Sunniva Inc.

Second Quarter 2019 Earnings

Conference Call Transcript

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Time: **5:00 PM PT**

Speakers:

Dr. Anthony Holler
Chief Executive Officer

Kevin Wilkerson
President

David Lyle
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. Second Quarter 2019 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 then one on your telephone keypad. Should you need assistance during the conference call, you may signal an Operator by pressing star and zero.

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

Rob Knowles:

Thank you and good afternoon to everyone joining us to discuss our results for the second quarter of 2019. Joining me today are Dr. Anthony Holler, our Co-founder, Chairman and Chief Executive Officer, Kevin Wilkerson, our President, and Dave Lyle, our Chief Financial Officer.

We'll begin today's call with comments from Dr. Holler, who will provide a strategic and operational update, followed by Kevin Wilkerson, who will give a more detailed review of our California operations, and then Dave Lyle will provide a financial recap of the quarter and an overview of our financial plan. Following their prepared remarks, we will then open the lines to analysts for questions.

Before we 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 today's news release, our MD&A, and our other public disclosure documents, which are available on the SEDAR website. These risks and uncertainties could cause actual future results to differ materially from those expressed in this call, 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 would now like to turn the call over to Dr. Holler. Dr. Holler, please go ahead.

Tony Holler:

Thank you, Rob.

Good afternoon and thank you for joining us today. We have taken significant steps towards our stated corporate objectives, and I am pleased to share an update of the progress we have made since our last update.

I will keep my comments relatively brief, as I will be handing the call over to Kevin and Dave for a deeper dive into the details of the quarter.

As we continue to position Sunniva to be a fully vertically integrated cannabis company with a California operational focus, we have been actively assembling a highly skilled team in the U.S. to professionalize management in pursuit of the enormous emerging market opportunity in front of us.

Kevin, as you know, has been with us for about nine months and has already demonstrated his ability to significantly build upon our critical operations in California and, quite frankly, to get things done. This includes the acquisition and completion of a new distribution and packaging facility, the establishment and corporate team buildout of our future corporate headquarters in Carlsbad, California, the development of our sales and marketing function and, most importantly, the implementation of a renewed glasshouse strategy and risk mitigation plan to ensure the glasshouse is completed in the most efficient manner possible. More on that from Kevin in a moment.

Dave joined in June of this year and has already built out much of his finance and business strategy team and is actively working with Kevin to recruit additional talent into key executive and management roles. He is also undertaking a full-scale business and financial review, preparing the business infrastructure to handle a large growth opportunity and helping to evaluate the most efficient and risk mitigated approach to completing the glasshouse with Kevin.

As we discussed in our Q1 earnings call, the cannabis industry has continued to evolve and grow at a rapid pace, albeit in different ways, on both sides of the Canadian and U.S. border with each side having its share of challenges while at the same time creating significant opportunities.

Sunniva is now fully focused on the ongoing construction of the glasshouse in Cathedral City, California, a facility that we believe will not only be among the premier cannabis cultivation operations in California, but all of North America and become the gold standard for large-scale cannabis production. High-quality flower production from this facility can be directed to both bulk sales and into our existing processing and distribution operations, which are located nearby to enable the current and future Sunniva brands to be developed and marketed throughout the state.

As part of the California focused strategy, we have made good progress in selling off our Canadian assets and transitioning the headquarters and human resources to California. We announced in late June that we entered into an agreement to sell Sunniva Medical Inc., the subsidiary that owns our property in OK Falls, British Columbia. As reported in today's press release, this transaction is now expected to close in the first half of September. We have had regular contact with CannaPharmaRx throughout this process. We have been recently advised that they will be in a position to close the transaction in the next two weeks. Net proceeds from the transaction after accounting for the initial deposit, settlement of the existing mortgage, transaction related costs and repayment of the principal and interest for the March bridge financing, will be approximately $10 million, which will be immediately deployed in California. The announcement of the $11.5 million financing this week and the expected proceeds from the OK Falls sale will provide the capital support to continue to execute on the completion of the glasshouse.

In addition, we have been entertaining potential buyers for the remaining Canadian assets, primarily Natural Health Services, or NHS, and we have one particular party that is actively pursuing this asset. We hope to have more information soon once we have something solidified.

