earnings call, we signaled that we saw ourselves making a significant effort to enter the adult use market. In Q3 2020, we had approximately $200,000 in adult-use net cannabis revenue, so we were essentially starting from scratch. In the last year, we've launched 5 consumer-facing adult-use brands, each tailored to specific consumer segments, and we've launched dozens of SKUs in that time. The results are beginning to show as we again reported a meaningful sequential increase in adult-use sales and an over 2,000% increase over Q3 2020.

We've also begun to capture market share. According to retail sell-through data from Ontario, Saskatchewan, BC and Alberta, we hold a formal top 10 market share position in both oils and edibles. Subsequent to the reporting period, we also reached a top 10 market share position in pre-rolls the third largest category in Canada.

The next objective for our team is to replicate this in the dried flower category. It's the largest in Canada by a wide margin. It also plays to our strengths. The largest input cost is the flower itself, not the packaging, not the processing. This is an area where we have an advantage over our peers that will allow us to maintain competitive pricing and protect gross profit margins.

We've also had some positive development in our domestic medical business. While we did see a small decline sequentially in sales here, this is consistent with last year, with lower order volume during the summer. We do expect to continue growing in the sector heading into Q4 and the new year.

Our team continues to execute on our partnership with Unifor, Canada's largest private sector union. The thesis underpin this relationship is that out-of-pocket costs remains the largest [indiscernible] for many potential medical cannabis patients. Through collective bargaining with some of Canada's largest employers, Unifor is advocating for medical cannabis coverage in insurance plans.

This is completely unprecedented program with many stakeholders involved. It's not something that will bring results overnight. And indeed, the ramp-up has taken more time than anticipated. One of the chief challenges is get in front of employees during COVID-19 environment. But I've challenged our team to find a way in the last 30 days, we've registered more patients than the previous 4 months of the program combined. While not yet material amount, I'm feeling encouraged that we are back on track.

We've also had 2 new collective bargaining units approved the use of medical cannabis under their insurance plans, bringing the total onboard unionized employers to 5. We remain as committed as ever to executing upon this differentiated opportunity. By owning the entire patient experience, you are able to create customer stickiness and drive consistent, repeatable, high-margin sales.

Matt, over to you.

Matt Sale

Thank you, Jeff. Good morning, everyone. It's great to speak with you today. One of the defining characteristics of this quarter is once again seeing a diversification of our sales mix, driven by the growth in the sale of branded cannabis consumer products in the adult-use and medical channels. The sale of consumer packaged goods accounted for 79% of net cannabis revenue in Q3 2021, up from 68% in the previous quarter. We view these revenue streams of higher quality as they are more stable, provide greater visibility into future revenue and pave the way for sustainable top line growth for the long term. Moreover, they produce stronger or sustainable gross profit margins.

Our adult-use business continues to perform well and put strong results. As you may recall, we launched our adult-use business in Q4 of last year. Since then, we generated $1.7 million of net cannabis revenue in Q1, $3.2 million in Q2 and $5 million in Q3, representing 56% sequential growth over the previous quarter. It now represents our single largest sales channel, which is also experiencing the highest growth rate.

Now we'll unpack some of the key growth drivers in our adult-use business. The single biggest catalyst in Q3 2021 was the launch of our large format dried flower SKUs some of which only occurred late in the quarter. Not only does this represent over half of the total adult-use market, but it's also a category where we have a competitive advantage over our peers. With most products, packaging and processing are the largest cost of goods sold, but with dry flower the flower itself is the largest component of the cost of production. With one of the only successful outdoor cultivation facilities in Canada, it's here where we have the largest advantage and is one of our commercial team intends to keep pressing.

