Sunniva Inc.

Third Quarter 2018 Earnings

Conference Call Transcript

Date: **November 29, 2018**

Time: **9:00 AM MT**

Speakers:

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

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. Third Quarter 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, 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, Corporate Development. Please go ahead, Mr. Knowles.

Rob Knowles:

Thank you and good morning to everyone joining us to discuss our results for the third quarter of 2018. With 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 all had a chance to review the news release, MD&A, and financial statements we issued yesterday, November 28, 2018.

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

Before we begin, I want to note that some of the matters we will discuss on this call, including our business outlook, are forward-looking in nature. These matters are subject to 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 our 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.

Dr. Anthony Holler:

Thank you, Rob. Good morning, everyone, and thank you for joining us today to talk about our third quarter results of Fiscal 2018. We have a number of operational and strategic updates to go over today that outline the progress we've made towards our goal of becoming a fully integrated cannabis company in California. In addition, I will outline our strategy that we've been working on for the past several months to spin out our Canadian assets which we believe will unlock significant shareholder value on both sides of the border and enable the Canadian side to move forward with several growth opportunities.

In California, we're focused on accelerating revenue growth through vertical integration. The pillars of our vertical integration strategy are: cultivation at scale; extraction, both volatile and non-volatile; Sunniva-branded products; distribution; and, finally, retail. In terms of cultivation, we are nearing completion of our 325,000 square foot purpose-built, high-technology cGMP greenhouse facility in Cathedral City. We expect on board a total of 100,000 plants from the Oakland facility in mid-Q1 2019. The facility is forecast to be fully operational by year-end at which time it will deliver about 200 kilograms of flower on a daily basis, or 15 million grams per year. Phase 2 will add an additional 22.5 million grams of annual flower capacity.

The Sunniva California campus greenhouse addresses the two key issues currently facing the California cultivation industry: sourcing clean, pesticide-free cannabis products and securing large-scale production.

Our extraction facility began operations in July 2018. The Extraction Team has been manufacturing a number of product lines and product formulations. We are currently stockpiling inventory in preparation for launching a series of products in Q1 2019. Our initial group of products will focus on high-margin premium concentrates, such as lybreden and shatter, as well as ultrapure dislits for filled vape cartridges and disposable vape pens. The extraction facility has the capacity to process over 10,000 pounds of biomass per month, which is equivalent to 500,000 vape cartridges or disposable vape pens per month. We are currently sourcing compliant biomass through existing relationships. Reliance on purchase of third-party biomass will be reduced as production from the California campus becomes available.

Establishing our brand presence is important, not just from a revenue point of view but also establishing our reputation as a supplier of premium product. Sunniva will be selling its premium cannabis product lines using a house of brands approach. Our in-house Marketing Team has been working closely with our Production and Distribution teams to create and define all product categories that will fall under each of our Sunniva brands. Our branding strategy may also include acquiring other brands in the marketplace, leveraging our large-scale (inaudible 5:38) manufacturing and statewide distribution capabilities. Vapor Connoisseur, our hardware brand, saw continued revenue growth in Q3, and we anticipate accelerated growth as our extraction products are launched.

Compliant distribution is a cornerstone of the highly regulated cannabis industry, with track and trace being implemented in 2019. We will be using Microsoft Dynamics NAV from d365 Cannabis, which we are currently implementing. We have recently announced the signing of a binding letter of intent to acquire a California cannabis distribution company, LTYR Logistics. LTYR has a highly skilled management and sales team, led by Kevin Wilkerson (phon 6:30), and services over 120 licensed retail dispensaries. We will be using Sunniva's distribution and delivery license. Currently, we are acquiring a 4,200 square foot facility as a distribution hub in Long Beach, California.

Having in-house distribution helps ensure our vertical integration strategy to sell all the products we produce from our large-scale production facility and our extraction facility. Kevin and his team have joined Sunniva in various management capacities.

The last pillar in our strategy of full integration is retail expansion. Our licensed flagship dispensary at the California campus facility will open Q2 2019 and we are currently evaluating a number of potential retail opportunities. We believe that retail is very important to our strategy as it is the touchpoint to the consumers. Getting real-time data on consumer preferences and purchases is essentially to responding quickly to a changing marketplace. We have already seen a move by consumers away from smokeable flower to extracted products like vaporizers.

