Sunniva Inc.

Fourth Quarter and Year End 2018 Earnings

Conference Call Transcript

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Speakers:

Dr. Anthony Holler
Co-Founder, Chairman, and Chief Executive Officer

Leith Pedersen
Co-Founder and President

David Negus
Chief Financial Officer

Rob Knowles
Vice President, Corporate Development

Operator:

Thank you for standing by. This is the conference Operator. Welcome to the Sunniva Inc. Fourth Quarter and Year End 2018 Earnings Conference Call. As a reminder, all participants are in listen-only mode and the conference is being recorded. After the presentation, there will be an opportunity for analysts to ask questions. To join the question queue, you may press star, one on your telephone keypad. Should you need assistance during the conference call, you may signal an Operator by pressing star, zero.

I would now like to turn the conference over to Rob Knowles, Vice President, Corporate Development. Please go ahead, Mr. Knowles.

Rob Knowles:

Thank you and good morning to everyone joining us to discuss our results for the fourth quarter and annual results for 2018. Joining me today are Dr. Anthony Holler, our Co-Founder, Chairman and Chief Executive Officer; Leif Pedersen, our Co-Founder and President; and David Negus, our Chief Financial Officer. We hope you've had a chance to review the news release, MD&A, and financial statements we issued yesterday, April 29, 2019.

We'll begin today's call with comments from Dr. Holler who'll provide an introduction, then provide a strategic and operational update, followed by David Negus who will provide a financial overview. We will then open the lines for analysts for questions.

Before I begin, I want to note that some of the matters we'll discuss on this call, including our business outlook, are forward-looking in nature. These matters are subject to both known and unknown risks and uncertainties, including but not limited to, those factors set forth in yesterday's news release, our MD&A, and other public disclosure documents which are available on the SEDAR website. These risks and uncertainties could cause actual future results to differ material from those expressed in this call and which are based on our current expectations. We assume no obligation to update the information presented on this conference call except as specifically required by applicable securities laws.

I'd now like to turn the call over to Dr. Holler. Dr. Holler, please go ahead.

Dr. Anthony Holler:

Thanks, Rob. Morning everyone, and thanks for joining us today. As many of you are aware, 2018 was a challenging year for us on a couple of fronts with respect to the development of our California and Canada cultivation projects. What gets a bit lost amongst those challenges is the successful year we've had from our existing operating businesses, Natural Health Services in Canada and full-scale distributors, our Hardware company in California, which generated almost $19 million in revenue, up 17% from 2017, and we expect similar contributions from those businesses this year.

As 2018 progressed, we shift our focus to the California market and the development of our assets there including solidifying our branding and distribution capabilities and assembling a seasoned management team within the state to run the California operations.

While there's still uncertainty around the ultimate decision of Federal legality in the United States, we are confident that the end game we'll see full legalization of cannabis for both medical and adult use across the entire country. The California market on its own currently represents the largest single market opportunity in North America; and while we remain positive on the future for the Canadian cannabis market, we have determined that by concentrating our efforts and our available capital on the development and expansion of our assets in California, we will create more value for our shareholders. David will be going through the numbers later on in the call, and now, I would like to take some time to outline our 2019 plans and outlook.

Our goal in California is to become a fully vertically integrated company and to become one of the lowest cost operators producing pesticide-free, premium, quality cannabis products, and we are well on our way to achieving that goal. We made great strides towards putting our strategic pillars in place that we believe will give us a competitive advantage, construction progressed on the purpose-built high-technology glasshouse in Cathedral City, which we expect will be completed later this year. We've brought our extraction facility into operation; we acquired a distribution company. In early 2019, we launched our first Sunniva-branded products into the market; and in early 2020, we expect our flagship dispensary at the glasshouse to be completed which will showcase our Sunniva-branded products. The development of each of these pillars has set the stage for an exciting 2019.

Turning to our extraction business, our extraction facility began operations in July 2018. While the revenue contribution in 2018 is minimal, the team concentrated on developing a number of product lines and product formulations in stockpiling inventory. This facility has its annual state licenses for both volatile and non-volatile extraction processes which give us flexibility in the range of products we can produce so that we can pivot when the market demands change. We have optimized the work flow and added equipment to improve the quality of our production and to increase the capacity of the facility. The current facility has the capacity to produce over 10,000 pounds of bio-mass and produce 180,000 grams of high-quality, pure distillate, and 125,000 grams of concentrate on a monthly basis. We continue to source clean bio-mass through existing strategic relationships, but our reliance on purchasing bio-mass externally will be reduced as production from the California campus glasshouse becomes available.