Additionally, sales growth was driven by greater product availability and increased sales of pre-roll products, which is the largest -- third largest adult-use product category in the Canadian market. In the pre-roll format, we achieved for the first time ever, a top 10 national market share position subsequent to the reporting period. We expect to keep the pace of adult-use growth heading into the fourth quarter. And this will be driven by growth in the dried flower category and more specifically with milled-flower product formats, where we are now a leader now in Alberta market, as well as product line extensions, which strengthen our product portfolio. To that end, we added a total of 35 and 46 SKUs in Ontario and Alberta, respectively, which will be listed by January 2022.

By industry standards, our adjusted gross profit margin in adult-use remained strong at 28%, up from 21% in the prior year's quarter. As large-format dried flower becomes a larger component of our sales mix, we will look to maintain or even improve upon these figures.

In medical cannabis, we continue to be in a ramp-up phase with respect to Unifor, our exclusive relationship. This growth was partially offset by the historically slow months of July and August for Canadian Medical cannabis sales. Our gross profit margins in Medical showed continued strength at 47%, up from 26% in the prior year's quarter.

In our bulk wholesale business, I think it's critical to note that while there was a negative gross profit margin on our income statement. This exclusively relates to the sale of aged inventory, which we opportunistically sold during the quarter. This does not reflect upon the gross profit margins of our core adult-use and medical sales channels, which remains strong.

We have a renewed focus on cost discipline to maximize operating leverage as we continue to rapidly scale our revenue base. This was evidenced by a 34% sequential decline in total operating expenses from $19.6 million in Q2 2021 to $13 million in Q3 2021. And within that, a 24% in core SG&A from $9.2 million in Q2 2021 to $7.9 million in Q3 2021.

As I discussed on our previous earnings call, there were substantial costs associated with the product development and launch of 5 new cannabis brands and multiple new product formats. These onetime expenses are largely behind us. And at the same time, we've undertaken a cost review initiative to optimize our cost structure and lead a clear pathway to profitability. This is ongoing and we expect to result in additional overhead savings in the near term.

Operator, over to you.

Question-and-Answer Session

Operator

[Operator Instructions]. Our first question is from Pablo Zuanic of Cantor Fitzgerald.

Pablo Zuanic

Geoff, can I just -- I know you talked about the outdoor crop and the domestic medical market. But just can you discuss the export outlook? How should we be thinking about modeling that over the next few quarters? That cost advantage you have from the other crop, can that help you overseas? Or it's about getting EU-GMP certification. Just more color on the export outlook for Aleafia and the value chain and hurdles you have to go through to make an impact there?

Geoffrey Benic

Yes. Good question, Pablo. So the requirements for shipping internationally is a lot higher in terms of the standard of product that you need to achieve in terms of the COAs, the thresholds to be able to ship internationally, specifically to EU-GMP designator acquired countries, specifically Germany. I'll talk about that, which as you know, we've been shipping and we continue to ship into Germany. So the outdoor grow, unfortunately, does not qualify and does not meet the thresholds under the EU-GMP. So as a result of that, the outdoor flower will probably most likely in the near term, not be able to meet that standard to be able to ship overseas. We wish it could because it's such low cost and the quality is just phenomenal in terms of THC and terpenes that we're getting out of the flower, which we will use in the domestic market.

So when you're growing at such low cost with such high THC, we're going to be able to put it right into our milled and pre-rolled formats at very, very, very aggressive cost points and still maintaining very, very strong margins just because low cost, high quality. So unfortunately, we can't. But I could tell you, our greenhouse is GCP certified. And we continue to see our order book fill up into the EU. As we continue to ship product into the EU, we've got a pretty full book for November and December. And we're going to continue shipping flower out of our GCP-certified facility into our -- through our partner, who is EU-GMP certified, which is a real clever low-cost, high barrier-to-entry way of us to be able to ship into the EU-GMP, and we're going to continue doing that.

So I just also want to make mention that our flower in the greenhouse is relatively low cost as well relative to our peers and relative to being able to manufacture or grow that flower in Europe specifically. So we see nothing but green opportunities for us with that greenhouse into the EU on an ongoing basis as we continue to look at getting our Paris facility, EU-GMP certified and our oils to flow into Europe as well at some point as well.