The other issue which this will address is shelf space. Very much like the alcohol industry, guaranteed shelf space is essential for Sunniva's house of brands. In Canada, we've concluded our formal engagement with Canaccord Genuity to conduct a thorough review of the market which has allowed us to define a strategy for our Canadian operations. We confirmed that we intend to spin out our Canadian assets, Natural Health Services, which operates the physician-based medical clinics throughout Canada, and Sunniva Medical, which is our license producer applicant. Sunniva Medical owns the 126 acre parcel of land in Okanagan Falls, British Columbia, which is a site for a large-scale purpose-built cGMP high-technology greenhouse facility. David Negus will discuss the particulars of this transaction in a few moments.

On-site, site grading, as well as footings and foundation work for Phase 1 is now complete. Our business strategy in Canada will shift from becoming primarily a wholesaler to focusing on the high-margin direct-to-patient distribution of medicinal cannabis. BMO Capital Markets estimates that medicinal cannabis will sell for approximately $8.50 per gram for the next several years. Currently in Canada there are approximately 400,000 registered cannabis patients, with that number forecasted to grow to over 2 million registered patients in the next three years, with insurance companies and unions providing medical cannabis coverage under group benefit plans. In this market, we have a significant competitive advantage through our ownership of Natural Health Services which will allow us to capture a share of the patients accessed in our clinics.

Natural Health Services has 105,000 registered patients; 18 healthcare specialists, including general practitioners and specialists; and 2 nurse practitioners. The physicians are the gatekeepers to achieving market share. We will leverage our experienced physicians, clinics, education, and proprietary medical software for additional patient aggregation, which will include creating an online virtual ecommerce clinic platform. From this platform, patients will be able to set up appointments at any one of our seven clinics or through telemedicine in the provinces that this is permitted. They will be able to get a prescription and then purchase product immediately from a licensed producer. Sunniva, once licensed, will become one of the licensed producers offering cannabis products.

We believe that in terms of creating value, the most important step is receiving our cultivation and sales license from Health Canada. To that end, we are starting construction of a small modular phased approach on our Okanagan Falls site. We expect capital expenditures to be modest and will initially require less than $1.5 million.

For production from the fully built-out modular phase is estimated to reach 5,000 kilograms per year by adding additional modules to fill this capacity. Our goal is to supply 20,000 patients in 2019 and over 50,000 patients in 2020. Current Healthcare Canada data suggests that the average spend per patient is over $2,000 per year. We intend to increase future production capacity through a phased development of our Sunniva Canada campus, eventually growing into our large-scale greenhouse facility. We will also look at strategic partnerships, which could accelerate the building of the greenhouse.

With respect to the Canopy wholesale contract, we are in discussions with them about extending the commencement date of the contract to coincide with future production from our large greenhouse facility. We are very happy with the progress we've made to date this quarter and are well-positioned for strategic growth in all operating segments. California marketplace in particular 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're excited about the current landscape and look forward to further expansion in California, and we're confident that the revised strategy for Canada will enable us to accelerate our timelines to licensing and cultivation and enable us to capture a larger share of the medicinal cannabis market.

It is now my pleasure to turn the call over to David Negus, our CFO, to go through the details of our financial results. David?

David Negus:
Thanks, Tony. Before reviewing the details of the third quarter and the outlook for the remainder of Fiscal 2018, I'll give an update on the spin-out transaction.

We expect to complete the transaction by the end of the first half of the year. We have engaged Borden Ladner Gervais to handle the legal aspects of the spin-out, including outlining the steps, timeline, preparation of the information circular, and preparation and filing of the necessary regulatory and court applications. PriceWaterhouseCoopers has been engaged as tax advisors to conduct the tax assessment and valuation of the spin-out assets to determine the allocation of value of the assets between the proposed Canadian and U.S. entities. MMP has been retained as the auditors to conduct the audit of the carve-out financial statements of Spinco. We expect to be in a position to set the record date and mail out the information circular in Q1 2019.

The circular will include information on the proposed Management Team, Board of Directors, and financial statements of Spinco. The shareholders meeting and vote on the transaction will occur late in Q1 or early Q2, with shares at Spinco expected to begin trading on the TSX venture by the end of Q2, provided all approvals and listing conditions are met. We will provide a more definitive timeline for the circular and shareholder meeting as we progress through.

