INDUS HOLDINGS, INC.

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First Quarter 2019 Earnings Conference Call

May 29, 2019

CORPORATE PARTICIPANTS

Gwyn Lauber, *Director, Investor Relations*

Robert Weakley, *Co-Founder and Chief Executive Officer*

Joseph Bayern, *President*

Tina Maloney, *Chief Financial Officer*

CONFERENCE CALL PARTICIPANTS

Doug Cooper, *Beacon Securities*

PRESENTATION

Operator:

Greetings, and welcome to Indus Holdings, Inc.'s First Quarter Earnings Conference Call. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. If anyone should require Operator assistance during the conference, please press star, zero on your telephone keypad. As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Gwyn Lauber, Director of Investor Relations.

Gwyn Lauber:

Good afternoon, and welcome to Indus Holdings, Inc.'s Fiscal First Quarter 2019 Financial Results Conference Call.

Before we begin, please let me remind you that during the course of this conference call, Indus Holdings' Management may make forward-looking statements. These forward-looking statements are based on current expectations that are subject to a number of risks and uncertainties that may cause actual results to differ materially from expectations. These risks are outlined in the Risk Factors section of our listing statement filed on SEDAR. Any forward-looking statements should be considered in light of these factors. Please also note, as a Safe Harbor, any outlook we present is as of today and Management does not undertake any obligation to revise any forward-looking statements in the future.

With me on the call today are Robert Weakley, Indus' Co-Founder and Chief Executive Officer, Joe Bayern, President, and Tina Maloney, Chief Financial Officer, who will, later in the call, go into detail about the Company's financial results for the quarter.

With that, I would now like to hand the call over to Robert. Robert, please go ahead.

Robert Weakley:

Thank you, Gwyn, and welcome to everyone who is listening into our Fiscal 2019 First Quarter Earnings Conference Call today.

Given that this is our first earnings call as a public company, I wanted to take an opportunity to introduce investors to Indus Holdings, Inc. Founded in 2014, and based in Salinas, California, Indus operates one of the largest cannabis brand portfolios in California, with 14 award-winning licensed and original brands, and another 30 distributed brands, including Altai, Cypress Cannabis, Humble Flower, Moon, Beboe, and Legal. Indus' vertically integrated business strategy brings together world-class production capabilities, state-of-the-art manufacturing facilities and an extensive distribution network, all being led by an experienced Management Team with backgrounds from some of the world's top CPG companies.

Tina Maloney, our CFO, will go into more details on the financials later on the call, but I wanted to provide a high-level overview. For the quarter, we reported record revenue of $6.4 million, up $4.1 million, or 180%, year-over-year, with gross margin of 21% and market penetration rate exceeding 84% for licensed California dispensaries.

You will hear me talk a lot about capacity. This is an uncharted territory with many variable regulations and a constantly changing landscape. As consumer awareness and demand grows, for a company to be successful, it has to be strategic, smart and adaptable, with the capacity to scale up. We have been laser-focused on building out the infrastructure to provide some of the largest capacities in one of the leading cannabis economies in the world, California.

Our cultivation operations, which currently consist of four greenhouses totaling 225,000 square feet, located in Monterey County, California, enable us to produce approximately 50,000 pounds of flower annually. These greenhouses are built to indoor standards, with 1100-watt gravita lights, blackout shades and positive pressure to produce five turns of indoor quality flower at a fraction of the price. As we continue to grow and expand beyond California, we will seek to expand our cultivation capabilities further to meet the increased demand for our products.

In Salinas, California, we also process our flower, as well as our trim, internally at our 5,000 square foot licensed type seven volatile extraction laboratory. Through six extraction rooms, along with additional refining and distillation rooms, we have an aggregate capacity to produce more than 10 million grams of cannabis oil yearly.

Our manufacturing operations enable us to produce a wide variety of cannabis-infused products in our 10,000 square foot manufacturing facility located in Salinas and newly licensed 10,000 square foot manufacturing facility in Downtown L.A. Indus has the ability to produce any form of infused products, from chocolate confections, baked goods, hard and soft non-chocolate confections, tinctures, capsules, mints and beverages.

An important differentiator, and key to our success in California, has been our distribution capabilities. We now operate two distribution centers in the state with a dedicated 15,000 square foot facility in Salinas servicing northern California and a 25,000 square foot facility in Downtown L.A. servicing Southern California. These locations are very strategic, with a zero percent distribution tax in Salinas and a 1.5 % in Downtown L.A. Both facilities have local and state medical and adult-use distribution licenses.