Pablo Zuanic

Got it. And just a quick follow-up. Maybe for -- I should know more about this, but in terms of the outdoor crop in Canada, can you talk about the competitive landscape? I mean back in the day, we used to hear of many companies aware in that segment, but then 48North, for example, exited that business. I hear that the people haven't really executed on it. How unique is it what you're doing in outdoor in the context of the Canadian market?

Geoffrey Benic

So I think we've proven over the last 3 years, Pablo, not only have we proven to the market that we're capable of growing outdoors, but we continue to prove to ourselves that we are improving in the quality of the outdoor growth. So as far as we know, we're still the largest legal outdoor producer in Canada. And I think a lot of folks are abandoning it, Pablo, because the amount of infrastructure that has to go into growing good quality product year-over-year is substantial. And the amount of IP that goes into it in terms of improving the process, like going from 80% cannabinoid content relative to our greenhouse and to our indoor to add par, and in some cases, even better than our greenhouse is 3 years of learning. And that's just something that you can't just pick up overnight, not to mention all the infrastructure that goes in. And furthermore, I could tell you this year, our costs are much lower than they ever were last year, and it's just proven how much more efficient we're getting at doing this. So our quality has improved tremendously, and our cost is reduced significantly and it just continues to give us a competitive advantage.

So I think the reason why a lot of these other LPs have abandoned outdoor grow, Pablo, is because they determined that the amount of time, effort and capital to go into it and patience, they just did not have it, and we're going to leverage that. So we're talking significantly low cost per gram that can easily be put in milled product formats and/or pre-rolls. That's in the rec channel, let alone the CBD strains, which we are now actually doing. As everyone knows, we have a Divvy pre-roll, which is flying off the shelves. And extracting a lot of that CBD oil, which we think CBD becoming OTC, over-the-counter is imminent. We see it's something going to be a phenomenon probably first quarter next year, where we're going to in the health and wellness brand have a significant competitive advantage over all our peers.

Pablo Zuanic

And if I may, one just last one. I mean, obviously, Unifor, it's kind of a largest private sector union, as you said. What could be other wins that you could report in over the next year in that topic, I mean, in terms of either federal government, labor unions or provincial unions or Unifor is really the largest, whether it's private or public?

Geoffrey Benic

So great question, Pablo. And I think I've consistently said that the key that we're developing here in our Unifor relationship, which, by the way, Jerry Dias, the Head of Unifor, is completely supportive and he is a big advocator of our service and cannabis as medical therapy, as a replacement to opioids. So he is a firm believer. And as all these collective bargain agreements are coming due, they are putting in cannabis as a therapy -- sorry, medical cannabis as an alternative therapy. So they are bargaining into all of these. So -- but what I did say, Pablo, is that the data that we are collecting in terms of having real quantifiable data that we can go to other employers and other unions and other insurers to be able to show them the real impact in terms of the effect of performance lifestyle and overall, just a quality of life that cannabis is having an improvement to a lot of these unionized employers, whether it's performance at work, showing up on time, showing up period, getting a good night sleep, dealing with some kind of pain or some eating disorder or mental stress.

We're collecting all this data, and we don't think anyone has this data that's quantifiable. That will be a great argument and a great way to get other larger employers and other unions such as large banks. And we're talking to a lot of these folks every day, Pablo, because a lot of folks are interested, especially post pandemic. There's a lot of mental stress out there people are dealing with. And ultimately, we think we're in a great position.

Operator

Next, we have Rahul Sarugaser from Raymond James.

Rahul Sarugaser

So it's great to see the trajectory on the adult-use sales. Hopefully, we'll see that more going forward. I'd like to dig in a little bit, however, into the medical use sales. We saw a dip there in this quarter. You've attributed that to sort of seasonal weakness. However, it's sort of a bit bigger than we have seen a lot that we saw last year. So could you give us a little more color into -- in terms of why we saw that softness? How do you see that playing going forward? And always my perennial question, what is the contribution from the union contracts? And how do you see that going forward?