Now looking at the third quarter financials, for the third quarter of 2018, revenue decreased 20% to $3.7 million from $4.6 million in the comparative third quarter of 2017. The decrease in revenue was driven by patient counseling revenue from NHS decreased 20% to $2.5 million due to a decline in prescriptions written since the comparative period. Merchandise revenue from FSD decreased 14% to $1.1 million due to a large portion of orders received at the end of September 2018 which couldn't be shipped prior to quarter end. CCPL realized initial extraction revenue of $89,000 in the third quarter of 2018. Inventory of clean biomass increased through September 2018, which will facilitate significant growth in the first quarter of Fiscal 2019.

Compared to the second quarter of 2018, total revenue decreased 15%, primarily due to the decrease in prescriptions and NHS. NHS revenue decreased 18% or $0.6 million from the second quarter of 2018 whereas FSD revenue decreased 15% or $0.2 million from the second quarter of 2018. NHS, FSD, and CPL represented 68%, 30%, and 2% of total revenue respectively in the third quarter of Fiscal 2018 compared to 72%, 28%, and 0% respectively in the third quarter of 2017.

Gross margin in the third quarter of Fiscal 2018 was $2.1 million or 57% of net revenue compared to $1.7 million or 38% of net revenue in the same period last year. The primary driver of this increase was revenue generated from licensed producers in NHS. This revenue stream was $0.7 million higher in the third quarter of Fiscal 2018 compared to the same period in Fiscal 2017, and incurs minimal direct costs.

SG&A expenses were $6.2 million or 163% of net revenue compared with $5.1 million or 111% of net revenue for the same period last year. The increase of $1.1 million in SG&A expense is primarily due to an increase in professional fees of $1.0 million due to advisory services related to strategic corporate objectives. Non-cash operating expenses were $2.9 million or 76% of net revenue compared to $4 million or 87% of net revenue for the same period last year. The $1.1 million decrease is due to a decrease of $1.0 million in share-based payment expense since the expense is frontloaded under IFRS, and an increase in amortization and depreciation expense of $0.1 million due to depreciation on newly acquired capital assets.

As a result, the operating loss for the third quarter of Fiscal 2018 was $6.9 million or 182% of net revenue compared with an operating loss of $7.3 million or 159% of net revenue for the same period last year.

During the third quarter of Fiscal 2018, the Company realized a non-cash gain of $1.1 million resulting from a fair value decrease in its warrant liability compared to a gain of $0.3 million in the third quarter of Fiscal 2017. Foreign exchange gain in the third quarter of Fiscal 2018 was $77,000 compared to a foreign exchange gain of $0.5 million in the third quarter of Fiscal 2017. Deferred tax expense in the third quarter of Fiscal 2018 was $182,000 compared to a deferred tax recovery of $366,000 in the third quarter of Fiscal 2017. This difference is due to a deferred tax expense being recognized in Sunniva Inc. due to the settlement of warrants earlier in the year. This was offset by a deferred tax recovery recognized on the intangible assets held in NHS. As a result, net loss was $6.6 million or $0.21 per share in the third quarter of Fiscal 2018 compared to a net loss of $6.2 million or $0.23 per share for the third quarter of Fiscal 2017.

Turning to the highlights of our year-to-date performance, net revenue increased 31% to $13.4 million for the first nine months of Fiscal 2018 from $10.2 million in the same period of Fiscal 2017. During the first three quarters of Fiscal 2018 gross margin was $7 million or 52% of net revenue compared to $4.2 million or 41% of net revenue in Fiscal 2017. Net loss for the nine months ended September 30, 2018 was $17.8 million or $0.59 per share compared to $18 million or $0.72 per share for Fiscal 2017.

Looking at our balance sheet highlights, we ended the quarter with $9.1 million in current assets versus $14.5 million in current assets at December 31, 2017 and had a working capital deficit of $6.6 million at September 30, 2018 versus a deficit of $1.2 million at December 31, 2017. Working capital has improved substantially since September 30, 2018 with the Company completing a bought deal public offering for gross proceeds of $23 million in October 2018. These proceeds will be utilized to fund the advancement of Sunniva California and Canada campuses.

During the quarter, $13 million was invested in CapEx and $2 million was utilized in building our working capital and funding our operating losses. Cash and cash equivalents as at September 30, 2018 was $3.6 million.

This now leads me to our outlook for the remainder of Fiscal 2018. Merchandise revenue from FSD is expected to continue its seasonal cycle with the strongest quarter being in Q4. FSD it has exceeded revenue targets to date and we are excited to see a strong finish as the year comes to an end. We anticipate both clinic and LP revenues from NHS to stabilize after the recent decrease in prescriptions in the third quarter of 2018.

