Sunniva Inc.

First Quarter 2019 Earnings

Conference Call Transcript

Date: **May 31st, 2019**

Time: **9:00 AM MT**

Speakers: **Dr. Anthony Holler**

Co-Founder, Chairman, and Chief Executive Officer

David Negus

Chief Financial Officer

Robert Knowles

Vice President, Corporate Development

Operator:
Welcome to the Sunniva Inc. First 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 anyone 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 Rob Knowles, Vice President, Corporate Development. Please go ahead, Mr. Knowles.

Robert Knowles:
Thank you, and good morning to everyone joining us to discuss our results for the first quarter of 2019. Joining me today are Dr. Anthony Holler, our Co-Founder, Chairman, and Chief Executive Officer, and David Negus, our Chief Financial Officer. We hope you've had an opportunity to review the news release, MD&A, and financial statements we issued yesterday, May 30, 2019.

We'll begin today's call with comments from Dr. Holler who'll provide an introduction, then provide an operational update, followed by David Negus who will provide a financial overview. We will then open the lines to 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 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'll now turn the call over to Dr. Holler. Dr. Holler, please go ahead.

Dr. Anthony Holler:
Thank you, Rob. Good morning, everyone, and thanks for joining us today. It has only been a month since our last update, and we are happy to able to share more progress with you today.

Before I go into the details, I would like to take a moment to address the departure of one of Sunniva's Founders and Directors, Leith Pedersen, who announced his resignation a couple of weeks ago. Leith and I co-founded Sunniva in 2014 as a medicinal cannabis company for this emerging industry. From this beginning, Sunniva stands today as an emerging player in the California market on the verge of being a fully integrated Company due to the dedication of time and effort that Leith contributed over these past years. As we move on to the next phase of Sunniva's evolution, and with our focus shifting to California, Leith determined that it was time for him to step down. We wish him the best in all his future endeavours.

In addition, we announced early this morning that our CFO, David Negus, will also be stepping down, and will be replaced by another David, David Lyle, who will come on board next week. Dave joins us from a long history of public and private company experience. I won't go through all his credentials here, but direct you to the Management page of our website if you want to read more about his background.

As we concentrate our business in California, a logical step was to shift the Company's corporate functions from Vancouver, British Columbia to our office in Carlsbad, California. David Negus has done a great job creating Sunniva's financial systems and operating structures from a private Company to a public Company, and we thank him for his contributions. David will continue to support the Company as a consultant to ensure a smooth transition with no disruption to operations.

Now onto the current quarterly results. We previously announced our Q1 revenue forecast of $14 million, reflecting a solid beginning to our sales of cannabis products in California. I will leave the full financial discussion for David and will focus on our operational achievements over the past month.

Construction of the Cathedral City facility continues on-schedule with initial operations expected to commence late in the third quarter, at which time we will be onboarding the mothering plants into the facility and will begin the inaugural planting cycle resulting in an initial harvest by the year-end.

Following harvesting, there is a five to six week period of drying and curing of the plants, testing and packaging in advance of sales. We anticipate first sales of our premium flower will be realized in early 2020. As with the commissioning of any new facility, we intend to bring each subsequent cultivation bay into production at a measured pace as we fine tune the operating processes. As we approach the operational date, we will provide further guidance on the expected ramp-up schedule, but currently anticipate having all eight cultivation bays operational by the end of the first half of 2020.

We continue to ramp up our sales and distribution capabilities, which you saw in last month's acquisition of two licensed packaging and distribution sites located in Coachella and with the hiring of additional sales personnel. We are currently upgrading the building for our packaging equipment and anticipate beginning operations in July, which will enable us to package and distribute the capacity of both the extraction facility and the Cathedral City facility.

We are also pleased to announce that we have recently received our provisional retail license for our Cathedral City retail location. This license allows the retail location to be fully operational once construction is completed.

As previously reported, our extraction facility and Sales team performed very well in the first quarter, generating significant revenues from both the sale of newly manufactured concentrates and distillates, and branded flower from our cultivation partners. The initial extract and flower products were launched under two new brand names, Sun Fire and KYNDNESS, which we sold to select dispensaries. Capital limitations in the second quarter have tempered our ability to acquire biomass and reduced the production of concentrates from the extraction facility. As a result, we anticipate modest sales in Q2 and more meaningful growth as we move into Q3. This resulted in our decision to delay the launch of our third brand, Herbella, into the summer.

As we outlined for you on the last call, we are currently evaluating various strategic options for our Canadian assets, and we will provide updates on that progress when there is something concrete to report.

I am happy with the progress we have made on all fronts so far in 2019, and I am very confident that our execution today will allow us to maximize the opportunities presented when the Cathedral City facility becomes operational in the near term. The existing Management and the new additions to the team will enable us to propel into the next stage of growth as the remainder of the year unfolds.

I will now turn the call over to David Negus, our CFO, to go through the details of the first quarter and provide a current financial outlook. David?

David Negus:
Thanks, Tony. Please note that all the figures I will mention are in Canadian dollars unless referred to as otherwise, and reflect the adoption of IFRS 16 accounting for leases.

Revenue for Q1 came in at $14.2 million, of which $10 million was from sales of our cannabis products in California, $2.4 million from Full Scale Distributors, and $1.8 million from Natural Health Services. With the commencement of cannabis product sales in Q1, total revenue for the period is up significantly from $5.1 million during the same period last year, and up from $5.4 million we reported in Q4 2018.