We currently deliver our brands to over 84% of the licensed dispensaries in California and are further enhancing our position as a leader in cannabis distribution by incorporating advanced technologies to drive increased logistics capabilities and compliance. For brands, this network provides a turnkey route to market, and for retailers, a complete solution for their wholesale ordering needs. Recently, we refined our distribution strategy, opting to focus on higher margin owned and agency brand distribution on a go-forward basis. While this might impact our top line growth initially, it will lead to increased profitability and a stronger company over the long term.

We believe it is the success of our integrated operations that have led to our market-leading position in California. Our ability to build a diverse portfolio of owned, agency and distributed brands demonstrates the power of our vertically integrated growth strategy and the value of our seed-to-sale business model. Our robust infrastructure continues to draw interest from other cannabis brands seeking to leverage our expansive capabilities.

Over the last year, we have fine-tuned our vision, our strategy, our team and our capacities. We are now well positioned to take our portfolio of brands, technology and team to additional markets as we look to grow our footprint in the national cannabis industry. We will selectively grow in a disciplined manner, with smart and very accretive deals, with an eye to high return, adding strategic and likeminded partners as we position ourselves as a multi-state operator.

With Joe's leadership, I am now focusing much of my attention on our M&A strategy and strategic partnerships that will drive our future. Our strategy is to identify companies who own one or more cannabis brands, that are licensed to operate in one or more states, with significant market potential. Our target companies are ones where we can strengthen their overall local market position by adding our portfolio of product offerings, helping them to attract additional dispensaries, and ultimately consumers, in the market they serve. We utilized this strategy in our recently announced pending acquisition of W Vapes.

W Vapes was an attractive acquisition target for us for several reasons. It operates in markets where our brand recognition is high. Nevada attracts approximately 50 million tourists per year and about a quarter of them are from California, where our presence is strong. W Vapes' brand is sold in over half of the dispensaries in Nevada, so acquiring the company gives us immediate access to that market. We believe that their market penetration will be even higher with the addition of our brands. Our brands are also well known in Oregon, and with the very low cost of biomass, it increases our margins greatly. W Vapes will benefit from the advanced production and manufacturing capabilities, capitalizing on efficiencies and economies of scale, that will make this a very accretive transaction for Indus. We believe this acquisition will be less than one times 2020 forecasted revenue and cash flow positive.

On the brand acquisition side, we structure deals in a way that incentivizes their Management Teams based on their future success, allowing us to use very little upfront cash, with minimal risk for Indus. As an example, we were pleased to announce the acquisition of assets and global rights to Humble Flower Company, a California original, female-founded company in the industry, bringing its cannabis-infused topical creams and oils to our portfolio of brands. This strategy was used to acquire 100% of the brand, paying 10% of top line revenue on a 36-month earn-out. This is also our entry into the pure CBD national market, with Humble Flower Company now being sold in Saks Fifth Avenue.

We also significantly bolstered our Management Team over the past six months, bringing on Joe Bayern as President of Indus, and Tina Maloney as Chief Financial Officer, among others. We are excited to have Joe and Tina as part of our Leadership Team. This talented group of executives has the global CPG and public market experience necessary to drive our strategy, and I believe that, with Joe's support, they will take Indus to the next level.

With that, I'll turn the call over to Joe to talk briefly about the professional experience that he brings to Indus and his strategy for leveraging our platform in both new and existing markets. Joe?

Joseph Bayern:

Thank you, Rob. I'm very excited to be part of the Indus Team. I believe we have a tremendous opportunity ahead of us. When I first met with Rob, I felt a little like Sully when he landed his plane in the Hudson and said, "Everything in my career seems to have led me to this moment." I feel the same way. We're all here because of the undeniable opportunity in this exciting and embryonic category. There are many variables and things change quickly, and I'm excited to leverage my experience with branding, sales, distribution and operations to help chart the course of Indus and to help define the industry.

I also have to share how delighted I was when I met the team for the first time and saw the level of talent that Rob was able to attract to our Company. If you couple that with the extensive capabilities and capacity that Indus brings to the table in the areas of cultivation, manufacturing and distribution, Indus represents a very compelling investment opportunity. As Rob says, we have the right vision, the right platform and the right team, and I'm looking forward to leveraging my own experience to help accomplish our goal of becoming the most admired company in the cannabis industry.