Next, looking at distribution and brands. Compliant distribution is a cornerstone of the highly regulated cannabis industry with track-and-trace being implemented in 2019. It is also one of the main pillars of our integration strategy. Late in 2018, we acquired a distribution company, LTYR Logistics, led by Kevin Wilkerson, who is now in charge of all our U.S. operations and is developing our sales and marketing strategy for California. LTYR has established relationships with high-quality flower growers and dispensaries across the state which enabled us to immediately begin to generate revenue from packaging and distribution. The integration of the LTYR management team and our existing team members at the extraction facility went very smoothly with the culmination of efforts resulting in the introduction of our first three cannabis brands into the market in March 2019.

Establishing our brand presence is important, not just from a revenue point of view, but also establishing our relationship, our reputation as a supplier of premium cannabis products within multiple product categories. Our first three brands are created with top-tier, third-party flower and bio-mass purchased from several top growers in the States. The additional products under the Sun Fire and Kyndness labels include flower, vape pens, and shatter, and were launched and put on shelves in strategic dispensaries beginning late in Q1 2019.The third brand, Herbella, is expected to be launched into market in Q2 2019 with a product focus on premium concentrates.

Sunniva intends to develop a house-of-brands approach for all its products across all major product lines. Towards the later part of 2019, we anticipate introducing additional brands that will be designed to showcase the premium cannabis strains that we will be producing from the glasshouse.

As we stated in yesterday morning's press release, we've acquired additional packaging and distribution space in Coachella. The new 6,600 sq. ft. licensed facility will give us the additional room for our anticipated growth and volume of products we can process, package, and store; as well as, expand our distribution capabilities in Southern California. The new facility will require minor renovations and we will consolidate our existing automated packaging equipment over the next several weeks. We anticipate that the facility will be fully operational in handling products for us by the beginning of July.

As we shared with you last month, the preliminary estimate of first quarter revenue generated from our product sales in California is estimated to be $7.5 million U.S. dollars or $10 million Canadian. We are forecasting that we will grow our sales through 2019 with total revenue just from our extraction and branded flower sales to be between $55 million and $60 million U.S. or $72 million to $78 million Canadian.

Now looking at our cultivation business. The primary pillar in our integrating strategy is to achieve large-scale production of high-quality cannabis. The Sunniva California campus greenhouse addresses the two key issues currently facing the California cultivation industry. Sourcing clean, reproducible, pesticide-free cannabis and securing large-scale production with low operating costs. The construction of the 325,000 sq. ft. purpose-built, high-technology, cGMP glasshouse facility that Sunniva is leasing in Cathedral City has been slower than expected. Quite simply, there have been only a handful of facilities in the world of similar complexity designed specifically for cannabis production.

Additional technical design changes incorporated into the final plans coupled with the project experiencing longer than plant construction times, delivery of certain equipment, and completion of some of their required regional infrastructure, has led us to revise the expected operational date to late Q3 of this year. Once operational, we will commence the onboarding of our genetic material into the propagation and vegetation bays for growing prior to the initial move into the flowering bays.

The glasshouse is a high-tech facility and we are forecasting that the initial four 22,000 sq. ft. flowering bays will be planted in two-week intervals in the fourth quarter with the next four following in the first half of 2020 as we dial-in the facility to optimal growing conditions leveraging our state-of-the-art climatic control systems. By the end of 2020, we expect the glasshouse will be reproducing from eight bays at the design run rate of 50,000 kilograms per year of premium flower with the approximately 10,000 kilograms of associated trim. When fully ramped-up, we believe that we will have one of the most advanced and low-cost facilities in the state with cultivation costs below $0.50 per gram and all-in operating costs, including lease payments and city and state taxes, of about $1.15 U.S. per gram. With the completion of the glasshouse we're looking forward to 2019 being a milestone year for Sunniva.

Looking at our Canadian Medical Company, Natural Health Services has also underwent changes in 2018. Late in the year, Dr. Mark Kimmins, previously the Medical Director of NHS, was promoted to President. Along with this move, there were a number of organizational changes designed to streamline our operations and to increase our business development efforts and revamp our business plan with a focus on generating greater patient growth and additional LP revenue capture for sales attributed to NHS. Our brick-and-mortar clinic model continues to build on its active-position recruitment program; and while we did lose some doctors last year, and some conversion of clinic doctors to Affiliate positions, we have successfully recruited an equal number of replacements with 16 doctors now employed in our seven brick-and-mortar clinics.

As medical cannabis becomes more common, we have begun to receive increased levels of interest from doctors wanting to join, as well as, seeing an increased level of service from the existing clinic physicians.