During the quarter, we brought on several new doctors on board, and expect patient revenue to rebound in the forthcoming quarters. Gross margin will continue to be driven by product mix. Extraction revenue and merchandise sales are expected to increase throughout the year, which may drive gross margins down, but we expect the overall margin to remain around 50%. SG&A is expected to be consistent in Canada but increases are expected in the U.S. as operations continue to advance in California. Personnel costs will increase significantly as we continue to staff our facilities and additional operating costs will also be incurred as the California campus because operational.

The Company's current cash position is $11.2 million.

With that, I'll turn the call back over to the Operator to 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, then one on your telephone keypad. You will 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. We will pause for a moment as callers join the queue.

Our first question comes from Jenny Wang with Canaccord Genuity. Please go ahead.

Jenny Wang:
Congratulations on the quarter end, the recently announced LTYR Logistics acquisition guys. My first question is in relation to your LTYR Logistics announced acquisition. Was is kind of the strategy to get the Sunniva brand out there? Could you kind of give us a little bit of colour on that and touch on that aspect please.

Dr. Anthony Holler:

Thank you. Currently, we're putting the strategy together with the recently acquired Distribution Team to really focus on high-end retail dispensaries. LTYR already has very good relationships with a large number of dispensaries. Their primary issue, really—and it's an issue that all distributors have in California—is accessing compliant clean product. This is one of the reasons that actually LTYR joined Sunniva was they looked at their business and looked at our capabilities in terms of clean product and scale, and decided that it was the only way that they could succeed.

Jenny Wang:
Thank you. In terms of your Canadian side, I know you mentioned that you're projecting around $1.5 million to complete the facility build-out. Is there any additional costs on top of that or what's your expected CapEx for the next year on the Canadian side?

David Negus:
Yes. The initial phase will be approximately $1.5 million of capital. We believe there is multiple opportunities for vendor financing on the further phases as we go out, so we're really looking to access vendor financing rather than in-house capital to build out those additional phases.

Jenny Wang:
Got it. My last question from me is in terms of your NHS, how is it tracking, how should we be looking at this going forward? Is there any colour you can give us on maybe how the number of prescriptions or the number of patients going forward will look like?

Dr. Anthony Holler:
Yes. With NHS I think it's really a business driven by two things. Number one, it's having access to doctors to write prescriptions and, number two, it's having a relationship with the customers. I think we excel in both of those areas. Our educational materials at NHS are fantastic. We've got an existing network of clinics and we've got a history of being able to attract patients. At times it had had backlogs of patients. The other piece is doctors. As we mentioned on last quarter's call, we did have a hiccup with some turnover in doctors. We've recently brought on several new doctors and we continue to bring on doctors to build out that business. Those are really the two key drivers in that business, just like any other medical clinic business.

Jenny Wang:

I'll go back in queue.

Operator:

The next question comes from Brian Caddy (phon 26:44) with Canaccord Genuity. Please go ahead.

Brian Caddy:

Hi, guys. This question is on Canada. Just wanted to know the status of your cultivation license in Canada. Now with your modular approach to growing out Canada, how does that affect the Canopy supply agreement that's supposed to, I guess, commence on Q1. Will you be able to meet those terms and supply them 45,000 kilograms in the next two years starting Q1?

Dr. Anthony Holler:

Yes. Brian, we obviously can't meet that deadline. There were a number of reasons for that facility not being able to meet the deadline, including our vendors in Europe not being able to deliver products to complete that facility. Some of the vendors are six months late at being able to deliver products. We clearly aren't meeting that deadline and we are in discussions with Canopy about extending the date of delivery to the actual date the facility is up and running.

In terms of the approach we are taking, we would very much like to have our production and sales license quickly because we have the patients. We're looking at this modular approach and have bought the first several modules because these modules have previously been approved by Health Canada. There's a very straightforward pathway to getting a cultivation license using this modular approach with very little capital expended. That's really our strategy: to get into business as quickly as possible.

Remember, we have the patients and we are building more patients. Obviously in our clinics we have a number of license producers, but we know that a portion of those patients will purchase Sunniva product. For us, it's really to get in the business to have a sales license so that we can access our own patients.

Brian Caddy:

What do you think the timing is for that cultivation license? Are we looking at end of first quarter, longer than that?

Dr. Anthony Holler:
I think, to be conservative, I would say second quarter.