To give you a quick overview of my background before joining Indus, I spent the last year as the Chief Executive Office of VOSS of Norway, a leader in the super premium bottled water segment. Prior to this, I spent seven years as the Chief Operating Officer there, where I helped the company achieve exponential growth on a global basis. Prior to VOSS, I spent ten-plus years in various C-level positions, where I was fortunate enough to be part of several successful business turnaround and transformation projects, including the turnaround of Snapple, transition of Cadbury into a singularly focused confectionary leader, and the creation of Dr. Pepper Snapple as a standalone publicly traded company, which, coincidentally, was recently sold to Keurig for about $19 billion. I've worked with great brands and great projects that have created substantial shareholder value, but, in my opinion, they will all pale in comparison to the opportunity I see at Indus and in the cannabis industry as a whole.

One of my first tasks at Indus was to evaluate the business strategy and to help ensure we had the plans in place to accomplish our goals. It's our perspective that, given the current regulatory landscape, being vertically integrated is a critical component of our strategy; however, long-term value will be achieved by building brands that consumers can trust and relate to. This process led us to the following strategic priorities:

1. We are expanding upon our leadership position in California by investing in our marketing and sales behind our brands.

2. We are continuing to build the most professional and robust distribution system to create an effective route to market for our brands and our partner brands.

3. We are selectively expanding our footprint into key strategic markets.

4. We are accelerating research and development behind new product formats to help attract new consumers into the category.

While I'd consider this an evolution of the existing strategy rather than revolution, it did cause us to shift our focus and resource allocation away from the distributed brands, where we generated the least amount of margin, to our owned and partnership brands, where we generate higher margins. Working with fewer, bigger partner brands will allow us to not only build scale within our cultivation, manufacturing and distribution, but become a more important and valued partner to our retail customers.

As we continue to execute against our strategy, we will employ a disciplined approach for evaluating potential organic and inorganic growth opportunities, seeking to expand our infrastructure, extend our geographic reach and further grow the value of our business where we can drive superior shareholder value.

In summary, I believe, with our strategy, advanced production and distribution platform, large and growing brand portfolio and our talented Management Team, we are well positioned to be a leader in this very large and rapidly growing industry.

Now, Tina will take us through our financial results for the first quarter of 2019.

Tina Maloney:

Thank you, Joe, and good afternoon, everyone. Before I begin, please note that a portion of my commentary will be on a non-IFRS basis, so please refer to today's earnings release for a full reconciliation of IFRS to non-IFRS results. We report all figures in U.S. dollars, unless otherwise noted. In addition, these results can be found in our quarterly financial report filed on SEDAR today.

As Rob highlighted, we reported record revenue of $6.4 million for the quarter, up 180% year-over-year.

Let me give you some insight into how we segregate our brands. There are three categories: owned, agency and distributed, or third-party brands. In Q1, approximately 61% of our revenue was from owned brands, 33% from agency and 6% from distributed brands. These results enforce our strategy with a higher percentage of owned and agency brands which will contribute to a stronger margin. Owned brands grew 136% year-over-year, impacted by the launch of Acme Vapes, relaunch of our Original Pot Company brand and new marketing programs across all our owned brands. Our agency grand revenues grew 205%, compared to the prior year. We continue to strongly support our strategic partnerships and will focus on helping them growth within their existing customer base and to expand into new markets along with Indus' owned brands.

Gross profit, excluding adjustments for the fair value of biological assets, was $1.3 million for the quarter, compared to $0.3 million in the first quarter of 2018, and sequentially more than double fourth quarter's gross profit of $0.6 million.

Gross margins, at 21%, improved from 11% in the prior year, with the increase attributable to product mix and operational improvements that we achieved as a result of our advanced production capabilities, directly increasing yield and efficiency in our cultivation and manufacturing processes.

Operating expenses were $4.5 million for the quarter, compared to $2.0 million in the same period last year. As I mentioned earlier, the growth in opex includes significant investments in marketing and brand activities and in our corporate infrastructure that were required to scale our business and to support our expansion plans. We will continue to invest in brand and product marketing initiatives and enhance our sales force by selectively hiring with a focus on key accounts. Due to efficiencies associated with scaling the business and as our revenues grow, operating expenses as a percentage of revenue are expected to decline. On a sequential basis, operating expenses at $4.5 million were up $0.4 million year-over-year, primarily due to amortization expense related to the adoption of the new lease accounting standard, which I will discuss in a moment. Excluding the amortization charge, opex would have been $4.1 million.