Our Affiliate clinic program where we provide independent clinics, our proprietary software for connecting patients to licensed producers, and access to our cannabis education platform has also grown. We now have a total of 12 Affiliated clinics in Alberta, B.C., and Ontario, with over 20 physicians operating from those clinics.

We began a relationship with HelloMD Talk or Telemedicine services to cannabis patients to provide more Canadian communities with convenient access to medical cannabis. We have completed the initial trial program and are now into ramp-up mode of this service in Ontario.

We announced our collaborative agreement with UNICOR, which is Canada's largest private-sector union where NHS will be a preferred referral for their members seeking cannabis information, a strong endorsement for the quality of our education and clinical services. This represents not only a large opportunity for NHS to access a significant number of potential medical cannabis patients, but also highlights the progression of the acceptance of medical cannabis in Canadian industry.

In concluding my remarks, we're very happy with the progress we have made this quarter and are well-positioned for a strategic growth in all operating segments. The California marketplace in particularly, continues to grow at a rapid pace and has presented a number of opportunities to expand our business. As a management team, we are maintaining our awareness of these opportunities ahead of the completion of the Sunniva California Campus.

We are excited about the current landscape and look forward to further expansion in California, and we are confident that the new leadership at NHS will enable us to capture a larger share of the medical cannabis market in Canada.

It is now my pleasure to turn the call over to David Negus our CFO, to go through the details of our financial results and to map out the financial outlook for 2019. David.

David Negus:
Thanks, Tony. I will provide a brief overview of the 2018 financial results as we anticipate that revenue generation from our California operations in 2019 will begin to overshadow the contribution from our operating businesses in 2018. Therefore, I will focus most of my discussion on the go forward expectations. Please note that all the figures I will mention are in Canadian dollars unless specifically referred to otherwise.

Twenty eighteen was a successful year for Sunniva with revenue from our operating businesses, NHS and FSD, increasing 17% year-over-year to $18.8 million primarily driven by an increase in sales from FSD. Our gross margin from these businesses remain strong at 42%, which was similar to last year.

Annual net loss increased to $29 million from $17.5 million. The increased large losses were largely due to significant progression of U.S. operations with the most significant increases related to personnel costs, legal costs, and insurance.

As Tony already discussed, we have made the decision to focus our cannabis cultivation and extraction efforts in California. As a result, all current development plans for the Sunniva Canada campus in Okanagan Falls, British Columbia, have been suspended at this time. We intend to continue to review strategic initiatives for the Canadian assets; however, we have determined that we will not be proceeding with the previously proposed spin-out of the Canadian assets into a separate publicly traded entity.

Looking to the U.S. operations and to the 2019 outlook, Sunniva will continue to be actively balancing our working capital requirements and our capital expenditures as we progress to completion of the glasshouse. Capital costs of the leased Cathedral City glasshouse are expected to be $95 million USD. As you recall, this building is being constructed for Aspire Partner, Barker Pacific Group, and we will be a tenant when completed. The original budget of $54 million USD has increased due to alterations in the design of the building and the increased construction costs. Of the total $41 million USD increase, Sunniva is contributing approximately $30 million USD, of which we have already paid approximately $20 million USD. Barker will be contributing the remaining $10 million USD of the increased capital costs.

In absence of available banking facilities, we continue to be active managing our working capital requirements through small financings as needed. We currently have about $4.2 million of cash-on-hand, including the proceeds of the short-term financing last week. As we have previously reported, preliminary Q1 revenue is approximately $14 million, with approximately $10 million of that coming from cannabis product sales in California.

Looking at the Full Year 2019, we are maintaining our previous guidance for cannabis product revenue of $55 million to $60 million USD. Gross margins in Q1 2019 are expected to be in the 30% to 35% range due to the higher production costs being realized as operations ramp up.

We expect to see similar results in 2019 for both NHS and FSD as compared to 2018 with modest growth.

In 2019, we anticipate the total corporate G&A will decrease as some functions that are currently being performed on both sides of the border will be consolidated in the U.S.

With that, I'll turn the call back over to the Operator, and open it up for Q&A.

Operator:
Thank you. We will now begin the question-and-answer session. To join the question queue, you may press star, one on your telephone keypad. You'll hear a tone acknowledging your request. If you are using a speakerphone, please pick up your handset before pressing any keys. To withdraw your question, please press star, two. We will pause for a moment as callers join the queue.

Our first question comes from Matt Bottomley with Canaccord Genuity. Please go ahead.