Geoffrey Benic

Yes. So Rahul, great to have you. Thank you for joining us today. So in terms of the dip, we know it's a seasonal dip. But one thing that we saw was that Health Canada was extending scripts to a lot of folks due to COVID. So the -- in terms of the renewal, and we saw that as a -- it did impact our sales this specific quarter as less folks were coming in looking for renewals because Health Canada was allowing them not to have to renew. But we're starting to see the pent-up demand, that coupled with us signing some really strategic relationships with some third-party clinics, large clinics, which subsequently we did here in Ontario and Quebec. So we have some large third-party clinics that we've become the exclusive medical cannabis provider, not just on education, but also in formats.

So we see that we've continued to build up that base and we're already seeing that this quarter. So outside of the -- those 2 issues in terms of the seasonality and the scripts with Health Canada, we see nothing but improvement and we're seeing it already this quarter, 6 weeks in. Not to mention on the rec side, to your point, we've seen -- we're 6 weeks in, and we're well above we think we're really going to blow that number away on what we did in rec Q3 into Q4, let alone all our other segments, international, wholesale and medical cannabis.

So in terms of Unifor, one of the challenges we've had is that everyone is hearing about the supply chain issues. It started off with chip shortages and it started with part shortages, harness shortages coming out of China. So a lot of these plants were dormant. And so one of the biggest challenges we had was trying to build the mousetrap in terms of being able to get out and get in front of these -- the uniform members. In the past, it would be easy to show up at and get invited to the plant floor, the union hall and/or the parking lot where we've set up pop-ups. The challenges that with COVID and all these issues with supply chain, closing down plants or -- sorry, delaying the reopening of all these plants, specific as Unifor as Ford was one of our first-off employers that we came on. We had to find other mechanisms of being able to reach out to these folks, and I challenged the team, and the team has done a phenomenal job, and I can tell you since the beginning of this quarter, in the last 30 days, we've really started hitting the nail on the head on a format in terms of how we're communicating them and how we're reaching out to the membership. And the membership is word of mouth, it spreads like wildfire.

And as I said in my discussion in my presentation is that we are seeing a significant uptick in Unifor member patient registration. In the last 4 weeks, it's incredible. It's starting to hit, and it's not significant yet relative to our 30,000 patients. But I'm feeling very, very strongly and very bullish that I think we've found a way of being able to work in this still this COVID environment. And we're anxiously -- and we're still looking forward that if we could be successful in this format once the doors open up, we're going to have a tremendous amount of success with the face-to-face kind of meetings.

Rahul Sarugaser

Great. We'll certainly look forward to that. Now pivoting a little bit to wholesale. We recognize that, that age inventory was sold at a relatively large loss. Given that we've seen some other relatively large wholesalers selling quite profitably, could you give us a little bit more clarity in terms of how we should be thinking about wholesale margins going forward?

Matt Sale

Yes. Rahul, thanks for that question. So I think the way to think about the margin in Q3 and wholesale was 2 factors; so one is aged primarily distillate and oil inventory that was in our warehouse, and we opportunistically found an opportunity to monetize this product. It was over and above our kind of internal needs to satisfy derivative products. And so we thought that was a favorable cash realization opportunity.

The second piece of that total sale related to some, I call it, off-spec flower. So whenever we have cultivation, we're trying to hit a specific product format or a specific bandwidth, a range for our flower products, and to the extent there is any, which is outside that range, we find the wholesale market as an attractive market to realize some margin on that product. So this is nonrecurring. It's opportunistic. It's realizing some cash, which otherwise we would not have achieved. And so we think about that very differently than the margin profile on our ongoing and core medical and adult-use businesses.