Adjusted EBITDA was a loss of $4.2 million, compared to a $4 million loss in the prior quarter.

As of January 1, 2019, the Company adopted IFRS 16 for leases, which requires a lessee to recognize assets and liabilities for all leases that previously would have been treated as an operating lease. Under the accounting standard, lessees recognize a right-of-use asset representing the right to use the underlying asset and a lease liability representing the obligation to make lease payments.

We used the modified retrospective adoption method, which allowed us to initially apply the new standard at the adoption date and recognize a cumulative-effect adjustment to the opening balance of our accumulated deficit. Upon adoption, we recorded a net charge to accumulated deficit of $0.8 million, right-to-use assets of $23.6 million, and $24.5 million in lease liabilities. Lease liabilities are included in our balance sheet under short-term and long-term debt. In addition, amounts previously recorded as rent expense are now recorded as amortization expense and interest.

As Rob and Joe have noted, we have identified and launched several new initiatives with the goal of positioning Indus for ongoing success and value creation. These initiatives include an operating review and a strategic review of the Company's portfolio of brands. As a result, we are shifting a significant portion of our focus to owned and agency brands in order to drive enhanced revenue and stronger margins. We are committed to adding consumer valued brands through internal product development and acquisition, and elevating our owned brand portfolio by introducing more one-of-a-kind product experiences. As we embark on these new initiatives, we believe the Q2 revenue growth rate over Q1 will be in the 45% to 55% range. With the capacity we have, the vision we are executing and a strong Management Team, we are excited about our future.

With that, I'll turn the call back to Rob. Rob?

Robert Weakley:

Thanks, everyone, for taking the time to join us for our first earnings call and for your ongoing support of Indus Holdings, Inc. In the five short years since our inception in 2014, we have grown from four employees to nearly 200. It's incredible what this team has accomplished, and to them, I would like to say thank you. I would also like to reiterate how excited we are about the opportunity we have to build an extremely successful business.

The past 24 months have been pivotal for the cannabis sector, both in terms of shifts in public opinion and the effect of changes in government policy. We expect these changes to continue as the industry develops resources necessary to achieve our vision, but we also believe that we've developed a world-class infrastructure that can scale, especially into new surging cannabis markets. Our strategy for 2019 is to effectively leverage our current position to drive strong top line sales and EBITDA growth. This is an exciting juncture for Indus and I look forward to updating you on our progress on our next quarterly call.

At this point, I'd like to take the opportunity to turn the call back over to the Operator. Thank you.

Operator:

At this time, we will be conducting a question-and-answer session. If you would like to ask a question, please press star, one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star, two if you would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star key. One moment, please, while we poll for questions.

Our first question comes from the line of Doug Cooper with Beacon Securities. Please proceed with your question.

Doug Cooper:

Good afternoon, everybody. I just want to focus on the gross margin for a second. So, 21% in Q1, up from 11% last year in Q1. Do you have what it was in Q4, just out of curiosity?

Tina Maloney:

Doug, it was slightly below 10% at 9.6%.

Robert Weakley:

Up just over double from Q1.

Doug Cooper:

What do you attribute the dramatic increase in gross margin versus—revenue was up $150,000-odd and gross profit margin up, whatever, over 10,000% (phon) so can you just talk about that, and what are your expectations of gross margin going forward given your strategy to focus on your own brands?

Tina Maloney:

We saw stronger product mix towards owned and agency brands with higher margins. That is a significant portion of that increase. We also had some efficiencies from our production, which also reduced costs for the quarter, and we would expect that to continue on with our shift into considerably more owned and agency brands than just distributed brands.

Doug Cooper:

Do you anticipate—is there a fixed cost component of that gross margin, to the effect that as revenue starts to scale, will you get even greater economies of scale on the gross margin line?

Tina Maloney:

We're looking deeper into that. I don't have a number for you right now, Doug, but we will be developing that over the next few months.

Doug Cooper:

Okay.

Joseph Bayern:

Doug, this is Joe Bayern.

Doug Cooper:

Hi, Joe.

Joseph Bayern:

I think that there's certainly a fixed cost component to our business. As Rob talked about in his section of the call, we've made significant investments in infrastructure, and as we grow our top line, we'll be able to leverage that infrastructure into increased margins. I think it's a combination of the shaping of our portfolio, I think it's gaining scale on our manufacturing and cultivation, and certainly at the delivery level, when we talk about our logistics and our distribution business, as we gain scale with retailers, that will offset the cost of our delivery costs.