Before handing it over to Kevin, I would like to reiterate our commitment to delivering a cultivation facility in Cathedral City that will be the prize centerpiece of our vertical integration strategy in California and to become a model for large-scale cannabis production and become the gold standard for the industry.

With Kevin in his new role as President and Dave as the new CFO, both having feet on the ground in California, and firmly focused on optimizing the delivery of the project, we believe we have a clear path to finishing construction without further delays. They have analyzed the project and identified resolution to many outstanding issues that have caused delays and have just recently reconstituted the internal team and reporting structure. In addition, we have significantly expanded the role of Colliers International, an internationally known project management company, that has experience building cannabis glasshouses, to take a more substantive role in providing project management oversight that will put the project on a more predictable path to completion. And while the current completion timelines have been pushed, we do not feel that the value proposition of Sunniva has changed, and we have every confidence that, in combination with the other facilities we've been developing in tandem with the greenhouse, the Company's long-term outlook remains very robust.

Kevin will take you through the operations in greater detail next, but for those of you who don't know Kevin, I thought it would be beneficial to briefly tell you more about him. Kevin spent 24 years in the U.S. Army and retired as a Colonel, finishing his military career in the Pentagon. He has a storied past including having led the first conventional troops into Afghanistan in 2001 where his troops conducted a combat operations in a chaotic and unpredictable environment, for which Kevin was awarded the Bronze Star.

His successful military career ultimately motivated him to become an entrepreneur. In 2006, Kevin became a mergers and acquisitions consultant which eventually led him to buy a retail restaurant territory that he expanded to over 22 sites in 2 states, and that he ultimately sold. His interest in the cannabis industry began in 2014 in Colorado, and when he saw the massive opportunity developing in California, he founded a cannabis distribution company, LTYR Distribution, based in San Diego. We were sufficiently impressed with Kevin and his team during our initial business dealings that we acquired the company in December 2018 as a key component of Sunniva's fully integrated strategic focus.

I'll let Kevin take it from here.

Kevin Wilkerson:
Thanks, Tony.

Since joining Sunniva, I've been focused on our overall strategy and the multifaceted process of fully integrating our operations, developing our branding, packaging, and distribution while at the same time overseeing and fine-tuning the extraction facility's operations. I am confident that our business is well positioned for future growth. Since moving into the role of President of Sunniva Inc. in July of this year, I've shifted my focus to the crown jewel of our portfolio, the glasshouse in Cathedral City, as well as building a team to execute on its potential.

As Tony discussed, Dave and I, along with the team in California, have been evaluating the current progress made on the glasshouse with a particular focus on how to minimize the risk of future delays. We have completed our preliminary review of the path forward following reorganization of our internal team and the engagement of Colliers International in a lead role. As previously announced, one of the operational issues we are facing is the expected timeline for connection of utilities to the site, including permanent power in late Q4 of this year. As a result of our ongoing project review with Colliers, we expect we will receive our certificate of occupancy no later than Q2 2020 with an intent of pulling that target forward. We will then be in a position to onboard genetic material and plants into the glasshouse. After allowing for growing time for our mother plants, we will begin populating the cultivation bays. The start-up schedule will continue to be refined and updated as we progress through the final construction stages.

As a result of recent analysis, we have decided to add additional back-up power equipment to the existing design to minimize the impact on our operations in the event of a possible temporary loss of permanent power. The additional back-up power will be installed such that different segments of the building can be offline without impacting the remainder.

Through discussions with our engineering consultants, we have determined that as an additional contingency measure, we will be increasing the chilling capacity. This additional capacity will also be segmented in a similar manner to the back-up power so that it will allow for the first four bays to be controlled under a separate system from the second four bays. This enhancement is expected to increase the total cost of the facility by approximated US$25 million, and we are working with the developer to determine how these additional expenses will be allocated. Additionally, we are investigating options to bring the facility into partial operations in an accelerated manner if at all possible. The increased risk mitigation ultimately results in significant long-term shareholder value. Once completed, we truly believe that this facility will be the gold standard for future cannabis cultivation in California.