Brian Caddy:
Okay. Okay. Thank you.

Dr. Anthony Holler:
Thanks, Brian.

Operator:
Our next question comes from Doug Cooper with Beacon Securities. Please go ahead.

Doug Cooper:
Hi. Good morning, guys. Just to start off on the U.S., just maybe a few more details about the LTYR. I think you mentioned they have access or supply 120 dispensaries in California. Can you just give us a bit of outlook of their infrastructure, how many trucks they have, with the revenue run rate is, any more details would be great?

Dr. Anthony Holler:
Yes. Doug, in terms of their revenue run rate, as you know, these distribution companies are all relatively newly formed, so currently their revenues are in the several hundred thousand dollars per month. Their biggest limitation, though, is that there's no product to distribute. They are compliant to regulation, so they cannot access product that isn't complaint. That was one of the biggest reasons that when they met with us, originally they'd come to us and they said, listen, in 2019 we'd like to buy 25,000 kilograms of flower and we will pay $4.00 to $5.00 5 a pound wholesale. In 2020, they wanted to buy 50,000 pounds of flower, and in 2021, 100,000 pounds of flower because they felt that without access to material, their business couldn't thrive.

When they met with us, though, we kind of told them that our strategy isn't to be a wholesaler. We took them through our strategy and they said, well, we'd be interested in being your distribution arm for the facility because of the mass amount of dry flower and extractible products that you'll be able to produce. That's really how we came together.

Doug Cooper:

Okay. Maybe how much do you envision of their business would be your product versus other third parties, how will that play out?

Dr. Anthony Holler:

In the short term they will continue to do some third-party distribution. In the future, it's going to be all Sunniva product. We have multiple lines of product that we're introducing to the marketplace, so they will be distributing our product throughout California.

Doug Cooper:

Okay. I think you mentioned, maybe on the call or the press release, first harvest in Q2; is that what's expected? Would that be first revenue in Q2 or Q3, do you think, first revenue?

Dr. Anthony Holler:

Revenue in Q1 and Q2 will primarily come from our extraction facility which is fully operational, has a capacity, as we said, to extract both from about 10,000 pounds of product a year. In Q1 and Q2, the primarily source of revenue for the Company will be from the extraction facility.

Doug Cooper:

Great. Then just, sorry, from the greenhouse product, I guess, I'm thinking about.

Dr. Anthony Holler:

From the greenhouse, that I think, to look at revenue from there, I would start, say, beginning of Q3. That's when you're going to start seeing the big revenue from the greenhouse facility.

Doug Cooper:

Okay. In Canada, what do you attribute the decline in the number of scripts written?

Dr. Anthony Holler:

It's really about physicians. We had some turnover of physicians. We've hired new physicians. One of the problems we've had is that with cannabis not being legal, we had some of the Colleges of physicians and surgeons being a bit tough on our physicians who prescribed cannabis and, consequently, we had some physicians quit. But since that time, it is now a legal product in Canada, both medically and recreationally, and so we've been able to recruit physicians successfully since that time. It all relates to the number of prescriptions written, which relates to the number of hours a doctor works in our clinic.

Doug Cooper:
Okay. David, maybe just a last question on the balance sheet, $11 million in cash, you said as of today, what do you anticipate the cash burn being over the next six to nine months?

David Negus:
Our burn from operations, we're looking at around $0.5 million a month, I would say, from operations. Everything else beyond that is capital being invested into the business.

Doug Cooper:
Right. How much more capital is needing to be invested into the U.S.? I know you said Canada was sort of $1.5 million. In the U.S., I guess including working capital, what do you think to get the greenhouse and the extraction up and running and into production?

David Negus:
Yes. In the U.S., we're probably looking at a range of 15 to 20-ish, but a lot of that will be financed. A lot of the equipment now, the equipment phase of the facility, will be financed—the IT equipment, the operating equipment—so, we're not expecting significant cash outlays in the future. We're getting close to the end of the capital we've got to put into the facility.

Doug Cooper:
Okay. Great. Thanks. That's it for me.

Operator:
This concludes time allocated for the question-and-answer session. I would like to 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. We look forward to advancing our Canada strategy which we believe will unlock significant shareholder value, and we are staying focused on putting the pieces in place, including the completion of our California campus that will drive our revenue growth through 2019 and beyond, enabling us to continue to leverage our cultivation and extraction facilities to pursue our goal of full vertical integration from seed to sale. Thank you.

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