Matt Bottomley (Canaccord Genuity):
Yes, good morning, thanks for taking some questions. First, I just wanted to chat quickly on potentially normalized margins throughout 2019. Obviously, you'll be relying mostly on wholesale product, it looks like for the first three quarters. So, you had a fairly high cost in sales in Q4 of about 85%. Just wondering if you can give any goalposts of where you see that going as you continue to construct your glasshouse facility.

David Negus:
I think you'll see it ramping towards and throughout the years towards that sort of 50% target that we're looking at for a gross margin. We'll start off the year slow as we're ramping up operations. But as we get efficiencies throughout the year, we should get close to that 50%.

Matt Bottomley:
Okay, great. Just moving to the Canadian operations, any more color you can give on potential recoveries you might get out of that facility throughout 2019, and also, any up-front costs that you guys have incurred. I know I think you mentioned you had to pay some losses to contractors and probably some other smaller things. Any other color on exactly where that's sitting now, that would be helpful.

David Negus:
Yes. I think that the total costs of our Canadian facility are fully loaded in. What I would say is we continue to look at strategic alternatives related to those assets. But you can anticipate that all the costs are loaded into our numbers at Q4.

Matt Bottomley:

Okay. Next, just on the distribution side of things. Can you give some highlights on, I guess, on a pro-forma or on a forward-looking basis, the combination of 420 and LTYR, how many dispensaries is that? Just say operating metrics with respect to what those businesses are doing today.

Dr. Anthony Holler:

Matt, currently, what we're doing is targeting large dispensaries where we have relationships like the Harbor Side dispensaries in San Francisco and that surrounding Northern California, and some of the large dispensaries in Southern California. The issue with the dispensaries for us is, you have to be able to supply products to them. If your product gets sold out and there's space, obviously, in the dispensary, it goes to another product. We've been very careful to nurture our relationships where we can supply those dispensaries everyday, basically, so they don't run out of product. Because shelf space is very valuable and once you have it, the only way of keeping it is by making sure those shelves are filled with products. As we ramp up production, obviously, we're going to expand into a number of dispensaries, but we have to be very careful how we do that because once you have shelf space, you don't want to lose it.

Matt Bottomley:

Got you. Last question for me, just on the Q1 numbers you guys pre-released. The $10 million of the $14 million that that's on the brand, I know that you launched two of the three towards the end of the quarter. Is that $10 million portion sort of a backend number with respect to how I look at that on an extrapolated standpoint? Did most of that occur towards the end of the quarter, or was it more uniformed than that?

David Negus:

Yes, it weighted more towards the end of the quarter, Matt, that's correct.

Matt Bottomley:

Okay, thanks, that's all I got.

Dr. Anthony Holler:

Thank you.

Operator:

Once again, if you have a question, please press star, one. Our next question comes from Doug Cooper with Beacon Securities. Please go ahead.

Doug Cooper (Beacon Securities):

Hi, good morning, guys. Can you just sort of walk through the greenhouse just in terms of the timing again? Construction finishes late Q3, you have planting in Q4. When do you expect your first harvest, and when would you ramp up to that 50,000-run rate? You said that was the end of 2020, did I get that right?

Dr. Anthony Holler:

No, no, not, Doug, I'll answer that. Thank you. We expect our first harvest in 2019 and think of the harvest being by the time you have the seedling, or the small plants, they're in vegetative, all that sort of stuff. Think of sort of a 12-week cycle. We would expect we would have our first harvest before the end of the year. In the 2020, we would expect the facility then to go ramp up to full eight bays. We're assuming that we'll be able to get to that rate in the first half of 2020.

Doug Cooper:

Okay. Okay, great. Then, on the extraction facility, what is the gross margin on that business today?

David Negus:

It would be north of 50 points on that.

Doug Cooper:

North of 50, okay. Dave, when you just talked about the Q1, you sort of guide, you said gross margin is anticipated at 30%, 35%, does that include the existing businesses then? Just the California?

David Negus:

Yes, that's just California, correct.

Doug Cooper:

Just California, okay. Okay. I think that's it for me, thanks very much.

David Negus:

Thanks, Doug.

Dr. Anthony Holler:

Thanks, Doug.

Operator:

This concludes the question-and-answer session. I would now like to turn the conference back over to Dr. Holler for any closing remarks.

Dr. Anthony Holler:

Thank you. As always, I'd like to acknowledge my appreciation of the dedication and hard work of the entire Sunniva team. We are focused on California and the execution of our strategy there. Thank you for joining us and we will speak to you at the end of May with the presentation of our Q1 results. Thank you.

Operator:

This concludes today's conference call. You may disconnect your lines. Thank you for participating and have a pleasant day.