Robert Weakley:

One thing, also, just as a note, we didn't mention it on the call, but our cultivation has—we have about 110,000 square feet in the next 60 days that'll be just being finished in the renovation, so that's going to triple the capacity of our flower coming more into Q3, and that's flower and trim that goes into our concentrate. That's only, again, additional things that will improve, and that's with both top line and margin.

Doug Cooper:

Rob, you mentioned the infrastructure you have in place across cultivation, and you just mentioned processing and manufacturing and the distribution centers, and logistics on that side. I guess the question is what is the revenue potential of those fixed assets and how much do you need to further invest or are you pretty happy with where you are now? How much revenue can you drive from those fixed assets, I guess is the question?

Robert Weakley:

Sure. I think in California, we're very happy with our fixed assets and now it's really maximizing those as we continue to really fine-tune it and execute our plan, and then as we look at going into Nevada and Oregon acquisitions, and then as we move into those, the great thing is both of those operations, the facilities are already there. In Nevada, there is opportunity to expand, there's about 50,000 square feet to expand, but certainly not needed right now, as the operation can produce our expectations going into 2020 currently.

Doug Cooper:

If we're just looking at the focus of the Company on the owned and agency brands, can you give us an idea of how many brands are in each of those buckets?

Robert Weakley:

Sure. Well, the owned and agency—well, owned is 14, and then agency, I believe there's 12 right now—16? Again, we're continuing to evaluate brands, and I think that's one of the big things, as Joe mentioned on this call, is we're focusing where—we had a strategy of bringing on any brand and, with Joe really fine-tuning the focus of making sure that the brands that we bring into our distribution and into our model really have the ability to scale and become very major brands, and have teams and resources to make sure that there's pull on the shelf when we put those out there.

Doug Cooper:

Right. I guess, the industry is pretty nascent at the end of the day here, it's only been legal in California for about 16 months. Are you looking to greenfield your own brands, create your own brands, as well as make acquisition of existing brands? Is that part of the R&D strategy you referred to?

Joseph Bayern:

It is. I think we'll be looking across both of those platforms. I think when we can create differentiated brands and/or product delivery formats, that's where we'll look to develop our own brands, and similar to what we've done in the beverage industry in my past, we'll use agency brands as a way to enter into categories that we think are attractive, but we don't want to make a 100% investment into today, and then look at how we accelerate the growth in those categories, and if we see brands and/or categories we want to participate more efficiently in, we'll look to acquire some of those brands.

Doug Cooper:

Okay. Just maybe you can just talk about California a little bit. California, clearly off to a little bit of a slow start with the regulations in 2018. I think there's around 600-odd dispensaries currently. You said you have penetration to 84% of those. How do you see the number of dispensaries ramping up over the course of the next 12 to 24 months, and can you maintain that 84% reach into them?

Robert Weakley:

Definitely, we're very optimistic. Right now, California—we said '18 was a major transition year—that California is starting to really come down on the black market and more compliance, and also issuing more dispensary licenses. I believe right now the feeling is by the end of the year, we're looking at probably around 1,000 dispensaries, somewhere between 900 and 1,000, and then that continues to grow. The estimates that are out there right now is there's still roughly about 3,000 illegal dispensaries, but, again, the state is starting to really crack down and we're optimistic on the enforcement on closing those. Recently, a bunch of letters actually came out from Sacramento to landlords, threatening civil forfeiture for leasing or having a tenant that's unlicensed in their facilities and their owned buildings. We're optimistic.

Again, not only do we look at things with our capacity and everything else, is with that 84%, is how many more brands we can dominate and get shelf space in those dispensaries. It is unchartered territory and we're going to continue to navigate that. I think a big part of it, also, is being very politically active and being in front of it, and so making sure that we're in constant communication with both local, state and national politicians to understand the regulatory market and where it's going, so that we're always ahead of it.

Operator:

Ladies and gentlemen, we have reached the end of the question-and-answer session, and I would like to turn the call back to Robert for closing remarks.

Robert Weakley:

Thank you. Again, I just want to thank everybody for taking the time, and I do want to make one note. We have submitted the release, but, unfortunately, it has not posted it. We do expect that momentarily, and again, look forward to our next quarterly call. Everybody have a great night.

Operator:

This concludes today's conference, you may disconnect your lines at this time. Thank you for your participation.