Gross margin for the quarter was 37 percent, which is slightly lower than the 41 percent reported last year, mostly as a result of lower margins from the extraction facility as it is in the process of ramping up to full capacity. Gross margins for FSD and NHS were 15 percent and 66 percent respectively, which is consistent with how they performed throughout last year.

The net loss for the quarter was $3.5 million, which decreased almost $3 million from the same period last year, and decreased $7.6 million from the previous quarter. Loss from operations was $3.1 million, which is a notable improvement over the $6.3 million operating loss in the same period last year and $9.6 million operating loss last quarter. The reduced losses were largely due to the significant revenue contribution from our branded product sales.

The ramp-up of operations in the U.S. has led to an increase in the number of employees, offset by the application of new accounting rules.

Total corporate G&A decreased to $8.3 million from $10.4 million in Q4 of 2018. As we consolidate our corporate functions in Carlsbad, California, we anticipate that the corporate G&A expense will continue to decrease throughout 2019. We are very pleased with the leverage of cash G&A against revenue on an annual basis, decreasing from 108 percent in Q1 2018 to 43 percent in Q1 2019.

Additions to PP&E for the quarter ended were $11.9 million, primarily related to our California operations. As mentioned on our previous call, all current development plans for the Sunniva Canada Campus in Okanagan Falls, British Columbia remain suspended at this time.

We continue to be very pleased with our progress at NHS under the leadership of Dr. Mark Kimmins. The reorganization of the operating structure has NHS well-placed to execute on a number of partnership opportunities to expand the patient base.

We have been prudent managing our limited capital this past quarter as we balance investments in working capital with the capital obligations on the Cathedral City facility.

Accounts receivable at the end of Q1 of approximately $10 million reflect the commencement of cannabis sales to dispensaries in California.

At this time, we are maintaining our previous 2019 guidance range for cannabis product revenue at US$55 million to US$60 million.

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

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

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

Matthew Bottomley:
Yes, good morning. Just wanted to touch base on the guided revenue for 2019 you just mentioned, keeping it the same. Maybe Anthony, just some of your commentary with respect to next quarter's revenue being modest. I just wanted to clarify if that was a particular line, or if that was the whole California branded product sales line you were speaking about?

David Negus:
Yes, it's David here, Matt, thanks for your question.

Matthew Bottomley:
Oh, sorry about that.

David Negus:
We're primarily referring to the California cannabis sales being a little modest. We believe that the upside in Q3 and Q4, as we get all the engines rolling, will be sufficient to hit our revenue targets.

Dr. Anthony Holler:
Matt, it's Tony. The other thing to bear in mind is, we're expanding our capabilities in terms of packaging and distribution, and that facility will be open the beginning of the July. That offers some very large opportunities for us to expand sales.

You understand that the goal at the end of the rainbow is getting our facility running and selling products out of that facility. But to do that we need the infrastructure in place now, and that's why you're seeing some of the things we're doing, because we have to expand our sales force, we have to expand our distribution capabilities, we have to expand our packaging abilities. We just acquired a brand new high-volume packaging piece of equipment. All these things have to be done in anticipation of the beginning of next year, when we're going to be selling a large volume of cannabis products, both dry flower and distillates.

Matthew Bottomley:
Okay, that's helpful. Is it fair, or is it too conservative to assume that next quarter's revenue will be predominantly FSD and NHS derived?

Dr. Anthony Holler:
I think there'll be more than that, Matt. I just don't think you'll see the number that we had in Q1.

Matthew Bottomley:
Great, okay. Then, just speaking again to your guided range of $55 million to $60 million, so those, I understand, are just the California branded product sales. Given the fact that it's going to be into 2020

as you continue to ramp up your Cathedral City location, what's your upside or moderate case scenario for what operating margins and gross margins you can get out of that business model? I think this quarter, they're at about 37 percent. How much more upside is to that, and is it possible, in your view, to break profitability before you actually have your own vertically-integrated sales model?

David Negus:
We see long-term margins in that business north of the 50s into the 60+ range. I think that cash flow breakeven is obtainable in the near-term. The challenge we have right now is obviously, we're making significant investments in working capital. You can see our investments into inventory, into AR, there's a lot of cash floating in working capital right now as we build up our operations. We really went from a standstill to a lot of revenue in Q1, and as we temper through this working capital and the engine starts turning over, I think you'll see a near-term cash flow breakeven.

Matthew Bottomley:
Okay, great. Just last one for me on the capital side; so as I could hear it in your release, May 30, $1.5 million of cash plus the working capital you referenced, particularly the AR of $10 million, that sort of $11.5 million. What type of runway do you think that gives you, considering all the activities you currently have your hands in?

David Negus:
Yes, we do have an additional $10 million we need to contribute towards the Cathedral City greenhouse facility; we talked about that in our last call a month ago. I think, obviously, we will require some additional capital to complete our activities, but we feel confident that we've got a good plan in place and we'll be sufficiently funded to get through.

Dr. Anthony Holler:
Matt, you'll recall that, in terms of our Canadian asset, we anticipate the sale of those assets. I think in the near-term, we'll report back to you on that.

David Negus:
Okay, thank you. That's it for me.

Dr. Anthony Holler:

Thanks, Matt.

Operator:

Once again, any analyst who has a question may press star, then one. There appear to be no further questions. This concludes the question-and-answer session. I'll now turn the conference back over to Dr. Anthony 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 our entire Sunniva team, and look forward to the next several months when we see the completion of the Cathedral City facility and the next step in Sunniva's evolution.

Thank you again for joining us this morning and each of your questions. I will remind you that we are holding our AGM on June 12, 2019 in Vancouver for those able to attend. Details can be found on our website. Thank you very much.

Operator:

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