Looking to the extraction and branded product sales strategy, our initial strategy in Q1 of this year was to fine tune our operations at the extraction facility, create our initial brand presence, and deliver our first products to market. I was pleased with the team's ability to create large volumes of quality cannabis extract products in a short timeframe and to use our existing distribution network to get products on the shelves, and most importantly prove our revenue generating capabilities. While we have deliberately slowed that part of our operations due to current working capital limitations, I am confident in the production capabilities and the high quality of product that we can manufacture and distribute.

We have begun investigating opportunities to maximize revenue in the near term by utilizing our additional capacity in the extraction facility and the distribution facility for third party processing and packaging, however, any revenue contribution in the short term will be determined only once we have secured necessary glasshouse funding.

We have made significant progress with our distribution and packaging expansion through our recent opening of our facility in Coachella with the receipt of all required licenses and installation of our automated packaging equipment. This facility has enough capacity to process all of our anticipated flower and extract products and will act as our primary distribution hub. Additionally, this state-of-the-art facility has additional capacity to partner with others to provide a full range of distribution and packaging options.

Before we dive into the numbers, I'd like to take a minute to give a brief introduction to our new CFO, Dave Lyle. Sunniva will be Dave's sixth CFO role, having spent the last almost 12 years as a public company CFO between two different high-tech NASDAQ traded companies, with the most recent company, Maxwell Technologies, being acquired by Tesla in May of this year. Dave is an operationally focused CFO having a very broad set of experiences, and we have already seen positive impacts from his contribution as he has formed an amazing team and helped move the corporate strategy forward. He is currently working with me and the broader team to optimize the glasshouse completion schedule.

I will now turn the call over to Dave to go through the details of the second quarter and provide an update to our financial outlook.

Dave Lyle:
Thank you, Kevin, for the nice introduction. I'm happy to be here, and I am embracing the many challenges that comes with a new role in a new industry. I joined Sunniva after studying the market, touring the facilities, and meeting the Senior Management team. I truly believe we are sitting on something very special here, and although we face some near-term hurdles, I believe we have a team

and plan in place for success. I hope you will find my management style to be one that emphasizes candidness, integrity, and credibility.

With that said, let's move on to a discussion of the specifics of the Q2 financials and some forward-looking thoughts. Please note that all the figures I will mention are in Canadian dollars unless referred to as otherwise.

Revenue for Q2 came in at $5.3 million, which is on par with Q2 of last year, however, down from the $14.2 million reported in Q1 of this year. Two million dollars was from Full Scale Distributors and $1.8 million from Natural Health Services, both of which were marginally lower than the previous reporting period. One point five million dollars from sales of cannabis products was limited in the quarter as a result of previously noted working capital constraints and reallocation of available capital to the highly critical glasshouse. Gross margin came in at $784,000, and not the negative $1 million as we projected in our preliminary forecast. This is due to an accounting adjustment in SG&A.

Gross margins for FSD and NHS were 17% and 61%, respectively, which is in line with how they performed throughout last year. California cannabis product gross margins were significantly negative, as we had to slow down the packaging and extraction lines in order to refocus cash needs towards the cultivation facility, while continuing to bear the high fixed operational costs of the facilities relative to a small revenue number.

As we stated on the Q1 conference call, with the announced increase in the glasshouse budget and capital limitations, in the latter part of Q2, we took the deliberate action of reducing our purchases of biomass and third party flower and redirected the majority of our available cash resources towards the glasshouse.

Overall, the net loss for the quarter was $15 million, which increased almost $10.1 million from the same period last year and increased $11.5 million from the previous quarter. This includes $3.9 million in impairment booking and interest charges. Loss from operations was $11.8 million which compares to $4.8 million operating loss in the same period last year and $3.1 million operating loss last quarter. The quarter-over-quarter decreases in cash from operations are mostly due to the ongoing fixed costs of the extraction facility and U.S. operations combined with reduced sales of cannabis products. Year to date, we have generated about $20 million in revenue, which exceeds the amounts that was generated in all of 2018.

Reported SG&A of $12.6 million included an accounting adjustment of approximately $1.8 million for production facility costs and a $2.3 million accounts receivable provision. Excluding these adjustments, Corporate G&A increased slightly quarter over quarter due to the continued expansion of our US operations, while incurring additional costs in relocating the corporate functions from Vancouver to California.