Rahul Sarugaser

Great. And you gentlemen, just one more question. So given that you really have kind of 3 lines on [indiscernible] cannabis revenue, how should we be thinking about a blended margin on cost of goods going forward? And then separately, tying back to my first question around medical patients, what -- could you quantify the patient registration ramp that you referred to there, Geoff?

Matt Sale

So we'll answer the first part on...

Geoffrey Benic

I was going to say go ahead, Matt, answer the first part of that question.

Matt Sale

Okay. Yes. So on the margin profile reveals there really is 3 different profiles. On the medical side, given 80%, 85% of those cannabis sales are derivative products, that will directionally -- typically always be our highest margin profile. And you see that -- saw that this quarter with the 45% margin. On the adult-use side of the business, where 2/3 of our sales are typically flower formats, that margin profile is typically a little less than that in the pre-roll categories. But I would say, can be equal or higher than that in our growing categories, which are large format dry flower.

And then the third margin profile is our wholesale. And when we sell any kind of onetime aged inventory, as you saw this quarter, the margins are lower. But where we are able to sell our products from our outdoor facility, which we have a low-cost advantage, we're able to achieve higher margin profiles. So those are 3 -- we think about those margins very differently in each business. I would say, to answer your question on direction where it is going, as our adult-use business continues to grow, is now the largest sales channel, and the highest growth rate, the margin profile in that business will start to lead towards the weighted average.

Maybe I'll pause then, Geoff, if you wanted to add some more color.

Geoffrey Benic

No, that's fine. So in terms of patient growth, Rahul, we're starting to see an uptick in patient growth as things get back to normalize in terms of living. So we're already seeing that in Q4. And we're going to see that right through the Q1 2022. Look, these things take time to get going. But I can tell you, they're heading in the right direction. I'm really looking forward to reporting our Q4 numbers, and I think we'll be a lot more -- it will be a headline number for us in terms of additional new patients, primarily specifically to Unifor as well as I can tell you that it's a pretty exciting period of time with Unifor as the patients are starting to come through. So a lot of these folks have spending accounts and allowances in ranges from $500 to $2,500 annually. So the good thing is we're tapping some of them at the -- and annually is calendar for them. So we'll see the uptick in this Q as they spend their $500, $2,500 allowances for the year this year and then right into Q1 beginning January 1. So we're excited and we're looking forward to reporting the numbers in Q4 for Q4 in early March next year.

Operator

Our last question is from Ven V Research Capital.

Venkata Velagapudi

I do have a question on segment-wise gross margins. So we noticed that gross margin for adult-use cannabis took a dip this time. I just wanted to understand, is it going to be temporary? Or is it a structural decline because of the launch of value brands recently.

Matt Sale

Yes, thanks for the question, Ven. Yes, on the margin profile for the adult-use business, two factors, maybe I'd point you to. With ramp up in the sales of our pre-roll products, which is the third largest category in Canada, and we now have established a top 10 market share position subsequent to the reporting period those products directionally have a lower margin profile than some of our other adult-use products.

The second factor, which, to a lesser extent, drove the margin profile in Q3 was some reclassification of distribution costs, which were previously in SG&A and are now reported in COGS. And so that would be an ongoing somewhat structural change in our reporting of our gross margins.

Venkata Velagapudi

Okay. So what do you think may lead to an improvement in the next quarter for this metric?

Matt Sale

Yes. So driving the margin profile going forward, as you know, we don't put out quantitative guidance. But qualitatively, I'll tell you building on those comments we made earlier on our outdoor harvest of over 11,000 of high potency THC-focused strains coming out of Port Perry, those are at a significantly lower growth cost per gram than out of our greenhouse. And so that will directionally improve our margin profile going forward.

Operator

And that concludes today's conference call. Thank you all for your participation. Enjoy the rest of your day. Keep safe, and you may now disconnect.

Matt Sale

Thank you, everyone.