With the announced pending sale of Sunniva Medical, we booked a $2.3 million impairment charge in the quarter.

Looking to the balance sheet, we focused significant energy during the second quarter and to date in Q3 towards the reduction of our accounts receivable balance, reducing the $10.5 million outstanding at the end of March to $6.5 million at the end of Q2, including a $2.3 million provision of accounts receivables in line with our corporate accounting policies, with this cash flow also primarily directed to the glasshouse. Going forward, we have some work to do in our working capital accounts as we built up excess inventory in Q1 in anticipation of continued third party flower product sales, as well as accounts receivable collections, where we need to more actively address slow aging collections. My team is focused on cleaning this up prior to year-end, so we have a fresh start going into an exciting year.

Let’s now move to where we are with our liquidity position and planning. First and foremost, we intend to continue to be prudent in the management of our capital resources. Funds from the sale of the Canadian assets and proceeds from the recent financings will largely be deployed towards the completion of the glasshouse and working capital needs.

We finished the second quarter with $1.6 million in cash on hand. As you know, the delay in the OK Falls asset sale closing put us in a difficult short-term cash situation, and that required us to quickly raise about $5.8 million at the beginning of August. We announced the closing of an 18-month debt financing on Wednesday, and today we announced the closing of the second tranche of our latest bridge loan. Together these additional financings total about $11.5 million Canadian. This committed amount will be received in two tranches with about $3.5 million Canadian in hand today and the remaining $8 million will be closed by the end of September. Coupled with the expected net cash proceeds of approximately $10 million from the OK Falls sale, cash received from our accounts receivable collections efforts, as well as sale of product in inventory, we believe this $21.5 million will provide sufficient cash flow to meet our needs in the near term. In the meantime, we continue to evaluate several different longer-term financing options to bridge us to positive cash flow.

Our current capital obligations for completion of the glasshouse are about USD$10 million. As Kevin mentioned, the total additional cost of risk mitigation enhancements, including the engineering and site work required will be approximately USD$25 million to be spent in the first half of 2020. The allocation of these costs between Barker Pacific and Sunniva is still being determined. For our allocated portion of the incremental piece, we continue to evaluate several financing options.

As a result of the current capital constraints, we anticipate third quarter cannabis sales to be minimal. As part of this shift, we are limiting the launch of our third brand, Herbella.

As we move into 2020, and with the glasshouse coming online in the first half of the year, we will also be fine-tuning our estimate of upfront working capital that will be needed for a large-scale glasshouse operation given the continued difficult banking and lending environment for cannabis companies. All in all, we have some work to do on the liquidity front, but we believe we now have the plan in place to adequately fund and operate our operations over the long-term.

We hope to have more information regarding our next financing to you upon execution of our plan over the next several months.

Now, I’ll turn it back to Kevin.

Kevin Wilkerson:

Thanks, Dave. Sunniva has had significant challenges in the past meeting our corporate timelines and targets. We acknowledge that, and going forward with this new leadership team our goal is to set and meet our stated milestones. Most importantly, we have restructured and reconstituted the project team focused on the glasshouse. Up until recently, Colliers International has been on site in an advisory role only. This month, Barker Pacific Group, the developer, and Sunniva jointly agreed to leverage the full construction leadership talent and robust reach-back capabilities that Colliers offers to a project that’s as technically complex as this one. Colliers International is now in charge of completing the construction of the glasshouse, reporting to Barker Pacific Group and Sunniva with the General Contractor and all Sub-Contractors reporting to Colliers. In conjunction with all our stakeholders, Colliers is in the process of developing and updating construction schedules that we can all rely upon. I believe these changes ultimately will result in significant long-term shareholder value.

Thank you for listening, and with that I'll turn the call over to the Operator to open it up for Q&A.

Operator:
Certainly, sir. We will now take questions from analysts. To join the question queue, you may press star then one on your telephone keypad. You will 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 then two. We will now pause for a moment as analysts join the queue. Once again, for analysts in the room, if you have a question, please press star then one now.

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

Tony Holler:
Thank you, Kharl. As always, I'd like to acknowledge my appreciation of the dedication and hard work of our entire Sunniva team for their continued commitment. Thank you again for joining us this afternoon and for each of your questions—and your continued interest and support of Sunniva. Thank you.

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